

A man and a woman are sitting at a table, looking down at some papers. The woman has curly hair and is wearing a blue top. The man has short brown hair and is wearing a light blue button-down shirt. They appear to be in a room with large windows in the background, looking out onto greenery. The image has a blue semi-transparent overlay on the right side where the text is located.

HELP!

I DON'T
UNDERSTAND THE
SERVICE CHARGE
ACCOUNTS

An Introductory Guide for Anybody
who lives in a Block of Flats

**HELP!
I DON'T UNDERSTAND THE
SERVICE CHARGE ACCOUNTS**

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This is the second in our *Help!* series. The first one by Jim Thornton and Janette Leaf, about being a Company Director of a Flat Management Company, has been through two printings and we have just issued a second updated edition. If you would like a copy of *Help! They Want me to be a Director* then contact us through our website www.hscpm.co.uk or you can buy it through Amazon.co.uk

“I have found this booklet extremely helpful in advising Clients and know that one of my Clients in particular will be interested in obtaining a copy”

Solicitor

“Thank you again for the outstanding work you have done.”

Director, RTM Company

“I would like to take this opportunity to say that we have always found Hurford Salvi Carr both professional and helpful...”

Director, RTM Company

“On behalf of the directors, I would like to thank you both for the excellent service you have provided to us.”

Director, RTM Company

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INTRODUCTION

I can still remember the sinking feeling in my stomach when I opened the letter. It was from the Managing Agent and it demanded without any warning 20% of my annual salary in the next 21 days so they could decorate the outside of the building.

I was a young engineer in my first flat, and there was little I could do about it except borrow the money and pay up.

So I can completely sympathise with the problems of flat owners who find that they have to deal with issues outside their comfort zones, in areas where they have no expertise.

In the years since I had my wake-up call to the problems of living in a flat, the law has moved the balance of power a long way from the landlord towards the tenant. Even so, buildings have to be maintained and if they are not, the value of your asset declines. So how can you avoid unpleasant surprises and make sure you are getting value for money?

As Property Managers, we are expected to know not only about law and accounting, but also building technology, facilities

management, IT, communications, and services engineering. We cannot hope to be proficient in all of these areas, but we do know enough to know when we need to bring in a professional.

I have tried to put aside my years of experience, and write this as a layperson for a layperson. I hope this brief summary of the important issues, as I see them, will be a help to you before you think about calling in the professionals.

When we talk about ‘Service Charge Accounts’ we mean TWO things: (1) a *Statement of Income and Expenditure* AND (2) a *Balance Sheet*. You should start by looking at the Balance Sheet.

There are seven key questions you need to ask your Landlord, Management Company or Managing Agent. If you do not have the accounts for last year, perhaps the first one is ‘Where are the accounts for last year?’ However, we will take that as Question Seven, because there are some important issues to think about first. So the first question is: **What does the Balance Sheet look like Today?**

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Freeholder: the freeholder is the legal owner of the land on which the building is situated

Landlord: A person who rents land, a building, or an apartment to a tenant. This may not be a Freeholder, but an intermediate Landlord such as a Head Leaseholder of the upper floors of a Block of Flats.

LTA: Landlord and Tenant Acts, the main ones that concern people living in flats are the 1985 and 1987 Acts.

RMC: a Residents Management Company which is usually the second party to the lease between the Freeholder and the Leaseholder. Generally, the flat owner has the right to be a Member of the RMC, but has to pass on the Membership to the next owner. For more on the governance of RMCs, ask for our Booklet Help! They Want me to be a Director

CLARA: the Commonhold and Leasehold Reform Act 2002 which brought in the Right to Manage

RTM: a Right to Manage Company formed under CLARA

ICAEW: The Institute of Chartered Accountants in England and Wales.

The Code: normally refers to the RICS (Royal Institution of Chartered Surveyors) Service Charge Residential Management Code. This is approved by the Secretary of State for England under s87 of the Leasehold Reform, Housing and Urban Development Act 1993. (Extracts from the RICS Service Charge Residential Management Code are reproduced with permission of the Royal Institution of Chartered Surveyors which owns the copyright). The RICS Service Charge Residential Management Code is currently being re-written and the Third Edition is now available in draft but no date has been given for publication.



ICAEW TECH 03/11: Residential Service Charge Accounts: Guidance on Accounting and Reporting in relation to Service Charge Accounts for Residential Properties on which Variable Service Charges are Paid in Accordance with a Lease or Tenancy Agreement (© ICAEW, ACCA, ARMA, ICAS and RICS 2011). This follows a previous Technical Release 01/10 in October 2010 on Accounting for Service Charges. Quotations from TECH 03/11 are reproduced with the permission of ICAEW, and first published in October 2011 within TECHNICAL RELEASE 03/11 'Residential Service Charge Accounts'.

FIRST QUESTION:

THE BALANCE SHEET – WHAT DOES IT LOOK LIKE TODAY?

The first thing I want to see when we take over a building is the Balance Sheet. This gives me the Big Picture.

It is like looking at an animal skeleton: if you can see how the bones are linked together, you can begin to identify and then understand a bone you have found.






Or it is like looking at a London Tube map: if you can see how all the stations are linked, you can plan your journey from Hertford North to Penge West.



Or like looking at a wiring diagram: if you can see how the circuits link together, you can start testing in order to find where the fault lies.



If nobody can produce a Balance Sheet for you, you know you probably have a problem.

If I have some concerns about the Service Charge Accounts, I start by looking at the Balance Sheet to **identify**  the components of the Accounts, see how they are **connected** , and then I can see where we should start **testing**  to see if everything is as it should be.

But are you as a lessee entitled to see today's Balance Sheet? A Director of an RMC or RTM Company is certainly entitled to this information, so start by asking a Director if this is the case in your building. If your service charges are the responsibility of your landlord, then your starting point may have to be last year's accounts (see Question 7).

Who Invented Double Entry Bookkeeping?

According to Wikipedia: The earliest extant accounting records that follow the modern double-entry form are those of Amantino Manucci, a Florentine merchant at the end of the 13th century. Another old extant evidence of full double-entry bookkeeping is the Farolfi ledger of 1299-1300. Giovanino Farolfi & Company were a firm of Florentine merchants whose head office was in Nîmes who also acted as moneylenders to the Archbishop of Arles, their most important customer. Some sources suggest that Giovanni di Bicci de' Medici introduced this method for the Medici bank in the 14th century.

However, the oldest discovered record of a complete double-entry system is the *Messari* (Italian: Treasurer's) accounts of the Republic of Genoa in 1340. The *Messari* accounts contain debits and credits journalised in a bilateral form, and contain balances carried forward from the preceding year, and therefore enjoy general recognition as a double-entry system. By the end of the 15th century, the bankers and merchants of Florence, Genoa, Venice and Lübeck used this system widely.

Luca Pacioli, a Franciscan friar and collaborator of Leonardo da Vinci, first codified the system in his mathematics textbook *Summa de arithmetica, geometria, proportioni et proportionalità* published in Venice in 1494. Pacioli is often called the "father of accounting" because he was the first to publish a detailed description of the double-entry system, thus enabling others to study and use it. There is however controversy among scholars lately that Benedetto Cotrugli wrote the first manual on a double-entry bookkeeping system in his 1458 treatise *Della mercatura e del mercante perfetto*.

What is a Trial Balance?



According to Wikipedia: “In the double-entry accounting system, each accounting entry records related pairs of financial transactions for asset, liability, income, expense, or capital accounts.”

If you list out the accounts with their totals, you have a Trial Balance and it looks like this:

	DR	CR
Asset: Cash in the Bank (Reserves + Income)	1,500	
Liability: owed to Cleaner		100
Capital Account: Reserve Fund		1,000
Income: Service Charges		500
Expenditure: Cleaning	100	
	1,600	1,600

The Balance Sheet items are normally at the top, and the Income & Expenditure items at the bottom.

Debits are recorded on the left side of an account in a ledger. Debits increase balances in asset accounts and expense accounts and decrease balances in liability accounts, revenue accounts, and capital accounts.

Credits are recorded on the right side of an account in a ledger. Credits increase balances in liability accounts, revenue accounts, and capital accounts, and decrease balances in asset accounts and expense accounts.

So if you debit one account and credit another account with the same amount, then at all times the total debits will be equal to the total credits for all accounts in the general ledger.

Double-entry bookkeeping is not a guarantee that no errors have been made – for example, the wrong ledger account may have been debited or credited, or the entries completely reversed.

You would normally make sure the entries that debit and credit related accounts include the same date and identifying code in both accounts, so that in case of error, each debit and credit can be traced back to a journal and transaction source document.

Debit accounts are asset and expense accounts that usually have debit balances, i.e. the total debits usually exceeds the total credits in each debit account.

Credit accounts are revenue (income, gains) accounts and liability accounts that usually have credit balances.

