



9 December 2013

Our ref: ICAEW Rep 169/13

Your ref:

Mei Ashelford
Financial Reporting Council
Aldwych House
71-91 Aldwych
London
WC2B 4HN

Dear Mei,

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

ICAEW is pleased to respond to your request for comments on *FRED 50 Draft FRC Abstract 1 Residential Management Companies' Financial Statements and Consequential Amendments to the FRSSE*

Please contact me or Nigel Sleigh-Johnson should you wish to discuss any of the points raised in the attached response.

Yours sincerely

A handwritten signature in dark ink, appearing to read 'S. Porthouse'.

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ICAEW REPRESENTATION

RESIDENTIAL MANAGEMENT COMPANIES

Memorandum of comment submitted in December 2013 by ICAEW in response to FRC exposure draft FRED 50, Draft FRC Abstract 1 Residential Management Companies' Financial Statements, published in August 2013

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the exposure draft *FRED 50 Draft FRC Abstract 1 Residential Management Companies' Financial Statements* published by the Financial Reporting Council (FRC) in August 2013.

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 FRC. We provide leadership and practical support to over 140,000 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.

MAJOR POINTS

5. While this matter continues to attract opposing views, we believe there is a strong desire to establish greater clarity and consistency in this area. The accounting treatment proposed by FRED 50 represents an improvement on the proposals outlined in UITF Draft Abstract 49. We believe that it will provide a more robust basis upon which a final set of principles can be agreed for the preparation of the statutory accounts. However, notwithstanding the progress made so far, there are a number of areas where we believe that further consideration by the FRC is required.
6. We believe that critical questions requiring further attention include the scope of the draft Abstract and – linked to this – how an RMC is defined in this context. We have observed that the use of the term and definition of a 'residential management company' under the draft Abstract differs from the definition of a 'residents' management company' outlined elsewhere. This results in a wider definition which would, for example, draw in companies that own and manage a large number of residential freeholds. We do not believe that there is any compelling case for the scope of the draft Abstract to be extended in this way and instead suggest that the term 'residents' management company' is used and that the definition is aligned with that used in ICAEW Tech 03/11. Thus for the purposes of this letter, when referring to an RMC, we have in mind the narrower definition as set out in ICAEW Tech 03/11. These issues are discussed in more detail below in paragraphs 10 to 13.
7. We are also concerned about the proposed treatment of the service charge cash (and other assets) which would not be recognised on the balance sheet in the RMC statutory accounts, but rather disclosed by way of a note. 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. In particular, tenants will have an interest in assessing whether the RMC has accumulated an appropriate level of funds for maintenance over the longer term as well as in assessing how service charge cash has

been disbursed during the year. There may also be an interest from future tenants seeking information in advance of entering into a lease on whether the RMC is sufficiently funded. We therefore believe that it is of paramount importance that there is transparency over any service charge cash held by the RMC at the year-end. Users may not regard as useful accounts that show the service charge transactions but not the residual cash balance relating to leaseholder cash.

8. We believe that it is important for the Accounting Council to consider again whose asset in substance the cash is before finalising the Abstract. If the FRC continues to maintain the view that service charge cash should not be recognised in the balance sheet, it will be very important to consider how best to draw attention to the need for the statutory accounts to form part of a coherent and well understood package of information provided to tenants. It might for example be appropriate to encourage directors to consider whether it would be helpful to explain the basis of preparation of the statutory accounts, how the wider information needs and interests of tenants have been satisfied, and how supplementary information can be accessed. This is likely to be of particular importance in cases where an RMC qualifies as a micro-entity and takes advantage of those exemptions, as discussed further in paragraph 9 below.
9. Finally, and importantly, we strongly recommend that the FRC should consider how the FRED 50 proposals interact with the December 2013 regulations introducing optional accounting exemptions for micro-entities. It is our understanding that many RMCs will meet the criteria of a micro-entity and, if opting to take advantage of these exemptions, will not be required to include notes to the statutory accounts. In this case, it appears that it will not be possible to require that a micro-entity discloses any details of the service charge cash it holds in trust. We believe that this is a critical factor to take into consideration when finalising the Abstract. Similar issues may arise in relation to the implementation of the new EU accounting directive provisions for small company accounts. These matters need to be resolved before any final decisions can be taken regarding the scope and nature of the new requirements for RMC accounting.

