

# Accounting for Lessees' Money - An interim guide for managers, accountants and their clients

## SUMMARY

This briefing note includes the following:

- The current legal requirements for accounting for lessees' money.
- The current best practice guidance on how to comply with the legal requirements.
- The main changes to the legal requirements that are anticipated.
- Some of the expected consequences that agents may wish to plan for.
- Particular attention is given to the requirements for residents management companies (RMCos). Note the reference to RMCos also includes Right to Manage companies.
- Appendix 3 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 legal 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

The current legislation relating to lessees' money 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) of the Landlord & Tenant Act 1987 (the provision of a summary of relevant costs of service charge expenditure).

S42 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, S21 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 to provide annual statements of account to all lessees in each block or for these to be certified or audited by an independent accountant (but see below); however, many leases require a statement in some form and either certification or audit. Currently therefore agents must only comply with the relevant covenants in leases and S.21.

## CURRENT BEST PRACTICE FOR ARMA MEMBERS ON HOLDING LESSEES' MONEY

There has not always been clarity about how to comply with S42 but best practice has been set out in ARMA's bye-law number 4 and the RICS residential management code. The relevant parts are set out in Appendices 1 & 2.

Putting the legal requirements, ARMA's bye-law and RICS code together here are the key points of current best practice:-

- Under S.42 of LTA 1987 service charges are regarded as trust funds and should be held by the landlord in a clearly designated trust account. There is no need to have a separate trust deed because the trust is created by statute.
- You must open one or more bank accounts to hold lessees' money. The account name should include the words 'in trust' or 'client'.
- Some banks may not like the word trust in the account name so some other designator may be required to demonstrate the account is ring-fenced.
- Ensure the bank acknowledges they are ring-fenced. Get a letter from the bank that clearly states it recognises the status of the account or accounts you set up.
- There is currently no legal requirement to open separate bank accounts for every scheme unless the relevant leases require it.
- There is no requirement to put any reserve funds into separate bank accounts unless the leases require it.
- You should not overdraw the funds for any one scheme.
- It is wrong and unlawful to use the funds for one scheme to pay for expenses of another scheme even though the funds for those schemes are kept in the same client account.

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- If you pay for any service charge items from your own funds you do so at your own risk.
- If you underwrite deficits on scheme accounts then you do so at your own risk and you should not do this without your client's consent.
- Whether the annual statement of account requires any audit or certification by named parties will depend on the wording of the leases.
- You should issue annually a service charge account that has been audited by an independent accountant unless the relevant leases do not allow you to recover the cost of an audit.

## 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 included in the Housing and Urban Regeneration Act 2008. These proposals 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 to be cautious about making changes at this time.

There is still no clear indication as to when the sections will be amended and commenced. At best guess commencement could possibly be 1.10.09 but more likely to be 1.4.10, hopefully with a sensible lead-in period, ARMA has asked for six months.

[NB: S.154 'Inspection etc of documents' (which will amend S.22 of the LTA 1985) will come in at the same time as S.152 but this GN does not deal with this section.]

## IMPLICATIONS FOR AGENTS OF THE FUTURE CHANGES FOR BANK ACCOUNTS

- The legal requirement to hold funds 'in trust' under S.42 does not change. What is proposed is an addition to S.42 to make clearer exactly how this trusteeship shall be carried out.
- Currently it is permissible to hold these funds in one client bank account for any number of schemes, but S.156 of CLRA 2002 is almost certainly going to mean you will have to have a separate bank account for each scheme. The Government's proposal is to allow more than one scheme in the same account but to set conditions upon doing so that make it an impractical option for landlords and their agents. The conditions proposed are that all schemes held in the same bank account must have the same financial year end and only service charge monies may be held in the account; in addition, the government may require that only one qualified person can report on the whole account and lessees may be given access to all the information in that account. Thus those agents who operate with one client account need to start considering switching to separate accounts, including talking to their banks and the providers of their software systems for property management accounting on the processes this will entail.
- In setting up separate bank accounts agents need to be careful how they do it as it is still not clear what, in detail, S.156 will require. Be wary of banks saying their system is fully compliant when we and they still do not know the detail.
- With the new money laundering requirements, the logistics of changes now and later to comply with S.156 need to be fully considered. (See ARMA GN 14).
- S.156 will require that service charge funds are held in the new designated accounts separate from other payments made by the lessee e.g. ground rents, admin, charges etc. Where a payment is made that combines say service charges and ground rent then the agent can either:
  - Pay into the designated bank account for service charges, BUT you will be expected to draw out the ground rent as soon as possible to a separate client account for the landlord;

- Or pay into a holding client account for income BUT you will be expected to pay the service charge element into the designated client account as soon as possible.

