



## FRED 58 – QUESTION 9: RESIDENTS' MANAGEMENT COMPANIES

ICAEW welcomes the opportunity to comment further on FRED 58 *Draft FRS 105 The Financial Reporting Standard applicable to the Micro-entities Regime* published by the Financial Reporting Council (FRC) in February 2015, a copy of which is available from this [link](#).

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## MAJOR POINTS

1. This letter deals solely with the Residents’ Management Companies (RMCs) issues raised by the FRC in FRED 58 (and also in FRED 59). Our comments on the other issues raised in FRED 58 have been submitted separately in [Rep 65/15](#).
2. The FRC is proposing in FREDs 58 and 59 to include a ‘clear statement of the legal position’ regarding RMC accounting, ie to the effect that they act as principals, in the Accounting Council’s Advice to the FRC. The FRC has noted that by clarifying the legal position, diversity in practice will be reduced, as an entity entering into transactions as principal would record those transactions in its accounts. We have three key concerns with this proposed statement of the legal position, explained in detail below in paragraphs 23 to 25. In summary, in our view the statement is simply not accurate, it does not sufficiently clarify how the transactions entered into by an RMC would be reflected in its accounts, and its nature means that there is no specified effective date and that the legality of accounts previously prepared on a dormant basis would be questioned. All in all, this approach would create huge uncertainty and disruption in the sector.
3. We continue to believe that the need for clarity about the statutory accounting position of RMCs is paramount. We acknowledge that this specialised activity is perhaps unusual in terms of the complexity of the overall regulatory and reporting requirements, the number and small size of the entities involved, the potential impact on the sector of the new micros regime, questions over the legal status of RMC transactions, and the long-established and strongly held views in the profession and the sector about the validity of the two main approaches currently used when preparing RMC statutory accounts. However, as the UK accounting standard setter, it is for the FRC to determine the accounting parameters within which an RMC can operate.
4. In our view, if the FRC believes that the well-known diversity in practice is not acceptable, it must provide a clear set of principles for accounting by RMCs within the UK accounting framework by amending UK standards, regardless of the restriction on the accompanying disclosure that the FRC can mandate for small and micro-entities. Otherwise, uncertainty, confusion and disagreement are likely to continue. If on the other hand, because of the unusual bifurcation of opinion about the appropriate accounting, on cost: benefit or other grounds, the FRC concludes that the current degree of diversity can or should be tolerated, it should say so, and thereby provide welcome certainty of a sort to those anxious to know whether a major change is needed to their current approach to RMC accounting.
5. In this latter scenario, it would then be for others to work to encourage transparent reporting of service charges to leaseholders and to consider how best to draw attention to the need for the statutory accounts to form one part of a coherent, well understood and accessible package of information provided to tenants. This is likely to be of particular importance in cases where an RMC prepares micro-entity or abridged small entity accounts under the revised regime.

## RESPONSES TO SPECIFIC QUESTIONS

### Question 9:

The FRC’s Consultation Document proposed that a new sub-section is added to Section 34 Specialised Activities of FRS 102 for residents’ management companies, setting out requirements that would be developed from the proposals set out in FRED 50 Draft FRC Abstract 1 – Residential Management Companies’ Financial Statements. Only some 32% of respondents to this question agreed with the proposal, with the rest disagreeing (50%) or providing some other response (18%). The most compelling reasons given for not proceeding with the proposal were that:

(a) the issue is too narrow and industry-specific to be dealt with in an accounting standard and inclusion in Section 34 of FRS 102 would open up the FRC to specific requests that could result in the standard becoming unwieldy and difficult to apply; and

(b) interpretations of law and accounting standards should be issued by other means with a significant number of respondents calling for an alternative solution such as sector-specific guidance developed by the FRC or the development of a Statement of Recommended Practice (SORP) by parties outside of the FRC.

In light of feedback received, the FRC now proposes that a clear statement of the legal position (ie that residents' management companies act as principals) should be included in the Accounting Council's Advice to the FRC (see paragraphs 54 to 59 of the Accounting Council's Advice). This clarification of the legal position should reduce the diversity in practice that currently exists because when an entity enters into transactions as a principal, such transactions should be recorded in its accounts.

Do you agree with this approach? If not, why not? What alternative approach do you propose?