RESPONSES TO SPECIFIC QUESTIONS

Q1: Do you agree with the proposed draft FRC Abstract 1 and Consequential Amendments to the FRSE? If not, why not?

Scope and definition

10. We believe that critical questions requiring further attention are the scope of the draft Abstract and - linked to this - how a residential management company is defined in this context. We have identified differing definitions for a 'residents' management company' (not a legally defined term as far as we are aware) which do not necessarily agree with the way a 'residential management company' is defined in the draft Abstract. To demonstrate this, we have set out below the definition of a 'residential management company' as per the Abstract and the definition of a 'residents' management company' per ICAEW Tech 03/11, Residential Service Charge Accounts, and the RICS Service Charge Residential Management Code:
 - *FRED 50 draft Abstract:* A residential management company is 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 the 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.
 - *ICAEW TECH 03/11 Residential Service Charge Accounts:* A residents' management company is 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.

- *RICS Service Charge Residential Management Code (2nd Edition)*: A residents' management company is 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. The code also states that a 'manager' of a property could be a 'group of flat owners who have formed themselves into a formal management or maintenance company (a residents' management company), which could be limited by share or guarantee.'

A key difference between the definitions appears to be that, under the draft Abstract, a 'residential management company' includes companies with shareholders/members who are not necessarily leaseholders of the property. This is a wider definition than that used by ICAEW Tech 03/11 and would for example draw in companies that own and manage a large number of residential freeholds.

11. We do not believe that there is any compelling case for the scope of the draft Abstract to be extended in this way. We suggest instead that the definition is aligned with that used in ICAEW Tech 03/11. For other entities, the accounting treatment for agents and principals is set out clearly in Appendix Note G to FRS 5, and we are not aware of non-RMC landlords having any particular difficulties in interpreting this aspect of UK GAAP. Equally, social housing providers who apply the Registered Social Landlord SORP 2010 are already required to recognise service charge transactions. As mentioned above, when referring to an RMC, we have in mind the narrower definition as set out in ICAEW Tech 03/11.
12. It may also be appropriate for the FRC to state very clearly in the final Abstract that the latter has been designed to deal with practical application issues for a particular class of entity, and that other entities looking to the Abstract by analogy should bear in mind that there may be important differences of fact. If similar application issues exist elsewhere, these should be considered as a separate exercise.
13. We note that the draft Abstract is limited to variable service charges over which section 42 of the Landlord and Tenant Act 1987 imposes a statutory trust. This is clarified later under the definitions section, which states that 'fixed service charges' are excluded. This is a key factor for those seeking to understand the scope of the Abstract and accordingly this guidance would be better placed in the opening paragraph, which outlines the overall scope of the draft Abstract.

The principles of accounting for RMCs

14. We welcome the FRC's conclusion that an RMC acts as principal (not agent) when entering into transactions with third party suppliers. The clear articulation of this fundamental principle eliminates the uncertainty which surrounds this matter. Indeed, ICAEW has previously expressed the view, following legal advice, that RMCs invariably act as principal in their transactions with suppliers of goods and services. Therefore we do not intend to reiterate our views on this matter nor reopen this debate. It is from this starting point that we have considered the proposed accounting treatment for RMCs outlined in FRED 50.
15. Having established that an RMC acts as principal, we agree that service charge transactions with third party suppliers should be recognised in the profit or loss account. The draft Abstract proposes that an RMC shall recognise the relevant service charge expenses arising from the management and arrangement of maintenance of a property and concurrently recognise income by drawing from the service charge cash. It also states

that these amounts shall not be offset. We agree with this interpretation, but believe that further clarification is required. Through our consultations with members, we have noted that a number of different views exist on the accounting that would follow from application of the draft Abstract, which could be resolved through the provision of some additional guidance within the final Abstract. In particular, it may be appropriate to make clear that the service charge expenses should be recognised on an accruals basis rather than as the cash is drawn down from the service charge cash. It would also be useful for the FRC to refer to the accounting treatment of provisions for future maintenance (or 'sinking funds') and how these would be accounted for under the current proposals.