- The Government has also made clear that it does not expect these dedicated bank accounts for service charges to run in deficit, as does current best practice above. If a landlord or agent wishes to loan monies to pay for service charge items that money should NOT go into the designated bank account. The item should be paid for from a loan or other landlord account and be shown as a creditor until enough funds are available from service charges to pay that creditor.
- Separate designated bank accounts for service charges for each scheme will cut across the way that many RMCos operate. The designated bank account required by statute is a trust account and cannot be used as the RMCo's account. Any monies belonging to the RMCo as a company e.g. shareholders funds, ground rents, income from lease extensions must not be placed in the designated account. Agents will need to advise their director clients of this. See below for further details.

#### IMPLICATIONS OF FUTURE CHANGES FOR REGULAR STATEMENTS OF ACCOUNT

- All agents, accountants and RMC directors will need to start reviewing their service charge accounting processes in the light of S.152. There will be some prescribed content and prescribed major headings to be used for expenditure.
- We still do not know what will be the precise requirements of S.152 but Annex A of the Consultation Paper of 2007 provides a good starting point - see Appendix 4. Those responsible for producing service charge accounts need to be sure they can provide a detailed income and expenditure account, a meaningful balance sheet and all movements on reserves - **and they must be produced within six months of the year end or lessees will have a statutory right to withhold service charges until you issue the required statement.**

#### IMPLICATIONS FOR THE REPORT ON STATEMENTS OF ACCOUNT

- As well as the prescribed content of annual statements of account, the new legislation will require, with limited exceptions, every statement to be accompanied by an independent accountant's report. The report's wording and underlying procedures will be specified by the professional accountancy bodies whose members are

eligible to undertake this work. The procedures do not constitute an audit. The accountant cannot be a director or employee of the landlord or managing agent. The consequence of this is that the current best practice in the RICS residential management code which requires an annual audit will have to be reconsidered by the RICS.

- The Government has already made clear that if the leases for a scheme require an audit then that audit is still required and will comply with the new legislation. The principle is that if what the lease requires is to a higher standard than the new legislation then that should satisfy.
- The exceptions proposed are for schemes with four or fewer dwellings or where total service charge expenditure is less than £5000 per annum.

#### 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; those 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 moneys to be held in a clearly designated trust account that is separate from any other account in the company'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.
- 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. This is wrong despite guidance to the contrary from Companies House.

## ACCOUNTING FOR RMCos -IMPLICATIONS FOR THE FUTURE

- Appendix 3 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.
- 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 be required. Any monies belonging to the RMCo 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. The government's mooted format is not compatible with the Companies Act as far as company accounts are concerned.
  - 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.
  - 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 for company accounts.
  - 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.

(Note: When the content of S152,154 and S156 are finally known, ARMA will be producing comprehensive guidance for its members.)

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## **GN72 Appendix 1 ARMA Bye-law 4 re Client and Lessee Monies**

Note: Until the related provisions in the Commonhold and Leasehold Reform Act 2002 come into force these Rules apply as if all money held for lessees is client money.

### **4.1 CLIENT MONEY**

4.1.1 Every Member shall keep at least one specially designated current and/or deposit account in the name of the firm at a recognised bank which shall formally be recognised as a "Client Account" and which shall be separate and distinct from the firm's trading account and accounts. The Member shall without delay pay into a client account any money received by way of service charges, rental or as a deposit, or by way of a premium on a lease, or for the purchase in connection with a letting of landed property, of chattels, fixtures or fittings. Monies held in a Client Account shall not be available for the ordinary trading purposes of the firm, nor for the use as security for any loan, nor for meeting any personal or business liabilities.

4.1.2 Every Member shall at all times keep properly written up such accounts as may be necessary to show all its dealings with any money dealt with by it through a Client Account and to show such dealings as they relate to individual clients.

4.1.3 Money shall not be withdrawn from a Client Account except:-

4.1.3.1 to pay over money held in the Account to, or to the order of, the person legally entitled to receive it; or

4.1.3.2 in discharge of a sum owed to the firm by the persons otherwise entitled to receive it out of the Account; or

4.1.3.3 for the purpose of paying it into another such Account kept by the firm; or

4.1.3.4 to correct an inadvertent overpayment into the Account; or

4.1.3.5 to withdraw interest accruing on the Account.

