



August 2013

FRED 50

Draft FRC Abstract 1

Residential Management Companies'
Financial Statements

and

Consequential Amendments to
the FRSSE

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SUMMARY

Withdrawal of UITF Draft Abstract 49

1. On 2 July 2012, the Financial Reporting Council (FRC) became the prescribed body for issuing accounting standards; the prescribed body was previously the Accounting Standard Board (ASB). The FRC established the Accounting Council as the relevant Council to assist it in the setting of accounting standards, and the role and responsibilities of the Urgent Issues Task Force (UITF) were transferred to the Accounting Council.
2. UITF Draft Abstract 49 *Residential Management Companies' Financial Statements* is withdrawn and replaced with FRED 50 Draft FRC Abstract 1 *Residential Management Companies' Financial Statements*.

Background

3. UITF Draft Abstract 49 was issued in May 2012, in response to a request from the Institute of Chartered Accountants in England and Wales (ICAEW) to consider the treatment of residential management transactions in the financial statements (statutory accounts) of residential management companies (RMCs).
4. The ICAEW identified that there is diversity in practice, with some RMCs regarding themselves as agents, and others regarding themselves as principals. At the time, the ICAEW had received legal counsel opinion that, irrespective of whether an RMC was acting as principal or agent, the cash balance representing service charge monies received from contributing tenants is held on statutory trust under section 42 of the Landlord and Tenant Act 1987, and is not an asset of the company.
5. 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's financial statements.
6. UITF Draft Abstract 49 was intended to assist RMCs in determining whether they were acting as principal or agent when undertaking residential management transactions with third party suppliers, and hence whether the transactions should be recorded in their financial statements.
7. Following the issue of UITF Draft Abstract 49, the ICAEW and the FRC separately obtained independent legal counsel's opinions on this issue. Both legal opinions concurred that RMCs always act as principals (not agents) in their residential management transactions with third party suppliers.
8. The Accounting Council considered that clarity was still required over the accounting treatment of these transactions by RMC's and advised that a new Financial Reporting Exposure Draft (FRED) should be issued.
9. The objective of this FRED is to address how RMCs shall 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 principals (not agents) in these transactions.

INVITATION TO COMMENT

1. The FRC is requesting comments by 11 November 2013. The FRC is committed to developing standards based on evidence from consultation with users, preparers and others. Comments are invited in writing on all aspects of this FRED. In particular, comments are sought on the questions below.

Question 1:

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

Question 2:

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

[DRAFT] FRC ABSTRACT 1

RESIDENTIAL MANAGEMENT COMPANIES' FINANCIAL STATEMENTS

Scope

1. This [draft] FRC Abstract shall be applied to the financial statements prepared by **residential management companies** that apply FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*, and that are intended to give a true and fair view of the entity's financial position and profit or loss for a period. This [draft] FRC Abstract only applies to **service charges** over which Section 42 of the Landlord and Tenant Act 1987 imposes a statutory trust.

Definitions

2. 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 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.
3. Service charges are amounts payable by a tenant to a residential management company in respect of services, repairs, maintenance, insurance, improvements or costs of management, and the amount may vary according to the costs incurred or to be incurred. If the service charge is fixed under the terms of the lease or tenancy agreement eg, as part of rent payable by the tenant, this is referred to as a 'fixed service charge'. The service charge provisions of the Landlord and Tenant Act 1985 and Landlord and Tenant Act 1987 do not apply to fixed service charges.

Residential management transactions

4. A residential management company acts in the capacity of principal (not agent) when transacting with third party suppliers in the management and arrangement of maintenance of a property.
5. The cash balance and other assets representing service charge monies received by a residential management company in accordance with the terms of the lease agreement are held in a statutory trust under Section 42 of the Landlord and Tenant Act 1987. The cash balance and other assets are not assets of a residential management company and shall not be recognised in a residential management company's balance sheet.
6. A residential management company shall recognise the relevant service charge expense arising from the management and arrangement of maintenance of a property in profit or loss. A residential management company shall concurrently recognise income in profit or loss by drawing from the service charge monies. This income and expense shall not be offset.
7. Where a receivable (from service charge monies) and a payable (to a third party supplier) arise from a single transaction and exist at the end of the reporting period, these balances shall not be offset.

