



RICS professional standards and guidance, UK

# Service charges in commercial property

1st edition, September 2018



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# Service charges in commercial property

Professional statement

1st edition, September 2018



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## **Author**

Peter Forrester FRICS (Peter Forrester SCCS Ltd)

## **Working Group**

Duncan Ashman (BDO LLP)

Ian Fletcher (British Property Federation)

David Gardiner MRICS (JLL)

John Gray (John Gray Service Charges Ltd)

Rose Lewis FRICS (Intu Properties PLC)

Hilary Rushby (Gowling WLG LLP)

David Tudor Morgan (British Land)

Warren Gordon (CMS Cameron McKenna Nabarro Olswang LLP)

Mark Alder MRICS (Cushman & Wakefield)

Tim Williamson MRICS (TJX Europe)

## **RICS International Standards**

Global property standards director: Paul Bagust

## **RICS Publishing**

Head of Publishing and Content: Sarah Crouch

Standards Publishing Manager: Antonella Adamus

Standards Publishing Project Manager: Katherine Andrews

Editor: Jo FitzLeverson

# RICS professional standards and guidance

## RICS professional statements

### Definition and scope

RICS professional statements set out the requirements of practice for RICS members and for firms that are regulated by RICS. A professional statement is a professional or personal standard for the purposes of RICS Rules of Conduct.

### Mandatory vs good practice provisions

Sections within professional statements that use the word '**must**' set mandatory professional, behavioural, competence and/or technical requirements, from which members **must not** depart.

Sections within professional statements that use the word 'should' constitute areas of good practice. RICS recognises that there may be exceptional circumstances in which it is appropriate for a member to depart from these provisions – in such situations RICS may require the member to justify their decisions and actions.

### Application of these provisions in legal or disciplinary proceedings

In regulatory or disciplinary proceedings, RICS will take into account relevant professional statements in deciding whether a member acted professionally, appropriately and with reasonable competence. It is also likely that during any legal proceedings a judge, adjudicator or equivalent will take RICS professional requirements into account.

RICS recognises that there may be legislative requirements or regional, national or international standards that have precedence over an RICS professional statement.



## Document status defined

The following table shows the categories of RICS professional content and their definitions.

### Publications status

| Type of document   | Definition   |
|--|--|
| <i>RICS Rules of Conduct for Members and RICS Rules of Conduct for Firms</i> | These Rules set out the standards of professional conduct and practice expected of members and firms registered for regulation by RICS.  |
| International standard   | High-level standard developed in collaboration with other relevant bodies.   |
| RICS professional statement [PS]   | Mandatory requirements for RICS members and regulated firms.   |
| RICS guidance note [GN]  | A document that provides users with recommendations or an approach for accepted good practice as followed by competent and conscientious practitioners.  |
| RICS code of practice [CoP]  | A document developed in collaboration with other professional bodies and stakeholders that will have the status of a professional statement or guidance note.  |
| RICS jurisdiction guide  | This provides relevant local market information associated with an RICS international standard or RICS professional statement. This will include local legislation, associations and professional bodies as well as any other useful information that will help a user understand the local requirements connected with the standard or statement. This is not guidance or best practice material, but rather information to support adoption and implementation of the standard or statement locally. |

# Glossary

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| <b>Accrual accounting</b>                   | Considered to be the standard accounting practice for most service charges, with the exception of very small operations. This requires that costs be recognised in the accounts when incurred, not when the invoice is actually paid. This is the opposite of cash accounting, which recognises transactions only when there is an exchange of cash.   |
| <b>Accruals</b>                             | Expenses incurred in a period for which no invoice has been received at the period end. As the cost relates to the period, it is to be charged to the service charge account for that period.  |
| <b>Adjudication</b>                         | A simple and efficient method of settling disputes. An adjudicator uses their own knowledge and investigations while weighing the evidence presented by the opposing parties. This helps them to reach a decision that is legally binding until the original dispute is referred to arbitration or the courts, or is settled between the parties themselves.   |
| <b>Administration charges</b>               | The manager's costs in procuring services directly (in other words, not through a contractor) where the actual cost of the service (e.g. the site-management team) is recovered through the service charge. The administration charge is intended to reimburse the manager's indirect costs (e.g. payroll, staffing, etc.) and is recorded to the cost category where they are incurred, as would apply if the service(s) were contracted. |
| <b>Alternative dispute resolution (ADR)</b> | The collective description of methods used to resolve disputes other than through the normal judicial process.   |
| <b>Allocation</b>                           | The splitting of the costs of a service to assign them to a specific schedule or cost category.  |
| <b>Amenities and facilities</b>             | Desirable or useful features, services or resources that are provided to make a place more pleasant and convenient, e.g. information desk, way finding, mobility services, children's play areas and clubs, free Wi-Fi, Click and Collect services, free phone charging, customer lounges or seating areas, etc.   |
| <b>Apportionment</b>                        | The spreading of costs within schedules between occupiers who benefit from the services in that schedule, based on the availability, benefit and use of the services.  |
| <b>Arbitration</b>                          | A procedure whereby two parties in a dispute agree to be bound by the decision of an independent third party (the arbitrator). The role of an arbitrator is similar to that of a judge, although the procedures are often less formal. An arbitrator is usually an expert in their own right.  |
| <b>Arrears statement</b>                    | A transaction list of all unpaid charges demanded by the landlord from the tenants, collated on a tenant by tenant basis.  |
| <b>Balancing service charge</b>             | The resulting difference between an individual tenant's apportionment of expenditure and the on-account service charges demanded from that tenant for any specific service charge accounting period, also having regard to any service charge concessions that may have been granted.  |
| <b>Buyer</b>                                | The buyer is the new/prospective owner of the property.  |
| <b>Commercial property</b>                  | All property that is not residential or agricultural and includes retail, office, industrial and leisure properties.   |

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| <b>Completion date</b>                                 | The date of the sale of a property.   |
| <b>Customer services</b>                               | The services provided to help and assist visitors to a property.  |
| <b>Depreciation charge</b>                             | The 'cost' to the owner representing the measure of the wearing out, consumption or other reduction in life of an asset.  |
| <b>Direct charges</b>                                  | Any expenditure that is charged directly to individual occupiers and not funded via the on-account service charges.   |
| <b>Early neutral evaluation (ENE)</b>                  | ENE is an ADR technique. ENE is voluntary, confidential and conducted on a 'without prejudice' basis. The evaluation is non-binding, and aims to help clarify and define legal and factual issues in the dispute, identifying risks and likely outcomes before further significant resources are spent on the matter.   |
| <b>ICAEW</b>   | The Institute of Chartered Accountants in England and Wales.  |
| <b>Independent expert determination</b>                | In the UK and other territories this is a process where an independent third party, acting as an expert rather than as a judge or arbitrator, is appointed to decide a dispute [as an independent expert or 'expert determiner' – not to be confused with an 'expert witness'].   |
| <b>In trust</b>  | Money or monies kept in a separately named account that is held in trust within the bank account of its owner.  |
| <b>International total occupancy cost code (ITOCC)</b> | ITOCC from the Investment Property Databank [IPD] Occupiers Property Databank [OPD] was designed to be the standard form of measuring property and facilities costs for all businesses and public-sector organisations. The code is prepared with the help of IPD occupier and other leading occupiers, consultants, accountants, service providers, developers and academics. As 'total' suggests, it takes account of all of the costs of occupancy, not just those in the common part[s].  |
| <b>Landlord</b>  | The term used in landlord and tenant legislation to denote the person or company who owns and rents or leases premises. The person or company may own the freehold or may have a superior leasehold interest in the property themselves. To avoid confusion, this term is only used in this professional statement where the context makes this necessary. In all other cases the reference is to 'owner'.  |
| <b>Manager</b>   | The person or team that budgets, forecasts, procures, manages and accounts for the services that comprise the service charge, whether they are the owner, an in-house team, management company or a managing agent [including any wholly or partly owned related companies].  |
| <b>Management charge</b>                               | The management charge is the reasonable price for the total cost of managing the provision of the services at the location, and relates only to work carried out in managing and operating the services and administering the service charge.   |
| <b>Management fees</b>                                 | <p>The remuneration of the manager and related entities including any profit element, for managing the services comprised in the service charge. Typically, this includes the supervision of the site team, overseeing the site contractors and the accounts work necessary to budget, forecast, manage, disperse, balance and apportion the service charge. Specifically, these fees are not to include property management work separate from the service charge, such as owner approvals, income generation or rent collection.</p> <p>Where the subject property/site-management team is not sufficiently large enough to justify specific service managers [for example, a health and safety manager or building surveyor] additional specialist fees may be charged to the relevant cost category for the 'manager provided' service.</p> |

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| <b>Management handover date</b>                      | The date on which the responsibility to manage the property transfers from one property manager to another.   |
| <b>Marketing and promotions</b>                      | Advertising and other forms of promotion of a shopping centre intended to bring additional custom to the centre [as distinct from attractions and entertainments of a general amenity, benefit, service or attraction within the centre].   |
| <b>Matrix</b>  | An array of costs set out in rows and columns, which is used as a system of methods and principles in the allocation and apportionment of costs between occupiers.  |
| <b>Mediation</b>                                     | The generally accepted description of commercial mediation is a voluntary, non-binding, private dispute resolution process in which a neutral person helps the parties to reach a negotiated settlement. A core principle of mediation is that the parties 'control' the outcome, rather than it being imposed on them.   |
| <b>Not for profit, not for loss</b>                  | Descriptions of the service charge costs, which are not inflated for profit (although the individual services within the costs may contain a profit element for the individual supplier); but also, there is no residual loss [assuming a fully let property with no concessions on service costs to specific occupiers] left for the owner to pay.   |
| <b>Occupier</b>                                      | A person in possession or occupation of premises and usually responsible for payment of the service charge to the owner.  |
| <b>Office service charge analysis report [OSCAR]</b> | Produced by Jones Lang LaSalle, OSCAR is an industry-leading benchmark. The industry cost classifications set out in Appendix B have been designed and agreed with IPD occupiers so that the OSCAR data can be incorporated into ITOCC from its OSCAR form for regular year-on-year, but not exceptional, expenditure.  |
| <b>On-account service charge</b>                     | An estimated charge raised in advance and anticipation of the final service charge liability, calculated from the service charge budget.  |
| <b>Owner</b>   | The person who receives or is entitled to receive the rent. This person is usually responsible for the provision, management, and administration of the services and the service charge. In practice the owner may appoint a manager to discharge the owner's obligations under the terms of the lease.   |
| <b>Planned preventative maintenance [PPM]</b>        | PPM is maintenance that is performed purposely and regularly to keep the fabric, facilities, plant and equipment of a building in satisfactory operating condition by providing for systematic inspection, detection and correction of failures, either before they occur or before they develop into major defects. PPM also helps to identify the point at which such items can reasonably be deemed to have reached the end of their economic life, such that replacement or renewal may be necessary. PPM programmes are usually prepared in periods of between 5–10 years in advance, and is to be regularly reviewed and updated at frequent intervals. |
| <b>Prepayments</b>                                   | Expenses paid in a given period that relate to the following period in whole or part.   |
| <b>Rateable value</b>                                | An official estimate of the value of a property used as a basis of local taxation. Rateable value is said to be the amount equal to the rent at which the property might reasonably be expected to be let from year to year if the occupier undertook to pay all of the usual occupier rates and taxes, and was also to bear the cost of repairs, insurance and other expenses (if any) necessary to maintain the property in a state to command that rent.   |
| <b>Rebranding</b>                                    | The upgrading of house or corporate style, logos, names badges, etc.  |

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| <b>Refurbishment</b>                           | The renovation of fabric or equipment to bring it to a workable or better condition. It is often a different concept to repair or improvement, and usually includes elements of both. Where a refurbishment project includes improvements or enhancements beyond normal repair or maintenance, this element of the cost would usually be met by the owner. |
| <b>Relaunching</b>                             | Marketing to change the perception in the eyes of its target audience. This may be for letting purposes (an owner's cost), or may benefit both owner and occupier – for example, a shopping centre following refurbishment – in which case, an agreement is to be reached as to how the relaunch costs are split between the parties.                      |
| <b>Reserve fund</b>                            | A fund formed to meet anticipated future costs of maintenance and upkeep in order to avoid fluctuations in the amount of service charge payable each year (for example, for external cleaning and redecorations).  |
| <b>Retail price index (RPI)</b>                | A measure of inflation in the UK published monthly, or such other comparable national statistics published from time to time.  |
| <b>Sale contract</b>                           | The contract setting out the terms on which the property is to be sold and transferred between the seller and buyer.   |
| <b>RICS Dispute Resolution Service (DRS)</b>   | RICS DRS can provide a simple, fast and cost-effective approach to resolving disputes in the complicated world of property and construction, where disputes are bound to arise.  |
| <b>Seller</b>                                  | The previous/current owner of the property.  |
| <b>Services</b>                                | Where the word 'services' is used, the reference includes works, such as maintenance and repair of the fabric and structure, and true services, such as the provision of heating, lighting, cleaning, security, etc.   |
| <b>Service charge account</b>                  | The service charge funds held for a specific property.   |
| <b>Service charge apportionment</b>            | The method and details of apportioning liability between tenants for contributing to a service charge.   |
| <b>Service charge apportionment matrix</b>     | Schedules containing as a minimum the information shown in appendix C (CD and CE).   |
| <b>Service charge arrears</b>                  | Any on-account service charge or balancing service charge owed by a tenant to the landlord.  |
| <b>Service charge budget</b>                   | The expenditure estimated by the landlord or its manager that will be incurred in a given service charge accounting period.  |
| <b>Service charge reconciliation</b>           | A comprehensive comparison of all service charge income demanded against all service charge expenditure (including accruals and prepayments) for a given service charge accounting period. This enables the calculation of any balancing charges and credits due from tenants and/or landlords.  |
| <b>Schedules</b>                               | The allocation of service charge costs into separate parts to reflect the provision, usage, benefit or availability of services between individuals or groups of occupiers.  |
| <b>Sinking fund</b>                            | A fund formed by periodically setting aside money for the replacement of a wasting asset (for example, heating and air-conditioning plant and equipment, lifts, etc.).   |
| <b>Statement of service charge expenditure</b> | The account of service charge expenditure/costs and related notes. Commercial leases usually provide for an annual statement of service charge expenditure to be issued to occupiers following the end of each service charge period.  |

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| <b>Tenant</b>               | The term used in landlord and tenant legislation to describe any person [physical or legal] who owns the leasehold interest in property and is liable to pay the service charge under the terms of the lease. As with 'landlord', this term is only used when the context requires; references in the context of commercial property and service charges are to 'occupier'. |
| <b>Value for money</b>      | Good value for money is the optimal use of resources to achieve the intended outcomes. 'Optimal' means 'the most desirable possible given expressed or implied restrictions or constraints'. Value for money is not about achieving the lowest initial price.   |
| <b>Virtual bank account</b> | A subsidiary or sub-account of a physical bank account that allows segregation of funds, e.g. in respect of individual properties, from other funds in the same account or alternatively where funds can be clearly identified through the use of separate ledgers.   |
| <b>Void liabilities</b>     | The share of the agreed service charge expenditure for any service charge accounting period that is attributable to vacant lettable accommodation.  |

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# 1 Introduction

Industry collaborative guidance for the management and administration of service charges in commercial property was first published in 1996. This is the 6th iteration of what has become known as the Service Charge Code and is now published as a 1st edition RICS professional statement.

In the 22 years since its inception, the Code has had a profound and positive impact on the commercial property sector and has facilitated major improvements in standards of delivery and accountability for service charges.

The move to formalising the Code as an RICS professional statement is a further significant step forward. This step not only underlines the importance of managing service charges consistently and effectively but also represents a continued evolution of best practice processes and procedures in an increasingly complex and challenging area of commercial property management, which requires practitioners to have a particular and demanding skill set.

This professional statement sets out best practice in the management and administration of service charges in commercial property, and provides **mandatory obligations** that RICS members and regulated firms engaged in this area **must** comply with.

For clarity, please be aware that this entire document is an RICS professional statement and RICS expects that members engaged in activity relating to service charges will be familiar with and comply with the whole document.

If members depart from the best practice requirements set out in the document they should only do so for justifiable reasons. It is not acceptable to simply comply with the mandatory obligations contained in this document.

- Chapter 2 of this document outlines the aims and objectives of this professional statement, along with stating its mandatory requirements.
- Chapter 3 sets out the core principles.
- Chapter 4 gives recommendations and guidance on how the professional statement can be followed.
- Appendix A onwards contains additional information and resources to support an understanding of the professional statement and assist with its implementation.

This professional statement is effective for all service charge periods commencing from 1 April 2019 and supersedes the RICS code of practice *Service charges in commercial property*, 3rd edition.

This professional statement is applicable across the United Kingdom. You should be aware that there are instances where different conditions may apply in Scotland and Northern Ireland. These are highlighted where appropriate.

## 1.1 Limitations of the professional statement

### Existing lease terms

This professional statement cannot override the lease but, if read in conjunction with it, can enable users to identify the best way forward in interpreting that lease to ensure effective management of services.

This professional statement sets out specific mandatory requirements for RICS members and there may be legal and/or disciplinary consequences for members in departing from professional statements, which may lead to a finding of negligence against a surveyor. However, subject always to the terms of the lease, a failure to meet the standards set out in the professional statement will not of itself be sufficient to negate or limit an occupier's liability to pay a service charge in accordance with the terms of the lease.

As business practice constantly evolves, so it is with service charges. Negotiating a new lease, or the renewal of an existing lease, provides an ideal opportunity to ensure that modern and flexible best practice service charge clauses are incorporated within the lease contract to facilitate effective management of the property and aid the relationships between the parties.

An alternative dispute resolution (ADR) clause will enable any difficulties during the term of the lease to be resolved efficiently and with reduced cost. All parties should carefully consider the principles and requirements of this professional statement prior to entering into a new or renewal lease.

### Proportionality

The extent to which owners and managers should seek to comply with the recommended best practice processes and procedures set out in this professional statement will often depend on a variety of issues, such as the size, nature and type of property, the aggregate of the total service charge costs and the amounts payable by individual occupiers, and this should be consistent with best-value principles.

Nevertheless, owners, managers and occupiers should seek to comply with the mandatory requirements and core principles set out in this professional statement at all times.

### The service charge arrangement

Service charges deal with the costs of servicing and operating a property, to comply with the landlord lease obligations for the provision of services.

The service charge arrangement is set down in the lease(s) and the aim is to entitle the owner to recover their charges and any associated administrative costs incurred in the operational management of the property. This will include reasonable costs of maintenance, repair and replacement (usually where beyond economic repair) of the fabric, plant, equipment and materials necessary for the property's operation, plus any other works and services the parties agree are to be provided by the owner, but subject to reimbursement by the occupier.

If the property is fully let, the owner will normally be able to recover all expenditure on services through the service charge, except any concessionary discounts the owner may have given.

Usually, there will be a manager who administers those services, for which they will receive a fee.

The City of London Law Society has drawn up service charge lease provisions that have been specifically designed to comply with the principles and provisions of this professional statement. This can be accessed from the City of London Law Society website: ([www.citysolicitors.org.uk/index.php?option=com\\_content&view=category&id=161&Itemid=471](http://www.citysolicitors.org.uk/index.php?option=com_content&view=category&id=161&Itemid=471)).

## RICS standards and regulatory requirements

You **must** comply with the *RICS Rules of Conduct for Firms*, the *RICS Rules of Conduct for Members* and the five RICS ethical principles, which say that you **must**:

- Act with integrity.
- Always provide a high standard of service.
- Act in a way that promotes trust in the profession.
- Treat others with respect.
- Take responsibility.

You **must** also comply with any related RICS professional statement – global and UK.

For ease of reference these include:

- *RICS property measurement*, 2nd edition, professional statement.
- *Real estate agency and brokerage*, 3rd edition, professional statement.
- *UK commercial real estate agency*, 1st edition, professional statement.
- *Conflicts of interest*, 1st edition. global professional statement.
- *Conflicts of interest – UK commercial property market investment agency*, 1st edition, professional statement.

Further information can be found at [www.rics.org/uk/regulation1](http://www.rics.org/uk/regulation1)



## 2 Mandatory requirements

The aims and objectives of this professional statement are to:

- improve general standards and promote best practice, uniformity, fairness and transparency in the management and administration of services charges in commercial property
- ensure timely issue of budgets and year-end certificates
- reduce the causes of disputes, and to provide guidance on the resolution of disputes if these arise and
- provide guidance to solicitors, their clients (whether owners or occupiers) and managers of service charges in the negotiation, drafting, interpretation and operation of leases, in accordance with best practice.

