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Our ref: DCS

Mei Ashelford  
Financial Reporting Council  
Aldwych House  
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London  
WC2B 4HN

11 November 2013

Dear Ms Ashelford

FRED 50 Draft FRC Abstract 1 Residential Management Companies Financial Statements and Consequential Amendments to the FRSSE.

We are pleased to have the opportunity to comment on the draft Abstract and welcome the withdrawal of draft UITF Abstract 49. We support the effort by the Financial Reporting Council ("FRC") to provide guidance in this area.

### **Scope**

As we set out in our response to draft UITF Abstract 49, we have concerns about the use of the term residential management company ("RMC") and therefore about the definition as "an organisation, which may be referred to in the lease, to whom service charges are payable and which is responsible for the provision of services, and manages and arranges maintenance of a property. The organisation does not necessarily have any legal interest in the property. This definition includes Right to Manage Companies as set out in the Commonhold and Leasehold Reform Act 2002".

In Tech 03/11 Residential Service Charge Accounts the term RMC is used for a residents' management company which is defined as "An organisation which may be referred to in the lease, which is responsible for the provision of services, and manages and arranges maintenance of the property, but which does not necessarily have any legal interest in the property. As the term implies, all or most of the members of RMCs will be leaseholders. In this guidance the term landlord includes RMCs and RTMCos." The scope of Tech 03/11 is not restricted to companies meeting this definition but applies to preparing and reporting on all statements of variable service charges on residential property.

The Accounting Council Advice to the FRC was to use the same definition as that used in Tech 03/11 but this advice does not appear to have been applied in full.



In our opinion the use of the term Residential Management Company and definition thereof is wider in scope than the term Residents' Management Company and related definition and may create confusion and diversity in practice as some preparers of accounts may interpret the scope of this draft Abstract as only extending to companies where the shareholders and the leaseholders are the same. In principle we believe that the same accounting should apply to transactions that are the same in substance regardless of the purpose and activities of the entity carrying out the transactions and so further clarification of the entities to which this draft Abstract applies would be welcome. We would also welcome clarification whether Residential Management Company applies to Registered Providers of Social Housing, for whom there are already well established and understood accounting practices.

We would also welcome clarification as to whether property managing agents fall into the definition of RMC. These act on behalf of landlords or other owners of freeholds to collect and administer service charges under contractual arrangements. Their responsibility for the provision of services is likely to be to the other party to the contract and service charge income is payable to them by virtue of such a contract. The FRED 50 definition above could be interpreted as applying to such companies although we do not think this was the intention of the FRC. It seems likely that the agency under which managing agents operate will be disclosed and therefore generally accepted accounting principles would not require such companies to recognise service charge transactions in their own financial statements. However, as we have explained below we believe the FRC have placed far greater weight on legal form than on substance so would welcome confirmation that the proposals in this draft Abstract do not apply to entities whose business is the management of service charges on behalf of owners of freeholds.

### **Substance of transactions**

We note that both the FRC and the Institute of Chartered Accountants in England and Wales ("ICAEW") have obtained counsel's opinion that residential management companies act as principal (rather than agent) in residential management transactions with third party suppliers. This is the legal situation that governs the contract between the supplier and the RMC.

Financial Reporting Statement ("FRS") 5 Substance of transactions requires that financial statements should report the substance of transactions and that in determining that substance all aspects and implications should be identified, with greater weight being given to those more likely to have commercial effect in practice. One of the considerations in determining the substance of transactions is the separation of legal title from benefits and risks. Where a RMC has complied with all the terms of the lease it is very difficult to see what significant risks it bears in relation to service charge transactions. In some cases RMCs will have no funds of their own since all they do is administer the service charge collection and expenditure. So even if they could be shown to be bearing risks in relation to the service charge expenditure or credit risk in relation to collection of service charge income this has no commercial effect as any costs will be met from the service charges and not the RMCs own (non-existent) resources. Any risks are ultimately



borne by the leaseholders. Equally it is not the RMC but the leaseholders who benefit from the services provided. Even in situations where the shareholders of the RMC are the leaseholders the company has separate identity to its members. In our opinion the contractual relationship between the RMC and third party suppliers should not be considered in isolation but in the commercial context of managing and administering service charges.

FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland will be effective for accounting periods commencing on or after 1 January 2015 but is available for early adoption now. It also requires transactions and other events to be accounted for in accordance with their substance and not merely their legal form as this enhances the reliability of financial statements.

It appears that, in arriving at the proposals in draft Abstract 1, the FRC has only considered the legal form of the relationship between the RMC and third party suppliers and has not taken into account the overall substance of service charge transactions and where the risks and benefits actually lie. We would urge the FRC to reconsider the proposals having regard to FRS 5 and FRS 102.