Disclosures

8. A residential management company shall disclose:
 - (a) the fact that a statutory trust is imposed over service charge monies received under Section 42 of the Landlord and Tenant Act 1987 and that the residential management company acts as a trustee in this capacity; and
 - (b) the closing balance of cash and other assets held in trust by the residential management company. For residential management companies that are trustees over more than one trust, this information should be disaggregated on a trust by trust basis.

Date from which effective

9. An entity shall apply this [draft] FRC Abstract for accounting periods beginning on or after 1 January 2015. Early adoption is permitted.

CONSEQUENTIAL AMENDMENTS TO THE FINANCIAL REPORTING STANDARD FOR SMALLER ENTITIES (EFFECTIVE APRIL 2008) (FRSSE 2008)

1. The following consequential amendments are made to the FRSSE 2008 (deleted text is struck through, inserted text is underlined):

(a) The following subheading, footnote and paragraphs 3.9 to 3.14 are inserted:

“Residential management companies’ financial statements*

3.9 Paragraphs 3.10 to 3.14 shall only be applied to the financial statements prepared by residential management companies and only in respect of service charges over which Section 42 of the Landlord and Tenant Act 1987 imposes a statutory trust.

3.10 A residential management company acts in the capacity of principal (not agent) when transacting with third party suppliers in the management and arrangement of maintenance of a property.

3.11 The cash balance and other assets representing service charge monies received by a residential management company in accordance with the terms of the lease agreement are held in a statutory trust under Section 42 of the Landlord and Tenant Act 1987. The cash balance and other assets are not assets of a residential management company and shall not be recognised in a residential management company’s balance sheet.

3.12 A residential management company shall recognise the relevant service charge expense arising from the management and arrangement of maintenance of a property in the profit or loss account. A residential management company shall concurrently recognise income in the profit or loss account by drawing from the service charge monies. This income and expense shall not be offset.

3.13 Where a receivable (from service charge monies) and a payable (to a third party supplier) arise from a single transaction and exist at the end of the reporting period, these balances shall not be offset.

3.14 A residential management company shall disclose:

(a) the fact that a statutory trust is imposed over service charge monies received under Section 42 of the Landlord and Tenant Act 1987 and that the residential management company acts as a trustee in this capacity; and

(b) the closing balance of cash and other assets held in trust by the residential management company. For residential management companies that are trustees over more than one trust, this information should be disaggregated on a trust by trust basis.”

[Footnote]

“* The requirements in paragraphs 3.9 to 3.14 apply to accounting periods beginning on or after 1 January 2015. Early adoption is permitted.”

(c) In Part C *Definitions*, the following definitions are inserted:

“Residential management company:

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 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.”

“Service charges:

Service charges are amounts payable by a tenant to a residential management company in respect of services, repairs, maintenance, insurance, improvements or costs of management, and the amount may vary according to the costs incurred or to be incurred. If the service charge is fixed under the terms of the lease or tenancy agreement eg, as part of rent payable by the tenant, this is referred to as a ‘fixed service charge’. The service charge provisions of the Landlord and Tenant Act 1985 and Landlord and Tenant Act 1987 do not apply to fixed service charges. Paragraphs 3.9 to 3.14 do not apply to fixed service charges.”

- (d) In Appendix IV *Development of the FRSSE*, paragraph 37A is inserted (date to be inserted):

“37A In [month 2014] the FRC issued [draft] FRC Abstract 1 *Residential Management Companies’ Financial Statements*. As a result, consequential amendments were made to the FRSSE (effective April 2008) to incorporate the requirements of [draft] FRC Abstract 1. [Draft] FRC Abstract 1 states that residential management companies (RMCs) are acting in the capacity of principals (not agents) when transacting with third party suppliers in the management and arrangement of maintenance of a property.

37B The FRC considered the impact of this FRC Abstract on RMCs that are currently filing dormant company accounts at Companies House (ie those RMCs that currently consider themselves to be acting as agents). The Accounting Council is aware that there are some RMCs that will now not qualify as dormant companies and that additional costs will be incurred as a consequence. The FRC believes that the need to prepare financial statements that give a true and fair view overrides the additional costs that will be incurred by these RMCs.

