



The
Property
Institute

ADVICE NOTE

SERVICE CHARGE
ACCOUNTING —
BEST PRACTICE

A summary of best practice for service charge accounting



CONTENTS

Background	3
Summary of best practice	3
Bank accounts for service charge money	3
Deficits, loans and overdrafts	3
Annual statements of account for service charges	3
Accountancy Definitions	4
Should you carry out an audit, certification or accountant's report?	4
Timescale for annual statements of account	4
Further information	4

NOTE

As the leading trade body for residential leasehold management, TPI is also an important resource for leaseholders. Our Advice Notes cover a range of topics on the leasehold system to help leaseholders understand their rights and responsibilities and ultimately get the most out of living in their flat.

BACKGROUND

In 2010 the Government pulled back from introducing important regulations that would have given greater protection to leaseholders' service charge money.

To fill this void TPI, along with 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), worked together to issue best practice guidance on service charge accounting.

This advice note summarises that best practice.

Note: References to Residents' Management Companies (RMCs) also include Right To Manage Companies (RTMs). And references to landlords include RMCs where they are responsible for the collection of service charges.

Summary of best practice

Here's the summary of best practice from the guidance:

- If the lease or tenancy agreement sets out how 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 these requirements must be followed.
- Service charge money paid by leaseholders is trust money and should be held in ring-fenced designated bank accounts (under S42 of the Landlord and Tenant Act 1987).
- Landlords and managing agents don't need to have separate bank accounts for each property or scheme unless the lease requires one. But the funds for each property or scheme must be separately identifiable. It's a breach of trust to use service charge money from one property or scheme to pay the bills of another or of the landlord.
- All leaseholders paying variable service charges should receive an annual statement from their landlord or RMC within six months of the end of the accounting year.
- The annual statement should include an income and expenditure account and a balance sheet. It should be prepared on an accruals basis.
- An independent accountant should examine all annual statements of account before they are issued to leaseholders.
- The type of examination will depend on the terms of the lease and should be proportionate to the size and nature of the property/scheme. The approach should be agreed on by the accountant and the client landlord, RMC or their agent.
- If the service charge statement is prepared on behalf of an RMC, then it should be separate to the annual accounts filed by the company at Companies House.

Bank accounts for service charge money

Service charge money must be held in trust under S42 of the Landlord and Tenant Act (1987). The landlord or RMC directors are the trustees.

Self-managing RMCs should open a bank account for service charge monies with a title along the lines of '[Name of Your Property] RMC Ltd Client Bank Account'.

Managing agents acting for RMCs should open one or more designated bank account for service charge monies. The bank account title should include either 'client' or 'trust' in its title.

The RICS Service Charge Residential Management Code requires managing agents opening these accounts to write to their bank to get acknowledgment of the ring-fenced status annually.

There's no statutory legal requirement for managing agents to open separate bank accounts for each scheme. But this may be a requirement under the terms of the lease.

There's also no obligation to put reserve funds into separate bank accounts, unless the lease requires it. But the RICS Code states that reserve should be placed in an interest earning account.

Because service charges are held in trust, the RMC directors and their agents are under a duty to invest the money. They have to invest in accordance with the Trustee Investments Act 1961 (as amended by the Trustee Act 2000), or the Service Charge Contributions (Authorised Investments) Order 1988 as amended. The latter enables service charge monies to be invested in a deposit account with certain banks, or in a share or deposit account with building societies.

Deficits, loans and overdrafts

Acting as a trustee or agent for a trustee means that service charge accounts should not be run in deficit.

If the funds for several developments are kept in the same bank account, and a managing agent uses money from one development to fund another that's overdrawn, this is a breach of trust.

It's also a breach of trust for RMC directors or an agent to commit to expenditure if they are aware that no service charge funds are available.

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

Annual statements of account for service charges

All managers must provide annual service charge accounts to each leaseholder within six months (or within a specified timeframe if stated in the lease) after the relevant financial year-end.

The annual accounts should include the following:

- An Income and Expenditure account
- A Balance Sheet
- A schedule(s) showing any changes in reserves
- The current year's budget, alongside comparative figures for the previous year's budget and actuals
- A statement confirming the details of the designated bank account in which the service charge funds are held.

The accounts should be prepared on an accruals basis, and it is recommended that they be accompanied by explanatory notes.

Accountancy Definitions

What does an ‘accruals basis’ mean?

The accruals basis of accounting is a method where transactions are recorded when they occur, rather than when cash is exchanged. This method ensures that revenues and expenses are recognised in the period they relate to, providing a more accurate picture of financial performance. Under this approach, revenues are recorded when earned, and expenses are recognised when incurred, regardless of the timing of the cash flows.

Accruals

Accruals refer to expenses or revenues that have been incurred or earned but not yet recorded in the financial statements. This concept ensures that financial transactions are recognised in the period in which they occur, regardless of when cash is exchanged. For example, supply of services but not yet paid by the end of the accounting period are considered accruals.

Prepayments

Prepayments are amounts paid for goods or services in advance of receiving them. These payments are recognised as assets until they are used or consumed. For instance, if a company pays insurance for the next six months in advance, the payment is recorded as a prepayment and then expensed gradually over the insurance period.

Creditors

Creditors are individuals or organizations to whom a business owes money for goods or services received. Creditors are typically suppliers or lenders, and amounts owed to them are recorded as liabilities on the balance sheet. The term is often used to describe short-term debt obligations, such as payments owed to suppliers.

Debtors

Debtors are individuals or organisations that owe money to a business for goods or services that have been delivered or provided. Debtors represent amounts due to the business and are classified as assets on the balance sheet. This term typically refers to amounts that are owed to the service charges, such as refunds.

Should you carry out an audit, certification or accountant’s report?

The first thing you should do is check what the lease requires and follow that.

If the lease specifies an audit, then the guidance recommends it should be carried out to the International Standard on Auditing 800 (ISA 800). More detail is included in Appendix E of the best practice guidance* (ICAEW Accounting For Service Charges Technical Release 03/11).

If the lease does not prescribe an audit then the ICAEW Account for Service Charges guidance offers an alternative form of examination, which is a report on factual findings. Appendix F of the best practice guidance* sets out the work for the independent accountant undertaking this report.

In the end you need to decide what level of checking is required, subject to the terms of the lease. RMCs should discuss the choices available with their agents and external accountants.

Timescale for annual statements of account

There’s no statutory requirement for annual statements to be issued within a timescale, although some leases may set them.

Best practice set out in the guidance* is for RMCs and their managing agents to issue all annual statements within six months of the end of the financial year. In addition, S20B of the 1985 Act provides for penalties if costs of services are not notified to leaseholders within 18 months of them being incurred.

It’s not always easy to ensure that annual statements of account are issued within six months. But where leases are clear about how statements should be audited, examined or certified, then there’s no reason for delay.

There’s often confusion about who ‘approves’ the annual statement. This should be stated in the leases. It’s helpful for RMC directors to check the figures before they issue them.

Further information

- The full title of the guide referred to in this advice note is: Accounting For Service Charges Technical Release 03/11: Guidance On Accounting And Reporting In Relation Service Charge Accounts For Residential Properties On Which Variable Service Charges Are Paid In Accordance With A Lease Or Tenancy Agreement.

You can download it free from TPI’s Leasehold Library at: www.TPI.org.uk

- The RICS Service Charge Residential Management Code also covers best practice for service charge management. It’s available to download from RICS at: <https://www.rics.org/profession-standards/rics-standards-and-guidance/sector-standards/real-estate-standards/service-charge-residential-management-code>

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