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## BY EMAIL

Dear Ms Ashelford

### Comments on: FRED 50

Firstly, may I thank you for allowing me to comment on the above way beyond the deadline set, and note that further consideration is to be given in the light of the micro-entities regime.

This will necessarily delay further any final definitive guidance on this subject which has already taken over three years to develop thus far and, in my view, has led to much greater complexity which I cannot help but question "is this in the best interests of the persons to whom it is designed to benefit?" In particular, those resident management companies (RMCs) that are wholly owned by the residents themselves.

In that regard, in my view there is a clear distinction between those companies that manage more than one property and which are usually independent of the residents of the properties concerned, and those companies which are owned and managed by the residents themselves. I believe that such distinction is sufficient to warrant a different structure than is currently envisaged as regards to the preparation and presentation of the Financial Statements, particularly for those RMCs that are owned by the residents.

I have had some experience in preparing the Accounts of a resident-owned RMC using the guidance that has been published in the last three years, and many of my comments that are appended hereto reflect that practical experience and the problems that have been encountered.

I have appended my own thoughts in terms of how I feel the Accounts of such RMCs should be prepared and given that there never seemed to be a problem with such Accounts until 2010, I cannot help but wonder what real purpose is being served by totally changing what was deemed to be acceptable until then?

As a result, I have concluded (perhaps radically) that rather than make major and ongoing changes, why not look at the problem in completely the opposite way? Decide what it is that the residents and members of such companies expect to see at their AGMs, and then design a legal and accounting framework to achieve that?

I trust you will find my comments helpful.

Yours sincerely

*Andrew Day*

A Day



## 1. **Background**

- 1.1 We have acted for a few RMCs over the years and still act for one such RMC since its incorporation in 1976. I mention the year as it will thus be appreciated from this that the company was formed BEFORE the Landlord and Tenant Act 1987 (LTA).
- 1.2 Indeed, the company was created by way of the 999 year leases (16 in total) that were granted for each of the 16 flats in the property. The leases stipulate that each lessee shall hold one share in the RMC and that each lessee shall pay (a) a rateable proportion of the property maintenance expenses and (b) a sum to be determined by the directors to cover the admin expenses of the RMC.
- 1.3 The RMC's Memorandum and Articles of Association (which usefully at that time) contain an objects clause setting out that the company shall maintain the property, and stipulates that each holder of a share shall thereupon become a director.
- 1.4 It will therefore be appreciated that all residents are therefore also equal shareholders and directors of the RMC. It is also prohibited in the Memorandum that no dividend shall be paid.
- 1.5 Whilst there are 16 flats, there are 18 shares in issue, the remaining two being held by the Freehold company. This was separately incorporated and was, at a later date, acquired by each of the residents, again equally. This is entitled to receive a nominal amount of ground rent from each lessee, and also is invoiced the annual buildings insurance premium, collecting this proportionately from the residents separately from any service charge monies.
- 1.6 Whilst I do not feel suitably qualified to challenge the legal advice that has already been sought, I cannot help but wonder why it is that the RMC, in the circumstances outlined above, could not be considered to be the "statutory trust" itself. After all, it is incorporated by statute, all the lessees are equally interested and involved in the company, and its sole purpose is to maintain the property on the lessees' behalf.
- 1.7 I accept that Section 42 of the LTA should be applied to non-incorporated entities or where not all the lessees are directly involved, and I therefore wonder, perhaps, whether the legislation introduced was only intended to cover such situations?

## 2. **Implementation**

- 2.1 Upon the issue of the original Technical Release 01/10 in October 2010, jointly by the ICAEW, ARMA and RICS, we decided to implement the guidance on behalf of our RMC client with their approval.
- 2.2 The company's 2011 Accounts were, therefore, the first Accounts to apply the new guidance, appended to which were the Service Charge Accounts prepared in the recommended format. These combined Accounts, which now include extensive notes and accounting policies, cover 14 pages!
- 2.3 Prior to this, we simply prepared a Balance Sheet and a detailed Profit & Loss Account (which also doubled up as the statutory P&L as there seemed little or no point in withholding such information from the public file given the nature of the company's activities). With the notes, directors' report, etc, these extended to just 7 pages!
- 2.4 Under the previously accepted accounting framework, the company's P&L account prepared showed the service charges received in the year, less all the expenditure which had been met including, rather importantly, all the expenditure that had been incurred, whether or not paid or indeed invoiced. The net surplus (or sometimes deficit) arrived at for the year, when added to the accumulated reserves brought forward, resulted in the accumulated reserves that existed on the balance sheet date for use in later years.