37C The FRC also considered whether it was appropriate to allow an exemption to these RMCs from having to provide corresponding amounts for the previous accounting period as set out in paragraph 2.23 of the Financial Reporting Standard for Smaller Entities (effective April 2008) (FRSSE 2008). The FRC concluded that regardless of whether a residential management company is dormant or not, it is their statutory duty to keep records of the service charges received from contributing tenants and associated expenditure in the maintenance of the property. Therefore, the FRC concluded that these RMCs should not be exempt from this requirement and that they are required to produce corresponding amounts for every item disclosed in the balance sheet, profit and loss account and notes to the financial statements.”

THE ACCOUNTING COUNCIL'S ADVICE TO THE FRC TO ISSUE FRED 50

Introduction

1. This section provides an overview of the main issues that have been considered by the Accounting Council in advising the Financial Reporting Council (FRC) to publish Financial Reporting Exposure Draft 50: Draft FRC Abstract 1 *Residential Management Companies' Financial Statements* (FRED 50).
2. The FRC, in accordance with the Statutory Auditors (Amendment of Companies Act 2006 and Delegation of Functions etc) Order 2012 (SI 2012/1741), is the prescribed body for issuing accounting standards in the UK. The Foreword to Accounting Standards sets out the application of accounting standards in the Republic of Ireland.
3. In accordance with the *FRC Codes and Standards: procedures*, any proposal to issue, amend or withdraw a code or standard is put to the FRC Board with the full advice of the relevant Councils and/or the Codes & Standards Committee. Ordinarily, the FRC Board will only reject the advice put to it where:
 - it is apparent that a significant group of stakeholders has not been adequately consulted;
 - the necessary assessment of the impact of the proposal has not been completed;
 - including an analysis of costs and benefits;
 - insufficient consideration has been given to the timing or cost of implementation; or
 - the cumulative impact of a number of proposals would make the adoption of an otherwise satisfactory proposal inappropriate.
4. The FRC has established the Accounting Council as the relevant Council to assist it in the setting of accounting standards.

Advice

5. The Accounting Council is advising the FRC to issue FRED 50: Draft FRC Abstract 1 *Residential Management Companies' Financial Statements*.

Background

6. UITF Draft Abstract 49 was issued in May 2012, in response to a request from the Institute of Chartered Accountants in England and Wales (ICAEW) to consider the treatment of residential management transactions in the financial statements (statutory accounts) of residential management companies (RMCs).
7. The ICAEW identified that there is diversity in practice, with some RMCs regarding themselves as agents, and others regarding themselves as principals. At the time, the ICAEW had received legal counsel opinion that, irrespective of whether an RMC was acting as principal or agent, the cash balance representing service charge monies received from contributing tenants is held on statutory trust under Section 42 of the Landlord and Tenant Act 1987, and is not an asset of the company.
8. 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's financial statements.

9. UITF Draft Abstract 49 was intended to assist RMCs in determining whether they were acting as principal or agent when undertaking residential service transactions with third party suppliers, and hence whether the transactions should be recorded in their financial statements.
10. Following the issue of UITF Draft Abstract 49, the ICAEW and the FRC separately obtained independent legal counsel opinions on this issue. Both legal opinions concurred that RMCs always act as principals (not agents) in their residential management transactions with third party suppliers.
11. In light of this new information, the Accounting Council advised that UITF Draft Abstract 49 should be withdrawn.
12. The Accounting Council, however, felt that clarity was still required over the accounting treatment of these transactions by RMC's and advised that a new draft FRC Abstract should be issued.

Objective

13. The objective of this draft FRC Abstract is to address how RMCs shall recognise transactions with third party suppliers in its financial statements when discharging their duties to manage and arrange maintenance of a property, on the basis of the legal opinions obtained that state that all RMCs act as principals (not agents) in these transactions.

Key issues

14. A number of issues were considered in determining the financial reporting treatment for these transactions which are discussed in more detail below.