The proposals for service charge cash

16. Under the current proposals, service charge cash (and other assets) would not be recognised on the balance sheet. In reaching this conclusion, the FRC considered the legal status of the service charge cash and concluded, in line with legal opinion received, that as the cash is held in trust, it is not an asset of the company. Outside of the legal framework, the FRC also considered service charge cash in comparison to the definition of an asset under FRS 102. It concluded that the RMC does not control the cash because the lease agreement would limit what the cash can be used for, and that the benefits of the cash would not flow to the RMC, but to the tenants of the property.
17. We have reviewed with interest the Accounting Council's advice to the FRC on FRED 50 (paragraphs 33-39), which usefully compares how service charge cash held in trust (and the transactions made with this cash) by an RMC differs from other reporting entities which hold assets on trust. Importantly, this analysis demonstrates how the accounting treatment of assets held on trust varies between these reporting entities depending on the substance of the underlying accounting transaction. It is on this basis that we have considered further the substance of the cash held in trust by an RMC and the appropriate accounting treatment. In particular, we have reflected on the fact that the service charge cash paid to an RMC by the tenants of a property will not be reimbursed to tenants should they choose to terminate the lease.
18. We are not aware of an equivalent situation where assets are held in trust on this basis and believe this point might differentiate the service charge cash held in trust by an RMC from other trust situations. Following this logic, despite the absence of legal ownership, in substance the funds might be 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 financial reporting. We thus believe that it is important for the Council to consider again whose asset in substance the cash is before finalising the Abstract, taking account of the responses to this consultation.
19. From our extensive consultations with members on this matter, it is clear that it is of paramount importance that there is transparency over any service charge cash held by the RMC 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. In particular, tenants will have an interest in assessing whether the RMC has accumulated an appropriate level of funds for maintenance over the longer term as well as in assessing how service charge cash has been disbursed during the year. There may also be an interest from future tenants seeking information in advance of entering into a lease on whether the RMC is sufficiently funded. It does therefore seem desirable in principle for service charge cash to be clearly visible when users refer to the RMC accounts. Users may not regard as useful accounts showing the service charge transactions but not the residual cash balance relating to leaseholder cash. Some may even consider such accounts to be misleading. This would be a very unfortunate outcome.
20. If the FRC continues to maintain the view that service charge cash should not be recognised in the balance sheet, it will be very important to consider how best to draw

attention to the need for the statutory accounts to form part of a coherent and well understood package of information provided to tenants. It might for example be appropriate to encourage directors to consider whether it would be helpful to explain the basis of preparation of the statutory accounts, how the wider information needs and interests of tenants have been satisfied, and how supplementary information can be accessed. This is likely to be of particular importance in cases where an RMC qualifies as a micro-entity and takes advantage of those exemptions, as discussed further in paragraph 21-22 below.

Micro-entity exemptions and RMCs

21. New regulations introducing accounting exemptions for micro-entities came into force on 1 December 2013. Companies which meet the criteria of a micro-entity and choose to apply the exemptions are not required to disclose any notes to their accounts. Instead, they will be required to disclose, at the foot of their balance sheets, any outstanding financial commitments by way of guarantee and any advances, credits or guarantees with directors. It is our understanding that a large number of RMCs in the UK are small and may well meet the criteria of a micro-entity. An RMC meeting the criteria and choosing to apply the micro-entity exemptions will not be required to include notes to the statutory accounts. In this case, it appears that it will not be possible to require that a micro-entity discloses any details of the service charge cash it holds in trust.
22. In the absence of the service charge cash balance being recognised on the balance sheet, the disclosure of this information in the notes is, in our opinion, key to the understanding and usefulness of the accounts. It is therefore critical for the FRC to examine how the current RMC proposals interact with the new micro-entity exemptions before finalising the Abstract. Similar issues may arise in relation to the implementation of the new EU accounting directive provisions for small company accounts. These matters need to be resolved before any final decisions can be taken regarding the scope and nature of new requirements for RMC accounting.

