

**The code will necessitate change on the part of landlords and agents**

**It offers no advice on what action the industry should take to fulfil its recommendations**



## It's the devil's own job

**Service charges** In the first of three articles, *David Barrass* considers what effect the new service charge code will have on the relationship between commercial landlords and tenants

In 2005, UK businesses paid £4.41bn in office service charges – costs that have increased year on year for more than a decade, typically ahead of inflation.

### A new culture

In June, in response to these concerns, the RICS published a new code on service charges. It comes into force on 1 April 2007 (see *EG* 9 September, p252).

The code sets out best practice. Practitioners will be expected to follow this and, as far as possible, to interpret existing service charge clauses in line with the principles and practices set out in the code. Leases will be brought up to the code standard on renewal. Since the average lease term is seven years, multilet buildings will inevitably operate under inconsistent leases. The code foresees the need to operate dual service charges and other interim measures to ensure the

operation of services and the recoverability of the service charge costs during the intervening period.

The code will require changes to management processes and will necessitate change on the part of landlords and agents. However, the RICS has not provided a measurable view of where the industry stands today. The code offers no advice on what action the industry must take in order to fulfil its recommendations and there is no indication of how such action will be monitored.

However, the service charge study undertaken by Loughborough University business school will measure the compliance of specific code items within Property Solutions' client database with the code's recommendations. This will assess financial controls, transparency, value for money and management. The results will be published in the autumn.

Standard lease terms will need to incorporate the code's provisions. The code does not give any recommendations but limits its application to new leases post-April 2007.

Codes of practice have an implied contractual force. This is particularly so in alternative dispute resolution (ADR) procedures; the parties' conduct in respect of the relevant code of practice will be taken into account when assessing the outcome of a dispute. The code provides access to ADR for parties involved in service charge disputes. However, since service charges embrace a diverse range of services, the practitioner appointed must have appropriate qualifications.

### Financial issues

● **Financial controls**  
The principal financial controls for service charges are the annual budget and certificate. The code sets out detailed

requirements for both procedures and gives examples of the expenditure and variance reports that will be required. One important element is effective communication between the landlord and tenant. The code's recognition of the need for continuous communication between the parties is encouraging.

Best practice determines that tenants will have the right of reasonable challenge to the propriety of the expenditure. By this, the code means that the tenant will be able to question the certificate. It does not appear to anticipate the need for the tenant to challenge the budget, although this is fundamental if the tenant is to accept the propriety of the expenditure. This is particularly important if the landlord is proposing, for example, to update plant within a building in order to reduce running costs that will benefit the tenant, as is required by the code. It seems sensible that landlords should involve tenants as early as possible in the budget-setting process since this will enable the landlord to explain the need for any unusual or extraordinary expenditure and to gain the tenant's comments and agreement prior to finalising the budget.

Tenants will need to consider how they will fund the additional tenants' meetings that result from improved communications. The attendee from the tenants' organisation must have responsibility for service provision and have budget approval authority.

● **Budgets and certificates**  
Tenants may be unable to deal with service charges accurately or within a reasonable time-frame since many budgets arrive late and without explanation. Similarly, tenants may not know whether balancing sums will be demanded because mid-year reporting can be poor and certificates may arrive many months or even years after the relevant service charge year. Thus, the tenant may not have an opportunity to challenge the actual costs other than by engaging in a costly and time-consuming dispute.

The code requires landlords to provide tenants with an estimate of likely service charge expenditure, including an explanatory commentary and the tenant's proportion of the costs, one month before the service charge year begins. This would improve the current position; the Loughborough studies show that 63% of budgets arrive after the beginning of the year to which they relate, with 20% arriving more than one year late.

The code requires landlords to submit certified accounts to tenants in a timely manner and, in any event, within four months of the end of the service charge year. This, too, would be a major improvement; the Loughborough studies indicate that 66% of certificates arrive more than a year after the end of the year to which they relate.

● **Management fees**  
Management contracts need to contain standard terms and key performance indicators and should be made available to tenants. Management fees are normally based upon a percentage of the service charge cost, thereby creating a conflict of interest; a failure to achieve value for money is rewarded with a higher fee.

### Why this matters

The 2005 RICS tenant satisfaction index showed "a high level of dissatisfaction... with the service provided... by landlords". It recommended four areas for improvement: communications; lease flexibility; contract detail; and problem resolution.

The 2005 Loughborough University service charge study found that service charges were higher than necessary and very variable. The latter was not explained by the location, size of building, air-conditioning or VAT status. The study concluded that poor communication between landlords and tenants was at the heart of the problem. It noted that although service charges are controllable costs, the tenant does not have an automatic say in their

The code states that the management fee has to be reasonable for the total cost of managing the provision of the services, and that it will not be linked to a percentage of expenditure.

However, although the code specifies a fixed-fee basis, it does not establish how that fee should be calculated, nor how it will be monitored and enforced. Since the market fee is principally based upon a percentage of cost, it makes little sense for the industry to benchmark itself against "the market".

### ● Apportionment

The basis of the apportionment of service charges between different tenants is often unclear. Although the code does not specify which system is preferred, it does require the apportionment to be fair and reasonable and applied consistently throughout the property. However, it does not suggest how this is to be achieved or, if apportionment systems are found to be unfair, how the potential unfairness of any reapportionment exercise will be resolved.

### ● Interest on accounts

Service charges are usually invoiced quarterly in advance.

Taking the annual UK cost of £4.41bn and typical payment terms exceeding 60 days, a substantial sum is under management at any one time, with a major potential for interest credits. Most service charge accounts do not benefit from accrued interest. Given the scale of the sums involved, this needs transparent regulation.

Under the code, interest earned on moneys held in service charge accounts will be credited to those accounts. Unless specified in the lease, however, landlords will not be obliged to retain advance service charge payments in separate bank accounts or to credit interest to tenants.

This means that managing agents, who generally operate separate client bank accounts, could be crediting interest to the service charge account, while landlords that manage their own portfolios, directly or through a management company where the RICS accounting rules do not apply, could benefit from the interest earned from advance service charge payments made by their tenants.

*David Barrass is managing director of Property Solutions*

management; efficiencies and savings can be achieved with negotiation. Service charge certificates use a variety of labels to describe costs, making it difficult to compare costs between buildings.

The Loughborough update study found that service charges are variable in name, nature and in their effect upon the tenant's budgeting and accounting processes. And it is getting worse. Each managing agent has a different attitude towards clarity. Certificates of actual expenditure and budgets use different cost descriptions or codes, sometimes inconsistently. The lack of standardisation has meant that tenants have not been able to compare service charges between buildings, heightening concerns about value for money.

Tenant dissatisfaction has led to many disputes between landlords and tenants. As the RICS report points out, tenants are less focused on rent in isolation, and are becoming more demanding in terms of the overall value of property to their business.

### Further Reading

#### Service Charge Study

Calvert J, Loughborough University Enterprises  
[www.property-solutions.co.uk](http://www.property-solutions.co.uk)

#### Service Charge Update Study

Calvert J, Loughborough University Enterprises  
[www.property-solutions.co.uk](http://www.property-solutions.co.uk)

#### RICS Code of Practice

[www.servicechargecode.co.uk](http://www.servicechargecode.co.uk)

#### RICS Tenant Satisfaction Index

[www.rics.org](http://www.rics.org)