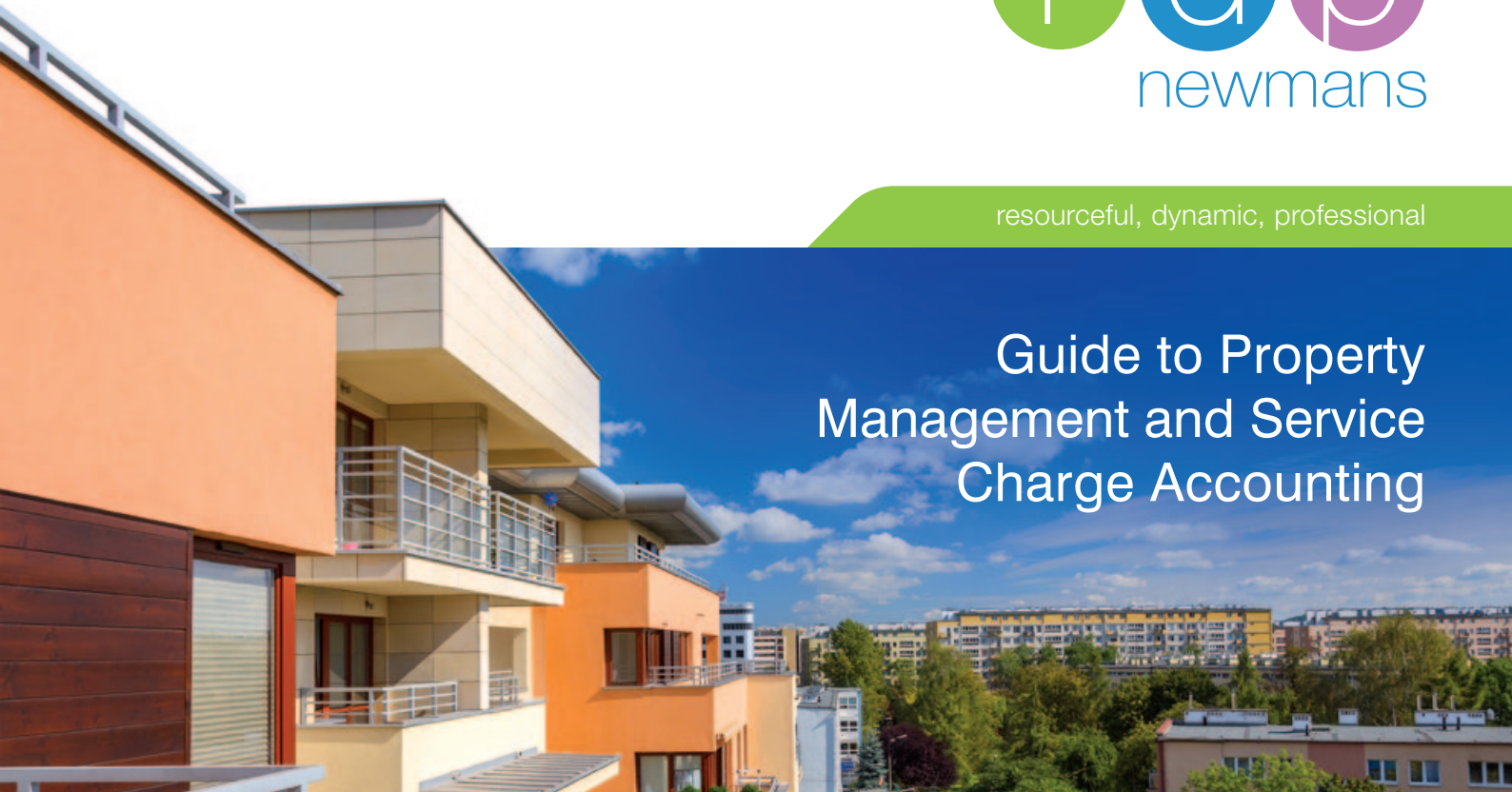




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Guide to Property Management and Service Charge Accounting