- 2.5 It should be appreciated that these reserves did not equal the monies held in the company bank account due to the existence of debtors, creditors, prepayments and accruals.
- 2.6 Over all the years that we have prepared these Accounts, we have never had to explain the accruals concept to any resident and would further suggest that the residents are probably only interested in seeing the P&L Account, the accumulated reserves going forward, and that there remained sufficient funds in the company bank account.
- 2.7 Having prepared the Accounts in 2011 under the revised guidance of TR 01/10, given the further guidance that has been issued since, including that in FRED 50, we have modified our application of some of the underlying principles in each of the succeeding three years. Had we appreciated, and indeed been given some guidance accordingly, that this question of RMC accounting would have taken this amount of time to resolve (it still is in progress), we would have continued to prepare the Accounts on the original basis even though, perhaps, that would not have been appropriate.
- 2.8 With the benefit of hindsight, one wonders whether it may have been better if we, as practitioners, were all advised to continue to prepare our RMC Accounts as we had been until final definitive guidance was agreed!
3. **Accounting issues**
- 3.1 In what follows, it has been accepted that the RMC acts as a principal in all of its dealings and that the service charge monies being received belong “in trust” to the residents and are not income of the RMC.
- 3.2 We therefore have a situation whereby the income (in the main) of the RMC is none, but that it incurs expenditure which it recovers from the service charge monies. That expenditure is in the form of maintenance expenditure on the property itself, together with the various admin expenses that will be incurred by the RMC itself. Such expenses will include its Annual Return fee and the Accountants fees, as well as certain other expenses, eg. company secretarial fees incurred on the registration of a new lessee.
- 3.3 Such admin expenses that are incurred by our RMC client can quite properly be recouped from the service charges that are received under the terms of the leases (see 1.2 above). What therefore is the position if that is not permitted if indeed the service charges can only be applied to maintain the property concerned?
- 3.4 At this point, it would seem to be important to consider the position as regards to the recognition of an expense that is incurred by the RMC.
- 3.5 Whilst it is clear that any expense paid for should indeed be drawn from the service charge monies (Para. 6 FRED 50) when paid, where there exists a “payable” from the RMC to a third party supplier (Para. 7 FRED 50) it would seem that should be treated as a creditor in the RMC balance sheet. Accordingly, an equal amount due from the service charge monies will need to be reported as a debtor. That balance therefore, between the RMC and the Service Charge balance sheet, will presumably need to be reported as “Amounts to be drawn down from service charge monies”?
- 3.6 What is not clear from the Draft Abstract is what is meant by “payable” in Para. 7. Does “payable” include accruals and indeed what about prepayments?
- 3.7 In a not untypical situation, there could exist, in addition to any unpaid bills:
- a balance due to or indeed held by a utility company eg. for communal electricity, that is being paid by monthly direct debit
  - unbilled charges that have yet to be invoiced, eg. communal water usage