6. The accounting for Residents' Management Companies (RMCs) has been the subject of considerable debate in recent years. However, despite progress being made in some respects, the topic continues to attract strong opposing views, fuelled by the lack of any convincing accounting solution for the sector.
7. In many ways, this topic is highly distinct within the UK financial reporting landscape, both in terms of the diversity and strength of opinions and the accounting issues arising from this specialised activity. We have therefore, as a starting point when considering the current FRC proposal in FRED 58, gone back to basics. We have re-visited the core issues surrounding RMC accounting, examining once again the reasons for complexity in this area. We have also returned to the two legal opinions obtained by ICAEW, considering what conclusions can or should be drawn, and keeping in mind any comparable accounting situations and the practical consequences of change in this area.

#### Complexity of RMC accounting

8. We have previously highlighted how the number of RMCs has increased significantly in recent years, not least through the emergence of the 'right to manage' companies following the 2002 Commonhold and Leasehold Reform Act. As the number of RMCs has increased and the law has evolved, so too has the number of questions asked about the appropriateness of the models typically used to discharge the RMC's accounting obligations. Clearer guidance has been called for, particularly by many in the sector exposed to the practical difficulties that can result where inappropriate accounting information is presented to lessees. We understand that in some cases accounts have been rejected in rent tribunal hearings, where the accounts have, for example, not distinguished service charge disbursements from other expenditure incurred by the RMC in question.
9. The complexity here arises largely from the fact that RMCs have in effect a triple accounting obligation. As companies, they are accountable to members and must prepare statutory accounts for them. They are also likely to be accountable under their leases to lessees, and therefore must provide information to these individuals about service charges received and expended. In addition, those paying service charges have a right under the less than satisfactory Landlord and Tenant Act 1985 to demand a 'statement of charges' detailing certain information about service charges paid. In addition, there has been disagreement over the capacity in which an RMC acts with third party suppliers, ie whether an RMC acts as agent or as principal.

10. This complexity is compounded by the fact that, while many RMCs are very small and the information needs of tenants relatively straightforward, some RMCs are larger and look after multiple properties. Some also hold investments which, for example, may yield ground rents.

### The search for a solution

11. To address the issue relating to the reporting for lessees, in 2011 a joint cross-profession working party, managed by ICAEW’s Business Law staff, issued TECH 3/11 to provide guidance on the preparation of ‘service charge accounts’ produced to address the accounting requirements of the lease.
12. This working party had originally set out to comment on an RMC’s corporate reporting obligations as well, but was unable to agree on the most appropriate treatment in the statutory accounts. As a result the professional and industry bodies represented on the working party agreed that ICAEW should approach the UITF on their behalf, leading to the issue of UITF draft Abstract 49 in 2012.
13. The draft Abstract proposed that each RMC should assess whether it was operating as an agent or principal with third party suppliers and account for service charge transactions accordingly in its statutory accounts. That is, as principal the transactions would be recognised in the accounts, but as agent the RMC might be able to prepare dormant accounts. The proposed approach was not widely welcomed due to the lack of certainty over which treatment to adopt and how to address the accounting for service charge cash held by the RMC at the year end.
14. Both the ICAEW, on behalf of the group of professional and industry bodies, and the FRC then individually sought independent legal advice. The broad conclusion was that an RMC always acts as principal with respect to service charge transactions with third party suppliers. ICAEW also sought further legal advice more specifically in relation to the treatment of service charge cash held by an RMC.
15. As a result of the comments received, the UITF proposals were withdrawn and in August 2013, *FRED 50 Draft FRC Abstract 1 Residential Management Companies’ Financial Statements and Consequential Amendments to the FRSSE* was issued in their place. Under the revised proposals, the FRC confirmed that an RMC always acts as principal when entering into third party transactions with suppliers. From this basis, the FRC went on to propose that an RMC would recognise transactions entered into with third party suppliers in the profit and loss account and concurrently recognise income from drawing on the service charge cash received from tenants. The FRC also proposed that the RMC would not recognise the service charge cash on the balance sheet prior to drawing on it in this way because the legal advice suggested that such cash is held in a statutory trust. The service charge cash balance would instead be disclosed in the notes to the accounts.
16. The proposals in FRED 50 were generally considered to be an improvement on the UITF draft Abstract 49, but proved to be equally divisive, particularly the proposed off-balance sheet treatment of the service charge cash (and other service charge assets). This was further complicated by the introduction in UK law in December 2013 of optional accounting exemptions for micro-entities, which meant that an RMC meeting the criteria for a micro-entity and choosing to take up the optional exemptions could not be required to disclose the service charge cash in the notes to the accounts.
17. ICAEW in its submission on FRED 50 supported in principle a solution provided through accounting standards, but called for the Accounting Council to first review the implications of the new micro-entities regime for RMC accounting and to consider once again whose asset, in substance, is the service charge cash.