Contents

Introduction to Service Charge Accounts	1
Preparation of Service Charge Accounts	2
Annual Statements	3
Explanatory Notes and Certificates	3
Maintenance of Service Charge Records	4
Banking for Service Charge Accounts	5
Statutory Requirements	5
Account Investment	5
Deficits and Debts	5
Forecasting Debt	6
Reporting on Service Charge Accounts	7
Audit	7
Engagement to Deliver a Report of Factual Findings	7
Section 21 LTA 1985 Certificate	7
Limited Company Accounts	9
One Set of Accounts or Two	9
Freehold Owning Company	10
Payroll	10
Pension Contributions	10
Working with an Accountant	11

Introduction to Service Charge Accounts

Firstly, let us define service charges, where a managing agent or a resident management company (RMC) or a right to manage company (RTM) or indeed landlord spend money in respect of repairs, maintenance, insurance, improvements, services or costs of management on a block of flats, they have the right to collect an appropriate proportion from each of the individual residents within the block.

As this amount may vary according to the costs incurred in any particular year, this is called a “variable service charge”.

If the service charge is fixed under the terms of the lease or tenancy agreement, this is referred to as a “fixed service charge”.

A service charge account should normally be prepared on an annual basis and should record the costs that have been incurred on the property during that period of time, such that the lessees can see with clarity what sums have been expended and how their service charge demand has been arrived at.



Preparation of Service Charge Accounts

There is no recognised accounting framework for the service charge statement, but Section 21(5), Landlord and Tenant Act (LTA) 1985 sets out the requirements for a summary of costs to be prepared when requested by a lessee.

The guidance issued by the major accounting bodies together with the Association of Residential Managing Agents (ARMA) and the Royal Institution of Chartered Surveyors (RICS), recommends that service charge accounts are prepared on the accruals basis and the accounts should include a balance sheet for the service charge fund, as well as an income and expenditure account and explanatory notes.

As a minimum, where service charge monies are held on trust, the records must be capable of showing the amount held at bank for an individual property, service charge scheme, and the amounts demanded and paid in advance by, or due from, each lessee. In some instances, however, the lease will require the accounts to be prepared on a cash basis.

The service charge statement will always need to include details of the costs incurred in the accounting period in relation to the property in accordance with the property lease(s).

The service charge statement will also normally need to include notes to explain the figures, for example any movements on reserves representing costs not included in the income and expenditure account.



Preparation of Service Charge Accounts *(continued)*

Annual Statement

Current legislation does not state how soon the annual statement of accounts for service charges should be produced and issued to leaseholders after the year end. There may be a date in the leases or a statement such as that the information should be produced 'as soon as practical'. However, landlords and agents need to be aware of s20B, LTA 1985 which sets limits on the recovery of expenditure on services incurred more than 18 months before the relevant costs are demanded from the lessees.

Further, where a tenant requests a summary of costs in accordance with s21, LTA 1985, the landlord must provide the summary within one month of the request or within six months of the end of the accounting period in question, whichever is the latter. It is therefore best practice to issue the service charge statement within six months of the accounting year end.

There is no statutory requirement for comparatives. However, some leases require comparative figures to be given and in any case it is good practice and helpful to users of the accounts if prior year numbers and/or budgeted figures are included.

Explanatory Notes and Certificates

It is good practice to include a note if any of the service charge transactions are with a director or associate of a director of the landlord or the managing agent, for example if a director or person connected with the director is paid for carrying out maintenance work or preparing the company and service charge accounts.

The service charge statement should include any certificates, statements and signatures by or on behalf of the accountant, landlord or agent that are required by the lease. In some cases, the lease may also require a separate certificate or signed declaration as to the amount payable by individual lessees.

“Care should be taken to ensure that any certificate or statement follows the exact terminology used in the lease. If there is no such requirement, it is good practice for the landlord or agent, as applicable, to sign and date the statement to confirm approval of the accounts.”