- a debtor in respect of an insurance claim
  - unbilled charges for property maintenance services that have been provided prior to the balance sheet date
  - payments in advance for work to be done
  - provision for accountancy fees.
- 3.8 From the Draft Abstract, it is not at all clear whether these balances should be accounted for on the balance sheet date, but clearly each do have an effect on the expenditure that should be recognised in the year in the Service Charge Income & Expenditure Account and will clearly affect the surplus to be carried forward.
- 3.9 It is my view that all prepayments and accruals should indeed be recognised and accounted for on the balance sheet date, but should those be dealt with within the Service Charge Accounts in isolation, or in the Accounts of the RMC?
- 3.10 If they are to be dealt with solely in the Service Charge Accounts, then clearly the expenditure dealt with therein will not match that dealt with in the RMC, so it would seem to be reasonable to presume that all the accruals and prepayments should be accounted for in the Accounts of the RMC. Such costs would then have to be included in the “Amounts to be drawn down from the service charge monies” in order to arrive at a no profit/no loss result in the RMC, and similarly recognised as such as a creditor in the Service Charge balance sheet.
- 3.11 Theoretically therefore, the total expenditure in the RMC Profit & Loss Account will be equal to the total expenditure in the Service Charge Income & Expenditure Account, providing all the costs of the RMC are capable of being recharged to or recouped from the Service Charge monies. To achieve a no profit/no loss, the reported income/turnover of the RMC will clearly need to be equal to the total of that expenditure.
- 3.12 In my view, it is therefore essential to apply accruals accounting to the Accounts of the RMC in order to provide to the residents a true and fair view of the Service Charge reserves going forward, but in order to do so, it is almost certain that there will always be a balance that will need to be accounted for in the Service Charge balance sheet representing “Amounts to be drawn down from the Service Charge monies”.
- 3.13 Consequently, the (cash?) bank balance will never represent the service charge surplus that is being held at any point in time.
4. **Disclosures**
- 4.1 As stated in Para 8 of FRED 50, I would agree that the closing balance of cash and other assets held in trust by the RMC should be disclosed in the notes to the Accounts of the RMC.
- 4.2 However, for the reasons explained elsewhere in this submission, surely there is a need to also disclose any liabilities too – those being, of course, the “Amounts to be drawn down from the Service Charge monies”. Failure to do this will give an incomplete and potentially misleading indication of the true position as regards to the Reserves that are held.
- 4.3 It is stated that the Service Charge Accounts do not form part of the statutory financial statements to be filed at Companies House, so the only way some indication can be provided of the reserves being carried forward is by way of a note in the Accounts of the RMC that are to be filed. It seems fundamentally important that any such statement of the reserves should take account of all liabilities.
5. **Bank & Cash balances**
- 5.1 Historically, it will have been the case that each RMC would have its own bank account in its own name, with possibly a separate deposit or deposit accounts to earn some interest or to house certain funds held for a specified purpose.

- 5.2 In a wholly resident owned RMC, such accounts would have been under the authorised control of the officers of the RMC; specifically the nominated person acting as the Treasurer, and the account would be operated under an appropriately authorised bank mandate.
- 5.3 This probably remains the case today in the majority of such RMCs, yet the advice received is that such accounts should be designated as Trust accounts. There seems to be no real need for this added protection as the account is in the name of the RMC anyway and under the control of the authorised officers.
- 5.4 Notwithstanding this, it is accepted that all service charge monies that are received are to be held “in trust” in a bank account, but is it really essential that a separate “trust” bank account be opened to receive such monies?
- 5.5 If the service charge monies are paid into the normal bank account of the RMC, as I suspect most still are, why cannot these monies still be considered to be held “in trust” within that bank account, but still be reported in the service charge balance sheet?
- 5.6 Is it the intention that all RMCs have a separate trust account to receive the service charge monies, and another bank account to settle the RMC’s own creditors (as principal)? This would therefore require a separate transfer to be made from the trust account to the current account to fund the payment of all outgoings, whereas if only one bank account existed (as has been the case), the payment of any creditor would simply be made from the service charge funds already residing in that bank account.
- 5.7 It should not be overlooked here that the persons in charge of such funds are residents with potentially no accounting or administrative skills.
- 5.8 To be fair, the Draft Abstract refers (Para. 5) to the “cash balance and other assets representing service charge monies received by a RMC.....are not assets of the RMC and shall not be recognised in the RMC’s balance sheet”. I am not sure that the intention behind this form of wording was to recognise that such monies can be paid into the RMC’s own bank account, even though for accounting purposes, they must not be reported in its own balance sheet. Perhaps that should be clarified as clearly that is the far more practical position.
- 5.9 However, if the service charge monies, or indeed the residual balance of these, are to be reported in the Service Charge balance sheet, what about other monies that are received?
- 5.10 The company may well have issued shares for which cash has been paid by the subscribers and shareholders. In our RMC client, the company receives the ground rent on behalf of the freeholder as well as the insurance premiums that are collected to settle the annual buildings insurance premium. In other situations, amounts could be borrowed to fund certain emergency repairs, etc and is interest received service charge money? None of these would appear to be service charge monies and therefore clearly do not need to be held “in trust”, yet they could, on any balance sheet date, form an integral **part** of the bank balance that is held by the RMC.
- 5.11 This issue arose when endeavouring to account for “Amounts to be drawn from service charge monies” under FRED 50 when this was expected to simply be the amount required to cover the creditors and accruals that then existed. However, the balance that had been struck to achieve a balanced balance sheet, having accounted for the whole of the bank balance in the Service Charge Balance Sheet as intended, resulted in a difference, that being the monies initially received for the shares that were issued.
- 5.12 It would therefore seem appropriate that the monies held in the bank account(s) should be split, purely for the purposes of the Accounts to be prepared, as between those that are attributed to the service charges and those that belong to the RMC itself. Has this been considered?

