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For the attention of Mei Ashelford

Our ref blp/djw/815

Contact Lynn Pearcy
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8 November 2013

Dear Sirs

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

We are grateful for the opportunity to comment on the above draft FRC Abstract and consequential Amendments to the FRSSE (the proposals).

We support the conclusion that an RMC's accounting should reflect the legal status of service charge monies held and that it acts as principal in transacting with third party suppliers. However, we do not find the proposals clear as to whether RMCs should adopt a full accruals accounting approach, although we believe that they should. On this basis, we have significant concerns about the case studies in the Impact Assessment, which we believe omit certain of the adjustments that will be required on adopting the Abstract's accounting and may therefore result in RMCs' failing to adopt the Abstract appropriately.

We also have a comment on the scope of the proposals, as explained below.

Accruals accounting and the case studies

Paragraph 6 of the FRED proposes that income shall be recognised concurrently with the recognition of service charge expense. We agree with this. However, it does not specify the basis on which that expense shall be recognised. We would expect this to be on a normal accruals accounting basis such that, for example, an insurance premium would be expensed over the insured period, regardless of when it is settled. However, the proposals do not refer to prepayments and, in particular, the case study for Entity A does not refer to any such balances needing to be introduced to its balance sheet on adoption of the Abstract.

In discussing the recognition of income, paragraph 6 of the FRED proposes that an RMC shall recognise income in profit and loss (concurrently with the recognition of expense in profit and loss) "by drawing from the service charge monies". We would expect an RMC to draw monies from the service charge account when required to settle third party invoices but would expect income to be recognised instead on an accruals accounting basis to match the related expense. Thus, we would expect that debtors might be recognised for monies due from the service charge

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monies but not yet drawn: paragraph 7 rightly acknowledges that these can exist, and we would expect this to be the case even if that debtor balance exceeds the amount of off balance sheet cash held.

We would also expect that the RMC might have to recognise a deferred income balance if it has drawn monies – for example, to settle the insurance premium mentioned above – in advance of the related expense and income being recognised in the income statement.

The case studies for Entities A and B do not refer to the possibility of deferred income balances needing to be introduced to the balance sheet on adoption of the Abstract. If we are correct in believing that RMCs should adopt normal accruals accounting, then we believe that the case studies' discussion of the adjustments required on moving to the Abstract should be expanded.

We illustrate our concern in Appendix 2 with a simple example.

Out-of-scope service charges

It is very clear in both the draft Abstract and the consequential amendments to the FRSSE that the proposals apply only to the accounting for service charges over which section 42 of the Landlord and Tenant Act 1987 imposes a statutory trust. However, this means that there will continue to be no guidance about how RMCs should account when section 42 of the Landlord and Tenant Act 1987 is not relevant.

One of the purposes of this Abstract is to reduce the diversity in practice between those RMCs that currently consider themselves to be dormant and those that bring everything on balance sheet and into their income statement.

If service charges outside section 42 of the Landlord and Tenant Act 1987 are common, in the absence of guidance there may continue to be diversity in practice in their accounting, which we believe should be to include the service charge monies in their balance sheet and all service charge transactions in their financial statements. Although we would not expect the final Abstract and consequential amendments to the FRSSE to cover this subject directly, it would be helpful if the Accounting Council's Advice to the FRC could cover this subject.

We set out our responses to the specific questions raised in the FRED in Appendix 1 to this letter. In Appendix 3 we have set out some drafting comments.

If you wish to discuss any of the points raised, please contact Lynn Pearcy on 020 7694 8075.

Yours faithfully

KPMG LLP

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Enclosures:
Appendix 1 Responses to specific questions raised in the FRED
Appendix 2: Example illustrating the effect of the adoption of the Abstract
Appendix 3 Drafting comments on the FRED

Appendix 1

Responses to specific questions raised in the FRED

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

Please see our covering letter.

Question 2:
Do you agree with the proposed effective date? If not, why not?

We agree with the proposed effective date of accounting periods beginning on or after 1 January 2015 with early adoption being permitted.

We believe that if the FRC is able to finalise this FRC Abstract in early 2014 this will provide preparers of financial statements within the scope of the Abstract / revisions to the FRSSE with sufficient time for them to be able to move to a new basis of accounting irrespective of whether they are currently type Entity A or Entity B in the Appendix 1 case studies within the Consultation Stage Impact Assessment.

We note that the proposed effective date is the same as that of FRS 102. Whilst it may be unlikely that it will happen in practice, we imagine that it will be possible as currently drafted for an entity to early adopt the FRC Abstract whilst remaining on "old" UK GAAP. We do not believe that such an adoption of this FRC Abstract in advance of adopting FRS 102 will result in any problems.