Professionals involved in the management of service charge accounts must act in accordance with the following principles:

- 1** All expenditure that the owner and manager seek to recover **must** be in accordance with the terms of the lease.
- 2** Subject to section 4.2.7, owners and managers **must** seek to recover no more than 100% of the proper and actual costs of the provision or supply of the services.
- 3** Owners and managers **must** ensure that service charge budgets, including appropriate explanatory commentary, are issued annually to all tenants.
- 4** Owners and managers **must** ensure that an approved set of service charge accounts showing a true and accurate record of the actual expenditure constituting the service charge are provided annually to all tenants.
- 5** Owners and managers **must** ensure that a service charge apportionment matrix for their property is provided annually to all tenants.
- 6** Service charge monies [including reserve and sinking funds] **must** be held in one or more discrete [or virtual] bank accounts.
- 7** Interest earned on service charge accounts – or where separate accounts per property are not operated, a proper and reasonable amount of interest calculated on normal commercial rates – **must** be credited to the service charge account after appropriate deductions have been made.
- 8** Where acting on behalf of a tenant, practitioners **must** advise their clients that if a dispute exists any service charge payment withheld by the tenant should reflect only the actual sums in dispute.
- 9** When acting on behalf of a landlord, practitioners **must** advise their clients that following resolution of a dispute, any service charge that has been raised incorrectly should be adjusted to reflect the error without undue delay.

These mandatory requirements represent what is considered to be an acceptable standard of performance for RICS members and regulated firms.

To provide a service that represents best practice in the management of service charges, practitioners should fully read this statement, which contains advice on RICS expectations on the implementation of the core principles and how to adhere to the mandatory principles.

## 3 The core principles

These principles underpin and support the mandatory requirements listed in chapter 2 of this professional statement. It is acknowledged that some of the following principles may be difficult to quantify, and in rare circumstances strict compliance may not always be possible. The appropriate level of compliance may be based on the professional judgment of all parties as to what is appropriate and reasonable considering all the circumstances.

### The service costs

- 1 All costs should be transparent so that all parties, owners, occupiers and managers, are aware of how the costs are made up. Management fees should be on a fixed-price basis with no hidden mark-ups.
- 2 Best practice recommends that services are procured on an appropriate value for money basis, and that competitive quotations are obtained or the costs benchmarked.
- 3 Owners should not profit from the provision or supply of services. Save for a reasonable commercial management fee that reflects the actual costs of managing the services, the amount an owner may recover is limited only to the proper and actual cost incurred in the provision or supply of services.

### Allocation and apportionments

- 4 Costs should be allocated to the relevant expenditure category. Where reasonable and appropriate, costs should be allocated to separate schedules and the costs apportioned to those who benefit from those services.
- 5 The basis and method of apportionment should be demonstrably fair and reasonable to ensure that individual occupiers bear an appropriate proportion of the total service charge expenditure that clearly reflects the availability, benefit and use of services.

### Communication and consultation

- 6 While the owner has the right to set the standards by which their investment will be managed and has a duty to manage, managers should consult with occupiers regarding the standard and quality of service charge provision required.
- 7 Managers should communicate with occupiers to ensure services are delivered effectively for the benefit of all, and to ensure that occupiers understand what they can expect to receive and how much they are required to pay.
- 8 Managers claiming compliance with the principles of this professional statement should be transparent in demonstrating how they comply with it.

### Duty of care

- 9 Those certifying service charge accounts should recognise that they have a duty of care to both owners and occupiers to act with professional care, diligence, integrity and objectivity.
- 10 The owner and/or manager has a duty to manage the property, as well as a duty of care to both the occupiers, who entrust the spending of their own business overhead and cash flow by funding the services, and to the owner whose investment they are servicing.
- 11 There should be clear policies as to how the service charge will be managed.

### Financial competence

- 12 When issuing statements of accounts and/or certifying expenditure, managers should do so in a non-partisan spirit, acting as experts.
- 13 In addition to the manager's certificate, annual statements of service charge expenditure should be supported by an independent review of the service charge accounts in line with the ICAEW Technical Release (Tech 09/14BL).
- 14 The Industry Standard Cost Classifications should be used in reporting budget and actual expenditure.

### Occupier responsibilities

- 15 Occupiers should ensure prompt payment of all legitimate service charge on-account and balancing charges.
- 16 Occupiers should recognise that the service charge provision of any lease has legal effect, and should ensure that any representatives involved in discussions, meetings, etc. have an appropriate level of responsibility and authority to make decisions concerning service charge matters.
- 17 In recognition that value for money and maintenance of quality standards will be enhanced through partnership, occupiers should be proactive in assisting owners in the operation and utilisation of services and service systems. For example, by separating waste to facilitate appropriate and cost-effective recycling, adopting energy-saving measures, etc.

### Right to challenge/alternative dispute resolution (ADR)

- 18 All new leases (including renewals) should make provision for either party to require the resolution of disagreements through alternative dispute resolution (ADR) as a cost-effective alternative to court action.

**19** If the parties cannot agree a mediator, or an independent expert to determine the dispute, the President of RICS should (on request) nominate a suitable person. Where leases do not allow for ADR, parties are reminded that there is nothing to stop them agreeing to use ADR to resolve a dispute.

### Timeliness

**20** Communication and consultation between managers and occupiers should be timely and regular to encourage and promote good working relationships and understanding with regard to the provision, relevance, cost and quality of services. Timely and regular communication and consultation would also be expected to help avoid disputes and resolve them should they arise.

**21** Managers should issue budgets to occupiers, including an explanatory commentary and apportionment matrix at least one month prior to the start of the service charge year. Detailed statements of actual expenditure, together with accounting policies and explanatory text, should be issued within four months of the service charge year-end.

### Transparency

**22** Transparency is essential to achieving good communication. By being transparent in the accounts, the explanatory notes, policies and day-to-day management, the manager will help prevent disputes. Prompt notification of material variances to plans or forecasts ensures better working relationships between owner, manager and occupier.

### Value for money

**23** Service quality should be appropriate to the location, use and character of the property. The manager should procure quality service standards to ensure that value for money is achieved at all times. The aim is to achieve effective, value for money service rather than merely the lowest price.

### Exclusions

**24** Service charge costs should not include any of the following:

- Any initial costs (including the cost of leasing of equipment) incurred in relation to the original design and construction of the fabric, plant or equipment.
- Any setting up costs, including costs of fitting out and equipping the on-site management offices that are reasonably considered part of the original development cost of the property.
- Any improvement costs above the costs of normal maintenance, repair or replacement. Service charge costs may include enhancement of the fabric, plant or equipment, where such expenditure can be justified following an analysis of reasonable options and alternatives, and with regard to a cost-benefit analysis over the term of the occupiers' leases. Managers

should provide the facts and figures supporting such a decision.

- Future redevelopment costs.
- Costs and fees relating to the owner's investment interest, for instance, asset management and rent collection, cost of letting units and matters between the owner and an individual occupier. This last category may include activities such as enforcement of lease covenants, dealing with landlord consents for assignments, sub-letting, alterations, rent reviews, additional opening hours, etc.
- Costs attributable to void premises and the owner's own use of the property.
- Any costs arising out of the negligence of the manager or owner.

# 4 Best practice to support the core principles

## 4.1 Administration

The best practice recommendations in this section will help RICS members and regulated firms achieve the following mandatory requirement:

- 2** Subject to section 4.2.7, owners and managers **must** seek to recover no more than 100% of the proper and actual costs of the provision or supply of the services.

### 4.1.1 Standard and quality of service provision

The aim of service provision is to ensure that services are beneficial and relevant to the needs of the property, its owner, its occupiers and their customers.

Managers and occupiers should consider the nature, type and complexity of each property, as the levels and standards of service provided will differ according to these factors. In providing these services, the aim is to achieve effective, value for money service rather than the lowest price.

The manager is responsible for:

- ensuring the standard of services provided are monitored
- ensuring the quality and cost of the services provided are regularly reviewed and
- demonstrating that service standards are being delivered and value for money is being achieved.

It is recommended that management policies and procedures be established to define the procurement, administration and management of services. It also ensures the respective obligations of owner and occupier are discharged and services are provided efficiently, economically, cost-effectively and safely.

Where there are sound reasons for implementing alternative procedures to those set out in this professional statement, the manager should explain and justify these in advance.

Effective communication is key to achieving best practice. The aim is to provide transparency between manager and occupier in the way services are provided and managed, and in how the costs of these services are recovered.

On occasion, additional services will be provided outside the service charge. Occupiers are entitled to expect similar transparency, accountability, etc. in these services. This professional statement applies to these as well.

### 4.1.2 Staffing and personnel

On-site management staff are required to have a sound knowledge of appropriate modern business practices and to be adequately skilled to provide the best and agreed performance standards. As they will need appropriate skills in general management, employment and health and safety matters, any necessary training costs may also be covered by the service charge.

To ensure the services are provided efficiently and cost-effectively, appropriately sufficient staffing of the right type and calibre is to be provided. In keeping with the goal of transparency, it is best to declare the total costs for such additional staff.

Site-management teams and managers should perform according to defined standards. It is also advisable to measure and review performance regularly against these performance standards.

Where reviews of staffing levels are undertaken, it is reasonable that costs associated with achieving beneficial changes – such as the termination of employment contracts – are recovered under the service charge. This is provided that such costs can be justified following the analysis of reasonable options, and that the purpose is proven to achieve greater cost-effectiveness and value for money.

### 4.1.3 Management charges

#### 4.1.3.1 Total cost of management

The total cost of management is the reasonable price for managing the provision of the services at the location, and relates only to work carried out in managing and operating the services and administering the service charge.

The total cost of management might comprise two elements:

- i. the fee charged by the manager and related entities for managing and supervising the services for a site (the management fee) and
- ii. the cost of the site-specific management staff, including accommodation and ancillary office costs etc., whether in a full- or part-time capacity (the site-management costs).

No two buildings are identical in the way they need to be run to meet the requirements of all parties with an interest in the property. Management fees and site-management costs should be set at the appropriate level.

It is not for this professional statement to prescribe the operating business model of the manager.

For instance, where in addition to the usual role undertaken by that of a property manager, a regional facilities manager is employed to oversee a number of properties, managers should be aware of the additional costs in creating a tiered management structure and should be prepared to demonstrate that the total cost of management is fair and reasonable in the circumstances and consistent with the value for money principles set out in this professional statement. Managers should be prepared to explain the role of the regional facilities manager, the number of properties that they are involved with, and exactly how their costs and time are split between them.

Best practice requires transparency and a management structure where costs are clearly identified and explained. It is therefore recommended that this information be contained within the explanatory notes included in the budget and in the annual service charge accounts.

### 4.1.3.2 Management fees

The management fees charged shall comprise only the reasonable costs and overheads borne in the process of operating and managing the services. These would also reflect the actual work necessary to fulfil the principles of this professional statement. It is recognised that whoever is providing the service is entitled to cover their costs and overheads, including a reasonable profit element.

Management fees should relate only to the actual work carried out in managing the service charge. Other costs – for instance, asset management and rent collection – should be excluded from the service charge management fee, which would be stated in the service charge report.

The professional statement requires that fees be set on a fixed-price basis rather than being calculated as a percentage of expenditure. Fees based on a percentage of service costs are no longer considered appropriate and are a disincentive to the delivery of value for money. The management fee should, therefore, be a fixed fee subject to annual review or indexation.

It is recognised that many leases refer to the management fee as a percentage of the total service charge, or contain a percentage cap.

This professional statement cannot override the terms agreed between the parties and recorded in the lease. However, where the lease limits the amount or quantum of the fee recoverable from occupiers it is a matter between the owner and occupier and should not prevent or limit the manager's ability to charge a commercial fee that reflects the requirements of this professional statement. In certain circumstances, this may result in a shortfall in the recovery of service charge costs on behalf of the owner, but the overriding principle should be to achieve best practice principles for the management and administration of services charges in commercial property.

Managers should confirm in the service charge report:

- the basis and duration of their appointment
- when they were appointed
- a summary of the services in connection with the management of the services and the service

charge, and the management fee payable, which is recoverable under the service charge and

- that the owner bears a proper cost of all other duties performed by the manager in relation to matters outside of the service charge.

Where the owner manages the property in-house they should have due regard to the principles as outlined previously, and be able to support the basis of their fees when benchmarked against other comparable service providers.

Where a lease includes a cap on the amount of management fee chargeable, unless stated in clear and unambiguous terms, it is the general intention that it refers to the fee the manager receives and not the on-site management cost.

Where specialist reports (e.g. fire-risk assessment reports, *Disability Discrimination Act* (DDA) reports, health and safety reports, etc.) are prepared by specialists working for the same organisation as the manager, the costs should be excluded from the management fee. Fees for these additional services should represent value for money and be clearly and separately stated within the service charge reports issued to tenants and included under a related cost classification.

### 4.1.3.3 Other income

There should be transparency regarding all other sources of income and related income or other benefits to the manager and related entities arising out of the management or provision of services, which should be declared in the annual year-end service charge accounts. On request, owners and managers should declare what services are provided for the income received and which should only be retained in return for a service of value and should be proportionate to the service. These may include insurance fees (including commissions).

### 4.1.3.4 Duties of the manager

The owner has the duty to manage or delegate management of the property, and the responsibility to administer and account for the tax properly due on the service charge. Best practice requires the manager to recognise a duty of care, both to the occupiers who fund the services being provided, and to the owners whose investment they are servicing.

The manager will usually perform additional roles and duties relating to investment interests, for instance asset management and rent collection. In such cases, the fees the manager charges in relation to performing such additional duties should be excluded from the service charge management fee.

### 4.1.3.5 Site management costs

Site management costs are the full employment costs for sufficient staff, as described in section 4.1.2. The job titles of the staff will vary, however, the total cost of the staff is to include wages, national insurance (NI), tax, compliance with statutory requirements, training and other appropriate benefits.

Site management costs might also include:

- the costs of providing appropriate office accommodation and administrative support where necessary
- a reasonable fee representing the human resources (HR) and payroll costs associated with dealing with staff (often referred to as an administration charge) and
- separate specialist consultancy fees payable, for instance, in connection with the carrying out of health and safety risk assessments, asbestos surveys, etc. and which should be clearly identified in the service charge accounts within a related cost classification and referred to in the expenditure report notes.

One way of ensuring the costs reflect value for money is to compare them to a third party providing similar services. Where such fees are included the basis of calculation and/or quantum of the fees included should be clearly communicated to occupiers to aid transparency.

The total on-site management cost should be explicitly shown in the service charge accounts and allocated under the 'site management cost' heading. Staff costs should not generally be split between other account code headings unless there is an appropriate reason for doing so and in such a case this should be explicitly noted in the budget and statements of actual expenditure.

For instance, the cost of an on-site facilities management team and on-site contract managers of the main building services, e.g. security or cleaning managers (either directly employed staff or those employed through third-party agencies, etc.) should be included as part of the 'site management cost', whereas a security or cleaning supervisor employed by the relevant service provider should be included in the security or cleaning cost classification.

However, where such costs are not included as a 'site management cost' but allocated to a specific cost heading (i.e. cleaning or security) the manager should be clear and explicit as to how these management costs have been treated.

Where additional management or supervisory functions are carried out by non-site-based staff, for instance, a regional/area facilities manager, these costs should be clearly identified and included under the 'site management costs' where they are performing site specific tasks.

Where such functions are performed in place of, rather than in support of, the duties usually expected of or performed by the manager and included within the management fee, the costs should not comprise or be regarded as a site management cost but as part of the management fee.

Where the cost of non-site-based staff is apportioned to more than one property, the calculation and basis of allocation should be clearly and explicitly communicated to occupiers in the budget reports and statements of actual expenditure.

Similarly, any additional administrative charges included should be clearly and explicitly identified.

Where on-site staff are responsible for more than one property, their costs (and any appropriate accommodation and administrative support costs) are best distributed accordingly so that each property covers a fair share of the cost. The service charge report should identify clearly whether this is the case and how the costs are split.

Many buildings require management 24/7. If it is reasonably considered that a property requires out of hours support a manager may consider supporting the function of the on-site staff by providing a customer support help desk to deal with property matters outside of usual business hours, or when the manager cannot be contacted. Where this is reasonably and necessarily provided as an alternative to employing additional on-site staff, the reasonable cost of running this service may be recovered from the service charge.

If the manager is instructed by a tenant to provide facilities services for their demised property, e.g. cleaning, security, etc. the manager's charges for providing these services should be directed to the relevant tenant and not included in the service charge. Additionally, if the site management team (whose costs are recovered from the service charge) are involved in the administration, oversight or contract management, etc. of these tenant services, an appropriate apportionment of their costs should be excluded from the service charge, and the basis for this apportionment should be transparent. In other words, 100% of the site management staff costs should not be recovered from the service charge if the team are also involved in providing tenant services.

Similarly, if the on-site management team are also involved with activities that are not directly related to the provision or management of the site services, such as asset management initiatives or rent collection on behalf of the owner, an appropriate proportion of their cost and overhead should be borne by the owner and not included in the service charge.

#### **4.1.3.6 Notional rent for management accommodation**

Many leases contain provisions for the inclusion of a notional rent within the service charge for management accommodation, or for other premises used in connection with the management of the property. Notional rents were originally included to provide developers with a return on otherwise unlettable space and to cover the initial provision costs for management accommodation.

In many cases, management accommodation cannot be separately let, and thus has no market value other than as a location for such an operation. However, there are situations where the management premises comprise accommodation (offices) that would otherwise be lettable space; in these cases, there is an element of rent foregone to provide accommodation for the on-site management team.

It is generally not considered appropriate to charge occupiers notional rent in situations where either the premises are incapable of beneficial occupation for any other purpose, or where provision has not been made for

facilities management accommodation – for example, a modern building designed without facilities management accommodation as part of the original design specification.

There is also an argument that if notional rents are applied, it may discourage an efficient use of space, or a consideration of alternative uses for areas currently occupied by centre or facilities management.

### 4.1.4 Contract procurement

#### 4.1.4.1 Service standards and provision

It is best practice to ensure that all contractors and suppliers perform according to written performance standards. On the basis that the manager is approving payment of supplier costs, on trust for the tenants, the manager should regularly measure and review performance against these defined performance standards, as well as to regularly review the appropriateness of the standards used.

#### 4.1.4.2 Procurement of services

It is the responsibility of the manager to identify the procurement strategy most suitable for the property based on an appropriate level of service and value for money.

*Procurement of facility management*, professional statement, 1st edition includes the following mandatory requirements for procurement practice carried out by RICS members:

- 1 You must have a clearly defined, detailed scope of the services, defining what is and is not included.
- 2 You must state clear objectives for the procurement project.
- 3 You must develop evaluation criteria that reflect your objectives.
- 4 You must have a clear pricing structure stating what services and costs are included and what is excluded.
- 5 You must have clear timescales for the procurement process.
- 6 You must provide a clear payment mechanism.
- 7 You must comply with relevant data protection rules.

The manager may use either an in-house or third-party procurement specialist to deliver best-value solutions, as long as the purpose is to achieve greater cost-effectiveness and value for money. The cost of any procurement specialists employed is considered to be recoverable through the service charge, but the costs should be clearly identified in the service charge report, along with details of whether it is a one-off fee or is to be spread over the duration of the contract (see appendix C). It is intended that the fee payable should reflect the work undertaken, which may also be performance-related.

It is the responsibility of the manager or the procurement specialist to develop procurement systems; vet and select the most appropriate contractors, based on track record, skill and management experience; and prepare a contract and specification – including *Transfer of Undertakings*

(*Protection of Employment*) Regulations 2006 (TUPE) information – where appropriate. Contract costs are to be transparent and in accordance with the provisions for transparent accounting.

The manager or procurement specialist is expected to be responsible for the provision of full pre-qualification assessments of suppliers and contractors in terms of their:

- financial standing and proven compliance with health and safety
- appropriate indemnity in respect of the services provided, including any undertakings via subcontractors (with provisions for prior approval thereof) and
- proven environmental/sustainability credentials.

Whether or not managers employ procurement specialists their approach to the procurement process outlined in this section should be transparent.

Managers should ensure that there is transparency in procurement fees and charges for verifying contractor financial standing, health and safety records, and environmental credentials, etc. including cost or fees charged either to their client or the suppliers and contractors.

If any fees are received from suppliers or contractors, the manager should clearly state, in the service charge accounts, what these are and what they are for. Managers should also be aware that the practice of requesting fees (other than a reasonable administration charge) from contractors for inclusion in approved contractor lists, contract tendering, etc. is contrary to best practice, and is wholly inappropriate under any circumstances.

