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URGENT ISSUES TASK FORCE

INFORMATION SHEET NO 92

10 May 2012

This Information Sheet sets out a proposed UITF Abstract 'Residential Management Companies Financial Statements'.

The UITF received a request from the Institute of Chartered Accountants in England and Wales (ICAEW) to consider the treatment of transactions relating to residential service charges in the financial statements (statutory accounts) of residential management companies (RMCs).

In issuing this draft Abstract, the UITF aims to:

- (i) assist RMCs to determine whether they are acting as principal or agent when undertaking residential service transactions with third parties, and thereby determine which transactions should be recognised in their financial statements;
- (ii) focus on and protect the needs of users of RMC financial statements (including tenants); and
- (iii) assist preparers in fulfilling their statutory duties.

The UITF invites comments on any aspect of the proposed Abstract. For ease of handling, we prefer comments to be sent by email to:

asbcommentletters@frc.org.uk

Comments may also be sent to Jennifer Guest, Project Director.

Comments should reach us by 13th June 2012. All replies will be regarded as on the public record unless the writer asks for confidentiality.

UITF DRAFT ABSTRACT 49:

RESIDENTIAL MANAGEMENT COMPANIES FINANCIAL STATEMENTS

The Issue

1. The UITF received a request from the Institute of Chartered Accountants in England and Wales (ICAEW) to consider the treatment of transactions relating to residential service charges in the financial statements (statutory accounts) of residential management companies (RMCs).
2. In bringing the concern to the attention of the UITF, it was noted that the ICAEW has received legal counsel opinion that, irrespective of whether a RMC was acting as principal or agent, the cash balance representing contributions received from lessees in accordance with the terms of their leases and held by a RMC under S.42, Landlord & Tenant Act 1987 is held on statutory trust and is not an asset of the company.
3. This has led to confusion as to whether the lack of beneficial ownership of the cash balance means that none of the relevant transactions should be recorded in the RMC financial statements and the ICAEW has identified variations in practice. In some cases the RMC apparently regards itself as acting as an agent and, accordingly, does not record the transactions which often means, for the purposes of company law, that it is dormant. In other cases the RMC apparently regards itself as acting as a principal or as an undisclosed agent and, hence, records the transactions in its financial statements. It is not clear which treatment is correct and whether or not this is dependent on the RMC acting as principal or agent.

Objective of the [draft] abstract

4. In providing this [draft] Abstract, the UITF aims to:
 - (i) assist RMCs to determine whether they are acting as principal or agent when undertaking residential service transactions with third parties, and thereby determine which transactions should be recognised in their financial statements;
 - (ii) focus on and protect the needs of users of RMC financial statements (including tenants); and
 - (iii) assist preparers in fulfilling their statutory duties.

Scope

5. This [draft] Abstract shall be applied by residential management companies. A residential management company is an entity 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.

Consensus

6. The UITF considers that:
- (i) to determine the transactions to be included in its financial statements, a RMC must first determine whether, in its dealings with third parties, it is acting as an agent or as principal (or undisclosed agent). A RMC should consider the guidance in FRS 5 'Reporting the Substance of Transactions' Application Note G. Paragraphs G62 to G66 provide principles for determining whether a seller is acting as agent or principal and this guidance should be applied by analogy to transactions to purchase goods and services. The guidance also notes, inter alia, that where the seller has not disclosed that it is acting as agent, there is a rebuttable presumption that it is acting as principal;
 - (ii) where the RMC determines it is acting as principal (or undisclosed agent), it shall record the relevant service charge transactions arising from contracts to purchase goods and services in the profit and loss account and concurrently recognises income by drawing from the service charge cash balances;
 - (iii) where the RMC determines it is acting as an agent (and has disclosed this fact), it should not record the relevant service charge transactions in its financial statements;
 - (iv) where a RMC determines it is acting as an agent and has no relevant service charge transactions, it may be dormant if it also meets all the requirements of company law for dormant companies; and
 - (v) where a RMC discloses it is an agent, the financial statements should refer to where tenants can obtain information regarding residential service charges transactions.

Date from which effective

7. The accounting treatment required by this [draft] Abstract should be adopted for periods ending after 31 December 2012. Early adoption is permitted.