Suppose you and I live in a small block of flats, and we have agreed with the other owners that we will collect in the cash and spend it on maintaining the building. If we collect in all the Service Charge demands and pay all the bills for the year, we will either have cash in the bank or we will need a whip round.

🔊 So in its simplest form, our Building Pot of Cash at the end of the year can be defined as the difference between our income and expenditure: **Pot of cash = Income - Expenditure**. Or, as we might say in a more general form: **Equity = Assets – Liabilities**.

When I was seven, my mother, who had trained as a banker, gave me a cash book and she told me the left page was 'Debit' (which is where I put my two shillings pocket money) and the right page was 'Credit' (which is where I listed out the sherbet fountains and Wagon Wheels I bought).

This was my '**Cash Book**', and you might ask: ***how do you know you have got it right?*** My answer might be: ***'well, I still have sixpence in my pocket, which is the difference between the total on the left page and the total on the right page.'***

'Fine', you might say, 'but isn't there a system in addition to your little cash book and back pocket that would make checking easier?'

This is where we should now talk about double-entry book-keeping.



Double-Entry book-keeping means that *every time you enter a Credit somewhere, you must enter an equal amount somewhere else as a Debit, and the sum of all your Credits must always equal the sum of all your Debits.*

Software packages now will simply not accept unbalanced entries. There will be some reading this who will remember month end reconciliations before spread sheets. You stayed up until 2am at the end of the month trying to find the missing 6p on the Trial Balance.



What do we Debit and what do we Credit?

1. **Assets Accounts:** debit increases in assets and credit decreases in assets
2. **Capital Account:** credit increases in capital and debit decreases in capital
3. **Liabilities Accounts:** credit increases in liabilities and debit decreases in liabilities
4. **Revenues or Incomes Accounts:** credit increases in incomes and gains and debit decreases in incomes and gains
5. **Expenses or Losses Accounts:** debit increases in expenses and losses and credit decreases in expenses and losses

	Debit	Credit
Asset	Increase	Decrease
Liability	Decrease	Increase
Income (revenue)	Decrease	Increase
Expense	Increase	Decrease
Capital	Decrease	Increase

A simple Balance sheet may have only two entries: Cash and Reserves

Suppose you own one of five flats in a building owned by Rubbish Landlord Ltd. You called a residents meeting in your flat, and you have all have decided to form a Right to Manage Company to take over the management yourselves. You have all agreed to chip in £250 into the Pot for the costs of the RTM process. At the meeting, three people hand over cheques, and the other two promise to give money later.

Your Balance Sheet looks like this:

Cash in the Bank	750
	750
Equity or Reserves	750
	750

Top and Bottom will always be the same, they will always be in 'balance'. This tells you that your Pot is worth £750, and the cash is in the bank.

But of course while this is true, we know it is not the whole story. Two people promised to pay, but have not yet done so. Our Pot is really £1,250, so our Balance Sheet should really be:

Debtors (people who owe us money)	500
Cash in the Bank	750
	1,250
Equity or Reserves	1,250
	1,250

You then ask Sue, Grabbit and Run Solicitors to form an RTM company for you, and receive their bill for £500. Your Balance Sheet now looks like this:

Debtors (people who owe you money)	500
Cash in the Bank	750
Creditors (people to whom you owe money)	-500
	750
Equity or Reserves	750
	750

🔊 This is the Basic Model: your Building Pot is what you have or can get your hands on, less what you have to pay out.

Equity = Assets – Liabilities.



So the reason we want to see a Balance Sheet first of all, is that this tells us:

- The size of the Pot
- Where the bits of the Pot are if they are not in the bank

Remember the Balance Sheet is only one part of the Service Charge Accounts, but it gives us the Big Picture. Once we have seen what this looks like, we can move on to look at the Income & Expenditure.

This is the usual way of presenting a Balance Sheet – we want to see what the enterprise is worth, its 'Net Worth'. In this case, after paying the bill it will be £750:

ASSETS	
Debtors (people who owe you money)	500
Cash in the Bank	750
LIABILITIES	
Creditors (people to whom you owe money)	-500
	750
Reserves	750
	750

However, the Service Charge accounts belong to the lessees, so you can argue that the Net Worth of the enterprise is nil. So it would be perfectly reasonable to present your Balance Sheet so that it totalled 'Nil' above and below.

The ICAEW Note TECH 03/11 recommends as follows:

- The service charge accounts are prepared on the accruals basis (Clause 2.2)
- The accounts should include a balance sheet for the service charge fund (Clause 2.2)
- The accounts should include an income and expenditure account and explanatory notes (Clause 2.2)
- It is good practice to include comparatives (the figures from the previous year (Clause 2.6)
- It is best practice to issue the service charge statement within six months of the accounting year end (Clause 2.5)
- It is good practice to include a note of any transactions with directors or associates (Clause 2.7)



What are 'Accruals' and 'Prepayments'?

- **Accruals** are costs incurred during the year to date, but not yet billed. So if the electricity is billed quarterly and the last bill was two months ago, you would expect to see an estimated accrual for two months probable cost of electricity **added to** the expenditure. If not, you will think you are using less electricity than you actually are.
- **Prepayments** are costs included in the figures which relate to the next few months. So if you have paid the quarterly lift maintenance in advance, there needs to be a **deduction** from the expenditure. Otherwise, you will be asking why the lift expenditure is over budget.
- **Journal Entries** is the name given to adjustments, such as accruals and prepayments. If your Managing Agent gives you a **Nominal Ledger** (this lists every item of expenditure, and might be called a General Ledger) you will see Journal Entries amongst the bills, invoices, cheques and payments.

Rubbish Landlord Ltd has produced some Service Charge Accounts, and they look like this:

Year Ending 31 December:		2013
Income & Expenditure		
Service Charges Collected		£2,700
Expenditure:		
Cleaning	£750	
Electricity	£127	
Gardening	£225	
Management & Accounting	£1,000	
Repairs	£3,746	
	£5,848	
Deficit for the Year:		-£3,148

Is that it?

If so, we need to demand a Balance Sheet. However, there is a basic question we need to ask Rubbish Landlord Ltd about this Statement of Income & Expenditure.



The basic question we ask is:

Is this Statement of Income and Expenditure prepared on a Cash or an Accruals basis?

It looks as though from the wording they may be on a cash basis: it says 'Service Charges Collected' which implies that this was the cash received. But what would this number have been if everybody had paid up? Does any of this income apply to a previous year?

Again, on the expenditure: was this simply what was paid out? If the December electricity bill arrived in January and was paid in February, in which year is the expenditure taken?



You query this with Rubbish Landlord Ltd, but they simply point you to the Landlord & Tenant Act (LTA) requirements.

It is true, as acknowledged by ICAEW TECH 03/11 that: *"The requirements in s21(5) [LTA 1985] do not equate to accruals-based accounts and there is no requirement for a balance sheet or comparative figures."* (Appendix A Clause 4).



You keep up the pressure on Rubbish Landlord Ltd (perhaps with some hint of asking a Property Tribunal for some help, after checking the lease wording) and they reluctantly send you the second part of the Service Charge Accounts, the Balance Sheet. It looks like this:

Balance Sheet at 31 December 2013:	
Cash in Bank	£165
Owed by Lessees	£3,897
Owed to Landlord	-£4,658
Owed to Contractors	-£2,731
	-£3,362

This is obviously not a proper Balance Sheet, because it does not 'balance' with anything. It also does not add up.

However, even with the totalling error, we can guess what the bottom part should look like:

Reserves	-£214
Deficit for the Year <i>(see page 11)</i>	-£3,148
	-£3,362

So we have identified a framework, a big picture. It raises a load of questions, but we can now see how Rubbish Landlord Ltd has connected things together, and so now we can ask some questions:



- What were the 'Opening Balances' on 1 January 2013? In other words, what did the Balance Sheet look like last year?
- Which number(s) is wrong, or is the total wrong?
- If the Income and Expenditure is on a cash basis, what would it look like if we re-worked it on an accruals basis?
- What would the Balance Sheet look like then?
- Can we see the Bank Statement showing the £165 in the bank at the year end?

For comparison, this is what TECH 03/11 recommends as an example of what the Income & Expenditure part of the Service Charge Accounts could look like:

Magnificent Mansions Management Ltd
Service Charge Income & Expenditure Account
For the Year Ending 31 December 2013

	Notes	2013	2012
		£	£
Income relating to the period			
Service Charges		£24,000	£20,000
Gross Interest		£156	£234
Less Tax	2	(£31)	(£47)
Other Income (give details)			
Total Income receivable		£24,125	£20,187
Expenditure relating to the period			
Repairs and maintenance:			
General repairs and maintenance		2,124	2,153
Lift repairs and maintenance etc		1,425	934
Cleaning		2,449	2,355
Major works:			

External decoration			
Lift works (new lift suspension ropes)		9,000	
Grounds Maintenance:		1,213	1,056
Utilities:			
Electricity and lighting		1,193	1,146
Water		100	100
Professional fees:			
Independent accountant's fee		350	300
Accountancy costs		700	700
Managing agent fees		2,400	2,200
Insurance - Buildings[/Terrorism]		2,209	2,112
General Expenses		482	55
Transfer to Roof fund	6(a)	4,000	2,500
Total expenditure		27,645	28,111
Deficit		£(3,520)	£(7,924)

This building is not very good at budgeting.