On receipt of tenders, a tender report should be prepared containing recommendations on which contractor is most suitable. Copies of all tender documents should be made available for inspection, if requested. If further copies are required, the manager is entitled to charge for the time, cost of copying and postage of such documents. Best practice is that the tender report and recommendations should be reviewed and approved by someone who is not directly connected with managing the actual delivery of the services on site.

Owners and/or managers are often able to achieve substantial savings and other benefits in the provision of services through bulk purchasing or through the placing of group contracts. However, the pricing of services under such contracts can differ in either providing a single-contract sum, a separate cost per property or a schedule of rates for different services.

Where such bulk or group contracts exist, occupiers are not entitled to have access to documents relating to properties other than the one they occupy. However, where the contract/tender includes other properties, transparency in terms of the apportionment and allocation of costs to the subject property is essential.

Where contracts are reviewed, it is reasonable that costs associated with achieving beneficial change, such as termination of contracts, are recovered under the service

charge. This is applicable where such costs can be justified following the analysis of reasonable options, and where the purpose is to achieve greater value for money and cost-effectiveness.

#### 4.1.5 Value for money

Service provision and quality is to be appropriate to the location, use and character of the property. The manager should procure quality service standards to ensure that value for money is achieved at all times. The aim is to achieve effective, value for money service rather than the lowest price.

Occupiers are to be proactive in assisting managers with operating and using services that are consistent with the aim of achieving value for money, for example, separating waste to facilitate appropriate and cost-effective recycling.

The manager is to keep all costs under review, and where appropriate (generally every three years), require contractors and suppliers to submit competitive tenders or provide competing quotations. However, where it is considered that formal re-tendering would not be cost-effective or practical, the manager should regularly benchmark the service standards and pricing to confirm that value for money is still being achieved.

In this context, 'regular' is subject to interpretation as to what is reasonable in the circumstances. Annual reviews may, in certain circumstances, be considered excessive and not cost effective whereas three yearly might be reasonable but ten yearly would not.

Managers should require major service providers to demonstrate that their services, methods and processes are continually reviewed to ensure value and efficiency.

#### 4.1.6 Direct recoveries

Service charges usually include the cost of utilities for any common parts and services. Traditionally, buildings and/or rent insurance is apportioned to occupiers outside of the service charge arrangement as a directly recoverable cost, with occupiers often being responsible for payment of electricity/gas consumption supplied to the occupied premises direct to the utilities provider. In some circumstances, however, the lease may provide for the cost of buildings insurance and demised electricity to be recovered within the service charge.

Where owners are seeking to recover the cost of insurance and utilities outside of the service charge arrangement, occupiers are entitled to expect the same level of transparency and accountability, etc. in these services, since this professional statement is also applicable to these.

##### 4.1.6.1 Insurance

###### Value for money

Where owners are responsible for insuring the property, the insurance policy terms should be fair and reasonable and represent value for money, and be placed with reputable insurers.

##### Commission

The principle of commission retention is now long established. In its base form, the use of commission to cover administrative costs – including broker fees – is to be recognised, also the owner's ability to benefit from the economies of scale generated by the pooling of risks into a common programme.

Owners, managers and related entities should at all times disclose any remuneration, commission and other sources of income and related income or other benefits received in connection with placing or managing insurance and details of any arrangements that impact on the level of commission, e.g. captive entities.

##### Service

Owners are obliged to provide full insurance details on request, and to be able to explain the process by which occupiers can make claims under the policy. Owners should also provide details of the basis of apportionment of the insurance premiums.

Policies are expected to include an ability to note the interest of occupiers either generically or individually, as well as any subrogation waivers and non-invalidation provisions for the benefit of the occupier. Again, these are to be in line with lease obligations.

##### 4.1.6.2 Utilities

Where a service is provided directly to an occupier or to the occupied premises – such as mains water or electricity supply as distinct from common works and services – it is important that the manager and occupier understand the basis on which the service is provided, and whether the costs are intended to be included within the service charge account, or are to be issued as a separate charge.

Separate metering, or full submetering of utility supplies, is considered essential to ensure an apportionment of cost between occupiers that reflects actual consumption and usage.

Costs should be recovered in accordance with the terms of the leases, which ought to allow additionally for the payment of a reasonable administrative charge. The recovery should state unit costs and the basis of the manager's administration charge. Therefore, if an administration charge is levied by the manager it should be transparent and clearly communicated to occupiers. The recovery should include copies of the original utility invoices in order to comply with the requirements for transparency set out in this professional statement.

To avoid ambiguity, and to ensure that accurate consumption and billing is recorded for occupiers, it is recommended best practice that the cost of reading meters (where carried out by a third party) is included as an acceptable cost under the service charge. Otherwise, such costs would usually comprise part of the on-site management costs.

Occupiers should be aware of the ever-increasing pressure placed on owners by utility providers for prompt payment and should, therefore, ensure that all invoices are paid



promptly. In certain circumstances payments in advance may be appropriate.

It is now also becoming increasingly common for utility companies to request that owners either pay large security deposits or higher energy rates.

Where a lease makes specific provision for the inclusion of a security deposit as a service charge cost, both owners and occupiers are urged to ensure that the lease allows for the occupier's proportion of the deposit to be reimbursed on expiry, or alternatively on sooner determination of the lease, in the event of a change of owner/manager, or if the deposit is otherwise reimbursed by the utility company.

Where a lease makes no such provision, it is considered appropriate for the owners to open a dialogue with occupiers to seek to agree to pay a security deposit in return for contract supply rates, as opposed to default supply rates.

The payment of a deposit can be included in on-account payments for the relevant service charge period, credited at year-end and then re-budgeted for the following period. Therefore, if a lease expires in any given period, the occupier should receive an appropriate credit in their final service charge balance.

## 4.2 Allocation and apportionment

The best practice recommendations in this section will help RICS members and regulated firms achieve the following mandatory requirements:

- 2 Subject to section 4.2.7, owners and managers **must** seek to recover no more than 100% of the proper and actual costs of the provision or supply of the services.
- 3 Owners and managers **must** ensure that a service charge apportionment matrix for their property is provided annually to all tenants.

### 4.2.1 Schedules

Costs should be fairly and reasonably allocated to the relevant expenditure category. Where reasonable and appropriate, costs should be allocated to separate schedules and the costs apportioned to those who benefit from those services.

The basis and method of allocating and apportioning the service charge expenditure is to be transparent and clearly communicated to all. Any inducements or concessions to attract occupiers to a property should be borne by the owner, and not spread among other occupiers. The rationale for the apportionment between occupiers should be set down in writing, and re-examined periodically to see whether there is a need for a new apportionment matrix or new apportionment method to be applied.

In many cases, particularly regarding buildings with a variety of users, not all of the occupiers will benefit from the services to the same extent. In such circumstances, it may be necessary to divide the service charges into separate parts (schedules) to reflect the availability, benefit

and use of services, with each part being individually apportioned between occupiers according to the core principles. The allocation of costs to separate schedules is essential in achieving a fair and proper apportionment of costs between those occupiers that benefit from specific services. Occupiers will, therefore, often pay different percentage apportionments under different schedules.

### 4.2.2 Flexibility

It is worth considering that the availability, benefit and use of the services within a building, and the demand for those services by individual users, could vary over time – therefore, leases would benefit from being drafted to include flexibility and variation. For example, additional units may be created or the use of a property may change, causing different demands for services and necessitating a change to the costs/payments structure. Even with the grant of shorter-term leases, the ability to change allocation and apportionment methods, where necessary and appropriate, could be made available during the term to ensure service charges are spread fairly and reasonably between beneficiaries and users.

### 4.2.3 Void and unlet premises

Occupiers are not expected to be liable for the costs attributed to unlet premises; the owner should meet the cost of these, as well as any special or personal concessions given to individual occupiers. Owners are also responsible for bearing a fair proportion of costs attributable to their own use of the property, for example, where an on-site management premises is also used for other purposes unconnected with the day-to-day management of the building and services.

### 4.2.4 The apportionment matrix

Managers are to provide a full apportionment matrix to all occupiers that clearly shows the basis and method of calculation, and the total apportionment per schedule for each unit within the property/complex. For the avoidance of doubt and to preserve confidentiality this should exclude details of any individual concessions or other arrangements between individual owners and occupiers; these are costs that are normally to be borne by the owner. An individual occupier should be able to clearly verify the basis and method of calculation used in arriving at their percentage apportionment.

### 4.2.5 Floor-area apportionment

Apportionment based on floor area is the most common and often the simplest method of apportionment. The standard floor-area apportionment is the ratio the premises bear to the total lettable parts of the building or estate.

Measurements should be done in accordance with the current edition of *RICS property measurement*, that sets out definitions of the measurement of buildings and their applications. Where the service charge is apportioned based on floor area, managers should ensure that the method and basis of measurement used is consistent. In certain situations, it may be appropriate to apportion costs

allocated to separate schedule using different methods of measurement but different measuring methods should not be used in the same schedule.

The basis of measurement used should be clearly communicated to tenants together with confirmation of how the floor areas have been established, for example, from computer-generated drawings, other drawings or by laser or tape measurement and whether or not the areas have been verified by an independent third party.

So far as they are able, occupiers are expected to check and verify the details in respect of their own premises and raise any anomalies or errors with the manager without undue delay.

#### 4.2.6 Rateable value apportionments

Rateable values are no longer recommended as an appropriate method for calculating service charge apportionments.

Rateable values take account of a variety of factors relating to value, such as location, etc., and do not generally reflect a reasonable assessment of the benefit and use of common services.

While many leases require service charges to be apportioned based on rateable value, with no provision for any alternative basis to be used and notwithstanding that this professional statement cannot override the contractual terms of any lease, it is nevertheless the view of the RICS Service Charge Code working group that rateable value apportionments should be changed to such other recognised methods of apportionment consistent with the aims and aspirations as set out in this professional statement.

Where the use of rateable value apportionments is unavoidable, owners and managers should be aware that rateable values may change over time as occupiers have the right to appeal against assessments by the Valuation Office. In such circumstances, it is considered best practice to use the values in the rating list at the service charge year end date. The date of the rating list and rateable values used should be clearly communicated to occupiers.

#### 4.2.7 Fixed percentage or fixed amount

In some instances, the amount or percentage of the overall service charge costs the occupier pays may be fixed at the time the lease is granted. The fixed percentage or amount offers certainty and simplicity but is inflexible. However, it may be advantageous for short leases where the property or the costs, standard and level of services provided, are unlikely to vary significantly. Provision is often included to review the fixed percentage if the property is altered or extended.

Fixed amounts or fixed service charge percentages can give rise to situations where the total service charge recoverable can be less than or greater than 100% of the actual cost of providing the services. In such circumstances, and notwithstanding the principle that owners **must** seek to recover no more than 100% of the

proper and actual costs of the provision or supply of the services, the terms of the lease remain paramount and this professional statement cannot override the lease.

When dealing with the renewal of leases containing fixed amounts or percentages all parties are encouraged to take reasonable steps to ensure that the terms of the lease reflects the best practice principles set down in this professional statement.

#### 4.2.8 Apportionment of service charges in shopping centres: weighted-floor area apportionment

In addition to the usual recommended methods for the apportionment of service charges, many shopping centre developments often feature a 'weighted-floor area' basis of apportionment that seeks to reflect the different costs involved in servicing different sized units.

A weighted-floor area apportionment discounts the percentage the occupier pays over a certain size to reflect the benefit of the services provided. The floor area is divided into bands with a progressive discount, and is a similar concept to the zoning of shops for rental purposes.

For example, a 5,000m<sup>2</sup> unit may not cost five times that of a 1,000m<sup>2</sup> unit, but a 500m<sup>2</sup> unit may cost twice that of a 250m<sup>2</sup> unit.

There is no such thing as a standard weighting formula. Where the use of a weighted formula is considered to be appropriate, this is to be formulated to reflect the particular circumstances, size of units, layout and use of the scheme being serviced [see below].

The following is for illustrative purposes only:

|                                  |   |      |
|----------------------------------|---|------|
| The first 500 m <sup>2</sup>     | @ | 100% |
| The next 500 m <sup>2</sup>      | @ | 80%  |
| The next 2,000 m <sup>2</sup>    | @ | 70%  |
| The next 2,000 m <sup>2</sup>    | @ | 60%  |
| Excess over 5,000 m <sup>2</sup> | @ | 50%  |

In this example, a 1,000 m<sup>2</sup> unit has a weighted floor area of 900 m<sup>2</sup> [i.e. [500 x 100%] + [500 x 80%]] whereas a 10,000 m<sup>2</sup> unit has a weighted area of 6,000 m<sup>2</sup>. Although 10 times larger in floor area, the 10,000 m<sup>2</sup> unit pays approximately six and a half times the service charge of the smaller unit.

Similarly, the floor area of ancillary basement and upper-floor accommodation, or of remote storage, might be discounted to reflect the reduced benefit derived from certain services as distinct from the ground-floor retail space or main offices.

For the avoidance of doubt, a reasonable and fairly administered weighting formula for apportionment of the service charge cannot usually be considered a concession.

## 4.2.9 Owner's cost/profit centres

Where there is a separate cost or profit centre within a property complex that generates income for the owner that is not credited to the service charge account, the costs associated with maintaining and running that cost centre should not be allocated to the service charge account (for example, car parks, mobile phone masts, advertising, radio aerials, etc.). If the separate cost/profit centre derives benefit from buildings, equipment staff or services that form part of the service charge, the cost/profit centre should be incorporated into the service charge matrix (for example, the car park, management office, etc.). Alternatively, owners can estimate and declare a contribution to the service charge that reasonably reflects the benefit and use of the common services enjoyed.

### 4.2.10 Tenant alterations

Alterations carried out by tenants may have an impact on or affect the calculation of the apportionment of occupier service charge liabilities.

Tenant alterations that change any factor on which the apportionment calculation is based (such as, but not limited to: floor area, rateable value, or the extent of use and benefit of the services derived) might determine whether adjustments to tenant service charge apportionments would be appropriate.

In the case of a warehouse/distribution centre, the introduction of an additional mezzanine floor, in preference to full eaves-height racking, may not affect or increase the utilisation of the premises, and, therefore, the use and benefit of the common services.

However, a mezzanine floor installed in a unit on a retail park might generate additional sales and customer footfall, with a corresponding increase in goods deliveries, etc. and an increase in the enjoyment, use and benefit of common services such as parking, security, cleaning, etc.

While this situation can often present a dilemma for the landlord, the answer may often be found in the precise wording of the lease. If the lease makes specific reference to the basis on which the service charge apportionment is to be calculated – for instance, for the floor area – the landlord would be obliged to factor in the additional floor area of the demised premises to the apportionment matrix.

Where the lease does not make specific reference to the basis of apportionment and refers, for instance, to a 'fair and reasonable proportion as determined by the landlord's surveyor', the landlord's surveyor, acting as an expert, is required to adopt a basis of calculation that conforms with the basic principles of service charge apportionment. This would need to be demonstrably fair and reasonable to ensure that individual tenants bear an appropriate, fair and reasonable proportion of the total service charge expenditure that reflects the benefit of the services enjoyed.

When dealing with alterations to premises – particularly where these require the prior consent or approval of the landlord – it is always desirable that careful consideration be given to the potential impact on the calculation of the

service charge, to ensure that the apportionment continues to be fair and reasonable. This is in view of the underlying principles set out in this professional statement.

Landlords are also advised to consider including appropriate wording within any licence for alterations to clarify the position and basis of calculation of the service charge for the future.

## 4.3 Communication and consultation

The best practice recommendations in this section will help RICS members and regulated firms achieve the following mandatory requirement:

**3** Owners and managers **must** ensure that service charge budgets, including appropriate explanatory commentary, are issued annually to all tenants.

### 4.3.1 Communication

As poor communication often gives rise to disputes, effective communication is key to achieving best practice. Here the aim is to provide transparency between manager and occupier in the way services are provided and managed, and in how the costs of these services are recovered. Communication needs to be timely and continuous, and works best when managers and occupiers deal with each other's reasonable enquiries and reciprocal obligations promptly and efficiently.

Managers are advised to seek feedback from occupiers on the performance management standards and service delivery, and take any action on this feedback as appropriate.

It is also important to have a clear communication structure. Best practice requires managers to provide full transparency on all service charge matters to include budget and reconciliation information and access to copy invoices that make up the service charge expenditure. This can be achieved, for example, by providing tenants and occupiers with access to a password protected web portal that holds all of this information.

Where hard copies of the supporting documentation concerning the certified accounts are supplied, the manager is entitled to make a proper and reasonable charge for the time, cost of copying and postage of such documents. However, where this information is held in existing electronic files, easily to hand and transmitted by email, it is expected that any charges would be nominal.

Best practice requires managers to hold regular meetings with occupiers, and occupiers have a duty of care to participate in these meetings and to be proactive in informing managers of the key contacts who deal with service charges. However, where the occupier is a large company or multiple retailer for instance it is advisable to ensure appropriate communication takes place with the occupier's head office as local staff may not be aware of or knowledgeable of service charge matters and the potential cost implications for which they may not have authority.

Managers are also obliged to make key contact information available to occupiers – for instance, the management surveyor, credit controller, accounts clerk, etc. – as well as the names of any on-site staff, along with their roles and responsibilities.

Managers are to provide occupiers with a copy of the management policy, which should contain standard information about how the property is managed and the aims of the management team (e.g. the manager and the on-site team). Managers should also inform occupiers of any future plans for the property, particularly if these are likely to have an impact on the service charge.

### 4.3.2 Consultation

Managers of residential premises are required to follow statutory consultation procedures, and should be keenly aware that if the proper procedure is not followed, the amount they can recover might be limited.

Managers of commercial property are not generally obliged to ‘consult’ with occupiers prior to incurring costs that are ultimately to be recovered under the service charge arrangement. However, some commercial leases might set out certain procedures to be followed, perhaps prior to incurring large extraordinary costs, such as major fabric or plant replacements, etc. The courts have recently ruled in a number of instances that owners are obligated to follow the terms of leases strictly when recovering service charges. Therefore, to ensure recovery of the service charge, managers should take particular care to follow exactly the procedures as set down within the lease.

Even where the lease is silent it is considered best practice for managers to consult with occupiers with regard to the standard and quality of the service charge provision(s) required. While the manager has a duty to manage the property and will not wish to avoid expenditure that might have a detrimental effect on the owner’s investment, managers should ensure that the standard of service provision (and therefore the cost to occupiers) does not unnecessarily exceed the reasonable requirements and needs of the occupiers.

### 4.3.3 Budgeting and cost review

It is the manager’s duty to keep expenditure under constant review in order to identify any unforeseen variances and to notify occupiers accordingly.

When significant variances in actual costs against budget are likely, it is good practice for the manager to notify occupiers promptly and within the current service charge year. When substantial works are planned, summary details of the results of tenders and the process used should be communicated to the occupiers, together with full information on the programme of works, costs and the process to be adopted for keeping occupiers informed.

Occupiers are entrusting their business overheads/ operating costs to an external manager, and as such are entitled to be notified of any significant or material variances to the forecast as soon as possible.

Whether a variance against forecast is to be regarded as significant or material will often be a subjective assessment, dependent on a variety of issues such as the size, nature and type of property and the amounts payable by individual occupiers. Prompt notification of unforeseen variances in the total annual spend should be made to all occupiers with an explanation as to how this is being mitigated at the earliest opportunity.

## 4.4 Dealing with existing and new leases

The best practice recommendations in this section will help RICS members and regulated firms achieve the following mandatory requirements:

- 1 All expenditure that the owner and manager seek to recover **must** be in accordance with the terms of the lease.
- 2 Subject to section 4.2.7, owners and managers **must** seek to recover no more than 100% of the proper and actual costs of the provision or supply of the services.
- 8 Where acting on behalf of a tenant, practitioners **must** advise their clients that if a dispute exists any service charge payment withheld by the tenant should reflect only the actual sums in dispute.
- 9 When acting on behalf of a landlord, practitioners **must** advise their clients that following resolution of a dispute, any service charge that has been raised incorrectly should be adjusted to reflect the error without undue delay.

### 4.4.1 Existing leases

The basis by which service charges are operated and managed is set out in the lease.

Many service charge disputes are caused by the failure of managers and/or occupiers to read and properly understand the respective obligations and liabilities under the contractual arrangement made between them. Therefore, care and attention is required to understand the contractual basis of the service charge arrangements properly.

Existing leases may contain service charge provisions that differ from the recommendations in this professional statement. Where this is the case, this professional statement cannot override the lease, but existing service charge clauses are to be interpreted as far as possible in line with the principles and practices set out here. This applies unless the lease specifically stipulates a different approach, which, therefore, has legal force.

Where doubt or possible ambiguity exists, it is recommended that specialist professional advice be sought. Where an existing lease lacks the necessary guiding provisions to manage the service charge process, the requirements of this professional statement should apply.

