Resident Management Company Accounts: Preparing for the future

ARMA
ASSOCIATION OF RESIDENTIAL MANAGING AGENTS

HDBK 7

LESSEE ADVISORY NOTE 08/08

Note:- One of ARMA's key roles is to provide its members with technical support. However, from time to time, technical or other issues arise where guidance for lessees as well as their property manager is deemed appropriate. Such guidance is contained in these Lessee Advisory Notes (LANs) which ARMA members can copy and distribute to their lessees as appropriate.

SUMMARY

- Many resident management companies (RMCos) account for service charge monies collected from lessees as part of their annual accounts for Companies House.
- This practice is not correct. Service charge monies are held in trust by the Company and should not be accounted for as if they were company assets to be included in the Company's statement of accounts for Companies House purposes.
- In addition the Government will soon be introducing a requirement for all RMCos to produce annual statements of account of service charges. The statement will have to contain certain prescribed contents and will not satisfy the requirements for company accounts as set out in Company Law.
- These statements of service charge accounts will also have to be checked and a report made upon them by an independent accountant. This accountant's report will be in addition to any report by an accountant or auditor on the Company's accounts.
- It is possible for most RMCos to produce dormant or near dormant accounts (after excluding service charge income and expenditure) which do not require audit or other formal, external review, thus saving costs when the Government's requirement for a separate service charge statement of account is introduced.
- Appendix 1 contains a summary, prepared by the Institute of Chartered Accountants in England and Wales (ICAEW), of informal guidance given to its members on the principles underlying the preparation of Companies Act accounts for RMCos.
- ARMA suggests its members may wish to await the final details of the new requirements before changing the method of annual accounting for RMCos to avoid making two changes to accounting formats in as many years.

CURRENT LEGAL REQUIREMENTS FOR RMCos AND SERVICE CHARGE MONIES

All RMCos whether companies limited by shares or guarantee must file annual accounts at Companies House. It is a responsibility of the directors to do so within the prescribed time limits. Note that for financial year ends after the 1st of April 2008 the period for filing annual accounts has been reduced from 10 to 9 months.

Many RMCOs have always assumed that service charge monies collected by them from lessees is the RMCo's money and should be accounted for within the Companies Act form of accounts.

The current legislation relating to service charge monies paid by lessees is primarily S.42 of the Landlord & Tenant Act 1987 (the holding of funds) and S.21 of the Landlord & Tenant Act 1985 as amended by (S.41 and Schedule 2) the Landlord & Tenant Act 1987 (the provision of a summary of relevant costs of service charge expenditure). S.42 requires that any service charge monies collected from lessees must be held 'on trust'; the law has created statutory trusts if the relevant leases do not create express ones.

With regard to the provision of regular statements of account for service charges, S.21 gives any lessee or recognised residents' associations the right to request a summary of relevant costs incurred during the last accounting year. Where the summary is for a block of more than four dwellings this summary must be certified by an independent accountant, who is a registered auditor, as a fair summary.

Note that there is at present no statutory requirement for landlords or RMCos to provide annual statements of account of service charges or for these to be certified or audited by an independent accountant (but see below); however, it is regarded as best practice and many leases require a statement in some form and either certification or audit. If the leases for your block do require a

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statement of service charge accounts and you only produce a set of the RMCo's accounts you may well find there are problems. There have been several Tribunal cases where RMCos have been unable to recover service charges because of failure to produce accounts of service charge expenditure according to the requirements of the leases.

ACCOUNTING FOR RMCos - CURRENT BEST PRACTICE

- It has already been established that service charge monies are trust funds because that is a statutory requirement under S42; these monies are therefore held by the company for the benefit of the lessees. If they are trust funds they are not company funds.

- It is ARMA's clear view that under present law it is wrong to assume that service charge monies are company's monies and to account for them as such in the annual financial statements prepared in accordance with the Companies Act 1985.

- Given that service charges are trust funds, they must be ring-fenced. ARMA therefore requires its members to arrange for service charge monies to be held in a clearly designated trust or client account that is separate from any other account in the member's name. Even if the person entitled to collect service charges is a RMCo (whether the freeholder or not) or Right to Manage Company these funds must not at any time be held in the company's own bank account. Correct practice is to maintain a separate account with trust or client in the name operated by the company or by the agent on its behalf; ensuring the bank recognises the status.

- In the case of 'outside' landlords the production of separate service charge accounts is not disputed. However, where there is a RMCo a great deal of confusion has arisen over incorporating the service charge accounts into the statutory accounts of the company.

THE FUTURE

The Commonhold and Leasehold Reform Act (CLRA) 2002 contains two sections that specifically relate to the holding of and accounting for lessees' monies, namely:-

- S.152 Regular statements of account.
- S.156 Service charge contributions to be held in a separate designated account.

However, subsequent to the 2002 Act receiving Royal Assent it was found both sections were unworkable and the primary legislation needed to be amended. A further Consultation Paper on these Sections was published in 2007 with a summary of the findings published early in 2008. Revised proposals were put into the Housing and Regeneration Act 2008. These clauses now refer to the 'provision of information' rather than a 'regular statement of account' and the reference to an accountant's report has been replaced by a report by a 'qualified person'. In ARMA's view this does not imply any changes to the content of this guidance note but we advise agents caution about making changes because there may yet be new ideas after the debate in Parliament.