What do we look for in the Balance Sheet?

1. Something Odd or Unusual: now we know what the usual items are, we can spot anything out of the ordinary. A 'Suspense Account'? A 'Contentious Items' Account? These are the sort of places where sometimes bodies are buried.
2. However, if you are trying to hide something, you will normally aggregate it with something else that looks more innocent. So next you might look at a breakdown of the Debtors. Does any particular person owe a lot of money? Is there a Debtor who is not a flat owner? Look at the list of Aged Debtors to see how long some of the debts have been outstanding.
3. Similarly, look at the breakdown of the Creditors, and the list of Aged Creditors.
4. Next, you may see Items like Other Debtors and Other Creditors. What are these?
5. Are the Accruals and Prepayments high relative to the turnover? If so, why is this? What have we prepaid, and for what liabilities have we accrued?
6. What happens if the Landlord or Managing Agent or Management Company refuses to give this information? You should then consider whether you need the help of the First-Tier Tribunal, Property Chamber, the FTT, formerly known as the LVT. However, do remember that Data Protection means that there are restrictions on the release of some information.



What is a Bank Reconciliation?

A **Bank Reconciliation** is a process that explains the difference between the bank balance shown on the bank statement, as supplied by the bank, and the corresponding amount shown in the accounting records at a particular point in time.

Reasons for differences:

- Cheques that have not been presented
- Somebody has paid into the bank account by electronic transfer and forgotten to tell you
- Somebody has paid in by mistake, or taken out by mistake (generally a bank error)
- The Bank has made a charge for a service

It may be easy to find the difference by looking at very recent transactions, but if not, you will have to work back and match up the transactions and see what remains on both sides as unmatched.

To minimize the work, do frequent reconciliations. Alternatively, you can use software that allows you to move transactions around easily so that the Bank Account at the Bank always matches exactly the Bank Account in your software. Auditors do not like this, but why should the lessees pay for the cost of numerous bank reconciliations?

Electronic payments

Cheque fraud has reduced in recent years, but electronic fraud has increased. The current scam is where the accounts department receives a phonecall from a contractor saying they have changed their bank account details.

Schools have been hit by this one: the fraudster drives past a school, sees building work going on, and the contractor's name board on the scaffolding. Claiming to be the contractor, the fraudster phones the school, gives his own bank account details, and in too many cases the next architect's certificate was paid and lost.

Even where procedures are in place, it can still happen. One accountant asked for confirmation in writing, and received a letter on the contractor's paper – but the fraudster had changed the phone number. So when the accountant phoned to double-check, the fraudster confirmed all was well.

You can get software to identify the name of the account to which you are remitting, but it is very expensive. At present, banks only require the sort code and account number of the account to which you are remitting. If you make a mistake, there is nothing

the banks can do, except ask politely on your behalf for the money to be returned. They have no power to do anything, and the police have no time for 'small' frauds. A recent one we are aware of for £1.4m was turned down by the Fraud Squad as being too small.

Having said that, the Hertfordshire Fraud Squad did help us with one for £10k, and we got a conviction at the Old Bailey, but we were told this was because we had done all the work to make it easily comprehensible to a lay jury (and the CPS).

You need to ask your landlord or managing agent what procedures they have in place to prevent electronic fraud, and what insurance they have in place.

Until the banks can (a) confirm the name on the bank account to which you are remitting and (b) have the right (for say 24 hours) to reclaim funds sent in error then you should not insist to your landlord or managing agent that all payments should be made electronically. Our bankers and our auditors confirm that many cautious companies are continuing with cheque payments, and neither of them can blame them.

SECOND QUESTION: HOW MUCH CASH IS IN THE BANK?

🔊 The Balance Sheet will tell you how much cash is in the bank.

🔊 How do you know this is correct? The only way you will know is to see a Bank Statement. But you need to be certain that the only cash in this account belongs to the building, and is held on trust for the lessees.

It is probably rare now for managing agents to operate one bank account and analyse their buildings in their accounting software. Some landlords may still hold the cash for several buildings they own in one account.

Section 42 of the Landlord & Tenant Act ("LTA") 1987 requires service charges to be **held in trust**. Where a s42 trust is established, the trustee is the legal payee, which could be the Landlord or the Management Company. ICAEW TECH 03/11 notes that s42 requires variable service charges to be held in trust but says: *"It does not specify what this would mean in practiceif service charge monies are held in the bank account of the RMC or RTM, they may be taken as the company's*

assets in any liquidation ... It is therefore best practice for landlords or their agents to open a separate bank account for each property/development. That bank account should have the word 'trust' or 'client' or the name of the property in its title." (Appendix A Clauses 8,10)

What about Reserve Funds? TECH 03/11 says: *"There is no requirement in the Code to open separate bank accounts for reserve funds apart from current service charge monies unless the lease requires it or a client/landlord prefers this arrangement."* (Appendix A Clause 13)

🔊 So if you have any doubts, insist that the funds are transferred into a bank account with confirmation from the bank that this is a trust account.

Since 2008, there has been some nervousness about the safety of cash deposits. One building's Directors asked us to split their Reserve Fund between three reputable banks. They gave us a list of eight in order of preference, and since they all worked in the City, this made interesting

reading. However, it was not as easy as we thought. When interest rates return to normal, then where a Landlord or RMC or RTM can or should put its cash held on trust will become more of an issue.

Can I ask to be allowed to monitor the bank account?

A lessee is unlikely to have this right in the lease, and apart from the practical difficulties, there are issues of data protection. Directors of RMCs and RTMs would expect to be provided with these if they request them from their Managing Agent. However, apart from verifying what it says in the Balance Sheet, a Bank Statement gives little information on its own.

Remember that the Balance Sheet in the formal accounts is 'historic' - it tells you what was in the bank on the date of the Balance Sheet. This may well be nine months ago, and a lot could have happened to the cash in nine months.

This is why you need to ask for a Balance Sheet if not today, then at least at the end of last month after the bank account has been reconciled.

Check that bank interest is being paid net: if it is paid gross, there is a requirement to complete a Trust Tax Return, and the tax rates are punitive.

How do we make a Trust Tax Return?

The guidance on the HMRC website is under Corporation Tax. Go to Charities, Organisations and Tax Agents, and then under that Unincorporated Organisations and Corporation Tax, and at the bottom you will see the guidance on Property Management Companies.

Tax for Trusts (the interest you get on your bank deposit account) is handled by:

Trusts & Estates

Ferrers House, Castle Meadow Road


Nottingham NG2 1BB

Telephone: 0845 604 6455

THIRD QUESTION: CAN WE PAY OUR BILLS?

On the Balance Sheet, you will see the total of the 'Current Liabilities'. The 'current' ones are distinguished from the 'Long-Term', but it would be unusual for a Service Charge Balance Sheet to have any Long-Term liabilities, such as a five year loan.

The Reserve Fund is normally treated as a Long-Term liability, because it is not thought of as being payable in the short term. If you think the Reserve Fund should be a Long-Term Asset, not a Liability, then have a look at the box on Trial Balances on page 6.

 **The number you should look for is the 'Trade Creditors', or simply 'Creditors'.** This shows how much you owe the cleaner, the lift maintenance contractor, the electricity supplier and so on.

If your landlord or managing agent is paying the bills reasonably promptly, then this number should be no more than about 8-12% of the annual budget. However, if you are paying the insurance premium by monthly Direct Debit, then the Creditors total will be distorted by the amount to be paid over the next few months.

Here is a Balance Sheet for Magnificent Mansions:

ASSETS	
Current Assets	
Accounts Receivable (Debtors)(Owed by Lessees)	61,961
Cash at bank and in hand	
Deposit account	8,010
Bank - 0210985	4,900
Bank High Int - 1732721	395,019
Total Cash at bank and in hand	407,929
Total Current Assets	469,890
Current Liabilities	
Accounts Payable (Creditors) (Owed to Contractors)	28,611
Other Current Liabilities	
Reserve Fund - Car Park	57,703
Reserve Fund - Common Parts	337,315
Total Other Current Liabilities	395,019
Total Current Liabilities	423,630
Net Current Assets	46,259
Long Term Liabilities	
Deposit for Flat 105	2,158
Deposit for Flat 310	5,847
Total Long Term Liabilities	8,006
NET ASSETS	38,254
CAPITAL AND RESERVES	
Surplus for the Year	38,254
LEASEHOLDER FUNDS	38,254

Although there is a great deal of cash in the Bank, it is in the accounts as a Reserve Fund. If they only have £4,900 in the bank current account to pay £28,611 worth of contractors and suppliers, then they will need to chase up the arrears of £61,960.