4.1.3.6 if there are sufficient funds available to the credit of the client to fully cover the payments

4.1.4 Members must account to their client for interest received unless otherwise agreed in writing.

4.1.5 All Members, who are not regulated by the Royal Institution of Chartered Surveyors or such other body as Council may prescribe from time to time, will deposit with the association upon their application and on an annual basis, a certificate from their accountant/auditor in the form prescribed from time to time by Council. Failure to provide the certificate by the required date or in the form prescribed shall be subject to review and, potentially, disciplinary action and/or costs.

4.1.6 Members who are regulated by the Royal Institution of Chartered Surveyors or such other body as Council may prescribe from time to time, may submit a copy of their RICS Annual Return and a copy of the results of their three yearly external audit. {It should be noted there is a protocol in place between ARMA and the RICS to share information in confidence.}

4.1.7 The reporting accountant/auditor must be a member of one of the recognised and registered professional accounting bodies and be subject to the control and regulations thereof.

**4.2 LESSEE MONIES:-** All lessee money is to be treated as held in trust and shall therefore be subject to all statutory requirements and particularly that of S.42 of the Landlord and Tenant Act 1987.

**4.3 BREACHES:-** Any breaches to these rules or where the accountant/audit report indicates irregularities shall be subject to review and, potentially, disciplinary action and/or costs.

## GN72 Appendix 2 - Extracts from the RICS Service Charge Residential Management Code

The RICS code which also applies to ARMA members states:

- Ref. 11.8 'Service charge funds for each property should be identifiable and either placed in a separate bank account, or in a single client/trust account where the accounting records of the Manager separately identify the fund attributable to each property.'
- Ref. 11.9 'Where interest is earned it belongs to the fund collectively. Interest should not be distributed to the contributing lessees but should be shown as a credit in the service charge accounts and should be retained within the fund and used to defray service charge expenditure.'
- Ref. 5.10 'Interest earned on client money belongs to the client, not to you. Unless the client agrees in writing otherwise you must credit interest earned on any client bank account to the appropriate client(s).'
- Ref. 5.9 'You may pay some of your own money into a client bank account but you do so at your own risk.'
- Ref. 5.22 'You should never overdraw a client bank account. You should ask your client to supply you with funds before the payment is made or you may make payment from your own funds, but in doing so you may be at risk if your client falls to pay you. You should never lend one client's funds to another unless specifically authorized in writing to do so.'
- Ref. 11.4 'You should arrange for service charge accounts to be audited annually and for copies to be made available to all those contributing to them.'
- Ref. 12.1 'Unless the costs of audit cannot be recovered service charge costs should be audited by a suitably qualified accountant who complies with the requirements of s21 of the L&T Act 1985.'

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

1. 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<sup>1</sup>. 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 practical, the Institute will issue formal guidance reflecting this summary (subject to any legislative changes).
2. 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 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 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).
3. 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.
4. 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 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.
5. 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.

<sup>1</sup> For practical examples, see *Residential and Commercial Service Charges: A Surveyor's Handbook*, published by RICS in February 2008, ICAEW Library reference 351.778.54 F73. For detailed legal provisions, see *Service Charges for Leasehold, Freehold & Commonhold*, by G Sherriff, ICAEW Library reference 351.778.54 S55

# Annex A

## General Rules and Content

### General Rules

1. Subject to the following provisions every income and expenditure account and balancing statement for a regular statement of account shall show the items listed under the headings and sub-headings set out below.
2. Items of expenditure under sub-headings to which Arabic numbers are assigned may be combined if the overall amount represents not more than 10% of total expenditure for the accounting period.
3. Any single item of expenditure representing 10% or more of total expenditure for the accounting period should be shown separately
4. A heading or sub-heading need not be included if there is no amount to be shown in the financial period in question.
5. Greater detail may be shown for any item of content in the income and expenditure account or balancing statement.

### Income and Expenditure Account and Balancing Statement Content

Notes following the required content are referable to the items numbered and indicate where further information should be supplied.

#### Service Charge Statement of Account for:

For the Accounting Period from     to

#### Income and Expenditure Account Content

- A. Repairs and Maintenance
  1. General
  2. Lift
  3. Cleaning and refuse
  4. Door entry system and Security

- B. Improvements
- C. Grounds Maintenance
- D. Utilities
  - 1. Gas
  - 2. Electricity
  - 3. Other
- E. Professional Fees
  - 1. Management Fees
  - 2. Accountancy:
    - i) Accountancy fees
    - ii) Section 21 report
  - 3. Legal and other Professional Fees
- F. Insurance
- G. Direct Staff Costs
  - 1. Wage Costs
  - 2. Expenses
- H. Contributions transferred to Reserve Fund
- I. Total Expenditure
- J. Service Charges receivable
  - i) from tenants
  - ii) from landlord
- K. Gross Interest received
  - i) Less Tax
  - ii) Net Interest
- L. Other Income
- M. Surplus/Deficit at end of accounting period
- N. Surplus/Deficit to be Returned/Transferred to/from Reserves/Collected

