

## **Residents Management Companies – The problem with service charges**

### **Background**

One of the hottest and most frequently asked questions currently being asked of the ICAEW Technical Enquiry Service relates to Residents Management Companies (RSMs) and service charges. Where costs such as cleaning, maintenance or utilities in common areas are recharged to residents by an RSM there are:

- Accounting questions over the treatment of the service charge and
- Legal issues over the handling of the monies.

### **Legislation – the problem**

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.

New legislation, expected to be in force later in 2010, will further reinforce this requirement. This will mean that RSMs will be required to hold service charge monies in separate Client Accounts and provide members with statements of service charge expenditure.

### **The Accounting Issue**

Many RMCs account for service charge monies collected from lessees as part of their annual accounts filed at 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 financial statements. Therefore, the income from the residents should not be included, neither should the expenditure earmarked for this income.

In practice these changes leave many RSMs dormant. Where RSMs in the past accounted for service charges in their financial statements they might have opted for a voluntary audit. Without the service charges in the accounts most of these would take the necessary steps to take advantage of audit exemption.

### **Annual statement of account – new requirement**

In addition the Government will soon be introducing a requirement for all RMCs to also 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 Companies Act 2006.

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' accounts.

### **Summary of ICAEW Guidance**

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 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 (now expected to be later in 2010). 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 lease holders/tenants because under S.42 of LTA 1987 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 transaction 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 overpayments 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 only transactions carried out by the management company are the receipt of service charges paid by the lease holders and payment of relevant costs, the management company is not carrying out any transaction 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 valuations, 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 (now expected later in 2010) - 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.