Sinking funds, reserve funds and depreciation

The lease will say whether or not the landlord or Management Company can collect a Reserve Fund, and will state the purpose for which payments can be collected.

The LEASE website says: 'A *reserve or sinking fund* is a fund collected over a period of time to be used for a specific purpose such as a large scheme of work. This could be roof renewal, external redecoration or other large expenditure. The aim is to split the cost over a longer period of time to avoid a very large bill in one service charge year. Your landlord can only set up such a fund if the lease allows them to.'

The RICS Information Paper Sinking funds, reserve funds and depreciation charge [RICS February 2009] says:

"Sinking funds, reserve funds and depreciation charges are all ways of making financial provision for future repairs or replacements. Fraught with financial and administrative difficulties, a major problem historically has been understanding the type of arrangement provided for (intentionally or otherwise) under the terms of the lease and knowing who 'owns' the sums collected through the service charge."

A **Sinking fund** is a replacement fund where the owner builds up a fund to pay for repair and replacement of major items of plant and equipment.

A **Reserve fund** is a fund built up to equalise expenditure with regularly recurring service items to avoid fluctuations in the amount of service charge payable each year.

A **Depreciation charge** enables the owner to include an amount in the service charge to reflect the 'cost' of the annual depreciation of plant and equipment and is based on the initial cost of an installation, rather than the future cost of replacement or repair."

So a 'sinking fund' is a one-off 'replacement fund' but a 'reserve fund' is a 'smoothing out' fund to spread the cost of intermittent repairs that may take place every few years.

If the lease does not make it clear, then the Landlord or the Management Company will have the responsibility to decide how the Reserve Fund should be spent.

FOURTH QUESTION: HOW MUCH IS IN THE RESERVE FUND?

Your building may have several Reserve Funds. Here is another way of presenting the Magnificent Mansions Balance Sheet:

ASSETS		
CURRENT ASSETS		
Cash at bank and in hand	407,929	
Net Balance Due from Lessees	53,387	
Prepayments	7,824	
Deficit for Year Recoverable from Lessees		
Other Debtors	750	
Total Current Assets		469,890
CURRENT LIABILITIES		
Creditors	26,273	
Accruals	2,338	
Net Balances due to Lessees	38,254	
Other Creditors		
Total Current Liabilities		66,865
NET CURRENT ASSETS		
		403,024
Long Term Liabilities		
Deposit for Flat 1	2,158	
Deposit for Flat 2	5,847	
Total Long Term Liabilities		8,006
NET ASSETS		
		395,019
CAPITAL AND RESERVES		
Reserve Fund - Car Park		57,703
Reserve Fund - Common Parts		337,315
RESERVE FUNDS		395,019

RESERVE FUND MOVEMENTS		
Reserve Fund - Car Park		
Opening Balance		63,566
Transfer to Reserves During the Year		10,000
Transfer from Reserves During the Year		(15,863)
Closing Balance		57,703
Reserve Fund - Common Parts		
Opening Balance		298,590
Transfer to Reserves During the Year		40,000
Transfer from Reserves During the Year		(1,275)
Closing Balance		337,315



It is a convention that it is assumed you will know which numbers are negative. This is fine for the professionals, but not so for lay people. If you remember **Equity = Assets – Liabilities** it should become clear.

Why is a Reserve Fund important?

One of the first questions on a sale is: 'how much is in the Reserve Fund?' and the reason for this is that if there is nothing set aside, the purchaser will want the price reduced. When buying, the purchaser needs to be sure that they will not be faced with large bills to pay for repairs.

Developers sometimes try and keep service charges artificially low to help sales, and one way to do this is to cut out the Reserve Fund collection. If an off-plan purchaser sells the flat after a month for a 10% profit, it is only fair that they should contribute to the 'depreciation', even for the month that they owned it.

Can we use the Reserve Fund to cover for people who are not paying their Service Charges?


There is an important difference between the cash in a separate Reserve Fund bank account, and the amount shown on the Balance Sheet as a Reserve Fund. ARMA-Q says that a Managing Agent must not use Reserve Funds to finance year-end deficits on the Service Charge account if the Lease does not permit borrowing from the Reserve Fund. It says nothing about how you are supposed to finance arrears.

When is the Reserve Fund collected if 10% of the Lessees have not paid up? The normal convention is to assume that the last cash collected is the Reserve Fund, so until everybody has paid up, you do not transfer from the Income & Expenditure Account to the Reserve Account. If it was demanded on an application as Reserve Fund, then the advice is that it is 'in' the Reserve Fund from the day it is paid. Transfers in and out of a Reserve Fund will then be controlled by the provisions of the lease.

A separate Reserve Fund Bank Account can probably not be raided to finance arrears. Therefore a landlord or Managing Agent or RMC or RTM director needs to look carefully at the process whereby Reserve Funds are transferred from the Income & Expenditure Account into the Balance Sheet and the bank. They also need to be careful in calculating whether there is sufficient **cash** in the Reserves for major works.

What is ARMA-Q? ARMA-Q is the new self-regulatory regime for ARMA members. It aims to raise standards across the sector and places consumers at its heart. It will take effect from January 2015, and there are details at www.arma.org.uk. Appendix 5 has some relevant extracts.

FIFTH QUESTION: WHAT DO WE NEED TO SPEND ON THE BUILDING OVER THE NEXT FIFTEEN YEARS?

 **You will want to be satisfied that the amount that is being collected for the Reserve Fund will be sufficient when the time comes.** Appendix 3 sets out the RICS Service Charge Residential Management Code position on this.

You should ask to see a copy of the Property Maintenance Plan (“the PMP”) and this will show you what has been included and how much the Surveyor thinks it is going to cost.

PMPs can come in three sizes, and all can qualify under the Code:

- **The Rolls-Royce:** prepared by a substantial Building Surveying Practice, running to many pages, including detailed projections of inflation, RPI and interest rates, setting out the lease provisions, background information on construction and building services, and ensuring that in no way could there ever be a claim against the Surveyor’s professional Indemnity Policy. (most expensive)
- **The Single Sheet of Paper:** this lists the main items and current costs, and spreads the probable expenditure out over a period of 15 or 20 years. From this, a sensible annual collection can be calculated, and should be re-visited every year or two. It can be prepared by the Property Manager, and will come with a number of caveats. (possibly free)
- **The Common Sense:** if there is a risk of a challenge, or there is need for a bit more certainty, then paying a Building Surveyor to prepare a half-way house is the best option. It will still come down to a single sheet of paper, but the accompanying schedules should demonstrate to a third party how the numbers have been derived.

Site: Magnificent Mansions			Survey Date: December 2013				
Item	Element	Work Required	Total Cost	Day One	2014	2015	2016
			Over 20 Yrs	Cost	Cost	Cost	Cost
1.1	Terrace and balconies	Stain timber decking to terrace and balconies every 5 years from 2012	£5,050	£2,200			
2.1	Facades	Redecorate all external decorative surfaces every 5 years from 2012	£25,900	£11,250			
2.2		Allowance for re-pointing and replacing a proportion of the ground floor wall tiles in 2022	£1,250	£1,000			
2.3		Scaffolding to carry out Ext Works	£39,150	£17,000			
3.1	Internals	Redecorate all internal decorative surfaces including walls, ceilings, doors, handrails and underside of the stairs every 5 years from 2012	£20,700	£9,000			
3.2		Varnish apartment doors and landing doors in 2022	£950	£750			
3.3		Allowance for repalcing 20% of stone flooring where broken etc in 2022	£4,700	£3,800			
3.4		Replace PVC flooring and nosings in 2024	£7,600	£5,800			
4.1	Mechanical & Electrical	Allowance for replacing Lift in 2025	£0	£50,000			
4.2		Entryphone System - Replace system in 2022	£6,200	£5,000			
4.3		Water Booster Pumps - Replace in 2025	£0	£6,500			
4.4		Fire Alarm System - Replace main panel in 2028	£0	£1,500			
4.5		Fire Alarm System - Replace smoke detectors in 2022	£750	£600			
Total Expenditure			£112,250	n/a	£0	£0	£0
Reserve Fund Collected Each Year			n/a	n/a	£16,000	£16,000	£16,000
Running Reserve Fund				n/a	£19,125	£35,125	£51,125

2017	2018	2019	2020	2021	2022	2023	2024
Cost	Cost	Cost	Cost	Cost	Cost	Cost	Cost
£2,350					£2,700		
£12,000					£13,900		
					£1,250		
£18,150					£21,000		
£9,600					£11,100		
					£950		
					£4,700		
							£7,600
					£6,200		
					£750		
£42,100	£0	£0	£0	£0	£62,550	£0	£7,600
£16,000	£17,000	£17,000	£17,000	£17,000	£18,000	£18,000	£18,000
£25,025	£42,025	£59,025	£76,025	£93,025	£48,475	£66,475	£76,875

NOTE:

1. All costings are based on the surveyor's estimates with reference to previous quotations and the BCIS Building Maintenance Price Book.
2. The costings take into account costs for materials, labour, taxation, overheads and profit of the contractor, and are uplifted by the following yearly tender price inflation forecasts: 2014 : 2% ; 2015 : 2.5% ; 2016 and each subsequent year thereafter : 3%
3. The above expenditures could be subject to Landlord & Tenant Act 1985 Section 20 consultations
4. No account has been taken of any bank interest earned which will be added to the reserve fund over the period.