**Balancing Statement Content**

- A. Assets (1)
  - 1. Service Charges owed by tenants
  - 2. Service Charges and other amounts owed by landlord
  - 3. Other Debtors
  - 4. Sums paid in this or previous period but relating to a subsequent period
  - 5. Deficit for the period to be collected
  - 6. Balances held (2)
    - Cash at Bank and in Hand

B. Liabilities

1. Service Charges paid in advance
  - i) by tenants
  - ii) by landlord
2. Costs relating to this or previous period but not yet paid
3. Surplus for the period to be credited/refunded

C. Net Assets

D. Reserve Fund

1. Balance brought forward from (date)
2. Transfer from/to Service Charge Account during the year
3. Gross Interest received
  - i) Tax
  - ii) Net Interest
4. Expenditure (1)
5. Balance (2)

## Notes on the Balancing Statement Content

- (1) Assets (A. 1 – 3) Amounts falling due within one year and after one year should be shown separately.
- (2) Balances held (A. 6) Provide details of where funds are held including type of account and name of account holder(s) and name of institution(s) where funds held.

## Notes on Reserve Fund Content

- (1) Separate items of expenditure in respect of which notices were issued under section 20 of the Landlord and Tenant Act 1985 should be clearly identifiable.
- (2) This figure should be the same as the Net Assets figure at C in the Balancing Statement.

## Accounting Policies

The statement should be prepared on an accruals basis under the historical cost convention.

## Example statement

Service Charge Statement of Account for Brown Estate, 1 High Street, London SW1

For the Accounting Period from 1 April 2008 to 31 March 2009

### Income and Expenditure Account

#### Estate Costs

Grounds Maintenance 5,000

#### Professional Fees

Accountancy

Accountancy Fees 800

Section 21 report 1,500

7,300

#### Building Costs:

##### Repairs and Maintenance

	Green Court	Red Court	
General	3,500	3,800	
Cleaning and refuse	2,100	2,000	
Door entry system and Security	0	1,300	
<b>Utilities</b>			
Gas and Electricity	550	600	
<b>Professional Fees</b>			
Management Fees	2,600	2,500	
<b>Insurance</b>	1,000	1,000	
<b>Direct Staff Costs</b>			
Porters Wage Costs	5,200	0	
Porters Expenses (telephone)	250	0	
Contributions to Reserve Fund	3,000	2,000	
	<u>18,200</u>	<u>13,200</u>	31,400
<b>Total Expenditure</b>			<u>38,700</u>
Less: Service Charges receivable:			
from tenants	34,000		
from landlord	3,900		
	<u>37,900</u>	37,900	
Gross Interest	50		
Less Tax	10		
Net Interest	<u>40</u>	<u>40</u>	37,940
Deficit at end of accounting period			760
Deficit to be Collected			760

## Balancing Statement

### Assets

Service Charges owed by tenants		3000
Service Charges and other amounts owed by landlord		300
Other Debtors		600
Sums paid in this period but relating to a subsequent period		350
Deficit for the period to be collected		760
Balances held		
Cash at Bank and in Hand		16,000
		<u>21,010</u>

### Less: Liabilities

Service Charges paid in advance			
i) by tenants	500		
ii) by landlord	500		
	<u>          </u>	1,000	
Costs relating to this or previous period but not yet paid		750	
		<u>          </u>	1,750
Net Assets			<u>19,260</u>

### Reserve Fund

	<b>Note</b>	
Reserve Fund: Green Court	1	10,388
Reserve Fund: Red Court	2	8,872
		<u>19,260</u>

**Notes:****1. Green Court Reserve Fund**

Balance brought forward from <i>(date)</i>		7,340	
Transfer from Service Charge Account during the year		3,000	
Gross Interest received	60		
i) Less Tax	<u>12</u>		
ii) Net Interest		<u>48</u>	10,388
Expenditure			<u>0</u>
Balance			10,388

**2. Red Court Reserve Fund**

Balance brought forward from <i>(date)</i>		8640	
Transfer from Service Charge Account during the year		2000	
Gross Interest received	40		
i) Less Tax	<u>8</u>		
ii) Net Interest		<u>32</u>	10,672
Less: Cost of redecoration of communal areas			<u>1,800</u>
Balance			8,872

**3. This statement is prepared on an accruals basis under the historical cost convention.**