Maintenance of Service Charge Records

When it comes to managing service charge accounts, there are a number of things all property management companies and landlords need to take into account to ensure their actions meet the best practice guidelines, as set out by 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).

These are as follows:

- Service charge money paid by leaseholders is trust money and should be held in ring-fenced designated bank accounts, as laid out in s42 of the LTA 1987.
- Landlords and managing agents are not required to have separate bank accounts for each individual property or the scheme, unless the lease requires one.
- Funds for each property or scheme must be easily and separately identified. It is considered a breach of trust to use service charge money from one property to pay the costs of another.
- If the lease or tenancy agreements sets out how service charges are to be accounted for, the costs that can be recovered and the periods of time for which the accounts should be prepared, then these requirements must be adhered to.
- This review should be prepared along the terms of the lease and should be proportionate to the size and nature of the property or scheme. This should be agreed by all parties in advance.

Although these rules are not included in a single piece of legislation, they are considered to be an important guide to ensuring service charge accounts are handled fairly and correctly. Failing to meet these requirements could potentially leave landlords and managing agents facing financial and legal issues.

Banking for Service Charge Accounts

Statutory Requirements

“By law, service charge money must be held in trust (S42 Landlord and Tenant Act 1987) and trustees must be either RMC/RTM directors, landlords or managing agents.”

In order to comply with these requirements landlords, RMCs and RTMs should create separate bank accounts for each scheme that are easy to identify. This is easily achieved by adding the name or number of the property to each new account that is opened.

Managing agents, acting on the behalf of other parties, should also open one or more designated bank account for service charge money, ensuring they are clearly identifiable with the name of the trust and client. Unlike RMCs/RTMs there are no statutory requirement for them to open separate accounts for each of their client's properties and there is no obligation to put surplus funds into a separate account.

Account Investment

Guidance from RICS Service Charge Residential Management Code recommends that reserves should be placed in an interest earning account. It also requires managing agents to write to their bank to inform them that the account should be ring-fenced.

Because all service charge accounts are held in trust, RMC/RTM directors and managing agents are also under a duty to invest the money in accordance with the Trustee Investments Act 1961 and the Service Charge Contributions Order 1988.

Deficits and Debts

As an agent acting on behalf of a trustee of a service charge account, you must ensure that a client's bank account does not run into debt. If funds for more than one property or scheme are kept in the same bank account and this account becomes overdrawn, because money is used to fund another property, this is a breach of trust.

Spending money on behalf of a property where insufficient service charges have been collected, thus causing the bank account to go into overdraft, is also a breach of trust.



Forecasting Debt

If an agent forecasts that a bank account is going to become overdrawn then they should discuss the situation with the RMC/RTM directors and take instructions. Some leases allow for the cost of taking an overdraft as an allowable expense.

Placing a service charge account into deficit or debt should be avoided at all costs. Managing agents and RMCs/RTMs who are concerned about debt on service charge accounts they manage should contact a professional for help immediately.

Reporting on Service Charge Accounts

Audit

Many leases contain requirements for service charge accounts to be prepared for each year and for them to be audited. The terminology governing annual statements of account, particularly in older leases, may be quite general, and auditing standards and practice have changed fundamentally over the years. The work effort required by current generally accepted auditing standards is unlikely to be what was anticipated when leases were drawn up; especially where the original lease dates back many years.

In practice, therefore, there is scope for the landlord or managing agent to consider whether the terms in the lease may be construed according to the meaning given to those terms at the time when the lease was drawn up. Whereas the term 'audit' in a lease made before 1980 would not have involved any particular procedures beyond those needed to assist in the preparation of the accounts, for an auditing professional or other qualified, practicing accountant to state now that an audit has been undertaken requires the professional to follow generally accepted auditing standards.

Where a lease that has been drawn up since 1980 refers to an audit then this is what should be undertaken.