Taking on the Vested Interests

Any Manager who wants to keep daily control of his business cash will sometimes find he is up against vested interests who have a different agenda. The Auditors want all the numbers to drop easily into their standard system, and the in-house Accountants want to be indispensable. So they both tend to defend their patches and do not really like Managers to be able to get information themselves.

The Auditor wants there to be a clean audit trail, so no messing with past figures. The in-house Accountant may prefer to spend time reconciling bank accounts rather than have a system that gives the manager instant information.

There are good reasons why Auditors and Accountants do things the way they do, but a director of a Residents Management Company (or a Property Management Company) needs to insist that accounts

are prepared for the benefit of the people using them, not the people preparing them or checking them.

In most cases the accounts of a Residents Management Company are simple, and easily verified, so they ought to be transparent and up to date. Make sure your Managing Agent is using accounting software that suits you, not them, and gives you as a minimum:

- Bank account printouts that can easily be reconciled with the Bank Statement
- Debtors Statements that are up-to-date for known transactions
- Creditors Statements that include contentious (but unpaid) bills

Cash is the life-blood of any company or organisation, and if somebody tries to prevent you monitoring it and verifying it, then alarm bells should be ringing loudly.

SIXTH QUESTION: WHAT IS THE LIKELY OUTCOME AT THE END OF THIS YEAR? SURPLUS OR DEFICIT?

The first five questions have been about the Balance Sheet, but now we turn to the Income & Expenditure. When you ask this question, the answer may well tell you a bit about the accounting package the Landlord or Managing Agent uses, and how they do their accounts.

If you run your own business, you want to know where you are each day, so you can plan ahead and avoid surprises. We believe that a Landlord or Director needs to know the following:



- **Who owes service charges today?**

The answer to this will depend on how and when they reconcile the bank account. Any cheques received will be entered, but Direct Debits and electronic transfers need to be confirmed by a bank reconciliation. You should expect to have monthly bank reconciliations.

- **How much do we owe suppliers today?**

When a bill comes in from a contractor or supplier, there will be a process of approval before it is entered. It is likely that a creditors figure is a couple of weeks out of date, but it should not be any more than that.

- **What is the cash book balance?**

The cash book says what should be in the bank when all the cheques are cleared.

Your Managing Agent should be able to produce for you a spread sheet showing the income and expenditure for the year to date, and the Budget for the year to date. However, the raw data from their computer may not be helpful, so you need to check whether the figures include **accruals and prepayments** (see Page 14).

Once you have a reasonably accurate figure for the year to date costs, these can be set beside the Budget for the year to date for comparison.

The Budget vs Actual tells you how you are doing so far, and as you get past the half-way point in the year, you can add another two columns for (a) the full year Budget and (b) the estimated total expenditure at the year end.

Setting a Budget is an art, not a science. It is perfectly legitimate to look at the last few years and project forward: there is no requirement to do a zero-base exercise every year.

The RICS Service Charge Residential Management Code says:

8.7 Budgets should be prepared as carefully as possible, using the best possible information available... It is better to estimate prudently and to include a contingency sum.

8.9 You should base budgets on a professional assessment of costs, The items in the budget need not necessarily be supported by quotations or estimates ... but should be reasonable having regard to the age and condition of the building and plant and work contemplated.

8.10 You should avoid giving low forecasts....



SEVENTH QUESTION: WHERE ARE THE ACCOUNTS FOR LAST YEAR?

So we are back to a question that perhaps we should have asked first of all: are you looking at a set of Service Charge Accounts, and trying to understand them, or are you worried because there are none to look at?

If it is more than six months after the year end, and you do not have any service charge accounts, you can serve a **s21 Notice** on the Landlord or the Management Company.

ICAEW TECH 03/11 says: *"There is no recognised accounting framework for the service charge statement. Section 21(5), LTA 1985 sets out the requirements for a summary of costs prepared in accordance with a request made by a lessee under s21(1), but the requirements do not equate to accruals based accounting and there is no requirement for any sort of balance sheet."* (Clause 2.1)

Section 21 summaries must be certified by a qualified accountant if there are more than four dwellings, which raises the question: **do Service Charge accounts have to be audited?**

The lease is the 'contract for the administration of service charges' and if it says an audit is required, then in principle an audit should be carried out.

However, audit requirements have changed over the years, and an 'audit' is now very expensive. The first Auditing Standards and Guidelines were published in April 1980. So TECH 03/11 comments: *"Where a lease that has been drawn up since 1980 refers to an audit then this is what should be undertaken."* (Clause 3.1.4)

If an audit is necessary, then the framework is set out in International Standard on Accounting 800 (ISA 800) *Special Considerations – Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*.

If an audit is not required by the lease, then TECH 03/11 sets out the alternative: *an examination resulting in a report of factual findings on the service charge accounts*. A Statement of Factual Findings is less expensive, and TECH 03/11 says: *"although a report of factual findings does not express the assurance that would follow from an audit or a review made in accordance with applicable International Standards, the statement gives comfort that the items listed in the report have been checked by a qualified accountant independent of the landlord/managing agent."* (Appendix D Clause 8)

What happens if the Landlord ignores the s21 Notice? You are unlikely to find an appropriate party willing to take action against the Landlord, but it does count against a Landlord at a Property Tribunal.



Do the Accounts have to be in a certain format?

TECH 03/11 states: *"The main statutory provisions for regulating variable service charges are contained in LTA 1985 and LTA 1987, which provide a framework to support tenant's rights under their leases. The Commonhold and Leasehold Reform Act (CLRA) 2002 contained provisions to update parts of both LTA 1985 and LTA 1987 but the sections relating to accounting for and reporting on variable service charges (mainly s21, LTA 1985), and the holding of service charge contributions in a designated bank account (new s42A, LTA 1987) have not yet been implemented and it seems unlikely that they will be in the near future."* (Appendix A Clause 2)

Company Accounts and Service Charge Accounts

The Accounts of the RMC or RTM Company have to be filed at Companies House. The Service Charges are held on trust and are neither an asset nor a liability of the company. In the past many RMCs have chosen to be **dormant** and obtain five years exemption from filing Corporation Tax Returns. An RMC can only be dormant if it has no company income, such as ground rent, licence fees, car parking licences or other charges for services not covered in the lease.

In such a case, there is no need or requirement for service charge numbers to be included in the RMC or RTM Company accounts. This may change as a result of legislation and recommendations from the relevant professional bodies. The only practical difference is that it will cost more to do the RMC or RTM Company Accounts.

What is a S20B Notice? If for some reason the accounts cannot be completed and circulated within six months, it is normal to tell everybody what they can expect the outcome to be. This is done by putting the information in a letter to each lessee, and the letter should state that it constitutes a s20B Notice. There is no statutory wording or recommended format.

The reason for doing this is that if there is a deficit, you may not be able to collect it. The Act says 'eighteen months' but this is from the date the cost was incurred, so to avoid a problem, tell everybody about a deficit within six months of the year end, which is eighteen months from the first day of the accounting year.

What happens if the RMC or RTM loses at a Tribunal? Read the Articles of the Company and see if you can find a way to raise money from the shareholders. You may have to call a General Meeting to change the Articles to enable you to do this. Directors of RTMs have a real problem here, as the Articles are prescribed by Statute and therefore cannot be changed; we would welcome feedback on possible solutions to this problem for the next edition of this booklet.

Summary:

🔍 If you are worried about the Service Charge Accounts in your building, start by looking at or asking for an up-to-date Balance Sheet. You may have to start with last year's accounts.

📊 Ask questions about the numbers that look high or low to you.

🗣️ Check and verify the information given to you. Your ultimate sanction if you fail to get satisfactory answers is an application to the First-tier Tribunal Property Chamber.