- 5.13 With reference to my earlier comments concerning the “Amounts to be drawn down from service charge monies”, presumably the bank balance to be reported in the Service Charge balance sheet will still contain those funds that have yet to be drawn down by the RMC on the basis that these have yet to be paid. Consequently, there will indeed need to be a creditor reported in that balance sheet as “Amounts to be drawn down”.

## 6. **Residential or Residents’ Management Company?**

- 6.1 Is it intended that these terms represent the same organisation? I would respectfully suggest not.
- 6.2 A definition of a Residential management company has been provided, but I would suggest that the definition for the purposes of separately identifying a Residents’ Management Company should be confined to include a company in which ALL of the residents are (or could be) equal members of that company.
- 6.3 In which case, for those resident owned RMCs, who are the service charge monies “held in trust” for, other than for the company’s members, all of which are residents anyway?

## 7. **Key Issues**

- 7.1 It therefore seems to me that the following practical matters need to be addressed:
- a) confirmation that accruals accounting should be applied and that such items are accounted for in the Accounts of the RMC and balanced by including them under the heading of “Amounts to be drawn down”;
  - b) that monies that are inherently contained in the bank account, but which are not service charge monies, should be accounted for in the RMC balance sheet;
  - c) that the expenditure passing through the P&L account of the RMC in each year should equal that being accounted for in the Service Charge Accounts by way of recharging or drawing down such expenses from the Service Charge monies.
  - d) whether a distinction should be made between, on the one hand, a RMC in which ALL the residents are shareholders (or can be), and those RMCs that are independent of the residents.
- 7.2 A worked example of the Accounts of a RMC which incorporates the required separate Service Charge Accounts would be of benefit, as was the case when the first Technical Release was issued.

## 8. **Micro-Entities**

- 8.1 Clearly most, if not all, resident owned RMC’s will qualify under the Micro-Entities Accounts Regulations.
- 8.2 Whilst the resulting restricted disclosure is to be welcomed for companies that exist in a competitive environment, RMCs are not such companies.
- 8.3 It is my view that the underlying principle which should pervade as regards to disclosures in RMC Accounts, which should properly contain both a Balance Sheet and a Profit & Loss account, should be **sufficient** to give any resident, as well as any potential resident, an adequate explanation of the disposition of the company’s funds and reserves, and of its assets and liabilities on the balance sheet date.
- 8.4 I would therefore suggest that the proposed simplified layout permitted for the profit & loss account of such micro-entities will not only be inadequate, but will not provide a sufficient explanation that is likely to be acceptable to the members/residents as to how and where their service charge monies have been expended.

- 8.5 Whilst there has been a tendency to reduce disclosure in company Accounts over many years, I would advocate that detailed disclosure, particularly of expenditure (even possibly itemised for major expenses) that has been incurred, should be a minimum requirement in the Accounts of a RMC.