Scope

15. The Accounting Council noted that careful definition of the scope of this draft FRC Abstract was required. This draft FRC Abstract only applies in situations where Section 42 of the Landlord and Tenant Act 1987 (LTA 1987) applies a statutory trust over variable service charges paid (and any investments representing those sums) to an RMC. This draft FRC Abstract does not apply where a landlord and tenant relationship does not exist (for example, where two or more freeholders contribute to a fund that is used to maintain communal areas of a property), or where the monies paid do not represent service charges as defined in Section 42 of LTA 1987.
16. UITF Draft Abstract 49 used part of the definition of an RMC from the ICAEW Technical Release 03/11 *Residential Service Charge Accounts*. The Accounting Council concluded that the full definition of an RMC should be used along with the definition of service charges and included in this draft FRC Abstract for clarity.
17. In determining the scope of this draft FRC Abstract, consideration was given to the information needs of different users of an RMC's financial statements and the comments received from the consultation on UITF Draft Abstract 49.
18. FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*¹ states that the objective of financial statements is to "provide information that is useful for economic-decision making by a broad range of users that are not in a position to demand reports tailored to meet their particular information needs".

¹ FRS 102 was issued by the FRC in March 2013.

19. The following potential users of RMC financial statements were identified:
- (a) the tenants (leaseholders) of the properties managed by the RMC;
 - (b) third party suppliers;
 - (c) shareholders; and
 - (d) external finance providers.

Tenants

20. Most respondents to the consultation on UITF Draft Abstract 49 agreed that it is important that tenants have access to information on the total levels of service charge monies collected, how these are spent and what balance remains. It was noted that tenants are in a position to demand some information under Sections 21, 21A and 22 of the Landlord and Tenant Act 1985 (LTA 1985) including services charges and relevant costs. Many respondents concluded that regardless of the basis on which the statutory accounts are prepared, it is unlikely that the statutory accounts would meet the legal requirements under LTA 1985.
21. The Accounting Council considered that tenants are in a position to demand some information tailored to their specific information needs (as is their statutory right under the LTA 1985) and that this draft FRC Abstract should not gold-plate these statutory requirements. However, the Accounting Council noted that it would be useful for tenants to see the closing balance of the service charge monies (and any other assets resulting from the investment of these monies that were held in trust) but that there is no legal requirement for RMCs to provide this information. It was noted that the ICAEW Technical Release 03/11 *Residential Service Charge Accounts* provides detailed guidance on the preparation of service charge accounts and recommends that a balance sheet is prepared for the service charge fund.
22. The Accounting Council advises that this draft FRC Abstract should only apply to the preparation of RMC's financial statements and not to the preparation of service charge information for the tenants, and that RMCs should be required to disclose the closing balance of the service charge monies held in trust (and any other assets resulting from the investment of these monies) in their financial statements. For RMCs that are trustees over more than one trust, this information should be disclosed on a trust by trust basis.

Third party suppliers

23. The Accounting Council considered the information needs of third party suppliers (ie whether the RMC could afford to pay for the goods purchased or services rendered). On the basis that this draft FRC Abstract states that service charge monies received by the RMC do not meet the definition of an asset and are not recognised on the balance sheet, this information would not be readily available in the financial statements of the RMC.
24. However, as noted in paragraphs 21 and 22 of this Advice, the Accounting Council concluded that RMCs should be required to disclose the closing balance of service charge monies and any other assets resulting from the investment of these monies in their financial statements.
25. Further, the Accounting Council considered that it would be useful for a third party supplier to understand the nature of the activities of an RMC in order to decide whether to transact with the RMC or not. Therefore, the Accounting Council advises that RMC's should be required to disclose the fact that a statutory trust is imposed over service charge monies received from contributing tenants under Section 42 of LTA 1987 and that the RMC acts as a trustee in this capacity.

Shareholders

26. In most cases, the shareholders of the RMC will also be the tenants of the properties managed. The Accounting Council believes that scenarios where this is not the case would be rare and advises that additional disclosures are not required for shareholders.

External finance providers

27. Given the nature of RMCs, it is highly unlikely that an RMC would have any external financing. The Accounting Council therefore advises that additional disclosures are not required for external finance providers.

Rsidential management transactions

28. Following the two independent legal opinions obtained by the ICAEW and the FRC respectively, it is clear that an RMC always act as a principal in transactions with third party suppliers. However, the question remains of how these transactions should be reflected in the financial statements of an RMC.

