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Lack of take up for the RICS code of practice on service charges is worrying, says Kingston University

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By ***Dr Timothy Eccles***, ***Dr Andrew Holt***

Professors Dr Timothy Eccles and Dr Andrew Holt say too many landlords aren't complying with 2006 rules

There is continuing disquiet in property about common services supply and management in multi-let commercial premises and the slow take-up of the 2006 RICS Code of Practice: Service Charges in Commercial Property (the Code) which came into force in April 2007.

Now, adding to these concerns, Kingston University research shows much of the industry is ignoring the principles of good accounting practise. The ongoing lack of transparency over service charges raises concern for tenants who fear that bad accounting procedures are masking bad management practises and costing them money.

Kingston is only part-way through detailed research on accounting processes in service charge accounts which will be published in 2010. However, we believe that the results of their research to date is significantly worrying to warrant interim exposure.

The background

The Code came into force on 1 April 2007, which means that the UK multi-let office industry has now had more than two years to respond to its guidance, and subsequently alter existing practices for accounting and record keeping for service charge monies.

It has to be remembered that the Code of Practice is a guidance note rather than a practice statement. However, it is reasonable to assume that Code compliance should be the priority of management agents and landlords that wish to supply a professional and "best practice" level of service to their tenants. The Code is also supported by information papers, and RICS warns that "members should note that when an allegation of professional negligence is made against a surveyor, the court is likely to take account of any relevant information papers published by the RICS in deciding whether or not the surveyor has acted with reasonable competence".

However, as Calvert in 'The Loughborough Report: the paradox of service charges' (2009), the Occupiers' Satisfaction Index [www.occupier-satisfaction.co.uk] and Jin and Tsourikova 'Fixing UK commercial service charges – has the credit crunch helped?' (2008) all highlight, levels of Code compliance and tenant satisfaction remain almost unchanged at relatively low levels.

These findings generally correlate with the results of ongoing research at Kingston University into the transparency of current accounting practices and disclosures for commercial service charge transactions in the UK.

This research commenced in August 2008 and, to date, has discovered strong evidence of widespread non-compliance with the Code in terms of its accounting requirements, continuing tenant dissatisfaction with level of information included within service charge certificates and examples of plain poor practice.

For example, one interviewee, who was generally positive and supportive about the Code, stated that there was "some way to go" before it could be claimed that the Code was widely practiced.

The qualitative and quantitative data for the research has been collected from sixteen in-depth interviews with various industry stakeholders, focus groups, questionnaires and an analysis of service charge certificates and documents prepared and issued during fiscal years 2004-2008.

The interviews and focus groups included various landlords, tenants, managing agents, RICS members and qualified accountants. The service charge certificates and documents analysed were all drawn anonymously for commercial and confidentiality reasons.

What is covered in the Code of Practice?

From an accounting perspective, the Code of Practice outlines a number of detailed requirements for the accounting and associated narrative disclosures for service charge monies, including:

- an annual budget of likely service charge expenditure one month prior to commencement of the service charge year
- certified accounts within four months of the end of the service charge year, that provide a consistent, detailed and comprehensive summary of items of expenditure with full explanations of material variations against the budget.
- narrative explanation and disclosures about significant individual costs and variances from previous year's budget/accounts
- the use of standard cost codes and a clearly defined apportionment basis
- disclosure on interest earned on service charge monies

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- disclosure of the calculation basis for any sinking, replacement or reserve fund contribution and the items to which it relates.
- disclosures on contributions to and expenditure from sinking, replacement and reserve funds, together with the opening and closing balances and the amount of interest earned and tax paid in the relevant period.

From the interviews and analysis of service charge budgets and certificates conducted during this research, it appears evident that many tenants are dissatisfied by the service charge documentation they receive and that the Code's accounting requirements are not being complied with.

What have we seen?

In most instances, service charge budgets were issued late and certified accounts typically arrived outside of the Code's prescribed time frame of four months. The budgets themselves were typically inaccurate (i.e more than the +/-2% of actual service charge plus RPI allowed by the Code), lacked a clear apportionment basis and were normally issued with virtually no accompanying narrative disclosure of significant items of expenditure or substantial differences from prior years.

From an accounting perspective, such fundamental problems threaten the integrity of the whole service charge process, and must be urgently addressed by the whole industry and the RICS.

As worrying, from a tenants' perspective, was the apparent variation in the certification and sign off procedure for service charge accounts. Some certificates did not appear to be signed off at all, some were signed off by managing agents or the landlord's surveyor, some were signed off by firms of accountants and some were jointly signed off by an accountant and managing agent.

In addition, the wording of the opinions attached to such signatures varied considerably, ranging from statements such as "the above figures have been independently checked and verified by", a statement made by a landlord's surveyor, to "I hereby certify that, according to the information available to me, the attached…records the true cost to the landlord of providing the services to the Property…in accordance with the lease", a statement made by an 'accounting services' firm.

This evidence helps to reinforce the doubts expressed by tenants about the quality and accuracy of the service charge information they receive. It also indicates a need for the Code of Practice to be clearer in formalising its sign off obligations for management agents and establish a pro forma statement of opinion that a certificate should include for auditors.

In terms of assessing the accounting for sinking, replacement and reserve funds, 88 service charge certificates (9.33% of the 943 checked) and 169 service charge budgets (17.6% of the 960 checked) for the period 2004-8 were found to mention such funds. These were analysed for their Code compliant level of disclosure.

Such funds were variably described as a "sinking fund", "contingency fund", "reserve fund", "plant replacement fund", "depreciation fund" or simply a "transfer to reserves". Despite reviewing the history of the disclosure on these funds in the period both prior to and post implementation of the Code of Practice, there was no evidence of increased transparency or disclosure with regard to any of these funds in certificates or budgets.

For example, in no instance was the current balance of a fund disclosed on the certificate, and only three certificates provided information about the specific items that a fund was intended to cover. More fundamentally, no certificate mentioned whether interest was being received on the sinking fund monies and how this income was being distributed. Furthermore, no certificate formally mentioned whether sinking fund monies were being held in trust in a separate bank account or identified who the trustees actually were.

Whilst such information appears relatively trivial, it has important implications for the tax treatment of sinking fund payments, as where a fund is held in trust then the Inland Revenue treats receipts as capital and it is not taxed as part of the landlord's income. In our interviews with tenants, all of the respondents voiced their concern with the inadequate disclosures on sinking fund contributions, and many specifically avoided leases that included the requirement for such a fund.

Conclusion

In summary, whilst our research to date highlights similar concerns raised elsewhere about the low level of compliance with the Code of Practice, it demonstrates the specific accounting shortcomings that continue to plague service charge accounting.

Whilst the Code of Practice provides general guidance on the preparation of "best practice" service budgets and accounts, industry practitioners appear to be failing in their professional duty to carry these out. One interviewee described the Code as "aspirational", but the rules are in reality very straightforward governance issues. Whilst "bad tenant practices" (another interviewee) coupled with the way in which some managing agents are employed do contribute to the problem, the fact remains that the preparation of a "code-compliant" set of service charge accounts is far from difficult.

We are in the process of preparing such a set of accounts with the help of accounting and industry experts, and hope other parties in the industry are working towards the same goal. Those who do are likely to obtain a substantial competitive advantage.

Postscript :
Dr Timothy Eccles and Dr Andrew Holt are professors at Kingston University