Appendix 2

Example illustrating the effect of the adoption of the Abstract

As explained in our covering letter, if RMCs are intended to adopt accruals accounting we believe that the summary of the effects on the adoption of the Abstract for the case studies in Appendix 1 within the Consultation Stage Impact Assessment are not correct.

Entity A currently accounts as a dormant company with all assets (including cash) and liabilities being off balance sheet and no transactions recognised. The case study refers to the most significant change as being the need to recognise the relevant service charge income and expenditure. However, this summary of change is not complete as there will also be adjustments required to the balance sheet. Assume that the RMC pays the insurance for the property in advance half way through its financial year and does normal accruals type accounting; therefore it recognises a prepayment at its balance sheet date. The funds for the payment to the insurance company will come from the off balance sheet service charge bank account. Hence the RMC will need to recognise an amount of deferred income in its balance sheet equal to the amount of the prepayment. This will be needed so that the total shareholders' funds will be £nil.

Entity B currently recognises all balances (including cash) and transactions on balance sheet / all in the income statement. The case study refers to the only change being the removal of the cash balance from its balance sheet together with additional disclosure. If RMCs are to adopt accruals accounting, we would expect that on adoption of the Abstract Entity B will need to do more than this. It will need to remove its cumulative total shareholders' funds so that they will become £nil. In the case of an insurance prepayment in the balance sheet, as above, this will result in an adjustment to create deferred income in its balance sheet equal to the amount of the prepayment.

In both cases if Entity A or Entity B had at its balance sheet date a creditor (as paragraph 7 of the Abstract and 3.13 of the FRSSE requires) there will be the need to establish a receivable (from service charge monies). For Entity A the adjustment on adoption of the Abstract will be Dr receivable Cr payable. However, Entity B already has this creditor on its balance sheet; part of its adjustment to remove its cumulative total shareholders' funds will be the new recognition of a receivable.

To illustrate the Entity B situation consider the very basic example set out below.

The RMC has existed for a number of years and built up some shareholders' funds (to provide "funds" for future repairs that are carried out on an ad hoc basis). It draws its financial statements up to 31 December of each year.

The amount receivable in service charges is £2,400 per annum. In year 20X0 and 20X1 it paid £1,200 for insurance on 1 July of each of those years and in 20X2 it paid £1,400 on the same date.

Under its existing accounting (Entity B type), its balance sheets and profit and loss accounts (all amounts are £) were as follows:

Balance sheets

	Dec 20X0	Dec 20X1	Dec 20X2
Cash	2,400	3,600	4,600
Prepayments	600	600	700
Total assets	3,000	4,200	5,300
Shareholders' funds	(3,000)	(4,200)	(5,300)

Profit and loss accounts

	Dec 20X1	Dec 20X2
Service charge income	2,400	2,400
Insurance expense	(1,200)	(1,300)
Net profit	1,200	1,100

Under its revised accounting following the treatment we believe will be required under the Abstract, its balance sheets and profit and loss accounts (all amounts are £) will be as follows:

Balance sheets

	Dec 20X0	Dec 20X1	Dec 20X2
Prepayments	600	600	700
Deferred income	(600)	(600)	(700)
Total assets	-	-	-
Shareholders' funds	-	-	-
Off balance sheet cash	2,400	3,600	4,600

Profit and loss accounts

	Dec 20X1	Dec 20X2
Service charge income	1,200	1,300
Insurance expense	(1,200)	(1,300)
Net profit	-	-

Appendix 3

Drafting comments on the FRED

1. Included with the draft Abstract are the proposed consequential amendments to the FRSSE.

   At present these are drafted as being consequential amendments to the April 2008 version of the FRSSE which ceases to apply for accounting periods beginning on or after 1 January 2015. The proposed consequential amendments to the April 2008 version of the FRSSE are needed if an entity is to early adopt this amendment.

   However, at present the proposed consequential amendments to the January 2015 version of the FRSSE are not being set out. These changes also need to be made as the FRC has already issued its January 2015 version of the FRSSE. The amendments to the 2015 FRSSE are similar to the changes to the 2008 FRSSE with the only differences in the text being to replace "April 2008" with "January 2015"; "2008" with"2015" and paragraph numbers 37A, 37B and 37C with 40A, 40B and 40C.

2. The proposed consequential amendments to the FRSSE present changes under sections (a), (c) and (d). Is there a missing section (b) of consequential amendments or is this just a numbering error?

3. Sub-paragraph (d) of the proposed consequential amendments to the FRSSE refers to paragraph 37A being inserted. This should be paragraphs 37A to 37C being inserted (and paragraphs 40A to 40C being inserted in the 2015 version of the FRSSE).