Service charge monies (cash) and other assets held in trust

29. UITF Draft Abstract 49 noted that the legal opinion concluded that variable service charge monies received by an RMC are held on statutory trust and therefore are not an asset of the RMC. Some respondents to the consultation disagreed with this view; one expressing the view that the RMC is itself the trust and therefore should recognise the cash. It is clear from the legal opinions obtained that the RMC and the trust are separate.
30. The Accounting Council however did consider whether, outside of the legal framework, the service charge monies met the definition of an asset. FRS 102 states that an asset is “a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity”². The Accounting Council concluded that the RMC did not control the cash because the lease agreement would limit what the cash could be used for. Further, the benefits of spending the cash would not flow to the RMC, but to the tenants of the property. Therefore, the Accounting Council advises that the service charge monies should not be recognised in the balance sheet of an RMC but an RMC should be required to disclose the closing balance of the service charge monies held in trust (and any other assets resulting from the investment of these monies) in their financial statements.

Service charge transactions – Income Statement

31. A more challenging issue was whether the service charge transactions should be recognised in the profit and loss account, even though the related asset is not recognised.
32. As part of the process of developing UITF Draft Abstract 49, the Urgent Issues Task Force (UITF) considered whether it was appropriate to recognise transactions in the profit and loss account where the associated asset (the service charge monies received from tenants) is not recognised in the balance sheet.
33. The UITF reviewed the accounting required by UITF Abstract 32 *Employee benefit trusts and other intermediate payment arrangements* and UITF Abstract 38 *Accounting for ESOP trusts*³.

² Paragraph 2.15(a) of FRS 102.

³ UITF Abstracts 32 and 38 have been incorporated into FRS 102 at paragraphs 9.33 to 9.38.

34. The UITF noted that similar to ESOP's, 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 that draft Abstract.
35. The UITF noted two important differences between residential service charge monies held by an RMC and assets and liabilities pertaining to an ESOP:
 - (a) Firstly, for RMCs, the lease agreements 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 UITF Abstract 38.
 - (b) Secondly, the UITF noted that ESOPs were different to RMCs in that the employer is obtaining the benefit of the employees' services, whereas there is no equivalent exchange of benefit between the RMC and the tenants.
36. The UITF also took into consideration the Statement of Principles for Financial Reporting (SOP), which states that in a trusteeship the dual definition of control (to deploy and to benefit) does not apply⁴. The SOP also defines the boundary of reporting of an entity as determined by its control, ie the right to obtain the future economic benefits embodied in an asset⁵, hence the trusteeship for residential service charges monies should not be reported in the financial statements of the RMC.
37. The UITF noted that the legal opinion stated that an RMC does not have the ability to 'enjoy' (benefit from) service charge monies and only has the ability to 'deploy' them.
38. The UITF considered whether UITF Draft Abstract 49 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.
39. In developing this draft FRC Abstract, the Accounting Council considered that this argument was incorrect given the statutory duties imposed on RMCs to provide service charge information under LTA 1985. The Accounting Council concluded that the key differentiator between pension scheme trustee companies and RMCs is that pension scheme trustee companies, unlike RMCs, are not exposed to the significant risks and rewards associated with transactions undertaken and therefore cannot be acting as principals.
40. The Accounting Council was also mindful of the Companies Act requirement that financial statements must give a true and fair view and that FRS 102 states that the objective of financial statements is to provide information that is useful for economic decision making by a broad range of users that are not in a position to demand reports tailored to meet their particular information needs.
41. FRS 102 defined performance as the relationship of the income and expense of an entity, as reported in the statement of comprehensive income.

⁴ Paragraph 2.9 of the Statement of Principles for Financial Reporting

⁵ Introduction to Chapter 2 *The reporting entity* of the Statement of Principles for Financial Reporting.

42. The Accounting Council considered the definitions of income and expenses which can only arise where there has been a change in the net assets (equity) of an entity⁶. It can be argued that the recognition of cash received (or receivable) from the service charge monies occurs simultaneously with the recognition of cash payment (or payable) to the third party supplier. Consequently, there would be no change in the net assets (equity) of the RMC and no income or expense to recognise.
43. However, the day-to-day operations of an RMC are to use the service charge monies from the trust to pay for the management and arrangement of maintenance of properties. Therefore, on the basis that RMCs act as principals in transactions with third party suppliers, their profit and loss account should reflect this activity to give a true and fair view of their financial performance.
44. On balance, after taking into consideration the conclusions drawn by the UITF and its own deliberations, the Accounting Council advises that for an RMC's profit and loss account to give a true and fair view, the recognition of income and expenses should be required.

