FINANCIAL REPORTING FACULTY

FAQ

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RESIDENTIAL MANAGEMENT COMPANIES: NEW PROPOSALS

The Financial Reporting Faculty answers your initial questions on the latest proposals for 'residential management company' financial statements.

The Financial Reporting Council (FRC) has issued revised proposals for the treatment of residential management transactions in the financial statements of residential management companies (RMCs).

1. What is a ‘residential management company’?

The FRC, in its current exposure draft FRED 50 Draft Abstract 1, defines a residential management company (RMC) 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 RMC does not necessarily have any legal interest in the property.

2. How are service charges defined?

The exposure draft explains that service charges relate to the amounts paid by tenants to the RMC for repairs, maintenance, improvements, insurance, services and other costs of managing a property. These costs may vary depending on the expenses incurred by the RMC. Indeed, if the service charge is a fixed amount under the terms of the lease or tenancy agreement ie, ‘fixed service charge’ then it is not covered by the provisions of the Landlord and Tenant Act 1987, and would therefore not be subject to the proposed reporting requirements under FRED 50.

3. What are the complications involved in RMC financial reporting?

Work undertaken by ICAEW when responding to the earlier FRC consultation identified three key factors which complicate financial reporting by RMCs.

Triple reporting requirement
RMCs potentially have a triple reporting requirement. As companies they are accountable to members and must prepare statutory company accounts. RMCs are also likely to be held accountable under their leases by the lessees and must provide information on the service charges paid. Finally, tenants paying service charges to the RMC have the right under the Landlord and Tenant Act 1985 to demand a ‘statement of charges’ which includes certain details about service charges paid.

Diversity in size
Although many RMCs are simple entities, with lessees and members being the same individuals and few transactions other than receipt and disbursement of service charges, this is not always the case. Some RMCs are much larger. They may manage numerous properties and enter into transactions in their own right, for example, generating income from renting parking spaces or incurring expenditure which cannot be recovered under the lease.

Principal versus agent
There has been some debate over whether an RMC acts as principal or agent when transacting with third party suppliers. Some RMCs regard themselves as principals and recognise service charge transactions within their statutory accounts. Others regard themselves as agents and prepare and file dormant company accounts.

These three factors result in competing demands for information. Leasehold industry specialists note that RMC statutory company accounts do not always satisfy the requirements of those lessees seeking information on the service charges paid. This is a particular problem should a case concerning an RMC end up before a tribunal. We understand that many specialists favour the production of detailed service charge accounts, with dormant statutory accounts produced by the RMC.

Conversely, we understand that many accounting practitioners consider the preparation of separate service charge accounts as an unnecessary burden. The preparation of statutory company accounts must be prepared and presented to members by law. Therefore, it is suggested that it should be possible to present sufficient and relevant accounting information within the statutory accounts which satisfies both members and leaseholders alike.

4. How are RMC financial statements currently prepared?

There is currently no consensus on what entries should be included within the statutory accounts of an RMC. This has resulted in diversity in practice. Some RMCs prepare and file dormant company accounts whilst others prepare statutory accounts including the service charge transactions and balances.

5. What solutions have previously been proposed?

To address this issue, the FRC's Accounting Council issued, in May 2012, UITF Draft Abstract 49. This draft abstract suggested that the information to be included in the financial statements of a RMC should depend on whether it was acting as principal or an agent. Under the draft abstract RMCs would have needed to decide for themselves the capacity in which they were acting. Thus the draft abstract provided no definite conclusions on the financial reporting for RMCs.

Another issue addressed in the draft abstract was the treatment of the surplus cash held by the RMC at the year end. The draft abstract suggested that the cash is not an asset of the RMC as the company does not 'enjoy the benefits' of holding it and its use is restricted to the terms of the lease. This would result in accounts that show service charge transactions in the profit and loss account without the corresponding cash balance in the balance sheet.

6. What does the new exposure draft propose?

In response to comments on UITF Draft Abstract 49 and legal advice received, the FRC has issued revised proposals for RMC financial statements. The key conclusions reached in FRED 50 Draft FRC Abstract 1 include:

- An RMC always acts as a principal when entering into transactions with third party suppliers;
- Transactions entered into with third party suppliers for the purpose of maintaining the property should be recognised in the profit and loss account of the RMC. Further, the RMC should concurrently recognise income from drawing on the service charge cash received from tenants; and
- The cash balance arising from service charges received from contributing tenants is held in statutory trust under section 42 of the Landlord and Tenant Act of 1987. It is not an asset of the company and should not be recognised in the statutory accounts. Instead, it is proposed that the RMC make detailed disclosures regarding the amount of cash and other balances held in trust.

7. What is the effective date for these proposals?

The exposure draft states that the effective date for the proposals would be for accounting periods beginning on or after 1 January 2015 although early adoption would be permitted.

8. How do the proposals fit in with the new UK GAAP reporting regime?

The proposals are intended to be applied to financial statements prepared under FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*. The exposure draft also sets out the required associated amendments to FRSSE 2008. We understand that the amendments made to FRSSE 2008 will be transferred across to FRSSE 2015 in due course.

9. Will ICAEW be commenting on the FRC exposure draft?

Yes, the ICAEW Financial Reporting Committee is reviewing the exposure draft and will be consulting with ICAEW members before submitting ICAEW comments to the FRC. ICAEW members are welcome to email any comments on the exposure draft to nigel.sleigh-johnson@icaew.com

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