

1 November 2013

The Financial Reporting Council
Aldwych House
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Dear Sirs

COMMENTS ON FRED 50 - DRAFT FRC ABSTRACT 1 (FRED)

I am writing in response to the invitation to comment on the above document, and offer the following comments and observations.

I am writing as the owner of a firm of Managing Agents, which has been managing residential property for over 23 years, and a Chartered Accountant who has been producing service charge accounts throughout that period. The views expressed are entirely my own.

My first difficulty with FRED 50 is to understand the intended scope? At page 10, Key Issue 15 "Scope" it states "This draft FRC Abstract only applies in situations where Section 42 LTA 1987 applies a statutory trust over variable service charges paid to an RMC". I am assuming that "paid to an RMC" is not so literal as to exclude situations where service charges are paid to an appointed managing agent, regardless of whether that managing agent does or does not maintain a bank account in the name of the RMC? In drafting my response I have made the assumption that FRED 50 is intended to apply in all cases where there is an RMC.

Summary of Thoughts/Observations

- It feels like the document has been produced to justify a desired conclusion, such that common sense has been ignored. I believe it is a highly inauspicious start by the Accounting Council, and could lead to confusion and a reduction in confidence in the accounting profession.
- The 'scope' of the FRED is illogical and unreasonable. The S.42 Trust concept does not exist solely for RMCs.



- The perceived overriding issue identified by the ICAEW regarding Agent v Principal is not, in my experience, the reason why dormant statutory accounts are produced.
- The invention of a new accounting convention, and with such a narrow scope, is not justified.
- The suggested benefit to users of the accounts is an illusion and suggests little practical knowledge of day-to-day property management.
- Insufficient consideration appears to have been given to the cost v benefit of the proposals.
- The document is poorly drafted and a document of this type needs to have worked examples.

Scope of FRED 50

I would be grateful to know if FRED 50 is intended to apply in situations where a managing agent is involved? It would seem illogical not to, but to say it applies only to RMCs and not to situations where the Landlord administers the service charge, either directly or through an appointed managing agent, is also illogical. In so doing, it breaches the fundamental accounting principle of consistency, and there can be no justification for so doing.

Agent v Principal

I have always produced separate service charge and dormant statutory accounts, and the reason for doing so has nothing to do with the concept of Agent v Principal. It is because, by maintaining a bank account outside of the company no transactions pass through the company, so ensuring it complies with the definition of 'dormant'. This simplifies the administration and reduces costs. Not only do corporate accounts have no place in the field of service charges because the principle of Profit or Loss does not apply, what the lessees want to see is a detailed breakdown of what expenditure has been incurred – to the penny, not to round pounds. So in situations where an RMC maintains a bank account in its own name, it will inevitably have to produce an additional non-statutory Income and Expenditure account to meet the needs of lessees.

I believe what the ICAEW perceives as a disparity between RMCs who consider themselves to be acting as agent or as principal is in fact nothing more than whether the RMC does or does not have a bank account in its own name, and so does or does not comply with the definition of dormant.

A New Accounting Convention

Accountants are famed for being conservative but FRED 50 is totally radical; A new partial, or Hybrid basis of accounting. Exclude the bank balance, but incorporate specific transactions from that bank account, but only in relation to RMCs? *"It's accounting Jim, but not as we know it"*. Is service charge accounting so special it warrants a whole new basis of accounting? But if it does, why should the scope be so limited?

Unfortunately the accounts that would result would offer no useful information. It is ironic too that FRED 50 (p.14 para. 43) refers to a Profit and Loss Account, as if each payment is to be matched by an equal amount of income, then neither state of profit or loss would ever arise. And nor should it, as there is no concept of profit or loss in service charge accounting.

For me, this aspect of the draft is the most farcical. Inventing a new system of accounting, just for RMCs, that will produce accounts of dubious value to any user risks bringing our profession into disrepute.

Users of RMC's Financial Statements and True & Fair View

P.11 para. 20 – There is absolutely no disputing "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". However the correct forum for this is the service charge accounts, not the RMC's statutory accounts. Why? Consider the fact that lessees are interested in the detail of how their money has been spent - to the penny. Consider complex service charge accounts where, to comply with the leases, expenditure is split between 29 different schedules. FRED 50 would have us amalgamate all of those schedules together, but excluding any transfers to reserves(?), and presumably classifying all or most of it as "Administrative Expenses", and that would somehow be useful to users of accounts?

With regards to the users of the RMC's accounts I have to question the level of practical knowledge present when FRED 50 was drafted. In 23 years in the industry no contractor has ever asked to view either the RMC's or the service charge accounts. We are of course managing agents, so that might have an influence? But what is the number of RMCs that manage without an appointed managing agent?

On one occasion only, an electricity supplier said they would only take over a supply if a deposit was made, because the RMC was dormant. I don't believe accounts produced in accordance with FRED 50 would have changed that view as the result each year would be zero, and there would be no reserves. In any event the utility company missed the point. Their security is the liability of individual lessees under their lease to pay their share of the costs incurred, and it is quite possible that the same utility company supplied the same lessees in their personal capacity.

One final thought on this, most RMCs would qualify as 'small' and presumably could file just a balance sheet, which rather brings us back to where we are now.

Conclusions

The document itself is poorly drafted. P.7 PARA 3.12 "profit 'OR' loss account"; The definition of RMC "MAY" be referred to in the lease? If it is not then there is no RMC and FRED 50 does not apply; Definition of Service Charge as "payable to an RMC" - but it is no less a service charge where there is not an RMC involved.

A document of this nature should always have examples to help the reader fully understand the principles of what is being proposed.

The document is almost dismissive of the extra costs involved, and frankly deludes itself regarding the significance of the changes to the so called users of these accounts. Such accounts would be produced, filed, billed for and ignored.

The two biggest issues though are the creation of a new 'hybrid' basis of accounting, coupled with the very limited 'scope' over what entities such a treatment would apply to. When you then consider the quality and usefulness of the numbers that would be produced, there is surely no justification for its introduction?

In choosing Form over Substance FRED 50 concludes in a most unsatisfactory way. I don't believe it enhances the reputation of our profession, nor does it advance the needs of lessees. Christmas is coming, and in my family we always called our Christmas turkey 'Fred'. It gives me no pleasure to say it but I believe FRED 50 continues this proud tradition.

Final Thoughts/Suggestions

The proposals in FRED 50 have not changed my view that the most efficient, economical and effective way to organise running a service charge for an RMC is to maintain a bank account outside of the RMC, and produce dormant statutory accounts for the RMC, and separate detailed service charge accounts in a format that complies with the provisions of the leases.

A pragmatic solution would be to require RMCs which maintain a bank account in their own name, to present details of the service charge bank account movements in a set of service charge accounts, as an integral part of their statutory accounts. The statutory P&L and Balance Sheet would only have non-service charge transactions in it, if applicable. Notes to the accounts would explain why the service charge transactions are not being incorporated into the company's statutory P&L and Balance Sheet.

I hope the FRC will reconsider just how useful accounts produced in accordance with FRED 50 would truly be, and question what benefit is gained by making RMCs produce them? Why should a Landlord 'company' operating in the same capacity as an RMC be treated differently, and how can such distinction be justified?

I believe it would do far more to enhance the standing of our profession if a common sense, practical and pragmatic solution is found.

Yours faithfully



R G Burnand