Outstanding balances at the reporting date

45. The Accounting Council gave consideration to any outstanding balances between the RMC and the trust (receivables from the service charge monies balance), and the RMC and third party suppliers (payables for goods/services) at the end of the reporting period. It could be argued that if any balances existed at the end of the reporting period that originated from the same transaction, the balances could be offset in the balance sheet. However, the Accounting Council concluded that the balances were with different parties and therefore should not be offset.

Additional disclosure requirements

46. The Accounting Council considered the information needs of users of RMC financial statements and whether additional disclosures would be useful (for example, the surplus/deficit of each trust fund). The Accounting Council's conclusions on this matter are set out in paragraph 21 to 28 of this Advice.

Dormant companies

47. The Accounting Council considered the impact of this draft FRC Abstract on RMCs that are currently filing dormant company accounts (ie those RMCs that currently consider themselves to be acting as agents). The Accounting Council is aware that there are some RMCs that will now not qualify as dormant companies and that additional costs will be incurred as a consequence. The Accounting Council believes that the need to prepare financial statements that give a true and fair view overrides the additional costs that will be incurred by these RMCs.
48. The Accounting Council also considered whether it was appropriate to allow an exemption to these RMCs from having to provide corresponding amounts for the previous accounting period as set out in paragraph 2.23 of the Financial Reporting Standard for Smaller Entities (effective April 2008) (FRSSE 2008) and paragraph 3.14 of FRS 102. The Accounting Council considered that regardless of whether an RMC is dormant or not, it has a statutory duty to keep records of the service charges monies received from contributing tenants and the associated expenditure in the maintenance of the property.

⁶ Paragraph 2.23 of FRS 102 states that "income is increases in economic benefits during the reporting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to distributions from equity holders" and "expenses are decreases in economic benefits during the reporting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions from equity investors".

Therefore, the Accounting Council advises that these RMCs should not be exempt from this requirement and that they are required to produce corresponding amounts for every item disclosed in the balance sheet, profit and loss account and notes to the financial statements.

Consequential amendments the FRSSE

49. The Accounting Council noted that the vast majority of RMCs would be applying the small company regime and therefore using the FRSSE. Users of the FRSSE are exempt from complying with other financial reporting standards and therefore the Accounting Council advises that consequential amendments to the FRSSE are required to incorporate the requirements of draft FRC Abstract 1.

Consultation period and effective date

50. The Accounting Council advises that this FRED is issued with a three-month consultation period and that draft FRC Abstract 1 should have the same effective date as FRSs 100 to 102.

CONSULTATION STAGE IMPACT ASSESSMENT

Introduction

1. As published in its Regulatory Strategy⁷, the Financial Reporting Council (FRC) is committed to a proportionate approach to the use of its powers, making effective use of impact assessments and having regard to the impact of regulation on small enterprises.

Rationale for introducing draft FRC Abstract 1

2. It had been identified by the Institute of Chartered Accountants in England and Wales (ICAEW) that diversity in practice exists with some residential management companies (RMCs) considering themselves to be acting as principals and some as agents when transacting with third party suppliers.
3. Draft FRC Abstract 1 and the consequential amendments to the FRSSE are intended to provide clarity over the treatment of residential management transactions in the financial statements of residential management companies, thus removing the diversity in practice identified and ensuring that the financial statements give a true and fair view and provide useful information.

Cost / benefit analysis

4. This draft FRC Abstract and the consequential amendments to the FRSSE are narrow in scope and only impact RMCs that hold funds in trust under Section 42 of the Landlord and Tenant Act 1987.
5. The key benefits of the new requirements are that the financial statements of RMCs will give a true and fair view of residential management transactions, provide useful information to users and consistency across the sector.
6. There will be minimal additional costs incurred in applying the new requirements. All RMCs should be keeping detailed service charge information to ensure they meet their statutory duties under the Landlord and Tenant Act 1985.
7. However, the FRC is aware that there are some RMCs that are not recognising these transactions in their financial statements on the basis that they consider themselves to be acting as agents, and are filing dormant company accounts. These entities will not qualify as dormant when they apply the new requirements. Additional costs will be incurred by these entities in relation to the preparation and filing of statutory accounts, and additional resources required in communicating with HMRC. The FRC believes that the need to prepare financial statements that give a true and fair view overrides the additional costs that will be incurred by these RMCs.