#### 4.4.2 New leases

As new leases are granted and older leases renewed, it is essential to bring service charge clauses up to modern standards. If modernisation of the service charge provision of the lease is required, both to meet best practice and in the interests of compatibility with other occupiers, and this results in an increase or decrease in the amount payable by the occupier, this is to be taken into account in any negotiations – for instance, as reflected in the rent payable.

While this professional statement cannot override the lease, it does set out the industry-accepted best practice in the field of service charges. It will help solicitors, their clients (be they owners or occupiers) and the managers of service charges to draft, interpret and operate leases in accordance with best practice.

It is recommended that owners, occupiers and their solicitors ensure the lease they sign reflects this professional statement, which will enable more effective, business-focused service charge management during the course of the lease. Terms should be relevant and appropriate, recognising the length of the lease term, and the scale and type of property concerned. At the time of lease renewal, the service charge clauses will certainly require review and probably modernisation/updating. It is recommended that new leases be drafted with sufficient flexibility to allow for changes in best practice.

The attention of owners, managers and occupiers is also drawn to the *Code for Leasing Business Premises*, which provides further guidance for negotiations before the grant of a lease or lease renewal in creating a document that is clear, concise and authoritative.

This document is currently being updated by RICS and will be released later in 2018.

It is unlikely that all leases within a multi-let property will fall for renewal on the same date. Modernising the service charges on an ad-hoc basis may lead to a 'dual' service charge, where in effect two service charge arrangements would operate in tandem, with one based on the older form of leases, and the other based on the modern form. Interim arrangements may, therefore, be necessary to ensure the practical operation of the services and the recoverability of the service costs during the intervening period until such time as all leases have been modernised. For example, renewal leases might reflect the ideal service charge regime going forward, as well as the status quo, so that when the tipping point is reached, the owner can swop from the old lease service charge regime to the new.

#### 4.4.3 Sweeper clauses

It is often difficult to predict precisely what services might be provided through the duration of a long lease, and which are to be covered by the service charge. To avoid the risk of incurring costs that might fall outside of the service charge, most leases contain a 'sweeper' provision entitling the owner to charge, not only for the services specifically listed, but also for other miscellaneous services that might be provided in the future but only in the context

of the existing services specified in the lease and sweeper clauses tend to be interpreted narrowly by the courts.

This is not usually a problem for short leases however, as in these cases, it is far easier to accurately predict the services that are to be provided. Unless a lease incorporates very clear wording to the contrary, if the owner had in mind the provision of a service, but has not covered the right to include the cost of providing it in the service charge, the owner will not generally be able to use the sweeper clause as authority to recover the cost.

A sweeper clause cannot be used to cover the cost of something that was left out of the lease in error. The intention is to give the owner the ability to provide further services that are not identified or in contemplation at the time the lease was granted, and that, for any reason, are considered necessary or desirable to be provided at a later time.

#### 4.4.4 Professional arbitration on court terms (PACT)

The Civil Procedures Rules (CPR) determine that alternative dispute resolution (ADR) must be considered before litigation, or the parties risk a punishment of costs by the courts.

PACT is a scheme offered by RICS and the Law Society as a form of ADR for lease-renewal disputes.

The scheme provides the opportunity for owners and occupiers to have the terms and rent payable under their new lease decided by a surveyor or solicitor, acting as either an arbitrator or independent expert. It is important to note that any decision made by either an arbitrator or independent expert is legally binding.

The objective of the scheme is to increase the effectiveness and flexibility of the legal system, and to give a greater choice to owners, occupiers and their advisers through the lease-renewal process.

### 4.5 Financial controls and competencies

The best practice recommendations in this section will help RICS members and regulated firms achieve the following mandatory requirements:

- 1 All expenditure that the owner and manager seek to recover **must** be in accordance with the terms of the lease.
- 2 Subject to section 4.2.7, owners and managers **must** seek to recover no more than 100% of the proper and actual costs of the provision or supply of the services.
- 3 Owners and managers **must** ensure that service charge budgets, including appropriate explanatory commentary, are issued annually to all tenants.
- 4 Owners and managers **must** ensure that an approved set of service charge accounts showing a true and accurate record of the actual expenditure constituting the service charge are provided annually to all tenants.

- 5 Owners and managers **must** ensure that a service charge apportionment matrix for their property is provided annually to all tenants.
- 6 Service charge monies (including reserve and sinking funds) **must** be held in one or more discrete (or virtual) bank accounts.
- 7 Interest earned on service charge accounts – or where separate accounts per property are not operated, a proper and reasonable amount of interest calculated on normal commercial rates – **must** be credited to the service charge account after appropriate deductions have been made.

In this professional statement, references to Tech 09/14BL are to Tech 09/14BL *Accountants' Reports on Commercial Property Service Charge Accounts* issued by ICAEW in effect on the date of this statement and to any amended or replacement version of it. Where Tech 09/14BL refers to earlier versions of the RICS code of practice for service charges in commercial property it should be interpreted as if referring to this professional statement with such changes as may be required to give effect to the substance of the guidance.

#### 4.5.1 Accounting policies

Service charge accounts should include a comprehensive list of accounting policies and principles on which the accounts are prepared as well as other information, including:

- whether the accounts are prepared on an accruals- or, where permitted, cash-basis and
- whether the owner has waived the exemption to charge VAT (opted to tax).

#### 4.5.2 Other disclosures

Other information to be disclosed includes:

- a description of the intended purpose for any sinking or reserve fund, together with an explanation of the tax treatment of contributions to and interest earned on such funds, and details of the trust where such monies are held
- a statement of all contributions to and expenditure from the sinking or reserve fund account, together with the account opening and closing balances, and the amount of interest earned and tax paid in the relevant period
- a statement of any forward funding agreed and included in the service charge accounts
- a statement detailing how insurance claims are accounted for
- an analysis of any material variances between budget and actual expenditure, with a detailed commentary to explain trends and variances where these are significant and

- statements by the owner and/or manager, to approve the service charge accounts in accordance with subsection 4.5.3.2.

Included in appendix C is a sample report setting out the disclosures and information that managers should include in the service charge accounts.

### 4.5.3 Approval and review of service charge accounts

#### 4.5.3.1 The requirements of the lease

It is usual for leases to provide for an annual accounts statement to be issued to occupiers following the end of each service charge period; this would normally include a summary of the costs and expenditure incurred in the provision of the services and a calculation of the service charge. The lease may use different terminology (for instance referring to annual 'statements'), but in this professional statement such statements are 'service charge accounts'.

Many leases will set out the procedures regarding the preparation of the service charge accounts, and will often require that they are formally approved by the landlord or on the landlord's behalf, for instance by the landlord's surveyor or managing agent. Terminology used for this approval may vary from lease to lease. For instance, leases may refer to the service charge accounts being 'certified'. In this professional statement the term 'approval' refers to the equivalent process however described in the lease.

Leases might also require the accounts to be reviewed by an independent third party (such as a chartered accountant) and for the third party to report on their review. Again, terminology may vary from lease to lease. Where a lease requires an 'audit' to be carried out, the implications should be considered carefully as outlined here. In other cases, managers should determine what form of review would be most appropriate taking into account the requirements of the lease (which will always prevail) and this professional statement.

It is essential that any contractual requirements in the lease be duly followed, including any requirement that an independent audit be carried out. Compliance with the requirements and procedures set down in the lease may be a 'condition precedent', and recent case law has determined that where a lease sets down specific requirements and procedures, a failure to comply may adversely prejudice the owner's ability to recover such sums.

Managers should therefore ensure that service charge accounts are issued strictly in accordance with the procedures and requirements as set out under the terms of the lease.

#### 4.5.3.2 Approval of the service charge accounts

The purpose of approval of the service charge accounts is to confirm that the accounts produced:

- represent the actual expenditure incurred by the owner in supplying the services to the building and

- that the expenditure the owner is seeking to recover is in accordance with the terms of the leases and, where practicable, the provisions of this professional statement.

The accounts should be approved by or on behalf of the landlord as complying with these statements. In approving the accounts, the manager is required to act in a professional, non-partisan manner, and not supposing that the only task is to recover as much money as they can for the owner.

The approver should be an appropriately qualified, competent person with experience in dealing with service charges. The approver should also recognise that in approving the service charge accounts, they have a duty of care to both owners and occupiers to act with professional care, diligence, integrity and objectivity.

The lease might also set down the credentials/qualifications required of the person who is to approve the accounts.

For transparency, the status of the person approving the service charge accounts, and the capacity in which they are acting, should be made clear (for instance, a director or employee of the landlord or the manager or surveyor as agent for the landlord).

In certain instances, approval may be issued in the name of the manager. Where this is the case, managers should have clear internal procedures in place that control who may sign in the name of the firm, and to ensure that this is an appropriately senior individual.

Where the manager undertakes the approval, the management fee is to include this cost. Where the lease requires approval by someone other than the manager, the costs of approval of the service charge accounts, together with the fees of that person, should usually be recovered through the service charge.

The approval of the service charge accounts is not intended to provide independent assurance regarding their preparation. The review of the accounts by an independent accountant is considered in section 4.5.3.3.

### 4.5.3.3 Review of the service charge accounts

An independent accountant might be engaged to review the service charge accounts and provide assurance regarding their preparation. The types of reports prepared by accountants that can be attached to service charge accounts are detailed in TECH09/14BL and fall into two categories.

- i. An audit report, carried out in accordance with International Standard on Auditing (ISA) (UK) 800 (Revised) *Special considerations – Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks* (see subsection 4.5.3.4).
- ii. An independent review report, carried out in accordance with International Standard on Review Engagements (ISRE) 2400 (Revised) *Engagements to Review Historical Financial Statements* (see subsection 4.5.3.5).

The level of assurance provided by these reports and details of the work undertaken in preparing the reports can be found in TECH 09/14BL.

### 4.5.3.4 Auditing of the service charge accounts

An audit is an independent external review process that adds to the credibility of an entity's disclosures, be it their annual financial statements, systems of internal control or compliance with contractual or legislative obligations. It will also add credibility to the service charge accounts.

An audit involves performing procedures to obtain evidence that a specified process is being followed in order to reassure that there is no material misstatement within the information subject to the audit (or in this case, the service charge accounts).

Where a lease made after 1980 specifically refers to an 'audit', this should be carried out in accordance with ISA 800 (UK) and should be performed by a registered auditor unless all the occupiers confirm in writing that they wish to depart from the terms of the lease. Even in this case it may be necessary to consider a variation of lease terms (see Tech 09/14BL for further information).

If all occupiers confirm that they do not wish to carry out a full audit, as required in the lease, an independent review should be carried out instead (see 4.5.3.5).

In carrying out an audit in accordance with accepted auditing standards, the auditor will assess the level of risk involved in the instruction, and adjust the level of work (and cost) accordingly. By its very nature, an audit is likely to be extremely time consuming, and hence costly, particularly for larger properties with many leases in operation. The auditor may also need to employ an expert in order to carry out certain aspects of their work, for example a review of the leases, on their behalf.

The auditor's reasonable and proper costs and fees should, subject to the terms of the lease, be charged to the service charge account.

Leases that refer to 'audit' and were made before 1980 may not have anticipated the work required by a modern auditing framework. In this case, the manager should consider whether conducting a modern audit would provide best value for occupiers. In such situations, owners/managers may consider having an independent review of the kind noted in section 4.5.3.5 carried out instead. Further detail on construing references to 'audit' is contained in ICAEW Tech 09/14BL.

### 4.5.3.5 Independent review of the service charge accounts

If the lease requires an independent review other than an audit to be carried out the owners/managers should engage an independent reporting accountant to examine the service charge accounts of the property.

Where a lease requires the service charge to be audited but an independent review has been conducted instead for the mentioned permissible reasons, owners and managers should make this clear in the service charge accounts.

The onus and style of an independent accountant's review differs from an audit. Such review engagement should be carried out in accordance with ISRE 2400 (revised). The scope of an independent accountant's review in accordance with ISRE 2400 (revised) is discussed in detail in Tech09/14BL and includes information on the type of procedures that an independent accountant may carry out. It would be usual for service charge accounts to be prepared by the owner or manager. In practice, for many small properties, an accountant (who may be the reporting accountant) may be engaged to prepare the statements from accounting records maintained by the owner or manager. However, the owner or manager will retain responsibility for the preparation and approval of the statement.

As stated in Tech 09/14BL, the independent accountant should issue a review report in accordance with ISRE 2400 (revised), which gives a conclusion as to whether the service charge accounts have been prepared in accordance with the provisions of this professional statement.

For smaller properties where the lease may be silent or the independent review is optional, the cost of carrying out an audit or independent review may be disproportionate to the total service charge expenditure. To be consistent with the best value principles and dependent on the quantum and nature of the expenditure, an external audit or independent review will give credibility to the service charge accounts. However, an audit or independent review does not absolve the owner/manager of their responsibility to prepare and approve reliable service charge accounts in accordance with subsection 4.5.3.2. In addition, an audit or independent review should not be used as a substitute for an alternative report or method of approval specified in the lease, unless this has been agreed with the occupiers in writing in advance as noted above.

#### 4.5.3.6 Independence of the reporting accountant

The International Ethics Standards Board for Accountants (IESBA) Code requires accountants carrying out independent reviews to be independent of the entity whose financial statements are reviewed. The accountant's independence safeguards the accountant's ability to form a conclusion without being affected by influences that might otherwise compromise that conclusion. Independence enhances the accountant's ability to act with integrity, to be objective and to maintain an attitude of professional scepticism. In the context of a review of an annual service charge accounts, the reporting accountant should not be an employee or director or associate of the owner or manager of the property concerned or of any associate or agent of the owner or manager.

All members of chartered accountancy bodies (e.g. the Institute of Chartered Accountants in England and Wales (ICAEW)) are required to adhere to strict ethical standards covering independence, as well as complying with other ethical and independence requirements in the FRC's Ethical Standard, as applicable. Any accountants

appointed to carry out an independent review should be members of a chartered accountancy body.

#### 4.5.4 Balance sheets

Where the accounts are prepared on an accruals basis, they should be accompanied by a schedule of closing prepayments and accrued expenses. Openness and transparency can be further enhanced by the inclusion of a balance sheet or cash reconciliation as part of or in addition to the statement of actual expenditure. These provide a full account of the assets and liabilities on the service charge account at both the start and end of the accounting period. Typical assets include prepaid expenses, cash balances held, long-term cash funds and service charge arrears. Typical liabilities include accrued expenses, sinking and reserve funds, and service charges collected in advance.

If a balance sheet or cash reconciliation is included in the service charge accounts, it should be included in the scope of any independent review of the service charge accounts.

#### 4.5.5 Industry standard cost classifications

Appendix B includes details of industry standard cost classifications that should be used in reporting budget and actual expenditure.

The industry standard cost classifications provide 3 levels of analysis as follows:

- cost class
- cost category and
- cost description.

As a **minimum** acceptable level of reporting, service charge budgets and statements of actual expenditure should be prepared at **cost class and cost category** level.

Adoption of the industry standard cost classifications will reap enormous benefits for the industry, as this will facilitate better cost comparison between properties and the benchmark indices. It will also reduce costs, and assist in the transfer of information between managers and owners when properties are sold, or when there is a change of manager (i.e. from in-house to external, or between managing agents).

However, to achieve transparency in accordance with the principles of this professional statement, it is recommended best practice that budget and actual expenditure analyses are provided at the detailed cost description level whenever practicable, and particularly in respect of larger properties, with a summary of the total costs under each cost category.

In accordance with the core principle of proportionality it is acceptable for smaller properties or those with limited service charge expenditure (for example, industrial sites) to report at the higher cost category level, although this is generally regarded as an exception rather than the norm.



To maintain consistent industry standards and to facilitate benchmark comparison, managers and those responsible for preparation of the accounts are encouraged to use all best endeavours to comply with the cost class and cost category analysis as set out and not permit the creation of new cost categories or cost classes.

However, the detailed cost descriptions set out are not intended to represent an exhaustive list, but are included for illustrative and guidance purposes only. Individual cost descriptions may vary from manager to manager, and the inclusion of additional cost descriptions is encouraged where this will facilitate greater transparency and clarity with regard to the expenditure incurred or proposed.

The use of the standard cost classes and categories in industry-standard format are essential if benchmarking is to be effective. However, for benchmarking purposes, accounts are only required at cost-category and cost-class level. It is not intended that benchmark analysis of expenditure be carried out at cost-description level.

### 4.5.6 Budgets and actual expenditure accounting

The service charge accounting sample report (see appendix C) establishes a basic framework for the preparation of service charge accounts, and identifies areas for special consideration by managers and reporting accountants.

Owners and managers must ensure that an estimate of anticipated service charge expenditure is provided annually. This is to be accompanied by appropriate explanatory commentary for the occupiers, together with a breakdown of their proportion of the costs. It is considered best practice that budgets are issued at least one month prior to the commencement of the service charge year.

Owners and managers must ensure that detailed statements of actual expenditure, together with accounting policies and explanatory text, are issued annually. It is considered best practice that annual statement of expenditure should be issued within four months of the service charge year end.

The accounts are to give an adequately detailed and comprehensive summary of items of expenditure, with full explanations of any material variations (+ or -) against the budget, and in a reasonably consistent format year on year.

It is recommended that the budgets and accounts be issued with a report that provides the following minimum information:

- a comprehensive level of detail to enable occupiers to compare expenditure against estimated budget
- explanations of significant individual costs and of variances from the previous year's budget/accounts
- a comparison against the previous year's actual costs, where appropriate
- information on core matters critical to that account (e.g. levels of allocation, apportionment, contracts, report on tendering, etc.)

- the achieved and/or targeted measures of improved management performance (e.g. successes in delivering improved quality services and greater value for money)
- on-site management team costs, separately identified
- a schedule of opening and closing prepayments and accrued expenses, details and results of the most recent previous and forthcoming tendering exercises. Occupiers are to be advised of the contractors who are providing the services
- a full apportionment matrix that clearly shows the basis of calculation and the total apportionment per schedule for each unit within the property/complex and
- the date of issue.

A set of industry standard cost classifications has been drawn up, and is included in appendix B (see also section 4.5.5). As a minimum standard when reporting service charge costs to occupiers these should be used at cost-class and cost-category level.

### 4.5.7 Right to challenge

This professional statement cannot override an occupier's legal right to challenge incorrect or inappropriate service charges subject to the prevailing statute of limitations.

Where the manager has demonstrably complied with the provisions of the lease and this professional statement, it is recommended that the manager allow occupiers a reasonable period (e.g. four months from issue) in which to raise enquiries or request further information in respect of the approved accounts. Managers are expected to deal with reasonable enquiries promptly and efficiently, and to make all relevant paperwork available for inspection.

Where hard copies of the supporting documentation concerning the certified accounts are supplied, the manager is entitled to make a proper and reasonable charge for the time, cost of copying and postage of such documents. However, where this information is held in existing electronic files, easily to hand and transmitted by email, it is expected that any charges would be nominal.

Occupiers and consultants appointed on their behalf have a duty to respect and conform to the principles of this professional statement. In the interest of promoting a swift and harmonious resolution of service charge queries there should be openness and transparency in disclosing the occupier's brief to their consultant and whether remuneration is on a contingency fee basis.

### 4.5.8 Change of owner or manager

In the event of a sale or change of manager, it is essential that a definitive timescale within which accounts will be closed and handed over, is agreed.

As soon as practicable – but no later than four months following the date of completion of a sale of a property, or a change of manager – a closing statement of expenditure, subject to all requirements of this professional statement, including full details of all service charge expenditure,

accruals, pre-payments, etc. for all outstanding service charge years should be approved by or on behalf of the old landlord and provided to the new owner/manager, up to the date of sale/transfer.

The new owner or manager should issue any future budget in such a way that it provides sufficient information to enable occupiers to compare it with the most recently issued approved accounts. The occupiers can then convert historical data into a consistent format for comparison where they were not responsible for previous years.

Where a property has had more than one manager in place during the service charge period the compilation of the service charge accounts may need to be reconfigured:

- If the former manager has supplied full supporting documentation to the new manager in a timely manner, the expenditure for the full period should be amalgamated and the service charge accounts prepared as normal.
- If full supporting documentation has not been supplied in a timely manner, the expenditure incurred by the two managers should be disclosed separately within the service charge accounts.

Where the expenditure for each managing agent is disclosed separately, the approval by the new manager should only cover the period under their control.

(Note that under the second approach there may be a period of the service charge accounts that will not have been approved or reviewed.)

For further information on the recommended processes and procedures in the event of a property's sale, or other circumstances where the manager changes, see the RICS guidance note *Commercial property service charge handover procedures*, 1st edition (see appendix D).