We can help you with this if you would like us to do so: email me on jim.thornton@hscpm.co.uk, but do talk to your Managing Agent first and do carry out proper research. Only think of going to a Tribunal if you really have evidence that will stand up in court, otherwise under the new regime it could be expensive for you.

APPENDIX 1: ICAEW TECHNICAL RELEASE -TECH 03/11 AND THE RICS SERVICE CHARGE RESIDENTIAL MANAGEMENT CODE

The RICS Service Charge Residential Management Code is dated April 2009 and a draft third Edition has now been produced. In the summer of 2014 this still remains the current document, but reference should also be made to the ICAEW TECHNICAL RELEASE – TECH 03/11. This lists as a summary of the best practice in the 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.
- 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 (RTM)) 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.
- All annual statements of account should be subject to an examination by an independent accountant before issue 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 RTM then it should be a separate statement to the annual accounts for the company required to be filed at Companies House.

This needs to be read in conjunction with the RICS Service Charge Residential Management Code Part 10, the main relevant text of which is in Appendix 2.

The RICS Service Charge Residential Management Code is published by the Royal Institution of Chartered Surveyors, Surveyor Court, Westwood Business Park, Coventry CV4 8JE ISBN 978 1 84219 168 2 © Royal Institution of Chartered Surveyors (RICS) April 2009. ICAEW Technical Release 03/11 ISBN 978-0-85760-434-7 © ICAEW, ACCA, ARMA, ICAS and RICS 2011.

APPENDIX 2: THE RICS SERVICE CHARGE RESIDENTIAL MANAGEMENT CODE

PART 10: ACCOUNTING FOR SERVICE CHARGES

- | | | |
|--|---|---|
| <p>10.1 <i>Often the lease/tenancy agreement will set out the way in which service charges are to be accounted for, the costs that can be recovered and the periods of time for which accounts should be prepared. You should always comply with the provisions of the lease/tenancy agreement (in so far as they do not conflict with statute) otherwise there may be difficulty in recovering the expenditure.</i></p> | <p>10.5 <i>Tenants are only obliged to pay service charges where the tenancy/lease requires this, where reasonably incurred and where the works have been carried out to a reasonable standard.</i></p> <p><i>The law protects tenants against costs unreasonably incurred, unreasonably high charges and services and works that are not of a reasonable standard. A Leasehold Valuation Tribunal (LVT – now the FTT Property Chamber) can be asked to make a determination on whether costs have been reasonably incurred or works have been completed to a reasonable standard. [Ss 19 and 27A – Landlord and Tenant Act 1985 (as inserted by S155(1) – Commonhold and Reform Act 2002]</i></p> <p><i>If tenants believe that the charges that they are being asked to pay are unreasonable and they are not satisfied with the manager’s explanation then they should seek professional advice or consult either the Citizens Advice Bureau or a local law centre.</i></p> <p><i>Recognised Tenants’ Associations have rights to appoint a surveyor (member of RICS) to advise them on service charge matters. The rights in summary,</i></p> | <p><i>allow the accountant or surveyor to have reasonable access to inspect the property and documents required to carry out his functions. This includes access to the common parts of relevant premises, including the structure and exterior of the building, and reasonable facilities for taking copies or extracts from documents. [S84 and schedule 4 – Housing Act 1996].</i></p> |
| <p>10.2 <i>Your accounts should be transparent and reflect all the expenditure in respect of the accounting period whether paid or accrued. This will enable the arrears and cash flow to be seen more easily.</i></p> | <p>10.6 <i>LVTs have the right to appoint a new manager if they are satisfied that unreasonable service charges have been made, and they consider it just and convenient to do so (.....). [S24 – Landlord and Tenant Act 1987].</i></p> | <p>10.7 <i>Section 42 requires service charges to be held in trust.</i></p> <p><i>For the purpose of section 42, ‘service charge’ means an amount payable by a tenant of a dwelling as part of or in addition to rent:</i></p> |
| <p>10.3 <i>You should present accounts so that they indicate clearly all the income in respect of the accounting period whether received or receivable.</i></p> | <p><i>a) which is payable, directly or indirectly, for services, repairs, maintenance, improvements or insurance or the landlord’s costs of management; and</i></p> | |
| <p>10.4 <i>You should arrange for service charge accounts to be audited annually and for copies to be made available to all those contributing to them where the lease requires this. Otherwise, you should consider the benefits and costs of an audit with regard to the tenants and the property concerned</i>
.....</p> | | |

- b) *the whole or part of which varies or may vary according to the relevant costs.*

[S42 – Landlord and Tenant Act 1987 (as amended by schedule 10, paragraph 15 and schedule 14 – Commonhold and Leasehold Reform Act 2002].

The relevant costs are the costs or estimated costs incurred or to be incurred by or on behalf of the landlord, or a superior landlord, in connection with the matters for which the service charge payable. [S18 – Landlord and Tenant Act 1985].

For this purpose ‘costs’ include overheads and are relevant costs in relation to a service charge whether they are incurred, or to be incurred, in the period for which the service charge is payable or in an earlier or later period. [S27 – Landlord and Tenant Act 1985].

It does not include service charges payable under the terms of a tenancy which is regulated by the Rent Act 1977, unless the rent is registered as a variable rent on the basis that service charges are payable which vary according to the costs payable from time to time.

10.8 *Service charge funds for each property, should be identifiable and either be placed in a separate bank account, or in a single client/trust account were the accounting records of the manager separately identify the fund attributable to each property.*

10.9 *Where interest is earned this belongs to the fund collectively. Interest should not be distributed to the contributing tenants 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. [S42 – Landlord and Tenant Act 1987].*

10.10 *Where statutory trusts apply, the contributions are held:*

- a) *on trust to meet the relevant costs; and*
- b) *subject to that, on trust for the contributing tenants for the time being in proportion to their respective liability to pay the relevant service charges. (This does not mean, however, that the tenants are entitled to any repayment of the service charge fund. Upon the termination of any tenant’s lease, his share of any service charge fund remains part of the service charge fund, and upon the termination of*

the last lease, the fund passes over to the landlord.) [S42 – Landlord and Tenant Act 1987].

10.11 *The trusts set out in section 42 do not always apply. Where there are express trusts created by a lease before 1 April 1989, the statutory trusts apply only to the extent they are not inconsistent with the express trusts. Also, express or implied trusts created by a lease on or after that date may vary the statutory trusts in certain respects. [S42 – Landlord and Tenant Act 1987].*

10.12 *There are two main aspects to the tax treatment of service charges, namely the tax treatment so far as the landlord is concerned of the service charge payments receivable, and the tax treatment of income earned on service charges received before they are spent on the provision of the relevant services.*

10.13 *If the statutory trust apply without any modification, then HM Revenue & Customs have confirmed that, in its view, so long as the trust terms are observed:*

- a) *the receipt of service charge payments subject to the section 42 trusts will not give rise to any tax liability in the hands of the payee;*
- b) *any investment income accrued on the service charge trust fund is*

subject to tax, but not at the special trust rates that would otherwise apply. Instead this income is taxable at the basic rate applicable to other persons. [Finance Act 2007] [Ss11, 479 and 480 – Income Tax Act 2007].

10.14 The purpose of this summary is only to draw attention to the general tax position and it does not refer to all the possible tax charges that can arise in connection with service charge funds. This summary does not apply if there is any modification to the statutory trusts, or if they do not apply to all (e.g. where the service charge payments are governed by express trusts set out in a lease entered into before 1 April 1989). Specialist advice should be taken in all cases.

10.15 A trustee is under a duty to invest the trust funds. The investment must be in accordance with the terms of the trust, the Trustee Investments Act 1961 as amended by the Trustee Act 2000 or an Order made under the Landlord and Tenant Act 1987 (which enables funds to be invested in a deposit account with certain banks or in a share or deposit account with a building society). Trustees who want to take advantage of the wider powers of investment under the Trustees Investments Act 1961 should have regard to the provisions of that Act. [Trustee

Investment Act 1961 (as amended by the Trustee Act 2000) – Section 42(5) – Landlord and Tenant Act 1987 – Service Charge Contributions (Authorised Investments) Order 1988 (SI 1988/1284) (as amended by the Financial Services and Markets Act 2000 (Consequential and Repeals) Order 2001 (SI 2001.36491))].

10.16 A tenant or the secretary of a Recognised Tenants' Association can request that you provide a summary of relevant costs incurred during the last accounting year or, where accounts are not kept on that basis, the 12 months before the tenant's request. You must comply with the request within one month of the request or within six months after the end of the accounting period, whichever is later. [S21 – Landlord and Tenant Act 1985].

10.17 The summary provided in response to a request must cover all costs incurred by the landlord for works and services, etc. showing how they are reflected or will be reflected in demands for service charges. The reasonable cost of preparation of the summary and its certification (see paragraph 11.20 below) is properly chargeable to the service charge account. [S21 – Landlord and Tenant Act 1985].