References

8. In preparing this [draft] Abstract the UITF made reference to the following:
- FRS 5 'Reporting the Substance of Transactions';
 - ICAEW Technical Release 03/11 'Residential Service Charge Accounts';
 - Abstract 32 '*Employee benefit trusts and other intermediate payment arrangements*';
 - Abstract 38 '*Accounting for ESOP trusts*'; and
 - Statement of Principles for Financial Reporting.

DEVELOPMENT OF THE [DRAFT] ABSTRACT

Introduction

A1. This Appendix sets out the UITF considerations in developing the draft Abstract, 'Residential Management Companies Financial Statements'.

Reason for the abstract – the issue

A2. The UITF received a request from the ICAEW to consider the treatment of transactions relating to residential service charges in the financial statements of residential management companies (RMCs).

A3. It was noted that the ICAEW has received legal counsel opinion that, irrespective of whether a RMC is acting as principal or agent, the cash balance representing contributions received from lessees in accordance with the terms of their leases and held by a RMC under S.42, Landlord & Tenant Act 1987 is held on statutory trust and is not an asset of the company.

A4. This led to confusion as to whether the lack of beneficial ownership of the cash balance meant that none of the relevant transactions should be recorded in the RMC financial statements and the ICAEW identified variations in practice. In some cases the RMC apparently regarded itself as acting as an agent and, accordingly, did not record the transactions which often meant, for the purposes of company law, that it was dormant. In other cases the RMC apparently regarded itself as acting as a principal or as an undisclosed agent and, hence, recorded the transactions in its financial statements. It was not clear which treatment was correct and whether or not this was dependent on the RMC acting as principal or agent.

A5. The UITF considered the request by reviewing various forms of arrangements for providing residential services by RMCs. The UITF concluded that various forms of arrangement were in place and that it could usefully assist preparers and users by providing guidance on determining the transactions to be entered into the financial statements of the RMC.

A6. The UITF reached agreement that an Abstract could provide useful guidance and will:

- (i) assist RMCs to determine whether they are acting as principal or agent when undertaking residential service transactions with third parties, and thereby determine which transactions should be recognised in their financial statements;
- (ii) focus on and protect the needs of users (including tenants), in particular to help avoid potential conflicts between tenants and RMC; and
- (iii) assist preparers in fulfilling their statutory duties.

Objective of the draft abstract

- A7. Prior to publication of the draft Abstract, the UITF carefully considered the benefits of producing an Abstract. The UITF noted that an Abstract could:
- (i) improve the information provided to leaseholders. There was evidence to suggest that not all leaseholders were being given all the information they needed regarding service charges even though they had a statutory right to information, despite ICAEW guidance regarding issuing statements to leaseholders;
 - (ii) provide clarity to the preparers of financial statements. Preparers have indicated to the ICAEW that they are not clear as to when service charge transactions should be included in financial statements and therefore when they may prepare dormant financial statements;
 - (iii) enable creditors to clearly identify the party with whom they are contracting. The Abstract, by providing clarity to preparers would enable creditors to identify whether they are contracting with the RMC as principal or as an agent. This should help contractors understand the parties to a contract where the RMC has filed dormant accounts; and
 - (iv) enable residents to identify whether the RMC is acting as principal, or as an agent. In the circumstances where the RMC is acting as an agent and produces dormant company financial statements, the UITF noted that residents may have unlimited liability. The UITF considered that the company financial statements should indicate that the information regarding service charge transactions can be found elsewhere and will not be identical to that found in the financial statements.

Scope

- A8. The UITF noted that it should carefully define the scope of the Abstract. The draft Abstract applies to RMCs, as defined in the ICAEW Technical Release 03/11.

CONSENSUS

Principal or Agent

- A9. The UITF concluded that before a RMC can determine the appropriate accounting it must first determine whether it was acting as principal, agent or undisclosed agent using the guidance in FRS 5 'Reporting the Substance of Transactions'. The UITF noted that FRS 5 provides guidance on when an entity is acting as principal or agent; although this advice is focused towards revenue transactions, it could be applied, by analogy, by a RMC to assist in determining whether the RMC is acting as a principal or agent. Paragraphs G62 to G66 of Application Note G to FRS 5 provide the relevant guidance.