This is particularly relevant to solicitors when drafting and reviewing sale contracts.

#### 4.5.9 On-account payments

Service charges are usually 'reserved as rent' in the lease; in reality however, the service charge is neutral in income and expenditure terms, after year-end balancing charges/credits. Service charge monies will be held in one or more discrete (or virtual) bank accounts in recognition of the fact that the monies are being held to deliver the service expenditure.

Furthermore, and based on the principle that owners should not profit from the supply of services, all interest earned should be credited to the service charge account (after appropriate deductions have been made, i.e. bank charges, tax, etc.).

Where separate accounts are not operated per property, or advance payments from more than one property are held in a single account, a proper and reasonable amount of interest on normal commercial rates must be credited to the benefit of the service charge.

#### 4.5.10 Interest on service charge accounts

Interest earned and late payment interest should be credited to the service charge account. Bank charges and account operating costs are to be offset against the interest. Owners are required to perform their obligations under the terms of the lease, and to account to occupiers for any balancing charges due/owed at the end of the service charge period.

Leases often enable owners to recover the cost of borrowing to fund expenditure as a cost to the service charge. In older leases, there is a risk of having to fund shortfalls from negative cash flows.

It is the owner's responsibility to fund the contribution in respect of void units and concessions, and to make these payments to the account as promptly as payments made by occupiers. If an owner is not as prompt as occupiers are required to be, the interest charges should apply in line with the payments made by occupiers.

When communicating with occupiers through budget and expenditure reports, managers should unambiguously state their policy concerning the crediting of interest to the service charge.

#### 4.5.11 Interest on forward funding of service charge costs

Leases should enable owners to recover the reasonable and proper cost of borrowing to fund major non-cyclical or exceptional unbudgeted expenditure as a cost to the service charge. Where the lease is silent there is a risk of having to fund shortfalls from negative cash flows. Where owners are crediting interest earned to the service charge account, they should be reassured that charging the interest at reasonable and commercial rates on borrowed money to fund major non-cyclical or exceptional unbudgeted expenditure meets best practice requirements. (See also section 4.8 – *Provision for anticipated future expenditure*.)

In situations where an agreement has been reached whereby the landlord funds the cost of works in the first instance and then recovers a percentage or all of those costs from the tenants through the service charge at a later date, an appropriate accounting policy should be included within the notes to the service charge expenditure report, along with a note disclosing the full details including the amount of interest charged on the deferred amounts.

#### 4.5.12 Timeliness

It is the responsibility of the manager to provide the occupiers with budget and reconciled accounts for anticipated and actual service charge expenditure at the appropriate time. This is to include appropriate explanatory comments with regard to costs proposed or incurred, together with details of the basis of allocation and apportionment, to enable occupiers to reasonably understand how their liability has been calculated.

Budgets should be issued at least one month prior to commencement, and reconciled accounts issued within

four months of the end of the service charge year in question.

Where an occupier raises queries or seeks further clarification on any matters relating to the budget or actual costs, the manager should deal with such proper enquiries promptly and efficiently.

### 4.5.13 Benchmarking and cost analysis

Adoption of the standard industry cost classifications (see section 4.5.3 and appendix B) is recommended to facilitate better cost comparison between properties and the benchmark indices. It will also reduce costs and assist in the transfer of information between managers and owners when properties are sold, or if there is a change of manager (e.g. from in-house to external, or between managing agents).

Further, these cost classifications are largely compatible with industry benchmark indices, which will facilitate a benchmark comparison of costs.

However, when using benchmark information to compare operating costs for any building, caution is needed. Industry benchmark indices are not intended as a definitive database of costs for operating service charges in commercial buildings, but do serve to highlight indicative trends in service charge costs. Buildings differ substantially in terms of construction, age, layout, gross-to-net floor-area ratio, staffing and security levels, hours of operation, and standards of maintenance and management.

These analyses take the average of service charges for similar properties, and, therefore, provide a guide to the cost effectiveness of the management service. However, property is not mass-produced in similar formats (as is a car, for example), and therefore each property will have its own variations from the average; therefore, 'beating the benchmark' is not necessarily proof of service efficiency and value for money. Industry benchmark indices provide an excellent guide, but managers may wish to reflect further on how their specific property is performing from a value for money perspective.

## 4.6 Dispute resolution

The best practice recommendations in this section will help RICS members and regulated firms achieve the following mandatory requirements:

- 8 Where acting on behalf of a tenant, practitioners **must** advise their clients that if a dispute exists any service charge payment withheld by the tenant should reflect only the actual sums in dispute.
- 9 When acting on behalf of a landlord, practitioners **must** advise their clients that following resolution of a dispute, any service charge that has been raised incorrectly should be adjusted to reflect the error without undue delay.

### 4.6.1 Introduction

There are times where managers, owners and occupiers can disagree on matters such as which services are

chargeable, what benefit the occupiers individually or collectively receive, how they are allocated and apportioned and/or how much they cost.

Traditionally, leases have not allowed for any form of redress for the occupiers and, therefore, expensive court action was historically seen as the only route to challenge the service charges payable.

Where service charge disputes arise, it will usually be of benefit to both owners and occupiers to resolve them quickly, as going to court can be slow and expensive and represent a disagreeable process for both sides. In the majority of service charge disputes, court action will not be a cost-effective solution and in almost all instances is to be avoided.

The likelihood of disputes is increased by the practices of some managers, owners and occupiers, who continue to fail to comply with best practice within this professional statement.

Some managers and owners display a lack of transparency in their service charge arrangements and a lack of responsiveness to reasonable enquiries from occupiers. Conversely, some occupiers employ consultants, paid on a 'no win, no fee' basis, who undertake unnecessarily intrusive investigations into the service charge arrangements, going well beyond reasonable due diligence. Those types of approaches fall far short of best practice and aggravate the relationship between landlord and tenant.

Instead, managers, owners and occupiers should look to adjust their behaviour in ways that will reduce the likelihood of a dispute arising. Landlords should comply with their lease obligations to provide service charge information and look to conform to the best practice standards of this professional statement. The information and responses to an occupier's reasonable enquiries should be provided promptly and efficiently. Full explanations should be provided where the service charge includes unexpected costly items.

Occupiers should ensure that the enquiries raised by their consultants are reasonable. If occupiers are unhappy with a service charge demand, their response should be proportionate with a view to focusing on the items at issue, in order to reduce the possibility of a dispute arising. While the occupier may choose to challenge and perhaps not pay for the items at issue, the other undisputed items that have been properly demanded should be promptly paid in accordance with the lease.

More generally, managers, owners and occupiers and their advisers are encouraged to have an on-going dialogue, liaising and seeking to address each other's areas of concern in relation to the service charge regime, in order to avoid issues escalating into full-blown disputes and potential litigation. Equally importantly, this will promote stronger long-term operational relationships between managers, owners and occupiers.

However good the relationships, there will from time to time be genuine disputes over service charges. If there is such a dispute, the parties are encouraged to define the

issues and to seek to resolve matters through alternative dispute resolution (ADR). This can often provide a quicker and more cost-effective way of resolving service charge disputes than using the courts. Landlords and tenants are encouraged to use ADR, even when the governing lease does not expressly provide for it. A party who declines to use ADR can be penalised in any subsequent cost order granted by the courts.

#### 4.6.2 Complaints

It is not always straightforward to differentiate between a complaint against a manager and landlord/leaseholder disputes. Complaints about matters such as service delivery, timescales and cost are typically landlord/leaseholder disputes. This section covers complaints against the direct actions and/or behaviour of the managing agent.

Managers must have a formal written complaints-handling procedure in place to deal with complaints about their own work and that of their staff. The procedure should be made available to clients and leaseholders. It should include a short series of steps and response times for its various stages and should provide for leaseholders to complain to the landlord. The procedure should provide for complaints about staff to be made to a responsible principal and for them to be investigated quickly and fairly. It must include details of the nominated Ombudsman Scheme to which the manager belongs. See RICS guidance note *Complaints handling*, 1st edition.

#### 4.6.3 ADR as industry best practice

The Civil Procedure Rules (CPR) are the rules used by the civil courts in all cases in England and Wales. They apply to everyone involved in the litigation process, including parties, their legal representatives and judges.

In the CPR, ADR is defined as a: 'collective description of methods of resolving disputes otherwise than through the normal trial process'. In other words, ADR is any method for resolving a dispute, which avoids the need for a court to intervene.

The CPR obliges parties to explore and use ADR if it is practical to do so. The position the courts take is that litigation should always be a last resort. The courts will explore the extent to which parties before them have endeavoured to avoid litigation, and have properly considered using ADR to resolve their dispute.

The courts have power to stay legal proceedings and direct parties to explore and, if appropriate, use a viable method of ADR rather than go through the trial process. Courts will frequently require parties to provide evidence that ADR has been properly explored. If a party has not taken steps to source a viable method of ADR, or has declined to use ADR, a court will likely want to know why. If the court is not satisfied with the explanation, the reluctant party could be penalised in a costs order. A number of cases in recent years have demonstrated that there are progressively fewer excuses that courts are prepared to accept for not using ADR.

All new leases (including renewals) should ideally provide for ADR where it concerns service charge disputes. Where leases contain no provisions for referral of disputes to ADR, there is nothing to stop the owner and occupier agreeing to use an ADR process to help them find a resolution to a dispute.

#### 4.6.4 Recommended ADR methods for service charge disputes

While there are many methods of ADR, two methods particularly lend themselves to resolving service charges disputes:

- mediation and
- independent expert determination.

Both procedures involve the appointment of an impartial person who is knowledgeable and experienced in the subject matter of the dispute.

Parties who choose to use mediation or independent expert determination often do so because, not only are the procedures usually quicker and more cost-effective than litigation, they are private and confidential.

If the parties cannot agree on the identity of their mediator or independent expert, they can seek assistance from the RICS Dispute Resolution Service (DRS), see: [www.rics.org/drs](http://www.rics.org/drs)

Whether the issues in dispute are technical/surveying, valuation or legal, RICS DRS can advise the parties of a suitable person(s) who they can agree to appoint. Alternatively, RICS DRS can appoint an appropriately qualified and impartial mediator or independent expert if the parties cannot agree who to appoint, and they require a neutral and objective appointment to be made (see section 4.6.5).

##### 4.6.4.1 Mediation

In mediation, the role of the independent person (the mediator) is to foster a negotiated settlement between the parties. The mediator's function is not to impose a decision, but to facilitate and structure discussions between the parties, and guide them to a mutually acceptable outcome. The mediator can, if the parties wish, provide recommendations on how their dispute could be settled.

Mediation is particularly helpful where parties wish to maintain friendly relationships with each other and/or want to avoid getting embroiled in a potentially confrontational process. Mediation, unlike many other forms of ADR, seeks to achieve compromise that satisfies both parties, and it is often described as a 'win-win' procedure.

Mediation proceedings are usually conducted on a 'without prejudice' basis. This means that nobody can use what has been said or recorded in the mediation in any subsequent legal proceedings, and the mediator cannot be called as a witness in any subsequent court proceedings. What is said remains confidential. The process is informal. A mediation hearing often lasts no more than one day, which makes it more cost-effective compared to court, and the parties

usually agree to share the costs of the mediation between them.

A mediated settlement is generally recorded in a formal agreement, which contractually binds the parties to the outcome.

### 4.6.4.2 Independent expert determination

Independent expert determination involves the appointment of an impartial person who is highly proficient in the subject matter in dispute. The independent expert's function is to gather information and evidence from the parties, and make their own enquiries, to arrive at a decision on the dispute.

Where parties refer a dispute to the decision of an independent expert, they will normally enter into a contractual agreement to be bound by the decision of the independent expert. A decision cannot normally be challenged unless it can be shown it is founded on a manifest error. In practice, it is very unusual for an independent expert's decision to be overturned by the courts.

Independent expert determination is particularly useful at resolving disputes involving questions around valuation of property and/or costs of works carried out.

The fees of an independent expert are usually split equally between the parties, unless they both agree that the independent expert will decide who will be responsible for paying their fees.

Other costs, such as expenses incurred by the parties in preparing their case and instructing professional or legal representation, are usually split between the parties equally, unless they both agree that the independent expert will apportion responsibility for paying the costs between the parties.

This professional statement encourages parties to agree that independent experts provide reasoned determinations when dealing with service charge disputes. Like other forms of ADR, expert determination is private and confidential to the parties involved in a dispute. The contents of a reasoned determination will only be known to the parties involved in the dispute. It cannot automatically be disclosed to other tenants. It does not follow that a reasoned determination will be helpful to other tenants, unless one or both parties to the determined dispute agree to disclose their expert's determination.

One possible way to achieve consistency in decisions by third parties on service charges is for the same independent expert to be appointed on subsequent disputes. For example, when RICS DRS is asked to appoint independent experts to resolve more than one dispute in a shopping centre, industrial complex or block of offices where there is a single landlord and multiple tenancies under different leases, RICS DRS will normally appoint the same expert.

## 4.6.5 RICS Dispute Resolution Service (DRS)

For further information about mediation, independent expert determination and other forms of ADR, and how to source independent appointments, contact:

RICS Dispute Resolution Service (DRS)

**E:** [drs@rics.org](mailto:drs@rics.org)

**T:** +44 (0)20 7334 3806

**W:** [www.rics.org/drs](http://www.rics.org/drs)

RICS DRS has issued informative fact sheets for surveyors and the public, covering the different methods of ADR, areas of disputes, courts, tribunals and other processes involved in resolving disputes. The fact sheets mainly cover the jurisdiction of England and Wales, but some also cover the position in other jurisdictions. Please see [www.rics.org/drtoolkit](http://www.rics.org/drtoolkit) for more information.

## 4.7 Mixed-use developments

Recently, there has been an increase in mixed-use developments. While the concept is not new, what is different about mixed-use developments today is the increase in the introduction of residential units into commercial buildings. This is being driven not by organic growth, but by public policy.

The mixture of commercial and residential uses, in management terms, presents challenges that will often require both residential and commercial service charge management skills and expertise.

The extent to which the owner will be obliged to provide and carry out works and services will, in respect of both commercial and residential leases, depend on a strict interpretation of the wording of the lease. The *Landlord and Tenant Act 1985*, subsequently amended by the *Housing Act 1996* and *Commonhold and Leasehold Reform Act 2002*, imposes statutory constraints in respect of service charges for residential properties.

It has been a common misconception among many practitioners that if the residential element of a mixed-use scheme was 'let' under a single head lease, it would not be subject to the residential legislation. The cases of *Heron Maple House Ltd v Central Estates* [2002] 1 EGLR 35 and *Oakfern Properties Ltd v Ruddy* [2006] EWCA Civ 1389 have determined that an owner of a lease that includes both residential and non-residential elements will also need to follow the statutory procedures laid down by the *Landlord and Tenant Act 1985* (as amended) to ensure that non-recovery does not result due to an infringement of the legislation designed to protect residential occupants only.

Further detailed information and guidance is available in the RICS guidance note, *Managing mixed use developments*, 1st edition, 2012.

See also the RICS *Service charge residential management code*, 3rd edition, 2016, which is approved by the Secretary of State for England and has RICS code of practice status.

## 4.8 Provision for anticipated future expenditure

The best practice recommendations in this section will help RICS members and regulated firms achieve the following mandatory requirements:

- 1 All expenditure that the owner and manager seek to recover **must** be in accordance with the terms of the lease.
- 3 Owners and managers **must** ensure that service charge budgets, including appropriate explanatory commentary, are issued annually to all tenants.
- 6 Service charge monies (including reserve and sinking funds) **must** be held in one or more discrete (or virtual) bank accounts.

### 4.8.1 Background

The nature of commercial leases and, in particular, the length of these leases, has changed substantially over recent years. Many items managed under the service charge will have a life expectancy longer than the lease term being granted. Owners and occupiers need to carefully consider how they will recover (or pay for) these major expenditure items when they are due. It is, therefore, recommended that proper planned preventative maintenance (PPM) plans are used.

In addition to regular expenditure on services, owners and occupiers may need to make provision for occasional one-off outlays on replacing major items of equipment (such as a heating system). Major expenditure of a regularly recurring nature (such as external redecorations) can also cause significant fluctuations in the amount of service charge payable each year.

The move towards shorter leases creates difficulties in the recovery of the cost of long-term maintenance/repair. For example, an occupier occupying under a lease for a term of, say, five years may only have a 'transitory' interest in the replacement of a boiler, which might have a life expectancy far beyond the term of their lease. That occupier is, therefore, not likely to be interested in the replacement of the boiler at an indeterminate date in the future.

Contrast this with the situation of an incoming occupier who has signed a new lease that includes a liability for payment of a proportion of the cost of repair and replacement of the owner's plant, who then finds that the boiler requires replacement within the first year of the term.

To the extent that these items can be foreseen, it may make sense for the cost of major extraordinary expenditure items to be spread over a number of years (and over a number or lease periods) by setting up a sinking or reserve fund, rather than charging the whole cost to the current occupiers in the year in which the equipment is replaced.

### 4.8.2 Legal and tax challenges

Where a landlord collects money for anticipated future expenditure over time, the problem for tenants has been that they are at risk of becoming unsecured creditors

if the landlord becomes insolvent or the landlord fails to undertake the works in a timely and comprehensive manner, or at all.

Therefore, the solution is the creation of a sinking fund held on trust for the tenants from time to time, into which contributions are paid by the tenants (and the landlord in respect of any voids) and in which funds accumulate until such time as they are required.

However, there are various different ways in which a sinking fund arrangement can be put in place, with potentially different tax consequences. As a result, many landlords prefer to avoid the issue altogether.

Furthermore, while for residential property interest earned on accumulated funds is taxable only at the basic rate of income tax, in the commercial property context trust income is taxable at the trust rate. This not only means that commercial sinking funds pay a higher tax but that there is also a substantially increased administrative burden with the need to file trust tax returns.

The creation of sinking funds under trust has not therefore been popular primarily due to the uncertainty surrounding the tax treatment, the terms under which the fund is held and the way in which the fund is administered in practice.

### 4.8.3 The contractual arrangement

An occupier will only be liable for making contributions towards a sinking or reserve fund, or for payment of a depreciation charge, so far as the lease allows.

Where the lease is silent, the owner cannot insist on including such arrangements within the service charge.

Issues that should be clarified between the owner and occupier include:

- the 'ownership' of the money
- the purpose for which the fund is being accumulated and its timescale and
- what will happen to it at the end of the lease?

It may be that the fund will continue to exist after an individual occupier's lease expires, and so the money will remain within the fund until it is needed. What happens to the fund when the subject building is demolished is often not thought about; therefore, any unexpended monies may 'revert' to the owner by default.

Occupiers should be aware of the potential for bearing a proportion of large costs during the course of relatively shorter-term leases, and are advised to carry out appropriate due diligence prior to signing any lease. Owners are required to act reasonably in seeking to recover any large costs from occupiers who take leases during the latter part of the life cycle of plant and equipment.

Whichever arrangement is used, clear communication is vital.

#### 4.8.4 Sinking funds, reserve funds and depreciation charges

Some confusion has arisen as the description and purpose of such funds has become interchangeable. The following definitions set out industry guidance on how these terms are to be used.

A **sinking fund** is a fund formed by periodically setting aside money for the replacement of a wasting asset (for example, heating and air-conditioning plant and equipment, lifts, etc.).

A **reserve fund** is a fund formed to meet anticipated future costs of maintenance and upkeep to avoid fluctuations in the amount of service charge payable each year (for example, for external cleaning and redecorations).

A **depreciation charge** is a measure of the wearing out, consumption or other reduction in the life of an asset (for example, heating and air-conditioning plant and equipment, lifts, etc.). An amount would be included in the service charge to reflect the 'cost' to the landlord based on the initial cost of an installation, rather than on the future cost of replacement.

##### 4.8.4.1 Sinking (or replacement) funds

It is recommended to set out a clear policy as to the purpose for which the monies are being built up, for example, to replace the lifts within the building. This will require the owner to act reasonably in estimating the amount of the contributions due. Ideally, the policy will also set out the basis used in calculating the charge, and include details of:

- how the monies will be held
- to whose order and
- how financial matters, including interest and tax, will be accounted for.

Where monies are held to the order of many, it would then be best for them to be held 'in trust' and protected from any liquidation or financial arrangements. Where monies are held in a client account that is properly named and designated as a trust account, case law suggests this might be sufficient to form an implied or constructed trust, and be so recognised by the bank where it is held (see *Kayford Ltd* [1975] 1 All ER 604, [1975] 1 WLR 279). In the case of more substantial funds, it may be advisable to have a formal trust deed setting out the arrangements, trustees, etc.