18. More recently, major changes to UK company law arising from the implementation of a new EU Accounting Directive have resulted in the FRC conducting a comprehensive review of the small and micro-entity financial reporting regime. Under current FRC proposals, first outlined in an earlier consultation in September 2014, small entities will be brought within the scope of FRS 102, although applying the reduced presentation and disclosure regime required by law. Eligible companies choosing to apply the micro-entities regime will apply the new FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*. Further changes to UK company law mean that small companies now also have the option, with full shareholder approval, to prepare and file highly simplified abridged accounts.
19. Accounting for RMCs must now be considered within the context of this new regime for small and micro companies.

### Revisiting the legal opinions

20. The FRC has now proposed in FRED 58 to include in the Accounting Council's Advice to the FRC a 'clear statement of the legal position' regarding RMC accounting, ie to the effect that they act as principals. The FRC has noted that by clarifying the legal position, diversity in practice will be reduced, as an entity entering into transactions as principal would record those transactions in its accounts.
21. Paragraph 59 of the Accounting Council's Advice to the FRC to issue FRED 58, included within FRED 58, states:  
  
*'For the avoidance of doubt, the Accounting Council advises that the FRC and the ICAEW have independently obtained legal opinions that state that residents' management companies act as principals, not agents, when transacting with third party suppliers in the management and arrangement of maintenance of a property and therefore it is not appropriate for an RMC to prepare dormant accounts if the RMC has entered into such transactions during the reporting period.'*
22. We have three key concerns with this proposed statement of the legal position, set out below.
23. Firstly, in our view the statement is simply not accurate. The first legal opinion obtained by ICAEW did delve into accounting treatment, but only in relation to the presentation of service charge cash. The second legal opinion obtained by ICAEW considered whether or not an RMC acts as principal or agent, but did not explicitly consider the accounting implications. Indeed, that was never the intention. Although we have not had sight of the separate legal opinion obtained by the FRC, we understand that the scope of the legal opinions is similar. If the legal opinions do not in fact establish a recommended accounting treatment for RMC accounts, we wonder why the proposed statement suggests that they concluded that an RMC must not prepare dormant accounts.
24. Secondly, the proposed statement does not sufficiently clarify how the transactions entered into by an RMC would be reflected in its accounts. For example, it does not make clear whether an RMC would be expected to follow the principles set out in FRED 50. Nor does it clarify the treatment of service charge cash, ie whether this must be off-balance sheet.
25. Thirdly, the nature of the statement means that there is no specified effective date and that the legality of accounts previously prepared on a dormant basis would be questioned. All in all, this approach would create huge uncertainty and disruption in the sector.
26. In short, we do not believe that the proposed statement would in fact reduce diversity in practice, as intended by the FRC. Indeed, we question whether any statement of this sort, issued without further explanation/guidance, would be sufficient to provide clarity on the accounting by RMCs. Although the FRC has previously confirmed that an RMC acts as principal when entering into transactions with third party suppliers, the accounting implications

continue to be unclear. We believe it is for the FRC as the standard setter to determine the consequential accounting treatment, including in relation to the treatment of service charge cash, discussed below.

### Cash on the balance sheet

27. Previously, the FRC has proposed (in FRED 50) that service charge cash should not be recognised on the balance sheet. It is not clear from the proposed statement of the legal position in FRED 58 whether the FRC continues to hold this view. Yet this is a critical issue, as highlighted by extensive consultations with our members. A key area of focus of lessees and other users when examining RMC accounts is invariably the amount of unspent service charge contributions that the RMC holds. Tenants will often want to assess whether the RMC has accumulated an appropriate level of funds for maintenance over the longer term, as well as how service charge cash has been disbursed during the year. There may also be an interest from future tenants seeking information in advance of entering into a lease on whether the RMC is sufficiently funded. It does therefore seem highly desirable in principle for service charge cash to be clearly visible when users refer to the RMC accounts.
28. We accept that in line with legal opinions received, service trust cash is held in trust, and is not an asset of the RMC. However, outside the legal framework, the accounting treatment of assets held on trust varies between different reporting entities depending on the substance of the underlying accounting transaction. With this in mind, we continue to think that it is important for the FRC to reconsider the substance of the cash held in trust by an RMC and the appropriate accounting treatment.
29. In particular, it is notable that service charge cash paid to an RMC by a tenant will not be reimbursed by the RMC should the tenant choose to terminate the lease. We are not aware of an equivalent situation where assets are held in trust on this basis and believe this point might differentiate the service charge cash held in trust by an RMC from other trust situations. Following this logic, despite the absence of legal ownership, in substance the funds might be an asset of the RMC. Such a decision could be viewed as analogous to the position of finance leases – despite the lack of legal ownership, these are recognised as assets (and liabilities) in the interests of good financial reporting.

