

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 clients and lessees as appropriate.

SUMMARY

- The Government decided in summer 2010 that it would not introduce regulations relating to the accounting for lessees' service charge monies.
 - To fill the void ARMA, the Institute of Chartered Accountants for England and Wales (ICAEW), the Association of Chartered Certified Accountants (ACCA) and the Royal Institution of Chartered Surveyors (RICS) cooperated to issue joint guidance on accounting for service charges.
 - This LAN summarises best practice for accounting for lessees' monies based on this joint guidance and the RICS Service Charge Residential Management Code.
 - The joint guidance was published in October 2011 and can be downloaded from the ARMA website-go to downloadable publications
 - Note: References to RMCos includes RTMCoS. References to landlords include RMCos where they are responsible for the collection of service charges.
- All lessees paying variable service charges should receive an annual service charge statement from their landlord or Residents' Management Company (RMC) (including Right to Manage Companies (RTMCo)) within six months of the end of the accounting year.
 - The annual statement should include an income and expenditure account and a balance sheet and be prepared on an accruals basis. This guidance includes an illustrative example of a service charge statement.
 - All annual statements of account should be subject to an examination by an independent accountant before issuing to lessees.
 - This Technical Release provides guidance on the two alternative types of examination that may be undertaken by the independent accountant depending upon the terms of the lease. The type of engagement, which should be agreed between the accountant and the client landlord, RMC or their agent, will depend on the terms of the lease and should be proportionate to the size and nature of the property/scheme.
 - If the service charge statement is prepared on behalf of an RMC or RTMCo then it should be a separate statement to the annual accounts for the company required to be filed at Companies House.

SUMMARY OF BEST PRACTICE

This is the summary of best practice from the joint guidance.

- If the lease/tenancy agreement sets out the way in which service charges are to be accounted for, who shall certify or approve the accounts, the costs that can be recovered and the periods of time for which accounts should be prepared, then the requirements of the lease must be followed.
- Service charge monies paid by lessees are trust monies and should be held in ring fenced designated bank accounts (s42, Landlord and Tenant Act 1987).
- A landlord or managing agent need not have a separate bank account for each property/scheme unless the lease requires one. But the funds for each property or scheme must be separately identifiable as it is a breach of trust to use service charge monies from one property/scheme to pay the bills of another or of the landlord.

BANK ACCOUNTS FOR SERVICE CHARGE MONIES

S42 of the Landlord and Tenant Act 1987 applies and best practice is in chapters 4 & 10 of the RICS Code. Service charge monies are held in trust and the RMCo directors are in the position of trustees.

A self-managing RMCo should open a bank account for service charge monies with a title say 'XYZ Court RMCo Ltd Trust Account'.

Managing agents acting for RMCos should open one or more designated bank accounts for service charge monies collected on behalf of RMCos with the words trust or client or the name of the property in the title.

The RICS Code requires managing agents that open such accounts to write to the bank and get a notice in writing from the bank that acknowledges the ring –fenced status of these designated accounts.

There is no statutory legal requirement on managing agents to open separate bank accounts for each scheme, but that may be a requirement of the lease.

There is no requirement to put reserve funds into separate bank accounts unless that is a requirement of the leases of a scheme but the RICS Code requires that reserves be placed in an interest earning account.

Because service charge monies are held in trust the RMCo's directors and their agents are under a duty to invest the monies. Further they have to invest in accordance with the Trustee Investments Act 1961 (as amended by the Trustee Act 2000) or an Order made by Parliament specifically about service charge monies.

That Order is the Service Charge Contributions (Authorised Investments) Order 1988 as amended and it enables service charge monies to be invested in a deposit account with certain banks or in a share or deposit account with building societies.

DEFICITS, LOANS AND OVERDRAFTS

A requirement to act as a trustee or agent for a trustee means that the account for service charges should not be run in deficit.

It is a breach of trust by a managing agent to use the funds from one scheme to fund another overdrawn scheme where the funds of more than one scheme are kept in the same designated bank account. It is also a breach of trust for the directors of an RMCo or an agent to commit service charge expenditure if they are aware no funds are available, perhaps because of arrears built up by lessees, or if they are aware that that expenditure is not allowed under the terms of the leases.

If a scheme is forecast to be overdrawn then the agent should discuss the situation with the RMCo's directors and take instructions. Some leases may authorise that the costs of taking an overdraft against service charges is an allowable expense, but it is difficult for an RMCo to obtain an overdraft if it has no assets other than service charge income.

ANNUAL STATEMENTS OF ACCOUNT FOR SERVICE CHARGES

An illustrative example of how to set out the annual statement is contained in Appendix C of the joint guidance referred to above. Annual statements should contain an income and expenditure account, a balance sheet and schedule(s) showing movement on reserves. The statement should be prepared on an accruals basis. A note to the statement should explain the type and nature of the designated bank account in which service charge monies are held.

AUDIT, CERTIFICATION OR ACCOUNTANT'S REPORT FOR SERVICE CHARGES

The first thing that the RMCo or agent should do is check what the lease requires. If the lease requires an audit then that is what should be done. If the lease requires certification by the landlord or agent or accountant, then that is what should be done.

If the lease refers to the need for an 'audit' or the landlord or RMCo requires an audit, then the joint guidance recommends an audit to International Standard on Auditing 800 (ISA 800) entitled Special Considerations – Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks, as a framework. More detail on the application of ISA 800 to the audit of service charge accounts is included at Appendix E of the joint guidance.

If the lease does not prescribe an audit then the joint guidance offers an alternative form of engagement for the independent examination which is more appropriate and should be less costly. This form is called a report on factual findings and Appendix F sets out the work programme for the independent accountant undertaking such a report.

In the end it is a choice for each RMCo to decide what level of checking by an independent accountant if any it requires, subject to the contractual requirement to do what the leases may state for annual service charge accounts. RMCos should discuss the choices available with their agents and external accountants.

TIMESCALE FOR ANNUAL STATEMENTS OF ACCOUNT FOR SERVICE CHARGES

There is no statutory requirement for annual statements within a timescale although some leases may set timescales.

Best practice in the joint guidance is that RMCos and their managing agents should have issued all annual statements of account for service charges within 6 months of the end of the financial year. This was what was proposed in the now abandoned government regulations. In addition the requirements of S20B of the 1985 Act provide for penalties if costs of services are not notified to lessees within 18 months of being incurred.

It is not always easy to ensure that annual statements of account for service charges are issued within a 6 months' timescale. There has been much misunderstanding about which party 'approves' the annual statement. Where leases are clear about how the annual statement shall be audited, examined or certified, then there is no reason why a landlord, developer, RMCo directors or the shareholders or members of an RMCo should hold up the issuing of annual statements of account for service charges. The leases put the responsibility for approval with the party nominated in those leases.

It is helpful for the directors of an RMCo to check the figures before issue but not to delay them if they have been reported upon by the independent accountant.

REFERENCES

- RICS Service Charge Residential Management Code- available to buy from the RICS.
http://www.ricsbooks.com/productInfo.asp?product_id=7552
- ACCOUNTING FOR SERVICE CHARGES Technical Release 03/11

Guidance On Accounting And Reporting In Relation Service Charge Accounts For Residential Properties On Which Variable Service Charges Are Paid In Accordance With A Lease Or Tenancy Agreement.

Go to the downloadable publications section of the ARMA website at : www.arma.org.uk

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