The ownership of sinking-fund monies is often poorly defined, particularly when the purpose of the fund has been discharged. However, a well-set-up fund will usually clarify what is being paid and by whom, to what purpose, and what will happen once that purpose has been achieved – or, in other circumstances (such as demolition), to residual monies – and to whom these monies will be disbursed. This may also possibly include any former occupiers who contributed to the fund.

At the same time as other occupiers are making their contributions the owner should contribute to the fund for any void properties as though he or she was the occupier.

Sinking funds remain part of the service charge, and all payments made out of the fund should be clearly communicated to occupiers, and included as part of the annual reconciliation of the service charge.

The nature of sinking funds means that they are best suited to being collected over the life of the item for which they are intended. Many leases of older buildings might make provision for a sinking fund, but if no fund has commenced, this may create a sense of inequity and unfairness if occupiers who took leases later in the life of the building were asked to contribute towards the full replacement cost.

Where major works are anticipated in the relatively short term, and it is decided to spread the cost during the period leading up to the point at which the expenditure was incurred, this then becomes a reserve rather than a sinking fund.

##### 4.8.4.2 Reserve funds

Reserve funds are generally relatively short-term in nature, and are created for a specific purpose; for example, external redecoration of a building or internal redecoration of common parts, the purpose being to minimise fluctuations in the amount of year-on-year service charge payable by an occupier as a result of regularly recurring items. As such, a reserve fund can only relate to those costs that are reasonably incurred during the term of an individual occupier's lease.

Following the Court of Appeal decision in *Brown's Operating System Services Ltd v Southwark Roman Catholic Diocesan Corporation* [2007] EWCA Civ 164 and *Friends Life Management Services Ltd v A&A Express Building Ltd* [2014] EWHC 1463 it is generally accepted that reserve funds are to be regarded as occupiers' monies, and if the fund has not been expended on expiry or sooner determination of the lease, the occupier is entitled to repayment of any monies contributed to the fund.

Reserve funds remain part of the service charge, and all payments made out of the fund should be clearly communicated to occupiers, and included as part of the annual reconciliation of the service charge.

##### 4.8.4.3 Depreciation charges

Depreciation is the measure of the wearing out, consumption or other reduction in the life of an asset. By this definition, it is clearly the owner's money. This view is supported by the decision in *Secretary of State for the Environment v Possfund (North West) Ltd* [1997] 2 EGLR 56, which determined that depreciation charges belong to the owner absolutely.

Occupiers do not want to pay for either the initial provision of an item (believing that to be the owner's responsibility), or to have to pay for something twice. If the owner is recovering any depreciation from the service charge, it is essential that the wording on the lease recognises this, and also requires the owner to carry out replacements to potentially pre-agreed service levels, etc.

#### 4.8.4.4 Forward funding

Where provision for future expenditure is to be made within the service charge accounts such sums should not be included as accruals but should be considered as contributions towards reserve or sinking funds as above and reported accordingly.

Accruals are expenses for goods and services actually incurred in a period for which no invoice has been received. As the cost relates to the period, it should be charged to the service charge account for that period.

However, in certain instances, owners and/or managers often seek to collect or retain money in anticipation of future expenditure by 'accruing' costs within a service charge period prior to any works being committed or any liability for expenditure being incurred.

Often the cost of anticipated major works is included in the service charge budget but for whatever reason, no works were actually commenced during the service charge period in question. In such circumstances, the amount included within the original budget is frequently, and incorrectly, retained as an 'accrual' against the anticipated commencement of works in the next or subsequent years.

If no expenditure has been incurred, it follows that costs cannot then be 'accrued' into the service charge period. Therefore, where no liability for costs has been incurred, the retention of occupier monies outside of a properly constituted sinking or reserve fund is contrary to best practice, and is considered to be wholly inappropriate under any circumstances.

However, where the lease does not make specific provision for the setting-up of a sinking or reserve fund, it can often be beneficial to both owners and occupiers to spread the anticipated future works over a number of service charge periods. Such a voluntary arrangement will require to be separately agreed and any forward funding agreed should be disclosed separately in the expenditure report under a different heading and not within another cost code, and titled, for instance, 'Agreed contributions towards future works'. Further details of the forward funding should also be disclosed within the notes to the expenditure report.

#### 4.8.4.5 Payment plans

Where a sinking or reserve fund or other basis of forward funding has not been put in place, the incidence of significant or extraordinary one-off expenditure can often represent an onerous burden for tenants. In such circumstances an owner might be agreeable to recovering the costs over more than one service charge period (perhaps as a gesture of goodwill to ease the burden on an occupier's cash flow). Where the lease is otherwise silent, this is to be regarded as a concession – which is not to be confused with a reserve or sinking fund, or a depreciation charge.

In granting such a concession, there needs to be a clear agreement, which would often be expressed as 'personal only' to each occupier. It would be usual to ensure that the period over which the expenditure is to be recovered is within the term of an individual occupier's lease. The

agreement would also need to set out what will happen with regard to payment of any outstanding balance on the original costs owed, in the event the occupier assigns their lease or becomes insolvent, or if the lease is otherwise determined. Where the occupier is a single individual such an arrangement could, under certain circumstances, be considered to be a credit agreement under *Consumer Protection Act 1987*, and therefore it is recommended that legal advice be sought prior to entering into such an arrangement.

#### 4.8.4.6 Best practice principles

In managing sinking and reserve funds or depreciation charges, the following is to be considered as best practice:

- Monies accumulated in a sinking or reserve fund are to be held in one or more separate discrete (or virtual) bank accounts to be maintained in trust for the occupiers.
- The owner or managing agent should act reasonably in estimating the amount of the sinking or reserve fund contributions to be included within the service charge, which should relate to specifically identified expenditure only (for example, repairs or replacement of the roof, boiler plant, lift, etc.) rather than other unidentified future expenditure.
- The owner or manager is to provide a clear explanation of the basis of calculation of the sinking or reserve fund contribution and the items to which it relates, and should apply a realistic assessment of the anticipated life cycle of the item in question and the funds accumulated from previous service charge periods (including any interest).
- Owners are to make all payments into the sinking or reserve fund to account for void premises.
- Statements of service charge expenditure should contain a clear statement of any contributions to and expenditure from the sinking fund account, along with the account opening and closing balances, the amount of interest earned and any tax paid in the relevant period.
- Where expenditure is required in respect of any item for which a sinking or reserve fund is established, the owner should apply funds from the sinking or reserve fund towards such costs.
- On completion of the sale of a property, the vendor should pass all sinking or reserve fund monies held to the purchaser, together with any accrued interest. It is advisable to seek advice to ensure any tax liability on the fund is appropriately mitigated and accounted for.
- Charges made in respect of depreciation belong to the owner. Accordingly, where a depreciation charge is made, the responsibility for the cost of replacement moves to the owner. The owner or manager is to act reasonably in estimating the amount of the depreciation charge, and is to provide a clear explanation of the basis of the charge calculation and the details of the specific items for which the depreciation charge is calculated.



- A proper and reasonable depreciation charge is to be considered as an annual cost to the owner rather than recovery of the initial cost of installation.
- Depreciation charges and sinking/replacement funds are mutually exclusive. A depreciation charge cannot be made where a sinking or reserve fund is or will be made in respect to a specific item, and vice versa.

## 4.9 Initial provision, replacement and improvement of fabric, plant and equipment

The best practice recommendations in this section will help RICS members and regulated firms achieve the following mandatory requirements:

- 2 Subject to section 4.2.7, owners and managers **must** seek to recover no more than 100% of the proper and actual costs of the provision or supply of the services.
- 3 Owners and managers **must** ensure that service charge budgets, including appropriate explanatory commentary, are issued annually to all tenants.
- 4 Owners and managers **must** ensure that an approved set of service charge accounts showing a true and accurate record of the actual expenditure constituting the service charge are provided annually to all tenants.

### 4.9.1 The principles of replacement and improvement in the context of service charges

The service charge would usually be limited to the recovery of the reasonable costs of maintenance, repair and replacement (usually where beyond economic repair) of the fabric, plant, equipment and materials necessary for the property's operation.

Service charge costs should not include:

- 1 any initial costs (including the cost of leasing of equipment) incurred in relation to the original design and construction of the fabric, plant or equipment
- 2 any setting-up costs that are reasonably to be considered part of the original development cost of the property
- 3 improvement costs above the costs of normal maintenance, repair or replacement (see section 4.9.5) or
- 4 future redevelopment costs.

Service charge costs may include improvements or enhancement of the fabric, plant or equipment where such expenditure can be justified following the analysis of reasonable options and alternatives, and with regard to a cost-benefit analysis over the term of the occupiers' leases. Managers should provide the facts and figures to support and justify such a proposal.

Current case law has determined that the length of the original or unexpired term of the tenant's lease may be a factor in determining whether costs are recoverable.

Current decisions do not give occupiers authority to sustain a proposition that, as a general rule, they cannot be required to pay a higher service charge for works carried out towards the end of the term of their lease. If an owner can demonstrate that repairs are necessary to comply with the obligations under the terms of and within the life of the lease, the costs are likely to be recoverable, even from a tenant whose lease is about to end.

### 4.9.2 Initial provision of fabric, plant and equipment

Service charge costs should not include any initial costs (such as the cost of leasing of equipment) incurred in relation to the original design and construction of the fabric, plant or equipment. The owner is expected to provide these.

This also extends to the cost of fitting-out and equipping any on-site management facilities, as these costs will be indistinguishable from other facilities and equipment such as

- lifts
- heating, ventilating and air-conditioning plant
- security systems or
- toilets, etc.,

that comprise part of the property. It is expected these systems will be provided for the management, administration and operation of the property's services from the outset.

In line with best practice, the initial cost of providing such furniture and facilities are not to be included as part of the service charge.

### 4.9.3 Like-for-like replacement

The service charge should be limited to the costs of replacement and renewal of fabric, plant or equipment only, providing:

- the relevant items being replaced or renewed are beyond economic repair, or efficient or economic operation
- replacement or renewal of such items is a relatively lower cost compared with the much greater cost that could occur due to material postponement of the replacement or renewal or
- replacement or renewal of such items is a proper requirement of any public or competent authority or legislation, or of the insurers.

Plant and equipment reaches the end of its economic life when it is more economic to replace it than to maintain it. Whether equipment is approaching the end of its economic life or not is determined by an inspection of the plant in operation by an experienced engineer. As equipment approaches the end of its economic life, it is reasonable to anticipate that failures will occur with increasing frequency; therefore, a review of service records, along with records of the occurrence and frequency of failures, will help to establish whether it is necessary to replace it.

#### 4.9.4 Replacement with enhancement

Where plant and equipment that has become dilapidated or worn out is replaced, the replacement will usually include an element of enhancement or upgrade of the previous equipment, due to the fact that the replacement will be of an equivalent modern standard.

Strictly speaking, replacement of plant and equipment by its modern equivalent would generally fall within the definition of repair and not improvements. However, there may well be a tendency towards exceeding the design specification of the original equipment in order to meet modern requirements, or to introduce new products or practices intended to improve the service levels and/or value for money.

If the costs are to be recovered through the service charge, it is important to consider whether the intention is to improve or repair the existing equipment.

If the additional cost of carrying out the improvement can be justified on a cost-benefit basis – for example, a reduction in the ongoing maintenance costs, increased energy efficiency, etc. – there is a case for the service charge to be made to cover these. In such circumstances, proper communication, supported by figures to support and justify such a proposal, will help achieve a practical and common-sense solution.

#### 4.9.5 Improvement and enhancement

Service charges would not generally include the cost of improvement above the cost of normal maintenance, repair and replacement; but it is likely that circumstances will arise where owners and occupiers would see a direct benefit from the introduction of new innovations or additional improvement or enhancements of the building fabric, plant, or equipment. The service charge might include such costs where the expenditure can be justified following analysis of reasonable options and alternatives, and having regard to a cost-benefit analysis over the term of the occupiers' leases. Managers should communicate any proposals clearly to occupiers, and provide the facts and figures to support and justify such a proposal (see also section 4.9.7).

#### 4.9.6 Refurbishment

Refurbishment is a different concept to improvement. Within the scope of the refurbishment works proposed there may include elements of catching up on accumulated disrepair as well as elements of improvement.

The amount occupiers will contribute towards the cost of refurbishment will depend on the extent and nature of the works proposed, in addition to the wording of the lease.

Owners will seek to protect the value of their investments and to maximise rental levels. Refurbishments are often dictated by market forces, and often timed to coincide with rent reviews or lease expiries. Occupiers usually object to contributing towards the cost of refurbishment because not only will they be paying for the cost of refurbishment through the service charge, but also through increased rents as a result of any improvements.

When refurbishments result in higher rental values, the owner is to be responsible for the cost of enhancements or improvements above those of maintenance.

The need to carry out extensive repairs or to replace services is also considered in the decision to refurbish. Prior to a refurbishment, major repairs or replacements may be deferred to benefit from economies of scale through placing one major works contract. The improved efficiency of the new environment and any improved services may produce cost savings in day-to-day services management, resulting in the annual service charge being reduced.

Occupiers may still be liable for the costs of repair or replacement carried out as part of a larger refurbishment contract, as though the works had been started separately from the refurbishment.

#### 4.9.7 Communication

To ensure agreement and avoid dispute, if it is proposed to include the cost of improvements in the service charge, this is to be communicated to occupiers before any expenditure is committed. It would also be advisable to record any agreement in writing.

In the case of refurbishment, the owner's proposals are to be communicated to all occupiers well in advance of commencement of any works to explain which costs the occupiers are responsible for in relation to the service charge. Best practice also recognises the need to establish regular communication between the manager and the occupiers to monitor the refurbishment and to agree which elements of the works are to be considered service charge costs. This reduces or avoids the potential for dispute over any unexpected costs following completion of the works.

### 4.10 Social, economic and environmental sustainability

The best practice recommendations in this section will help RICS members and regulated firms achieve the following mandatory requirements:

- 1 All expenditure that the owner and manager seek to recover **must** be in accordance with the terms of the lease.
- 2 Subject to section 4.2.7, owners and managers **must** seek to recover no more than 100% of the proper and actual costs of the provision or supply of the services.

#### 4.10.1 Green leases

The sustainability debate has been focused on how to develop more sustainable buildings, but it has ignored two issues:

- what to do with existing buildings and
- the role of the occupier in reducing emissions.

Green leases - commercial property leases that set down obligations on behalf of landlords and tenants to co-operate with the aim of reducing waste production

and energy and water consumption – may be one way of addressing these issues.

Owners and occupiers are advised to be aware of the environmental impact of their respective operations. This professional statement supports and promotes a cooperative and collaborative approach in recognising and managing the environmental impact of the occupation and management of commercial premises.

Leases are binding documents that are not easy to amend. There may be value in owners and occupiers entering into a non-legally binding memorandum of understanding (MoU), which provides a roadmap for cooperation between the parties on improving the environmental performance of buildings. This allows the MoU to be updated to reflect the latest business practice as agreed between the parties during the term of the lease.

Further information can be obtained from the Better Building Partnership's *Green Building Management Toolkit*, which is available at: [www.betterbuildingspartnership.co.uk/green-lease-toolkit](http://www.betterbuildingspartnership.co.uk/green-lease-toolkit)

### 4.10.2 Carbon Reduction Commitment Energy Efficiency Scheme

In May 2010, the government committed to increasing the proportion of tax revenue accounted for by environmental taxes. The government classifies environmental taxes as those that meet all of the following three principles:

- 1 The tax is explicitly linked to the government's environmental objectives.
- 2 The primary objective of the tax is to encourage environmentally positive behaviour change.
- 3 The tax is structured in relation to environmental objectives (for example, the more polluting the behaviour, the greater the tax levied).

The Carbon Reduction Commitment Energy Efficiency Scheme (often referred to simply as 'the CRC') is defined by the government as an environmental tax based on these principles.

The CRC is aimed at improving energy efficiency and cutting emissions in large public- and private-sector organisations. It does not apply to all organisations but owners, managers and occupiers should continue to monitor for any updates.

The CRC dilemma is that it is a tax levied on organisations and is not property specific. Furthermore, it is a tax levied at the highest corporate level of an organisation and therefore in many instances the tax would not be paid by a tenant's immediate landlord, but by the landlord's parent company.

CRC is not, therefore, a property specific charge in the same way that the Climate Change Levy is directly linked to actual electricity or gas consumption and as a tax on organisations is not a tax or charge on landlords per se.

The position is further complicated in situations where the owner is responsible for the electricity supply to the whole of a building and is able to recover the cost of direct

electricity consumption to the occupational premises, in addition to the costs of the landlord common parts areas, through the use of sub-meters, etc. In such circumstances, the owner in effect and inadvertently becomes liable for payment of CRC costs for which the occupier would otherwise have been directly liable.

In older leases it is a matter of contract law as to whether the lease specifically and unambiguously permits the landlord to recover the cost of CRC within the service charge. While the debate continues as to whether, in principle, CRC costs should properly be recoverable under a service charge arrangement owners and occupiers, managers and lawyers should carefully consider the implications when drafting new leases.

Nevertheless, there should be a fair and reasonable approach in the apportionment and recovery of CRC costs between owners and occupiers, based on the core principle that owners should be able to recover the full cost of providing bona fide services to occupiers and that occupiers should be in a no better or worse position than had they occupied premises on the basis of a full repairing and insuring lease, although with the emphasis on the ethos that the 'polluter should pay'.

Where CRC costs are to be recovered under a service charge arrangement the following is considered to embody best practice:

- 1 Occupiers should not be responsible for the owner's costs of managing and administering the CRC scheme.
- 2 Owners owe a duty of care to take such steps as are reasonably necessary to keep costs down and to procure that the relevant member of the group that has CRC responsibilities complies with its duties.
- 3 The method of apportionment across the landlord's group and between buildings owned by the landlord's group should be:
  - a. fair and reasonable and
  - b. consistently applied.
- 4 In the spirit of openness and transparency, occupiers should be provided with information to reasonably verify the accuracy and performance of these objectives (particularly in relation to the method of apportionment).

Note the government has confirmed that the CRC is to be abolished and organisations will report under the CRC for the last time by the end of July 2019 and surrender allowances for emissions from energy supplied in the 2018–19 compliance year by the end of October 2019.

### 4.10.3 Improving environmental performance

The sharing of data and other related information is essential. For this reason, it is advisable for owners, managers and occupiers to cooperate on the running of any building management systems and on a range of environmental improvement measures. Non-reporting

will incur heavy penalties for owners and occupiers. Cooperation on data sharing is essential.

There should be a fair and reasonable approach to:

- the apportionment of sustainability costs between owners and occupiers, although consistent with the principle outlined previously that there should be an emphasis on the ethos that the 'polluter should pay'
- the carrying out of works that improve the environmental performance of the building and
- restrictions on works by either party that adversely affect the environmental performance of the building.

In accordance with the principles set out in this professional statement, improved sustainability and other environmental improvement measures are to be taken into account when considering and assessing whether any particular service or provider offers value for money. These are also to be factors in any cost-benefit analysis carried out to justify improvement costs above the costs of normal maintenance, repair or replacement (for example, the installation of energy-efficient plant).

#### 4.10.4 Energy Performance Certificates (EPCs)

For the avoidance of doubt, the cost of obtaining an Energy Performance Certificate (EPC) would not normally be considered a recoverable service charge cost. An EPC is only required when a building is sold or rented, and therefore has no relevance to, nor is it a requirement for, the provision and management of common services.

#### 4.10.5 Minimum Energy Efficiency Standards and EPCs

The *Energy Efficiency (Private Rented Property) (England and Wales) Regulations 2015* introduced Minimum Energy Efficiency Standards (MEES) and are intended to improve the performance of existing property through energy efficiency upgrades to address energy used and reduce emissions across non-domestic properties. From April 2018 it is unlawful, subject to certain exemptions, for landlords of buildings within the scope of the MEES regulations to renew existing tenancies, or grant new tenancies, of buildings with an energy rating of less than E. MEES will also apply to all lease renewals from 1 April 2023. The obligation for compliance rests with the lessor or vendor and the cost of obtaining an EPC would not normally be considered to be a recoverable service charge cost as it is not a requirement for the provision and management of common services.

Subject to the terms of the lease and the principles set out in this professional statement, any subsequent costs of improving energy efficiency might comprise a legitimate service charge item as long as there is a proportionate cost benefit to tenants (see section 4.10.3).

#### 4.10.6 Social initiatives

Communication and involvement with local stakeholders and communities is recognised as of being of benefit to all.

While the direct benefits of this can be difficult to quantify, this professional statement supports and promotes a cooperative and collaborative approach.