10.18 The summary must distinguish between items/costs for which no payment has been demanded of the landlord within

the period to which the summary relates; for which payment has been demanded of the landlord but not paid within that period; and for which the landlord has paid within that period. [S21 – Landlord and Tenant Act 1985].

10.19 The summary must also include the total of any money received by the landlord for service charges and still standing to the credit of the tenants paying these charges at the end of the period, and any costs which relate to works for which grants have been or will be paid and show how they have been reflected in the service charge demands. [S21 – Landlord and Tenant Act 1985].

10.20 If the service charges are payable by the tenants of more than four dwellings, the summary must be certified by a qualified accountant as a fair summary sufficiently supported by accounts, receipts and other documents which have been produced to him.

Qualified accountant means a member of one of the following:

- a) the Institute of Chartered Accountants in England and Wales;
- b) the Institute of Chartered Accountants in Scotland;
- c) the Association of Certified

Accountants; or

- d) the Institute of Chartered Accountants in Ireland.

However, certain persons are disqualified from acting as the qualified accountant even though they are a member of the above bodies. See section 28 of the Landlord and Tenant Act 1985 for more details. [S21(6) – Landlord and Tenant Act 1985] [S28 – Landlord and Tenant Act 1985].

- 10.21 You must notify the tenants in writing of costs incurred within 18 months of incurring those costs or the costs will not be recoverable. [S20B – Landlord and Tenant Act 1985].
- 10.22 If within six months of receiving the summary under section 21 (see paragraph 10.16) a tenant or the secretary of a Recognised Tenants' Association makes a request to inspect the accounts, receipts and other supporting documents, you must provide such an opportunity. You must not charge for the inspection and copies or extracts from any documents supporting the summary may be taken. You are not precluded from including a reasonable cost of the inspection in the cost of management. [S22 – Landlord and Tenant Act 1985].

- 10.23 Any charge made for providing copies of any documents or having a member of your staff in attendance must be reasonable.
- 10.24 You must respond to the tenant's or Recognised Tenants' Association's secretary's request in writing to inspect the accounts, receipts and other supporting documents within one month, and must allow them a period of two months beginning no later than one month after the request is made, to inspect the accounts, receipts and other documents supporting the last accounts or the expenditure in the last twelve months. [S22 – Landlord and Tenant Act 1985].
- 10.25 If you act for an intermediate landlord who does not possess all the relevant information or documents, you must make a written request for them to the superior Landlord. [S23 – Landlord and Tenant Act 1985].
- 10.26 The procedure is different depending on whether the tenant or Recognised Tenants' Association asks for a summary of service charges or facilities to inspect supporting documents. Where a request is made for a summary the intermediate landlord must make a written request to his superior landlord who must in turn comply within a reasonable time. Where

a request is made for facilities to inspect, the landlord must inform the tenant or Recognised Tenants' Association of the name and address of the superior landlord, to whom they should address the request instead as section 22 would apply to the superior landlord in this case. [Ss21, 22 and 23 – Landlord and Tenant Act 1985].

- 10.27 If you fail to comply with the requirements in sections 21, 22 and 23 of the Landlord and Tenant Act 1985 (see above) without reasonable excuse you will be committing a summary offence and will be liable on conviction to a fine not exceeding level 4 on the standard scale (£2,500). [S25 – Landlord and Tenant Act 1985 – S37 – Criminal Justice Act 1982].
- 10.28 When a tenant has paid service charges in advance the amount payable must be reasonable and you must repay any excess paid, or deduct it from subsequent charges, as the lease directs once the costs have been incurred. Advance payments and actual expenditure should be presented clearly. [S19(2) – Landlord and Tenant Act 1985].

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APPENDIX 3: THE RICS SERVICE CHARGE RESIDENTIAL MANAGEMENT CODE

PART 9: RESERVE FUNDS

- 9.1 Reserve funds are often permitted by the lease. A reserve fund is a pool of money created through the payment of service charges which are not immediately needed towards repairs, maintenance or management, etc. but which are collected and retained to build up sums which can be used to pay for large items of infrequent expenditure (such as the replacement of a lift or the recovering of a roof) and for major items which arise regularly (such as redecoration of the common parts). A reserve fund also helps to spread costs between successive tenants and can, if the leases/tenancy agreements allow, be used, on a temporary basis, to fund the cost of routine services, avoiding the need to borrow money. Legislation ensures that the money in a reserve fund, as is the case with service charge funds and advance payments, is held on trust – see paragraph 10.7. [S42 – Landlord and Tenant Act 1987]
- 9.2 The usual method of working out how much money is to go into the fund each year, assuming the lease/tenancy does not make any other provision, is to take the expected cost of future works and divide it by the number of years which may be expected to pass before it is incurred. However, it is advisable to have new estimates of the cost of replacing the item from time to time and to adjust payments into the funds to match costs. If the fund is invested prudently, the interest earned will itself help to meet rising costs. Tax will be charged on the interest income
- 9.3 You should be able to justify the contributions to reserves by reference to the work required, the expected cost and when it is to be carried out. Experience of similar work should be used in support of the calculations. It is not considered appropriate for specifications and tenders to be obtained merely to support the reserve allocation. These will be required at the time the work is to be carried out. It should be indicated to tenants that the figures may vary when the work is undertaken.
- 9.4 Although some tenants may be able to achieve better returns on money they retain and invest themselves, one of the purposes of reserves is to facilitate the carrying out of expensive non-annual items of work. Unless money is accumulated collectively there is always the likelihood of work not being carried out due to lack of funds. Even if tenants intend to live at a property for a short period they can achieve financial benefit on sale by pointing out to purchasers the existence and extent of the reserve fund.
- 9.5 You must hold such sums in trust for the purpose of meeting the relevant costs in relation to the property and they should not be distributed to tenants when the lease is assigned/terminated, subject to any express terms of the lease relating to distribution, either before or at the termination of the lease. [S42(6) – Landlord and Tenant Act 1987]
- If after the termination of any lease there are no longer any contributing tenants, any trust fund shall be dissolved and any assets comprised in the fund immediately before dissolution shall, if the payee is the landlord, be retained by him for his own use and benefit, and in any other case, be transferred to the landlord by the payee.

Again this is subject to any express terms of the lease relating to distribution, either before or at the termination of the lease. [S42(7) – Landlord and Tenant Act 1987]

- 9.6 Funds held for longer terms, or comprising large balances, should be held in an interest earning account. Funds required to meet day-to-day expenditure should be immediately accessible.

Where reserve funds are invested this must be invested in accordance with current regulations [S42 – Landlord and Tenant Act 1987 – Service Charge Contributions (Authorised Investment(s) Order 1988 – SI 1988/1284 (as amended by the Financial Services and Markets Act 2000 (Consequential Amendments and Repeals) Order 2001 (SI 2001/3649))]

- 9.7 A trustee is under a duty to invest the trust funds. The investment must be in accordance with the terms of the trust, the Trustee Investments Act 1961 or an order made under the Landlord and Tenant Act 1987 (which enables funds to be deposited at interest with the Bank of England or with certain institutions under part 4 of the Financial Services and Markets Act 2000, including a share or deposit account with a building society, or a European Economic Area firm mentioned in schedule 3 of the Act). Trustees who want to take advantage

of the wider powers of investment under the Trustee Investment Act 1961 (as amended by the Trustee Act 2000) should have regard to the provisions of that Act, and to the various subsequently enacted statutory instruments. [Trustee Investment Act 1961 – Trustee Act 2000 – S42 (5) – Landlord and Tenant Act 1987]

You should consider holding the reserve fund in the same account as the service charge fund if the aggregation of the two funds invested will achieve a better return or exemption from bank charges – remembering that the arrangement must be discrete to the property or contributions concerned. [Service Charge Contributions (Authorised Investments) Order 1988 (SI 1988/1284) (as amended by the Financial Services and Markets Act 2000 (Consequential Amendments and Repeals) Order 2001 (SI 2001/3649))]

- 9.8 If tenants are contributing towards different costs (e.g. one group of tenants contributes towards the lift, whilst another group contributes towards gardening), the funds should be differentiated. This should be done by way of different service charge schedules, each totalling 100%.
- 9.9 You should not differentiate between different items of expenditure in a reserve

fund, e.g. not having separate accounts for lifts and boilers. This is because you may find yourselves with insufficient funds for immediate expenditure and overprovision for work not required for the foreseeable future, where contributions are received from tenants contributing towards the same costs.