## **9. Historical background**

- 9.1 The traditional RMC which is owned, managed and operated under the direct supervision of the residents of the property concerned has historically (at least up until 2010) produced a Profit & Loss Account showing its surplus or deficit for the year in respect of its service charge receipts and maintenance expenditure, and a Balance Sheet showing its assets, liabilities, bank balance and its reserves for use in later years.
- 9.2 Residents have always understood this simple form of Accounts, accompanying which will have been a few notes, accounting policies and their Directors' Report. Unlike the majority of small companies these days, RMCs still tend to convene AGMs to discuss the Accounts, the expenditure that has been met in the year and their plans for the future, including decisions over the level of the service charges and any additional funds that they may wish to reserve.
- 9.3 Most RMCs will have a nominated officer (as Treasurer) and/or officers placed in charge with the necessary authority to manage the funds being received. It is here that the role of the independent Accountant becomes useful, not just in preparing the Accounts, but will also be expected by the other residents to carry out a review of the transactions that arose during the year to ensure all was in order. We may not be auditors anymore (although such companies would have required an audit up to 1996!), but it must be presumed that we would be viewed by the remaining residents as fulfilling that role.
- 9.4 What is proposed by these new regulations is, effectively, two sets of Accounts leading to much misunderstanding and complexity, resulting in additional and completely unnecessary expense.
- 9.5 Most RMCs will be in existence for decades, indeed for the life of the property that they were incorporated to manage and maintain. They will always be small, their purpose or function will not change and I therefore wonder why any change to the manner in which their Accounts have been prepared in the past should even be contemplated.
- 9.6 Indeed the approach of the various bodies thus far has been to try to fit RMCs into the existing framework and accounting requirements of a trading company, which plainly they are not.
- 9.7 RMCs do not seek to make a profit or a loss, they have income and expenditure, a surplus or a deficit, and they have reserves or funds for future use.
- 9.8 May I respectfully suggest that this be looked at from a completely different perspective.

## **10. An Alternative Approach.....**

- 10.1 The Accounts of a wholly resident owned RMC are, in all practical terms, prepared solely for the benefit of the residents of a particular property. They would expect to see:
- Income & Expenditure Account (on the accruals basis);
  - Balance Sheet (or Statement of Assets & Liabilities);
  - Report of the Accountants;
  - Notes, but only to support or further explain the above; and
  - all written in more appropriate terminology.

- 10.2 We have separate tranches of legislation and financial reporting standards dealing with Charities and, to a lesser extent, Community Interest companies, amongst others.
- 10.3 It occurs to me that, would it not be better for there to be separate legislation and an accounting framework that covers just resident-owned RMCs? For existing RMCs, perhaps such legislation could permit existing companies to re-register as RMCs, perhaps by adopting a standard set of Articles (or Table) whereby the protection intended by the LTA 1987 can be provided for.
- 10.4 Under such framework, I would advocate that all RMCs be routinely excluded from any future changes in Financial Reporting Standards, unless clearly they are relevant and appropriate, and therefore any future FRSSes or any directives from the EU can totally ignore their impact on such companies.
- 10.5 It might even be possible to dispense with such inappropriate terminology that we are obliged to use under the Companies Acts such as: Turnover, profit or loss, etc and instead use: Income, expenditure, surplus or deficit, Statement of Assets & Liabilities. In other words not too dissimilar to a Charity or Not-for-profit organisation.
- 10.6 It might therefore be hoped that once an acceptable framework can be established, that could remain in place for the lifetime of the RMC which, as mentioned above, could be for many decades. I would foresee that the Accounts of a RMC would rarely need to be changed to reflect current accounting practice and law which, in most cases, is updated and modified for trading or investment companies.
- 10.7 There are already a number of Statements of Recommended Practice (SORPs) that have been issued and one cannot help but wonder why RMCs have not already been brought within that framework.
- 10.8 It is appreciated that government may need to be involved in any change in the law, but the government has been willing to reduce the burden on SMEs in the recent past and in the RMC, we do have a classic example where we seem to be making matters worse at the present time for, I would imagine, thousands of small companies.
- 10.9 Whilst I accept that the present direction of the RMC guidance would be appropriate for un-incorporated property management entities, those that manage more than one property, and those that are not owned by all the residents, surely single property owner managed companies could be treated differently to achieve a much more sensible and realistic framework.
- 10.10 If it were possible for a new accounting framework to be established that can fulfil the requirements of all RMCs, that would clearly be better, but otherwise I do believe that property owner managed RMCs, as described above, are different, and therefore, in my view, the guidance thus far provided does not seem to be suitable for such companies.
- 10.11 If it is possible to start afresh with new legislation, etc, perhaps we could achieve some simplicity and clarity which, judging by the comments thus far received, I cannot help but feel is completely lacking at the present time.