## 4.11 Additional best practice guidance for shopping centres, retail and leisure parks and business campuses

### 4.11.1 Marketing and promotions

The marketing of and promotional activity supporting schemes such as shopping centres, retail and leisure parks and business campuses, are recognised as being of joint benefit to all stakeholders, and are therefore rightly jointly funded. This would usually be expected to be on a 50/50 basis unless specific circumstances determine a different approach. This joint funding should cover not just the actual marketing and promotions, but also the costs of providing specialist staff (and accommodation, etc.) whether directly or via an agency arrangement.

The service charge budget and accounts should be transparent and should include the gross marketing and promotional expenditure and the contribution from the owner and clearly show the net contribution due from the occupiers.

It is best practice for marketing plans (including promotions) to be prepared and presented to occupiers in advance of the period to which they relate. It is often useful to agree and regularly review marketing plans with occupier/retailer associations in order to analyse their effectiveness, and to ensure that the stated objectives are achieved.

As marketing and promotions are of joint benefit, it is important for owners/managers to encourage occupiers to recognise that they have an obligation to proactively communicate their views on the best approach to marketing and/or promotions.

Any costs incurred in relation to the initial promotional launch and/or rebranding of a scheme should be borne by the owner, and should not be considered as recoverable service charge costs. It is recommended that any plan to relaunch a scheme be discussed between owner and occupiers so that they can agree to an appropriate split of the expenditure to each party.

The marketing of vacant units is not a service charge item.

### 4.11.2 Customer services, amenities and facilities

#### 4.11.2.1 Pedestrian flow and car counting

Systems that collate information on the number of customers or cars visiting a site often provide useful data to managers to help schedule resources to match the varying needs and demands of schemes. Such systems are quasi-management tools and the cost of operating and maintaining such systems should therefore be clearly and

explicitly shown as a separate cost heading within budget and actual expenditure reports. Best practice requires that the information obtained is to be shared with occupiers as a matter of course.

However, pedestrian flow and car counting data, combined with sales or turnover statistics, is principally a tool for measuring or monitoring the effectiveness of marketing and promotion expenditure and should be either a shared marketing cost or a landlord cost, depending on the nature of the data collected and the extent to which it is shared.

Where the service charge bears the cost, all pedestrian flow data collected is to be issued to occupiers as a matter of course.

### 4.11.2.2 Entertainments and seasonal decorations

The costs of entertainments, attractions, Christmas and other seasonal decorations and events within schemes are not classed as a marketing and promotional cost, but are regarded as amenities or facilities and should be included under the appropriate cost heading (see *Boots UK Ltd v Trafford Centre Ltd* [2008] EWHC 3372 (Ch)).

### 4.11.2.3 Amenities and facilities

Scheme management has moved beyond just providing clean, safe and secure environments, partly as a response to changing customer needs and expectations. There are many additional services, facilities and amenities that are often considered as a standard requirement by customers, for example, the provision of free Wi-Fi connectivity or mobility and less abled services.

Where providing such services requires the addition of a new facility, this would generally be considered to be an improvement and the installation cost should be met by the owner, while the on-going operating and maintenance cost, subject always to the terms of the lease, would usually be met through the service charge, as is standard practice with other areas of expenditure.

It is considered too prescriptive to attempt to provide a list of potential additional services here, as these might vary considerably from property to property, but the provision of such amenities and facilities should be appropriate to the property and location and be the subject of appropriate consultation and communication with occupiers.

The potential for the requirement to provide additional amenities and facilities will often result from technological innovations and where this is the case the provision of additional services and amenities should be carefully considered, be appropriate to the location and provide benefit to the customer experience.

### 4.11.3 Commercialisation (non-core income)

Increasingly, owners are finding additional non-core income streams from their investments. They are entitled to receive this income from the investment they have made; however, if the service charge has provided either the initial capital or ongoing services for the income stream, the income is to be used as a credit against the service costs. When

the owner provides the capital but uses the services to support the operation, a fair and reasonable contribution to the service charge is to be made by the owner to reflect the benefit and use of the services. Best practice for the owner is to clearly state their policy with regard to miscellaneous income within the development.

As well as rents being collected on occupational leases, income is also generated from other sources. Many properties receive income from vending-machine takings, selling recyclable waste, etc., while owners might also receive income from promotional space (e.g. advertising on displays and drums, and in car parks, etc.) and licences granted for other activities within the common part areas (e.g. children's rides, photo booths, etc.). Occupiers may also have (chargeable) use of photocopiers in the management offices. How such income is treated varies considerably from property to property, and from owner to owner.

There is to be a clear statement of policy on how and to where costs and income generated from services and activities are allocated. Transparency is required at all times.

Income derived from the provision of a service or activity, where the cost is included in the service charge, is to be treated as a service charge credit, for example, photocopy and fax reimbursements, etc. Income derived from promotional activity is to be credited to the marketing expenditure budget.

Where the owner retains income from common-part areas, and the space is used on a permanent or semi-permanent basis, e.g. retail mobile units (RMUs) or kiosks, the space is to be included in the service charge apportionment matrix. Alternatively, appropriate equivalent credit is to be given for the costs of that space.

For less substantial or temporary fixtures, a sum is to be credited to the service charge to reflect a contribution towards the benefit of the services enjoyed. Owners are to estimate and declare a contribution to the service charge to reflect the benefit and use of the common services enjoyed.

Managers are to clearly state their policy on how costs and income generated from services and activities are allocated. The following general principles should apply:

- If the item is not funded by the service charge, nor does it use any services, 100 per cent of the income goes to the owner.
- If the item is funded by the service charge, the income is credited to the service charge (e.g. photocopying for occupiers).
- If the item uses some of the services and/or needs support from the site team who are being paid via the service charge, a contribution is to be made to the service charge in accordance with the policy.

In addition to the minimum information set out in section 4.5.4, budgets and statements of actual expenditure are also to include a statement detailing how income generated from commercialisation or mall income is dealt

with, and how shared services are charged. The statement is also to clearly set out how this income impacts on the service charge, and what reimbursement has been made to it.

## Appendix A: Compliance checklist

This compliance checklist is a basis to enable owners, managers and occupiers to self-assess their compliance with the core principles set out in this professional statement. However, merely ticking the boxes does not constitute full compliance with the professional statement, which also entails adhering to the further recommended best-practice recommendations as provided to support the core principles.

| Core principle  | Evidence  | Comply |
|---|---|--------|
| <p><b>Value for money</b></p> <p>Procure an appropriate level of service for the occupiers in the building.</p> <p>Demonstrate that services offer good value for money.</p>  | <p>Competitive tender.</p> <p>Other market testing.</p> <p>Regular cost benchmarking.</p>   |        |
| <p><b>Transparency</b></p> <p>All costs, apportionments and policies are explicit and open to any scrutiny by occupiers or their agents.</p>  | <p><b>1</b> A full apportionment matrix for the entire property/estate/complex along with appropriate percentage allocation calculations is published.</p> <p><b>2</b> All policies are outlined in budget packs.</p> <p><b>3</b> Detailed explanations are provided in year-end statements where the costs have materially varied from the budget.</p> <p><b>4</b> The landlord bears the cost of all voids and concessions.</p> <p><b>5</b> The manager's fees relating to the property during the year are fully disclosed in the notes to the expenditure report.</p> |        |
| <p><b>Timeliness of reporting</b></p> <p>All reports are issued within timeframes recommended by the professional statement.</p>  | <p><b>1</b> Budgets are issued at least one month prior to the start of the service charge year.</p> <p><b>2</b> Year-end statements of actual expenditure are issued within four months of the end of the service charge year.</p>   |        |
| <p><b>Approval</b></p> <p>Actual expenditure approved by the manager or an audit or independent review.</p>   | <p><b>1</b> Certificate issued by manager.</p> <p><b>2</b> Audit or independent review undertaken in accordance with the lease and TECH09/14BL.</p>   |        |
| <p><b>Management fee</b></p> <p>The management fee reflects a reasonable cost to undertake necessary work to manage and operate the services and to administer the service charge.</p>  | <p><b>1</b> Fixed fee [not per cent of service charge].</p> <p><b>2</b> Meets professional statement guidelines on what can and cannot be charged for management.</p>   |        |
| <p><b>Duty of care to occupiers – consultation and approval</b></p> <p>All costs are recoverable in accordance with leases.</p> <p>The occupiers are consulted where appropriate for their agreement to the levels of service and services to be offered.</p> | <p><b>1</b> All occupiers are given the opportunity to comment on the budget.</p> <p><b>2</b> The occupiers are consulted on the levels of service and/or the introduction of new services.</p> <p><b>3</b> All communication and queries are to be dealt with fully and in a timely fashion.</p>   |        |

| Core principle  | Evidence  | Comply |
|---|---|--------|
| <p><b>Standardised financial reporting</b></p> <p>Budgets and statements of actual expenditure are reported in line with this professional statement's cost categories.</p> <p>Where appropriate, separate schedules are prepared to allocate costs to reflect the availability, benefit and use of different services.</p> | <ol style="list-style-type: none"> <li><b>1</b> Standardised cost categories are used.</li> <li><b>2</b> Separate schedules are included as appropriate.</li> <li><b>3</b> Full allocation and apportionment schedules included as standard.</li> </ol> |        |
| <p><b>Interest income and expenses</b></p> <p>Separate interest-bearing accounts are operated for each building, with all interest income and expenses credited or expensed within the service charge.</p>  | <ol style="list-style-type: none"> <li><b>1</b> Bank statement of interest income and expenses.</li> </ol>  |        |
| <p><b>Professional statement – compliant terms in new leases</b></p> <p>New leases have adopted professional statement – compliant terms.</p>   | <ol style="list-style-type: none"> <li><b>1</b> Standard lease terms.</li> </ol>  |        |
| <p><b>Support for alternative dispute resolution (ADR)</b></p> <p>ADR is supported and recommended as the basis to resolve service charge disputes.</p>   | <ol style="list-style-type: none"> <li><b>1</b> Lease makes provision for ADR in the event of dispute.</li> <li><b>2</b> ADR is proactively pursued to facilitate resolution of disputes.</li> </ol>  |        |



# Appendix B: Standard industry cost classifications

## B1 Notes

- The cost descriptions are for illustrative purposes only and not intended to represent an exhaustive list.
- Owners and managing agents are encouraged to include additional cost descriptions where this will facilitate greater transparency and clarity with regard to the expenditure incurred or proposed. However, to maintain industry standards and to facilitate benchmark comparison, the cost class and cost-category structure should not be altered.
- Where reasonable and appropriate cost should be allocated to separate schedules. Separate cost categories are not to be used to describe activities provided across different elements of a subject property, such as the estate, car park, etc. However, where multiple schedules are not used, in order to achieve transparency it may be necessary to repeat certain cost descriptions to make a clear distinction between specific areas where costs have actually been incurred, for example, cleaning costs for estates and car parks.

## B2 Cost classifications

| Cost class                       |  |  |  |
|----------------------------------|--|--|--|
| Cost category                    |  |  |  |
| Cost description                 |  |  | Notes  |
| <b>Management</b>                |  |  |  |
| <b>Management fees</b>           |  |  |  |
|                                  |  | Management fees                          | Owner's or manager's fees for managing and administering the services that are permitted to be recovered under the terms of the lease, excluding rent collection, asset management, etc. |
| <b>Accounting fees</b>           |  |  |  |
|                                  |  | Service charge accounting fees           | Fees for preparation of year-end service charge statement and reconciliation.  |
|                                  |  | Independent accountant's fees            | Independent accountant's fees to review the year-end service charge accounts.  |
|                                  |  | Audit fees                               | Auditor's fees for carrying out a formal audit of the service charge.  |
| <b>Site-management resources</b> |  |  |  |
|                                  |  | Staff costs                              | Direct employment or contract costs for provision of staff for management of on-site facilities.   |
|                                  |  | Receptionists/concierge                  | Direct employment or contract costs for provision of reception and concierge staff, including associated administrative and training costs.  |
|                                  |  | Site accommodation [rent/rates]          | Rent, service charge and rates associated with the site-management accommodation.  |
|                                  |  | Office costs [telephones/stationery]     | Day-to-day running costs of the on-site management office.   |
|                                  |  | Systems                                  | Costs of computer licences, etc. and other systems.  |
|                                  |  | Help desk/call centre/information centre | Operational costs for providing helpdesk/call centre/information centre facilities.  |
|                                  |  | Administration fee                       | Fees for HR and payroll costs associated with dealing with on-site staff [where not included as part of the management fee].   |
| <b>Professional fees</b>         |  |  |  |

|                                    |  |   |  |
|------------------------------------|--|---|--|
|                                    |  | Landlord's risk assessments, audits and reviews | Consultancy fees and other costs associated with provision and review of owner's health and safety (H&S) management systems. |
|                                    |  | Other professional fees                         | Fees of specialist consultants engaged in respect of the provision of services.  |
|                                    |  | Legal fees                                      | Legal advice in respect of the placing or termination of contracts for the provision of services.                            |
| <b>Utilities</b>                   |  |   |  |
| <b>Electricity</b>                 |  |   |  |
|                                    |  | Electricity                                     | Electricity supply to common part and retained areas and central plant, excluding the direct consumption of occupier[s].     |
| <b>Gas</b>                         |  |   |  |
|                                    |  | Gas   | Gas supply for the owner's central plant, excluding the direct consumption of occupier[s].                                   |
| <b>Fuel oil</b>                    |  |   |  |
|                                    |  | Fuel oil  | Fuel-oil supply for the owner's central plant, emergency generators, etc., excluding direct consumption of the occupier[s].  |
| <b>Water</b>                       |  |   |  |
|                                    |  | Water and sewerage charges                      | Water supply to central plant, common part and retained areas, excluding direct consumption of the occupier[s].              |
| <b>Utility consultancy</b>         |  |   |  |
|                                    |  | Utility procurement and consultancy             | Consultancy and procurement fees incurred for negotiating, reviewing, auditing and reporting on all utilities.               |
| <b>Soft services</b>               |  |   |  |
| <b>Security</b>                    |  |   |  |
|                                    |  | Security guarding                               | Direct employment or contract costs incurred in providing security guarding for the building[s].                             |
|                                    |  | Security systems                                | Servicing and maintenance of building security systems [e.g. CCTV, access control, intruder alarms, etc.].                   |
| <b>Cleaning and sustainability</b> |  |   |  |
|                                    |  | Cleaning  | Cleaning of common-part and retained areas.  |
|                                    |  | Window cleaning                                 | Cleaning of external windows.  |
|                                    |  | Hygiene services/toiletries                     | Cleaning and servicing of common-part toilets and toiletry accommodation.  |
|                                    |  | Carpets/mats hire                               | Provision of dust and rain mats to common-part areas.  |
|                                    |  | Waste management                                | Refuse collection and waste-management services provided for building occupiers.   |
|                                    |  | Pest control                                    | Pest-control services provided to common-part and retained areas.  |
|                                    |  | Snow clearance/road gritting                    | Costs incurred in clearing snow and supplying snow-clearing equipment and gritting salt.                                     |
| <b>Landscaping and environment</b> |  |   |  |
|                                    |  | Internal floral displays                        | Providing and maintaining floral displays within the common part areas.  |
|                                    |  | External landscaping                            | Provision and maintenance of external landscaped areas and special features.   |
|                                    |  | Seasonal decorations                            | Provision and maintenance of seasonal decorations to common-part areas.  |
|                                    |  | Events and entertainments                       | Events and entertainments within the common parts areas.   |

| <b>Marketing and promotions</b>                     |   |  |
|---|---|--|
|   | Marketing   | Marketing and advertising in accordance with marketing strategy.   |
|   | Research  | Research into local market conditions, customer surveys, pedestrian flow counting systems, etc.  |
|   | Marketing staff costs                               | Direct employment of staff or staff contract costs for marketing and promotional activity.   |
|   | Landlord's contribution to marketing                | Financial contributions made by landlord towards marketing and promotions.   |
| <b>Hard services</b>                                |   |  |
| <b>Mechanical and electrical services (M&amp;E)</b> |   |  |
|   | M&E maintenance and repair                          | Planned maintenance and repair of the owner's M&E services, including the contractor's H&S compliance.   |
|   | Life safety systems maintenance and repair          | Planned maintenance and repair of the owner's fire protection, emergency lighting and other specialist life safety systems, including the contractor's H&S compliance. |
|   | H&S [mechanical and electrical]                     | Works carried out to M&E plant and equipment in accordance with H&S regulations or recommended best practice.  |
|   | M&E/life safety systems inspections and consultancy | Auditing the quality of maintenance works and the condition of M&E plant and life safety systems to ensure H&S compliance.   |
|   | Car parking M & E maintenance and repairs           | Maintenance and repair of entry systems, payment systems, car counting systems and other specialist car park equipment.  |
| <b>Lifts and escalators</b>                         |   |  |
|   | Lift maintenance contract and repair                | Maintenance and repair of lifts in the common part and retained areas, including the contractor's H&S compliance.  |
|   | Escalator maintenance and repair                    | Maintenance and repair of escalators in the common part and retained areas, including contractor's H&S compliance.   |
|   | H&S [lifts and escalators]                          | Works carried out to lifts and escalators in accordance with H&S regulations or recommended best practices.  |
|   | Lift and escalator inspections and consultancy      | Auditing the quality of maintenance works, the condition of lift plant and H&S compliance.   |
| <b>Suspended-access equipment</b>                   |   |  |
|   | Suspended-access maintenance and repairs            | Maintenance and repairs to the owner's suspended-access equipment, including the contractor's H&S compliance.  |
|   | Suspended-access inspections and consultancy        | Auditing the quality of maintenance works, the condition of suspended-access equipment and H&S compliance.   |
| <b>Fabric repairs and maintenance</b>               |   |  |
|   | Fabric repairs and maintenance                      | Repair and maintenance of the building structure and fabric common parts and retained areas.   |
|   | Redecoration  | Redecoration and decorative repairs.   |
|   | H&S [Fabric]  | Works carried out to building fabric in accordance with H&S regulations or recommended best practice.  |
|   | Building fabric inspections and consultancy         | Auditing the quality of maintenance works, the condition of the building and H&S compliance.   |
|   | Car park fabric maintenance and repairs             | Maintenance and repair of the car park structure, fabric and road surfaces.  |
| <b>Income</b>                                       |   |  |
|   |   | Distinct activities that yield a true income to the service charge account.  |

|                                  |                                       |   |
|----------------------------------|---------------------------------------|---|
| <b>Interest</b>                  |                                       |   |
|                                  | Interest                              | Interest received on service charge monies held within the owner's or manager's bank account.   |
| <b>Income</b>                    |                                       |   |
|                                  |                                       | Income yielded from any facilities installed and/or maintained at the occupier's expense.   |
|                                  | Car park income                       |   |
|                                  | Commercialisation income              |   |
|                                  | Vending machine income                |   |
|                                  | Gift card income                      |   |
|                                  | Other income                          |   |
| <b>Income operating expenses</b> |                                       |   |
|                                  | Operating expenses                    | Overheads, expenses and operational costs incurred in providing any of the income streams, including gift cards.  |
|                                  | Bank charges and transaction costs    | Cash collection costs, transaction fees related to income   |
|                                  | Staff costs                           |   |
| <b>Insurance</b>                 |                                       |   |
| <b>Engineering insurance</b>     |                                       | Landlord's engineering insurances.  |
|                                  | Engineering insurance                 |   |
|                                  | Engineering inspections               |   |
| <b>All-risks insurance cover</b> |                                       | Landlord's all-risk insurance costs.  |
|                                  | Building insurance                    |   |
|                                  | Loss of rent insurance                |   |
|                                  | Public and property owner's liability |   |
|                                  | Landlord's contents insurance         |   |
| <b>Terrorism insurance</b>       |                                       | Landlord's terrorism insurance cover.   |
|                                  | Terrorism insurance                   |   |
| <b>Exceptional expenditure</b>   |                                       |   |
| <b>Major works</b>               |                                       |   |
|                                  | Project works                         | Exceptional and one-off project works, over and above routine operational costs.  |
|                                  | Plant replacement                     | Replacement of the whole or major components of plant and equipment (where beyond economic repair).   |
|                                  | Major repairs                         | Significant one-off repairs or maintenance costs over and above the costs of routine operational maintenance and repair.  |
| <b>Forward funding</b>           |                                       |   |
|                                  | Sinking funds                         | Forward funding of specific major replacement projects (e.g. plant and equipment replacements, roof replacements, etc.).  |
|                                  | Reserve funds                         | Forward funding of specific periodic works to even out fluctuations in annual service charge costs (e.g. internal/external redecorations).  |
|                                  | Depreciation charge                   | Depreciation charge in lieu of sinking/replacement fund contribution for major plant and equipment costs.   |
|                                  | Agreed contribution to future works   | Forward funding of major projects but where the lease does not allow for a sinking or reserve fund to be set up. This is a voluntary arrangement and must therefore be agreed in writing between the owners and individual occupiers and full details provided within the notes to the service charge expenditure report. |
| <b>Miscellaneous charges</b>     |                                       |   |
| <b>Irrecoverable VAT</b>         |                                       |   |

|                               |                                     |  |
|-------------------------------|-------------------------------------|--|
|                               | Irrecoverable VAT                   | Cost of any irrecoverable VAT (if not included in headings above). |
| <b>External contributions</b> |                                     |  |
|                               | Contributions from external parties |  |
|                               | Contributions to external parties   |  |

# Appendix C: Service charge accounting sample report

In managing the provision of services and in certifying the service charge, managers have a duty to both owners and occupiers to act with professional care, diligence, integrity, and objectivity.