- 9.10 You should review contributions annually and base the amount you request from tenants on current up-to-date forecasts including fees and VAT.
- 9.11 Where funds accumulated are considered to be low, having regard to future commitments, you should indicate this to tenants.
- 9.12 A reserve fund can have benefits for both landlords and tenants alike. Where the lease allows for a reserve fund to be set up but no such fund exists, you should recommend to your client that a reserve fund be created. Where the lease does not allow for the collection of reserves, consider seeking the agreement of the tenants to a variation of leases, or an application to the Leasehold Valuation Tribunal (LVT)

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APPENDIX 4: ICAEW TECHNICAL RELEASE TECH 03/11: COMPARISON OF AUDIT TO AN ENGAGEMENT TO REPORT ON FACTUAL FINDINGS

1. Unless the costs cannot be recovered, Service Charge Accounts should be subjected to examination by an independent accountant, qualified as set out in Appendix J.
2. Subject to the terms of the lease, as explained in section 3 of this guidance, the alternative forms of examination considered most suitable for Service Charge Accounts are audit and an engagement to provide a factual report of findings. The following paragraphs describe the key features of the two types of engagement and the differences between them.
3. The procedures to be undertaken in an audit are governed by International Standards on Auditing (ISAs). The purpose of the audit is to enhance the degree of confidence of intended users in the Accounts by the expression of an opinion on whether the Accounts are prepared, in all material respects, in accordance with the stated accounting principles. As a basis for the auditor's opinion, ISAs require the auditor to obtain a high level of assurance – that is, evidence-based – that the Accounts as a whole are free from material mis-statement, whether due to fraud or error.
4. ISAs set rigorous standards for the planning, conduct and recording of audit work. The time needed to complete an audit is much greater than that needed to check a specified number of items and make a factual report of findings. The objective of an audit is to give an opinion that gives a high level of assurance about the Accounts. The audit report is expressed in terms of a professional judgement that the Accounts are prepared, in all material respects, in accordance with the stated accounting policies.
5. There is a level below which it is not possible for a fee to be charged that covers the cost of the auditor's time and other resources used when an audit is carried out in accordance with ISAs. To be recovered from the service charge, the audit fee must be divided between the lessees, so that the fewer the number of dwellings in a property, the higher will be the cost of audit per dwelling.

6. The more long leasehold dwellings that are contained in a property or service charge scheme, the lower will be the cost of the audit to each lessee. The larger the property, the less likely it is that all or a significant proportion of lessees will be actively involved in the management. It is also likely that larger blocks will include commercial properties with some shared services so that the allocation of shared costs to residential and commercial lessees may be complicated. The larger the property, therefore, the more likely it is that an audit will be appropriate, to reassure lessees that they can place reliance on the Service Charge Accounts.
7. A statement of factual findings is based on relatively limited procedures and does not require the same exercise of professional judgement, so is less expensive than an audit. This form of examination is appropriate for the Service Charge Accounts of a small property containing relatively few dwellings and where lessees are actively involved in the management of the property, unless the lease requires, or is construed as requiring, an audit to be carried out.
8. Although a report of factual findings does not express the assurance that would follow from an audit or a review made in accordance with applicable International Standards, the statement gives comfort that the items listed in the report have been checked by a qualified accountant independent of the Landlord/ Managing Agent.

APPENDIX 5: ARMA-Q - EXTRACTS FROM SECTION 4.0 FINANCIAL MATTERS

ARMA have kindly given us permission to quote from Section 4.0 of the ARMA-Q Guide, and they have asked us to point out that ARMA-Q Standards do not come into effect until 2015.

4.1 Bank Accounts

The Managing Agent Must open one or more Client Bank Account.

See: The Service Charge Contributions (Authorised Investments) Order 1988 (SI 1988/1284. Amended by the Financial Services and Market Act 2000 (Consequential Amendments and Repeals Order 2001 (SI2001/3649))

On opening a Client Bank Account the Managing Agent:

- a) Must give or receive notice in Writing to or from the bank or building society concerned:
 - i) that all money to the credit of that account is Client Money and that the bank or building society is not entitled to combine the account

with any other account or to exercise any right of set-off or counterclaim against money in that account in respect of any sum owed to it on any other of the Managing Agent's accounts;

- ii) that any interest payable in respect of sums credited to the account should be credited to that account;
 - iii) that they require the bank or building society to acknowledge in Writing that it accepts such notice.
- b) Should inform all Leaseholders:
- i) of the name and address of the institution where their money is held;
 - ii) of the account name;
 - iii) whether or not it is an interest bearing account and if it is, the withdrawal notice period and any restrictions on withdrawal. If not

immediately accessible, such restrictions will require the Client's approval in Writing.

- c) Must keep properly written up general records to show all dealings with Client Money received, held or paid and to show all dealings through Client Bank Accounts on behalf of that Client and enable the current balance of that Client Bank Account to be shown. Records Should be retained for at least 6 years from the date of the last entry;
- d) Should carry out reconciliations of their cash books with the Client Bank Account statements and with the Client ledger balances for the end of every month within four weeks of that month end and keep a record of this. Discrepancies Must be investigated and shortfalls on Client Bank Accounts Must be made good;
- e) Should send a written account

- to the Client (unless requested otherwise) for all Client's Money held, paid or received, (whether or not there is any payment due to the Client) at appropriate intervals agreed with the Client but Must not be less than once a year;
- f) Should pay any Client's Money received into a Client Bank Account either on the same working day or the next working day after receipt;
 - g) Must pay any cheque or banker's draft which includes any element of Client's Money into a Client Bank Account before withdrawing any monies which are due to the Managing Agent from that Client;
 - h) Must not endorse cheques;
 - i) Should never overdraw a Client Bank Account;
 - j) Must never use one trust fund to the benefit of another trust fund;
 - k) Must not withdraw money from a Client Bank Account unless:
 - i) it is the Managing Agent's own money paid into a Client Bank Account if a specific purpose of opening or maintaining the account;
 - ii) it is for payment to a Client (this must be the designated Client if a specific Client Bank Account is held for that Client);
 - iii) it is for duly authorised payment on behalf of a Client to a third party;
 - iv) it is for payment of the Managing Agent's fees and/or disbursements provided that the Client has a copy of the invoice and the Client has authorised the payment in Writing or it is permitted by the Management Agreement;
 - v) it was paid in by mistake.
 - l) Must ensure that sufficient funds will be available to meet payments due prior to committing to expenditure.

4.2 Service Charge Monies

When dealing with Service Charge Monies the Managing Agent:

- a) Must hold this money, and any interest accruing, by way of trust funds in a Client Bank Account;
- b) Should only use the monies to meet the expense for which the money has been collected within the overall context of the annual budget;
- c) Should obtain and retain documentation with sufficient information for authorisation of payment.

4.2.2 Reserve Funds

When dealing with Reserve Funds the Managing Agent:

- a) Must only collect these if permitted by the Lease;
- b) Must only collect and spend Reserve Funds on those items prescribed in the Lease. If Leaseholders are contributing to different costs, the funds should be differentiated by way of different Service Charge schedules;
- c) Must be able to justify that contributions satisfy the Test of Reasonableness:

See: Ss 19 and 27A Landlord and Tenant Act 1985 (as inserted by S.155(1) Commonhold and Leasehold Reform Act 2002)

- d) Must ensure that Reserve Funds are held as trust funds;

See: S.42 Landlord and Tenant Act 1987

- e) Must hold the funds in an interest bearing account in accordance with current regulations and interest must be credited to the trust account;
- f) Should review the level of contributions annually as part of the budget process;
- g) Must not use Reserve Funds to finance year-end deficits on the Service Charge account if the Lease does not permit borrowing from the Reserve Fund;
- h) Must not distribute Reserve Funds to a Leaseholder at the termination or assignment of a Lease, subject to any express terms of the Lease relating to distribution.

4.2.4 End of Year Service Charge Accounts

Where the lease sets out the way in which Service Charges are to be accounted for, then the requirements of the Lease Must be followed. Managing Agents Should also follow the guidance contained in the publication Residential Service Charge Accounts Technical Release 03/11 issued by the professional accountancy bodies jointly with the Association of Residential Managing Agents and the Royal Institution of Chartered Surveyors.

Managing Agents Must always prepare documentation to enable the production of Service Charge Accounts.

Service Charge Accounts Should be distributed within 18 months of the date expenditure exceeded the budget, a Section 20B Notice Should be served on an interim basis and any such notice Must be followed by Service Charge Accounts within a reasonable time.

See: S.20B Landlord and Tenant Act 1985.

When preparing Service Charge Accounts the Managing Agent:

- a) Must ensure these, and any supporting documents, are transparent in that they reflect all the expenditure in respect of the accounting period whether paid or accrued;
- b) Must not distribute interest earned to the contributing Leaseholders but show this as a credit in the Service Charge Accounts and this Should be retained within the fund and used to defray Service Charge expenditure;
- c) Must follow the requirements of the Lease where the Lease sets out the way in which surplus and/or deficits shall be accounted for. Where the Lease does not, Managing Agents Should follow S.19(2).

See: S.19(2) Landlord and Tenant Act 1985

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