Service charge cash as a disclosure note

23. Should the Accounting Council continue to maintain the view that service charge cash should not be recognised in the balance sheet, we agree that, as proposed, this information should be included as a disclosure in the notes to the statutory accounts. However, in order to ensure that information disclosed is transparent and understandable to users, we recommend that the disclosure requirements are expanded such that the service charge cash is adjusted for the amounts committed to service charge creditors and for service charges in arrears from tenants at the financial year end. Otherwise there is a danger that tenants will have an inaccurate impression of the service charge cash available to the RMC. For example:

Service charge cash held in trust	x
Amounts committed to service charge creditors*	(x)
Service charges in arrears from tenants	<u>x</u>
Adjusted service charge cash held in trust	x

**Also appears as the debtor balance in the RMC accounts, representing amounts to be drawn down from service charge cash to cover service charge creditors*

An alternative disclosure may be to show a reconciliation between the brought forward and carried forward position of cash held in trust by the RMCs. This would show incoming cash and the drawdown of cash to cover service charge expenses.

24. We have noted that the draft Abstract appears to be written on the assumption that most RMCs currently do not include the service charge cash in their statutory accounts. Indeed, the second case study provided in the appendix to the Abstract is based on this

assumption. We question whether this is a correct assumption; we are advised that many RMCs do currently include service charge cash in their statutory accounts. Should the current proposals remain unchanged, it is highly likely that these entities in particular will require further guidance, including on the adjustments needed to comparative figures.

25. We are also aware through our consultations that different interpretations have already emerged on how the service charge cash balance would be presented under the current proposals (in addition to the divergence in interpretation regarding the profit or loss account noted above). This is particularly the case for those RMCs which currently recognise the service charge cash on their balance sheets. Whilst the current proposals outline the treatment of service charge cash, no guidance is given on the treatment of the credit side of this entry. In addition, the term 'other assets in trust' is not clearly defined in the Abstract and may be interpreted to mean any other assets held by the RMC. It is our understanding that this is not the case and that these assets are intended to represent service charge cash which has been invested by the RMC and the returns on these investments. We recommend that further clarification is provided within the final Abstract on this matter.
26. In some cases, an RMC may also hold its own interests which, for example, may yield ground rents. Accordingly, it may be appropriate to provide guidance on how RMCs should account for income received for any transactions other than service charges. A clear understanding of the difference between the treatment of service charge cash disclosed in the notes to the accounts and cash balances appearing on the face of the balance sheet will be important.

Further guidance and worked examples

27. Irrespective of the final decision taken regarding the service charge cash balance, additional practical guidance may be necessary to ensure that uncertainty is kept to a minimum and that the transition to the new regime is as smooth as possible. For many companies, the proposals will result in additional costs, particularly those that are currently preparing dormant accounts. It is therefore important that the requirements of the Abstract are as straightforward as possible and that appropriate guidance should be available sufficiently far in advance of the effective date to enable RMCs to prepare properly for the change and for costs to be kept to a minimum.
28. Accounting by RMCs can be complicated by their multiple reporting obligations, and confusion can arise over the interaction of the statutory accounts and the service charge accounts produced in accordance with the terms of the lease for the tenants or as best practice. Once the FRC has completed its consultations with all the key industry and professional bodies with an interest in RMC accounting and has determined the way forward, ICAEW will explore the case for additional illustrative guidance, referring to other professional bodies and the FRC as appropriate, reflecting on the position of the statutory accounts as part of a wider package of information for tenants. In particular, further consideration will also be given to any changes needed to ICAEW Tech 03/11, which provides cross-professional guidance on service charge accounts.

Q2: Do you agree with the proposed effective date? If not, why not?

29. We agree that the proposed effective date should be no earlier than 1 January 2015. However, publishing a change in accounting of this significance in 2014 with this effective date allows very little time for the practical implications to be considered and for adequate preparation and communication of the changes to the wide range of stakeholders with an interest in the financial reports of RMCs. In particular, we believe that additional implementation guidance may be required. The FRC might like to consider a later effective date, while permitting earlier adoption, taking account of the interaction with the micro-entity regulations.

30. In addition, we would also point out that the draft Abstract currently refers to consequential amendments to FRSSE 2008 whereas in fact amendments would need to be made to FRSSE 2015.

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