### **Proposed accounting treatment**

The objective of draft Abstract 1 is to address how RMCs recognise transactions with third party suppliers in their financial statements when discharging their duties to manage and arrange maintenance of a property, on the basis that all RMCs act as principal (and not agent) in these transactions.

For the reasons set out above we do not believe the proposed accounting reflects the substance of the transactions arising from the management and administration of service charges.

FRS 102 paragraph 2.24 states that recognition of income and expenses results directly from the recognition and measurement of assets and liabilities. Service charge expenditure is settled using the service charge money collected so RMCs will never have an asset in relation to that money (the draft Abstract does not suggest that there is ever a reimbursement to the RMC for its own money it has expended) so we do not understand how it is appropriate to recognise income.

We agree that the service charge monies collected and any other assets representing service charge monies received should not be reported on the balance sheet of the RMC as these are not assets of the RMC.

We understand the rationale for requiring RMCs to report service charge expenditure and simultaneously a matching amount of income receivable from the service charge account but we do not agree this is correct. As we have explained above it is our view that this accounting treatment is proposed to reflect the legal form of the contractual relationship between suppliers and RMCs and not the wider context in which service charges are administered. As explained more fully below we do not believe that the resulting profit and loss account, which would show no profit or loss from service charge transactions, provides any useful information for users of the



accounts. In situations where the RMC has other transactions of its own such as collection of ground rents or where it administers the service charge of more than one property, the inclusion of the service charge transactions is likely to cause confusion for users.

### **Advice to the FRC**

The Accounting Council has advised the FRC that preparation of RMCs' accounts applying the proposals in draft Abstract 1 will benefit a range of users of those accounts. It is said that tenants will benefit from disclosure of the balance of service charge monies held in trust. It is already best practice for statements of service charges to include a balance sheet but we acknowledge that not all companies responsible for the provision of service charges will comply with best practice. Where leaseholders and shareholders are the same we consider leaseholders will be able to obtain the information they need. In circumstances where an RMC manages the service charges for more than one property there is no requirement to disclose separate balances for each property so we do not see any benefit for leaseholders. In our view the additional costs and potential confusion arising from the preparation of statements of service charges and statutory accounts including service charge expenditure, which may not be the same as that shown in the statement of service charges because for example, of different year ends, transactions relating to more than one property, or because more service charge income has been collected than expended, far outweigh any perceived benefit from disclosure of the balance of service charge money held.

The Accounting Council advised it would be beneficial for suppliers for RMCs to report service charge transactions. We do not understand how reporting a no profit or loss position on service charge expenditure provides any useful information to suppliers to assist them in deciding whether or not to transact with an RMC. While the disclosure of service charge monies held might provide some useful information for suppliers it does not present a full picture. If this is deemed relevant information it could be mandated disclosure without the proposed accounting requirements.

The Accounting Council believes it will be rare that there are situations where leaseholders are not shareholders of the RMC. We do not know on what information this belief is based but if it is the intention that the accounting requirements of draft Abstract 1 only apply in such a situation we request that this is set out far more clearly in the Abstract. In our experience, there are many situations where the leaseholders have no interests in the company which collects service charges and administers the repairs and maintenance of the property.

The FRC have taken the view that reporting service charge transactions in the manner required by the draft Abstract will result in accounts of RMCs that give a true and fair view of the activities of RMCs and result in accounts that give useful information to users. They believe that any costs incurred by RMCs that have previously prepared accounts showing no transactions will be outweighed by those benefits. We do not agree with this view since the statutory accounts will not give the details of the expenditure of service charge monies, will not show amounts demanded but not collected and where there are other transactions or more than one property may not



give users any relevant information. There will however be additional costs in preparing accounts and explaining to leaseholders why these are different to the statements of service charge expenditure.

Finally we have no particular comment on the proposed effective date except to note that the consequential amendments to the FRSSE have been made to the FRSSE 2008 and not incorporated into the FRSSE 2015, which will be the relevant version for companies that apply the FRSSE when this draft Abstract becomes effective.

In conclusion we request that the FRC reconsiders its proposals in the context of the commercial substance of the activities of RMCs. In particular we request further clarification of the scope of the proposals. In our view a more appropriate solution to current inconsistencies in practice would be to exclude service charge transactions from the accounts of RMCs but, if this information is considered relevant, require disclosure of the balance of service charge monies held. We believe this approach would reflect the risks and rewards of these transactions, be understandable, would not involve significant additional costs for companies and would provide users of the accounts with information not elsewhere available that the FRC believes is relevant.

If you wish to discuss any of the points we have raised please contact Amanda Rawdon Smith ([amanda.rawdonsmith@bakertilly.co.uk](mailto:amanda.rawdonsmith@bakertilly.co.uk)).

Yours sincerely

**Danielle Stewart OBE**  
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