### Accept diversity or clear set of principles

30. In our comments (Rep 161/14) of 1 December 2014 on the FRC consultation document *Accounting standards for small entities: implementation of the EU Accounting Directive*, we commented as follows:

*Our views on the most recent proposals for the accounting for Residential Management Companies (RMCs) are set out in detail in our representation letter 169/13 to FRED 50 Draft FRC Abstract 1 – Residential Management Companies' Financial Statements. This response was the result of detailed enquiries into the current accounting practices for RMC accounting and extensive consultation with ICAEW members and other stakeholders. We are aware, through numerous responses and queries received in recent months from ICAEW members that this continues to be an area of significant uncertainty and disagreement. Past experience, moreover, shows very clearly that this uncertainty cannot and will not be resolved by ICAEW or the profession at large. Thus if, for example, the FRC (as the authoritative standard setter) chooses simply to reiterate the legal position that an RMC acts as principal (not agent) when entering into transactions with third party suppliers without proving any authoritative commentary on the accounting implications, uncertainty and debate about diversity in the statutory accounting of the mainly very small companies involved will continue.*

31. We continue to believe that the need for clarity about the statutory accounting position of RMCs is paramount. We also acknowledge that this specialised activity is perhaps unusual in terms of the complexity of the overall regulatory and reporting requirements, the number and

small size of the entities involved, questions over the legal status of transactions, and the long-established and strongly held views in the profession and the sector about the validity of the two main approaches currently used when preparing RMC statutory accounts. However, as the UK accounting standard setter, it is for the FRC to determine the accounting parameters within which an RMC can operate.

32. In our view, if the FRC believes that the well-known diversity in practice is not acceptable, it must provide a clear set of principles for accounting by RMCs within the UK accounting framework by amending UK standards, regardless of the restriction on the accompanying disclosure that the FRC can mandate for small and micro-entities. Otherwise, uncertainty, confusion and disagreement are likely to continue. If on the other hand, because of the unusual bifurcation of opinion about the appropriate accounting, on cost: benefit or other grounds, the FRC concludes that the current degree of diversity can or should be tolerated, it should say so, and thereby provide welcome certainty of a sort to those anxious to know whether a major change is needed to their current approach to RMC accounting.
33. In this latter scenario, it would then be for others to work to encourage transparent reporting of service charges to leaseholders and to consider how best to draw attention to the need for the statutory accounts to form one part of a coherent, well understood and accessible package of information provided to tenants. This is likely to be of particular importance in cases where an RMC prepares micro-entity or abridged small entity accounts under the revised regime.

#### **Other practical considerations**

34. As noted above, the accounting treatment for assets held on trust varies between different reporting entities, depending on the substance of the accounting transaction. Therefore, we strongly recommend that the FRC considers carefully how the final outcome of this debate may be perceived by other entities looking to RMCs by analogy, in particular, pension scheme trustee companies, which we understand invariably produce dormant accounts. If a clear set of principles or guidance is deemed appropriate, it will be important for the FRC to state very clearly that it has been designed for a particular class of entity.
35. Cost:benefit considerations must also loom large in the FRC's consideration of this matter. While providing a clear set of principles for accounting by RMCs would help reduce uncertainty, it would also, depending on the approach adopted by the FRC, require a large number of RMCs to make significant changes to their financial reporting. Indeed, under the proposals set out in FRED 50, in effect all RMCs would have been required to make changes to their statutory accounts. We strongly encourage the FRC to consider very carefully the full range of costs associated with each option. For example, the necessity for prior year adjustments, any tax consequences for an RMC ceasing to be dormant, and how the information required in RMC accounts would fit within the revised accounting regime for small and micro-entities.