Case studies

8. The case studies set out in Appendix 1 represent typical scenarios of requirements before and after the introduction of draft FRC Abstract 1 and the consequential amendments to the FRSSE. Both case studies assume that the RMC will continue to apply the FRSSE (as amended by FRED 50), however these case studies equally apply to RMCs that will apply FRS 102 and hence draft FRC Abstract 1.

⁷ <http://www.frc.org.uk/Our-Work/Publications/FRC-Board/FRC-Regulatory-Strategy-Our-Role-and-Approach.aspx>

Appendix 1: Case studies

Entity A – An RMC that currently accounts for transactions as an agent

Scenario

Entity A is a residential management company. It has been preparing its financial statements in accordance with the FRSSE.

Entity A only participates in transactions that relate to the provision of services, and the management and arrangement of maintenance of the property, funded through the receipt of variable service charges that fall within the statutory trust provisions of the Landlord and Tenant Act 1987.

Entity A currently accounts for these transactions on the basis that it is acting as an agent when transacting with third party suppliers.

Applicable accounting standards

Entity A will continue to apply the FRSSE, as amended by FRED 50.

The most significant accounting impact to Entity A will be the need to recognise the relevant service charge expense and income concurrently in profit or loss. This income and expense shall not be offset.

The cash balance and other assets representing the balance of service charges received by Entity A are not assets of Entity A, and therefore Entity A should continue to not recognise these items in its balance sheet.

Entity A will also be required to make additional disclosures including:

- (a) the fact that a statutory trust is imposed over service charge monies received under Section 42 of the Landlord and Tenant Act 1987 and that the residential management company acts as a trustee in this capacity; and
- (b) the closing balance of cash and other assets held in trust by the residential management company.

Costs of implementing the applicable accounting standards

Although Entity A will be required to recognise these transactions in its profit or loss, minimal additional costs will be incurred as the information should be readily available. Entity A should have this information available to comply with the requirements of the Landlord and Tenant Act 1985 to provide service charge information to its tenants.

If Entity A previously prepared dormant company accounts, it may also incur additional costs in filing its accounts.

Entity B – An RMC that accounts for transactions as a principal

Scenario

Entity B is a residential management company. It has been preparing its financial statements in accordance with the FRSSE.

Entity B only participates in transactions that relate to the provision of services, and the management and arrangement of maintenance of the property, funded through the receipt of variable service charges that fall within the statutory trust provisions of the Landlord and Tenant Act 1987.

Entity B currently accounts for these transactions on the basis that it is acting as a principal when transacting with third party suppliers.

Applicable accounting standards

Entity B will continue to apply the FRSSE, as amended by FRED 50. Unlike Entity A, the only changes required by Entity B will be to make the additional disclosure requirements stating:

- (a) the fact that a statutory trust is imposed over service charge monies received under Section 42 of the Landlord and Tenant Act 1987 and that the residential management company acts as a trustee in this capacity; and
- (b) the closing balance of cash and other assets held in trust by the residential management company.

Entity B will already be recognising the relevant service charge expense and income in its profit or loss.

Costs of implementing the applicable accounting standards

Although additional disclosures are required to be made by Entity B, there will be minimal additional costs incurred as the information should be readily available. Entity B should have this information available to comply with the requirements of the Landlord and Tenant Act 1985 to provide service charge information to its tenants.

This draft is issued by the Financial Reporting Council for comment. It should be noted that the draft may be modified in the light of comments received before being issued in final form.

For ease of handling, we prefer comments to be sent by e-mail to:

ukfrs@frc.org.uk

Comments may also be sent in hard copy to:

Mei Ashelford

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

Comments should be despatched so as to be received no later than 11 November 2013.

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The FRC will publish a summary of the consultation responses, either as part of, or alongside, its final decision.



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