A10. The UITF also noted that paragraph G64 of FRS 5 provides a rebuttable presumption that, where a seller has not disclosed that it is acting as agent, it is acting as principal. The UITF noted that this should apply equally to RMCs. An RMC which has not disclosed that it is acting as agent, and not rebutted the presumption that it is a principal, shall be deemed to be exposed to legal rights and obligations under the contracts it has entered into and should prepare financial statements which record service charge transactions. Notwithstanding this, the law of agency is complex and, where there is sufficient doubt as to the status of the RMC as principal or agent, legal advice should be obtained.

The accounting treatment

A11. Once the RMC has determined whether it is acting as principal or agent, the appropriate accounting can be determined. A principal should recognise the relevant transactions in its profit and loss account and concurrently recognise income by drawing from the service charge cash balances. An agent should not recognise the relevant transactions in its financial statements.

A12. The UITF noted that ICAEW counsel's opinion had identified that, irrespective of whether the RMC was acting as principal or agent, the cash balance representing contributions received from lessees in accordance with the terms of their leases and held by a RMC under S.42, Landlord & Tenant Act 1987 is held on statutory trust and is not an asset of the company. Therefore a RMC acting as principal or undisclosed agent would recognise transactions in the profit and loss account, and not the associated asset. The UITF gave careful consideration to whether this was appropriate.

A13. In considering whether it was appropriate to recognise transactions in the profit and loss account where the associated asset (the contributions received from lessees) is not recognised in the balance sheet, the UITF reviewed the accounting required by Abstract 32 'Employee benefit trusts and other intermediate payment arrangements' and Abstract 38 'Accounting for ESOP trusts'. The UITF noted that similar to ESOP's, residential service charge monies are held in trust, however, the ESOP monies are recognised as assets of the reporting entity in contrast to the proposals in the draft Abstract.

A14. The UITF noted two important differences between residential service charge monies held by a RMC and assets and liabilities pertaining to an ESOP. Firstly, for RMCs the leases clearly indicate how residential service charge monies may be spent. Unlike the sponsoring company of an ESOP that is deemed to have de facto control of the assets and liabilities, in the case of residential service charge monies the RMC, both contractually and by statute, funds can only be spent on items authorised under the leases and further such expenditure must be reasonable. Therefore the RMC does not have de facto control of the monies as outlined in paragraph 10 of Abstract 38. Secondly, the UITF noted that paragraph 6(a) of Abstract 38 identifies that an ESOP trust provides a warehouse for the sponsoring company's shares and paragraph 6(b) identifies that shares held by the ESOP trust are distributed to employees through an employee share scheme. The UITF considered that this differentiated an ESOP, where the employer is obtaining benefit of the employees' services, from a RMC, where there is no equivalent exchange of benefit between the RMC and the residents.

- A15. The UITF also took into consideration the Statement of Principles for Financial Reporting (SOP), which states that, in a trusteeship (paragraph 2.16); the dual definition of control (to deploy and to benefit) does not apply. In the introduction to chapter 2, the SOP defines the boundary of reporting of an entity as determined by its control, i.e. the right to obtain the future economic benefits embodied in an asset - hence the trusteeship for residential service charges monies should not be reported under the financial statements of the RMC.
- A16. Counsel's opinion states that a RMC does not have the ability to 'enjoy' (benefit from) service charge monies and that a trust does have beneficiaries, as these are the lessees/ contributing tenants who pay the service charge monies. Therefore the RMC does have the ability to 'deploy' but not to 'enjoy' (benefit from) the funds.
- A17. The UITF considered whether the draft consensus was consistent with generally accepted position for pension scheme trustee companies which do not include the transactions of the pension scheme (trust) in their financial statements. The UITF considered that there were factors which distinguished the position of pension schemes, including a regulatory regime which ensures that financial statements of the trust are prepared and made available to members. Parties transacting with pension scheme trustees will have a clear understanding of the capacity in which the trustees are acting. The UITF also noted that by limiting the scope of the draft Abstract to RMCs, it would be clear that it should not be applied by analogy to pension scheme trustee companies.

Dormant company financial statements

- A18. The UITF noted that the ICAEW had drawn attention to when a RMC may file dormant company financial statements with Companies House. The UITF reached the consensus that only RMCs that have disclosed that they are acting as agents can file dormant company accounts (assuming they also meet the company law definition of a dormant company). The financial statements should make reference to where tenants can obtain the full set of information about service charges, irrelevant of whether the RMC is dormant.