If the terms of the lease require, or are construed as requiring, an audit, or the landlord or managing agent requires an audit to be carried out; International Standard on Auditing 800 (ISA 800) should be applied.

Engagement to Deliver a Report of Factual Findings

If the lease does not specify that an audit is to be undertaken, or if the landlord has construed the lease as allowing a form of engagement other than an audit, the normal arrangement is to engage an accountant to make a report of factual findings, although there may be circumstances where an audit is appropriate.

Section 21 LTA 1985 Certificate

If a lessee requests a Section 21 LTA 1985 certificate, or indeed if such a certificate is being issued without such a request, then that report must be signed by a registered auditor and an otherwise qualified accountant, will not be sufficient.



Limited Company Accounts



One Set of Accounts or Two

The generally accepted principal is that when the RTM or RMC operate a service charge account, they do so as an agent for the lessees, rather than in their own right. As such, the RTM or RMC can remain dormant and a separate service charge account should be prepared as described previously.

Although these accounts are dormant, they nonetheless need to be filed with Companies House and a Return, listing the officers of the company and where appropriate, its shareholders, is likewise required to be filed on an annual basis.

Dormant accounts for the RTM or RMC are often required to be filed with HM Revenue & Customs (HMRC) however, sometimes the tax authorities will merely request these on a sample basis rather than an annual basis, just to ensure the company has remained dormant.

Freehold Owning Company

If the freehold is owned by a limited company, which may or may not be owned by the lessees and a ground rent is charged by it to the tenants, that company is considered to be trading.

“Once again, these accounts will be required to be filed with Companies House, together with an Annual Return.”

As the company will be deemed to be trading, more detailed accounts will be required than the dormant set and a corporation tax return will need to be prepared and filed on an annual basis with HMRC. The corporation tax return will evaluate if, in fact, any corporation tax is payable by the company.

The freehold owning company may have income from ground rent as above, investment income, such as bank and building society interest, or indeed lease extensions, where it has received a lump sum for an extension of a lease to a particular lessee. All these items are taxable and need to be reported in the company's accounts and tax returns.

Payroll

Where expenditure contained within the service charges includes wages paid to an employee, such as a porter, pay as you earn (PAYE) needs to be operated on that payroll.

The general principle of PAYE is that tax is deducted from the individual's pay by their employer and handed over to HMRC on their behalf.

In addition to the tax and National Insurance Contributions (NICs) that are deducted from the individual's pay, the employer is required to make a NIC of their own, which is paid over, together with the deductions from the employee's pay, to the Collector of Taxes on a monthly basis.

Pension Contributions

If the service charge does employ the services of employees, with the commencement of auto-enrolment, they will be required to enrol eligible employees into workplace pensions schemes and make minimum pension contributions on their behalf.

Working with an Accountant

It is vital that you take care in choosing the right accountant to help you with managing service charge accounts. Here are our suggestions of what to look for:

- Your accountant ultimately needs to be someone you feel comfortable with and that you trust.
- You should also confirm that your accountant is appropriately qualified and affiliated with their national governing body. Many people may call themselves “accountants”, but they may not actually have any qualifications.
- In the case of service charge accounts, it is also important that they can demonstrate that they are able to carry out the tasks required. This should include the ability to provide testimonials or references from other clients.
- If you require specific support or services then it is important to check that the accountant offers these in advance.

At RDP Newmans, we work with managing agents, RMCs and RTMs of all sizes. We can provide an accounting package to suit your requirements; providing as little or as much assistance as you desire. Some of our clients prefer to outsource all of their service charge account requirements to us, whilst others maintain some of their functions in-house and we work with them to provide support and advice.

RDP Newmans have been in practice for more than 50 years and have built up a wealth of expertise and developed an industry leading reputation during that time. Our service charge account team has lots of experience working with property management companies and their managing agents to deliver the services they require.

Why not contact us to arrange a free consultation? This consultation is without any obligation and will help you go through your current position and future requirements. We would be pleased to provide you with a fixed fee quotation for the service you require.

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