There is still no clear indication as to when the sections will be amended and commenced. At best guess commencement could be 1.4.09, hopefully with a sensible lead-in period.

ACCOUNTING FOR RMCos - IMPLICATIONS FOR THE FUTURE

Whatever the arguments about separation of company and service charge accounting under current law, when new legislation is introduced it will be made even clearer that what is required is separation.

This is what will be the case:

- A separate designated bank account solely for service charges will required unless strict conditions can be met. Any monies belonging to the RMCo e.g. ground rents should not be left in that account.

- An annual statement of account for service charges will have to be issued to all leaseholders of the scheme within 6 months of the end of the financial year. The service charges format does not meet the Companies Act requirements for the RMCo's accounts, and the Companies Act format does not meet the requirements of service charges legislation, for the reasons explained in this leaflet.

- This annual statement will have to be accompanied by a report by an independent accountant with a prescribed content. This report is not an audit and neither is it a review of the RMCo's activities. (There are proposed exemptions for small schemes with less than £5000 per annum expenditure on services or 4 or less units.)

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- The leaseholders of the RMCo will have to pay for the independent accountant's report on service charges. They will also have to produce accounts for Companies House with or without an accountant's report. It makes sense for all this to be done at the same time albeit within 6 months rather than the 9 months currently allowed.

- There will be savings that could accrue to an RMCo from the changes. In the case of RMCos with no income e.g. ground rents, rents etc, if the service charges are taken out of the RMCo's accounts then it may be possible to produce simplified dormant accounts.

- Where an RMCo has some other income in addition to service charges, then a decision on whether an audit of the company is necessary will have to be considered. The current exemptions from audit cover all RMCos if they chose to be exempt.

- When service charge and company accounts are separated then you will need to consider how certain company costs may be recoverable. Careful reading of lease clauses on insurance may allow the inclusion of D & O insurance. Clauses allowing all costs relating to the good management of a scheme may allow Companies House filing fees to be recovered.

A CALL FOR ACTION

RMCo directors can expect that their ARMA member agent will approach them soon to make changes to their annual accounts if they will not comply with the changes to be introduced. Even if the Government does not introduce these changes until 2009 there is little time to change the format of company accounts and introduce a new way of presenting service charge statements of account.

ARMA fully supports these changes. They will lead to greater transparency of accounting for lessees, introduce greater protection for service charge monies and clarify at last the difference between company and service charge monies.

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Summary of Institute of Chartered Accountants in England and Wales guidance to its members

- The Institute of Chartered Accountants in England and Wales (the Institute) has given the following guidance to its members who ask how to present service charge accounts information in a company's annual accounts where, for example, the company owns the freehold of a block of flats and is the 'landlord' for the purposes of the 1985 Landlord and Tenant Act (the 1985 Act), or the company manages the block and service charges under the terms of the lease. This scenario assumes that no tenant has asked for a summary of relevant expenditure under section 21 of the 1985 Act . It is also based on legislation current at 1 July 2008. The requirements will change when new Regulations are made later in 2008 or early 2009. As soon as is practicable the Institute will issue formal guidance reflecting this summary, subject to any legislative changes.

- The key point to bear in mind is that the management company does not 'own' the transactions relating to service charge expenditure and the collection of monies from the leaseholders/tenants, because under S.42 of LTA1987 service charges are regarded as trust funds. The cash at bank does not belong to the company because it is held on trust for the leaseholders. The only items/transactions that belong to the company are non service charge transactions such as ground rent if the company owns the freehold. Non service charge items such as ground rent do belong to the company (if it owns the freehold, and is not collecting the rent on behalf of a superior landlord).

- Where no tenant has required a summary of costs, the management company must prepare two statements to satisfy the Companies Act accounts requirements: an income and expenditure account (if there is any non-service charge income or expenditure) and a balance sheet. In addition, two additional statements are included, one to provide information to the leaseholders about service charge relevant costs, and the other to show balances such as service charges owed or paid in advance, any sinking funds, etc. and balances at bank that represent the cumulative excess of service charges paid by the leaseholders over payments on relevant expenditure. These latter two statements do not constitute a s.21 summary of costs.

  It follows from paragraph 2 above that, where the <u>only</u> transactions carried out by the management company are the receipt of service charges paid by the leaseholders and payment of relevant costs, the management company is not carrying out any transactions in its own right. The company may not, therefore, need to prepare a profit and loss/income and expenditure account. The balance sheet will contain only items that belong to the company, such as the freehold of the block at cost of valuation, share capital (if the company is limited by shares) or any initial contributions by members of the company to working capital when the company was set up..

- When the new Landlord and Tenant legislation is implemented - expected to be effective for accounting periods beginning on or after 1 April 2009 - a separate summary of service charge expenditure and a balancing statement will be required in addition to the Companies Act accounts, but in this case the latter need no longer include the service charge statements. Further, formal guidance on accounts and accountants' reports will be issued by the Institute in due course.