Accounting for service charges in the property industry is a specialist area that requires expertise and an understanding of the sector.

*Service charges in commercial property*, RICS professional statement, 1st edition, recommends as best practice that an annual statement of service charge expenditure be certified by the manager to confirm that it represents a true and accurate record of expenditure incurred in supplying the services to the building, and that the expenditure being recovered is in accordance with the terms of the occupational leases.

The professional statement also recommends that annual statements of service charge expenditure should be reviewed by an independent accountant.

The Institute of Chartered Accountants in England and Wales (ICAEW) and RICS have issued a technical release to provide guidance on reporting on commercial service charges. This technical release provides good practice guidance on technical and practice issues relevant to the work of accountants and other professionals.

This sample report sets out recommended best practice for the disclosures and information that managers should provide to the accountants appointed to carry out an independent review of service charges and to tenants.

It is not for this professional statement to prescribe the operating business model of the manager and, therefore, there is no strict layout or order of preference for the statement of service charge expenditure. However, it is recommended best practice that the statement of service charge expenditure should include the following elements:

- the expenditure report (C3 and CA and CB)
- the service charge certificate (C4)
- the independent accountant's report
- notes to the expenditure report and variance report (C5 and CC)
- operational review (C6) and
- the apportionment matrix (CD and CE).

The information referred to in this sample report under 'Operational review' is considered to be best practice to meet the core principles for communication and transparency as set out in the professional statement as to the nature, type and cost of services provided but would usually be outside of the scope of the independent accountant's review.

## Statement of service charge expenditure

[OWNER'S NAME]

[PROPERTY NAME AND ADDRESS]

[dd/mm/yyyy] TO [dd/mm/yyyy]

**Total service charge expenditure** £

### C1 Introduction

This report has been produced by [manager's name] on behalf of [owner's name], landlords of [property name] and relates to the reconciled service charge for the period [dd/mm/yyyy] to [dd/mm/yyyy]. This report has been produced having regard to the best practice guidelines for service charges in commercial property that have been published through the collaboration of a number of professional bodies representing a diversity of interests throughout the property industry.

The report is intended to provide further explanation as to actual service charge costs incurred and any material variances against the property budget issued to tenants on [dd/mm/yyyy]. A summary and detailed expenditure report is included at CA with a variance report showing percentage charge year-on-year at CC.

### C2 The management team

[Insert names and contact details of management team, i.e. property managers, building/centre manager, accounts manager, etc.]

### C3 Service charge expenditure report

The summary or detailed expenditure report should be inserted. This should be prepared and presented in accordance with the current edition of RICS professional statement, *Service charges in commercial property*. Examples of the summary and detailed expenditure reports are included as CA and CB respectively, to this sample report.

### C4 Service charge certificate

#### Model landlord surveyor's certificate

**Certification period: [dd/mm/yyyy] to [dd/mm/yyyy]**

Landlord: .....

Managing agent: .....

Building: .....

I hereby certify that, according to the information available to me, the attached statement of service charge expenditure and accompanying information on pages [ X ] to [ Y ] records the actual cost to the landlord of providing the services to the property for the period [dd/mm/yyyy] to [dd/mm/yyyy], in accordance with the current edition of the RICS professional statement, *Service charges in commercial property*.

Signed .....

[Name and qualifications] .....

Position .....

For and on behalf of [manager's name] .....

### C5 Notes to the expenditure report

#### C5.1 Accounting policies

##### C5.1.1 Accruals basis

A statement should be made as to whether the accounts are prepared on an accruals basis or cash basis (note: best practice recommends all statements of service charges should be prepared on an accruals basis).

##### C5.1.2 Insurance claims

A statement should be made detailing how insurance claims are accounted for, e.g. it is policy to recognise income in respect of insurance claims in the service charge period in which confirmation has been received from the insurers that the

claim will be settled. The associated costs of the claim are charged to the service charge in the period in which the costs are incurred.

### C5.1.3 Landlord forward funding

A statement should be made detailing how forward funding by the landlord is accounted for, e.g. where the costs of major works expenditure has been borne upfront by the landlord the cost is to be recovered through the service charge in accordance with the terms agreed between the landlord and tenants.

This section may also be used to provide further details in respect of other policies accounting policies adopted in preparing the expenditure report. For example, details of landlord contribution to the service charge.

## C5.2 VAT

### Example wording

With effect from [dd/mm/yyyy] the landlord elected to waive the exemption from VAT. Therefore, all service charge expenditure is shown exclusive of VAT. VAT will be charged at the appropriate rate on all service charge payments demanded/invoiced by the landlord.

OR

The landlord has not elected to waive the exemption from VAT and therefore all service charge expenditure is shown inclusive of VAT where applicable.

## C5.3 Sinking fund/reserve fund

This section is to include a description of the intended purpose of any sinking/reserve fund and details of the calculation of the contributions together with an explanation of the tax treatment of contributions to and interest earned on such funds, and details of the bank account where such monies are held.

It is important to recognise and understand the distinction between sinking funds and reserve funds and all contributions thereto should be accounted for separately.

|  |   |
|--|---|
| Balance brought forward as at [dd/mm/yyyy]       | £ |
| Contributions during the year excluding interest | £ |
| Interest credited                                | £ |
| Expenditure during the year excluding tax        | £ |
| Tax paid   | £ |
| Balance carried forward as at [dd/mm/yyyy]       | £ |

## C5.4 Depreciation charges

This section is to include a clear explanation of the basis of the charge calculation and details of the specific items for which the depreciation charge is made.

## C5.5 Agreed contributions to future works

Where the lease does not specifically allow for sinking or reserve funds to be set up, but there is an agreement between the owners and occupiers to include a charge in the service charge in anticipation of future works, then these costs should be shown on the expenditure report under a separate heading within forward funding titled, 'Agreed contributions towards future works'. Details disclosed in this note should include:

- the nature of the works
- the total cost
- the amount being charged to the tenants via the service charge and
- a timetable of when the charges will be made.

## C5.6 Landlord forward funding

Details disclosed should include:

- the nature of the works
- the total cost



- the amount being recharged to the tenants via the service charge and
- a timetable of when the recharges will be made.

If the owner is seeking to include interest on borrowed monies full details are also to be provided.

## C5.7 Banking

A clear statement is to be provided as to whether service charge monies are held in one or more discrete (or virtual) bank accounts and whether interest earned is credited to the service charge account.

## C5.8 Commercialisation

Where income is generated from services and activities in the property include a clear statement of policy on how and to where costs and income generated from such services and activities are allocated.

## C5.9 Marketing and promotions

The service charge accounts should be transparent and should include the gross marketing and promotional expenditure and the contribution from the owner, to clearly show the net contribution due from the occupiers.

|                                       |   |
|---------------------------------------|---|
| Gross marketing/promotion expenditure | £ |
| Contribution from the owner           | £ |
| Net marketing/promotion expenditure   | £ |

## C5.10 Total cost of management

### C5.10.1 Management fees

The manager should provide details of the basis of their appointment and whether this relates only to the subject property or includes other property owned by the same landlord/client.

The manager should confirm the basis of the fee, e.g. a fixed fee subject to annual review/indexation and should include a clear statement as to whether the fee relates only to work carried out in managing the service charge. RICS professional statement *Service charges in commercial property* clearly states that asset management and rent collection costs are excluded from the service charge management fee. Good practice would be to confirm this in the service charge budget and statement of actual expenditure.

### C5.10.2 On-site management

The manager should provide details of all on-site management staff and the total employment costs, which would usually include National Insurance, pension contributions and other direct employment costs. A separate breakdown of any other costs incurred in employing on-site staff, such as the provision office accommodation, etc. should be provided.

If staff are employed on more than one property a clear explanation is to be given of the calculation of the costs charged to the subject property, which should generally only relate to those costs associated with the actual time spent working on that property.

If a separate administration charge is made in relation to human resources and payroll costs associated with dealing with on-site staff, this should be clearly stated together with the amount of the fee and identified as a separate cost heading.

### C5.10.3 Summary of all fees charged by the managing agent

All fees charged by the managing agent should be separately disclosed in the service charge accounts. This can either be done by using separate codes on the face of the expenditure report or by providing additional detail by way of a note. An example note is provided below:

| Expense code             | Total fees | Professional fees | Procurement fees |
|--------------------------|------------|-------------------|------------------|
| Management fees          | £1,000     | £1,000            | -                |
| FM fees                  | £500       | £500              | -                |
| Help desk                | £250       | £250              | -                |
| Staff salaries [on-site] | £250       | £250              | -                |
| Office costs [on-site]   | £50        | £50               | -                |
| Electricity              | £250       | -                 | £250             |

Where there have been multiple managers during the period the relevant fees should be shown in separate columns.

### **C5.11 Accruals**

These are expenses for goods and services actually incurred in a period for which no invoice has been received. As the cost relates to the period, it should be charged to the service charge account for that period.

A schedule of accruals included in the service charge expenditure should be provided. Where invoices are not received in respect of an accrual brought forward from the previous year, the accrual should be credited back to the service charge unless there is a realistic expectation that an invoice will be received in the future.

Large round sum provisions included to spread the cost of significant works over a period of time are not accruals as they do not represent a liability at the end of the period. Accordingly, they should not be included as accruals but should be considered as contributions towards reserve or sinking funds and disclosed separately (see section C5.3).

### **C5.12 Prepayments and security deposits**

A schedule of prepayments included in the service charge expenditure for the period should be provided (including utility deposits).

### **C5.13 Empty units and concessions granted to tenants**

Where appropriate, costs are apportioned on a daily basis and for the avoidance of doubt it is confirmed that the landlord bears an appropriate proportion of the service charge expenditure in respect of voids and vacant premises.

Likewise, if any tenant has any form of concession, whereby their contribution towards the service charge is capped, or is lower than the apportionment due, the landlord pays the difference.

## **C6 Operational review**

This section should comprise a comparison between the budgets and finalised actual expenditure for each service line for the period in question. The report should be prepared using the same headings as the service charge expenditure report and should include a detailed commentary and an explanation of significant variances.

### **C6.1 Service procurement**

#### **C6.1.1 Procurement fees**

Where a procurement specialist is used this should be clearly stated together with the amount of the fee and the cost category in which it is included. A clear explanation should also be provided as to the basis of calculation of the fee to demonstrate delivery of best value solutions, greater value for money and cost effectiveness.

### **C6.2 Contracts**

The manager should provide tenants with a schedule of contracts in force during the service charge period with details of the contractor, a summary of the scope of the contract, the annual contract sum, the date of commencement and length of the contract and dates of any reviews.

Where a contract has been retendered or placed during the service charge period the manager should provide a brief summary of the results of the selection process and a clear explanation of the rationale for the appointment.

Where appropriate and at least every three years, contractors and suppliers should submit competitive tenders or quotations although where this is not considered to be cost effective the manager should benchmark the service standards and pricing to confirm value for money.

For each of the main service lines the manager should provide a summary of when the service line contract was last retendered.

### **C6.3 Service charge allocation and apportionment**

#### **C6.3.1 Service charge allocation – schedules**

Where costs are allocated into separate schedules, managers should provide a detailed description of the schedules and the basis and rationale for the cost allocation.

#### **For example:**

#### **Service charge allocation**

Costs are allocated to separate schedules and the costs apportioned to those who benefit from those services as follows:

[Insert list of schedules and description]

|            |            |
|------------|------------|
| Schedule 1 | Estate     |
| Schedule 2 | Building 1 |
| Schedule 3 | Building 2 |

[Note to managers – add additional schedules as necessary to achieve fair and reasonable allocation of costs].

### **Schedule 1 – Estate**

[Insert detailed description of schedule and basis of allocation]

### **Schedule 2 – Building 1**

[Insert detailed description of schedule and basis of allocation]

### **Schedule 3 – Building 2**

[Insert detailed description of schedule and basis of allocation]

## **C6.3.2 Service charge apportionment**

Managers are to provide a full apportionment matrix for the property/complex to all occupiers, which clearly shows the basis of calculation and the total apportionment per schedule for each unit within the property/complex. To avoid doubt and to preserve confidentiality this should exclude details of any individual concessions or other arrangements between individual owners and occupiers; these are costs that are normally to be borne by the owner. An individual occupier should be able to clearly verify the basis and method of calculation used in arriving at their particular percentage apportionment.

Managers should also be transparent with regard to the treatment of void and unlet premises, and the cost attributable to the owner's own use of the property (see empty units and concessions granted to tenants in C5.13).

See CD and CE for example apportionment matrices

## **C6.4 Notes on expenditure**

A full copy of the budget is enclosed in Appendix A in both summary and detail form. The total anticipated expenditure for [property name] is £xxx split across x schedules.

The expenditure comprises the following:

### **Note to managers:**

Include summary information under each standard industry cost classifications detailing the service provided, the cost and comments on the specification or staffing levels, last tendered, etc. Explanatory notes are to include a detailed explanation of significant individual costs together with an analysis and full explanation of any material variances between budget and actual expenditure.

Service charge budgets and actual expenditure reports should use the standard industry cost classifications. As a minimum acceptable level of reporting, all reports should be detailed at cost class and cost category level as below.

However, to achieve transparency in accordance with the principles of the professional statement it is recommended best practice particularly in respect of larger properties, that budget and actual expenditure reports and analyses should be provided at detailed cost description level whenever practicable, with a summary of the total costs under each cost category.

In accordance with the proportionality statement included under the professional statement's core principles, for smaller properties or those with limited service charge expenditure [e.g. industrial sites] it is considered acceptable to report at the higher cost category level although this should generally be regarded as an exception rather than the usual practice.

## **C7 General notes**

[Insert any other relevant information].

## CA Example service charge summary expenditure report

| Period [dd/mm/yyyy] to [dd/mm/yyyy] |                 |                      |                          |                          |
|-------------------------------------|-----------------|----------------------|--------------------------|--------------------------|
| Property address.....               |                 |                      |                          |                          |
| Cost category                       | Expense total   | Schedule 1<br>Estate | Schedule 2<br>Building 1 | Schedule 3<br>Building 2 |
| <b>Management</b>                   |                 |                      |                          |                          |
| Management fees                     | £60,000         | £10,000              | £25,000                  | £25,000                  |
| Accounting fees                     | £1,600          | £1,600               |                          |                          |
| Site management resources           | £71,135         | £21,135              | £26,600                  | £23,400                  |
| Health, safety and environmental    | £10,000         | £10,000              |                          |                          |
| <b>Subtotal</b>                     | <b>£142,735</b> | <b>£42,735</b>       | <b>£51,600</b>           | <b>£48,400</b>           |
| <b>Utilities</b>                    |                 |                      |                          |                          |
| Electricity                         | £229,900        | £5,900               | £112,000                 | £112,000                 |
| Gas                                 | £11,050         | £1,050               | £5,000                   | £5,000                   |
| Fuel oil (heating)                  | £0              |                      |                          |                          |
| Water                               | £7,000          |                      | £3,500                   | £3,500                   |
| <b>Subtotal</b>                     | <b>£247,950</b> | <b>£6,950</b>        | <b>£120,500</b>          | <b>£120,500</b>          |
| <b>Soft services</b>                |                 |                      |                          |                          |
| Security                            | £144,100        | £137,500             | £3,500                   | £3,100                   |
| Cleaning and environmental          | £185,730        | £52,250              | £58,300                  | £75,180                  |
| Marketing and promotions            |                 |                      |                          |                          |
| <b>Subtotal</b>                     | <b>£329,830</b> | <b>£189,750</b>      | <b>£61,800</b>           | <b>£78,280</b>           |
| <b>Hard services</b>                |                 |                      |                          |                          |
| Mechanical and electrical services  | £187,970        | £32,750              | £74,750                  | £80,470                  |
| Lift and escalators                 | £24,500         |                      | £14,000                  | £10,500                  |
| Suspended access equipment          | £5,300          |                      | £2,800                   | £2,500                   |
| Fabric repairs and maintenance      | £99,325         | £36,850              | £40,700                  | £21,775                  |
| <b>Subtotal</b>                     | <b>£317,095</b> | <b>£69,600</b>       | <b>£132,250</b>          | <b>£115,245</b>          |
| <b>Income</b>                       |                 |                      |                          |                          |
| Interest                            | -£1,068         | -£332                | -£373                    | -£363                    |
| Income from commercialisation       |                 |                      |                          |                          |
| <b>Subtotal</b>                     | <b>-£1,068</b>  | <b>-£332</b>         | <b>-£373</b>             | <b>-£363</b>             |
| <b>Insurance</b>                    |                 |                      |                          |                          |
| Engineering insurance               | £900            |                      | £500                     | £400                     |
| All risks insurance cover           |                 |                      |                          |                          |
| Terrorism insurance                 |                 |                      |                          |                          |

| <b>Cost category</b>           | <b>Expense total</b> | <b>Schedule 1<br/>Estate</b> | <b>Schedule 2<br/>Building 1</b> | <b>Schedule 3<br/>Building 2</b> |
|--------------------------------|----------------------|------------------------------|----------------------------------|----------------------------------|
| <b>Subtotal</b>                | <b>£900</b>          | <b>£0</b>                    | <b>£500</b>                      | <b>£400</b>                      |
| <b>Exceptional expenditure</b> |                      |                              |                                  |                                  |
| <b>Major works</b>             | £92,483              |                              | £92,483                          |                                  |
| <b>Forward funding</b>         | -£90,000             |                              | -£90,000                         |                                  |
| <b>Subtotal</b>                | <b>£2,483</b>        | <b>£0</b>                    | <b>£2,483</b>                    | <b>£0</b>                        |
| <b>Grand total</b>             | <b>£1,039,925</b>    | <b>£308,703</b>              | <b>£368,760</b>                  | <b>£362,462</b>                  |

## CB Example service charge detailed expenditure report

| Period [dd/mm/yyyy] to [dd/mm/yyyy]     |                 |                   |                       |                       |
|---|-----------------|-------------------|-----------------------|-----------------------|
| Property address.....                   |                 |                   |                       |                       |
| Cost category                           | Expense total   | Schedule 1 Estate | Schedule 2 Building 1 | Schedule 3 Building 2 |
| <b>Management</b>                       |                 |                   |                       |                       |
| <b>Management fees</b>                  |                 |                   |                       |                       |
| Management fees                         | £60,000         | £10,000           | £25,000               | £25,000               |
| <b>Accounting fees</b>                  |                 |                   |                       |                       |
| S/C audit fees                          | £1,600          | £1,600            |                       |                       |
| <b>Site management resources</b>        |                 |                   |                       |                       |
| Staff costs                             | £15,000         | £15,000           |                       |                       |
| Receptionists/concierge                 | £50,000         |                   | £26,600               | £23,400               |
| Site accommodation [rent/rates]         | £4,335          | £4,335            |                       |                       |
| [telephones/stationery]                 | £1,800          | £1,800            |                       |                       |
| <b>Health, safety and environmental</b> |                 |                   |                       |                       |
| Risk assessments and audits             | £10,000         | £10,000           |                       |                       |
| <b>Subtotal</b>                         | <b>£142,735</b> | <b>£42,735</b>    | <b>£51,600</b>        | <b>£48,400</b>        |
| <b>Utilities</b>                        |                 |                   |                       |                       |
| <b>Electricity</b>                      |                 |                   |                       |                       |
| Electricity                             | £224,000        |                   | £112,000              | £112,000              |
| Electricity procurement consultancy     | £5,600          | £5,600            |                       |                       |
| Fuel [standby electrical power]         | £300            | £300              |                       |                       |
| <b>Gas</b>                              |                 |                   |                       |                       |
| Gas                                     | £10,000         |                   | £5,000                | £5,000                |
| Gas procurement/consultancy             | £1,050          | £1,050            |                       |                       |
| <b>Fuel oil (heating)</b>               |                 |                   |                       |                       |
| <b>Water</b>                            |                 |                   |                       |                       |
| Water and sewerage charges              | £7,000          |                   | £3,500                | £3,500                |
| <b>Subtotal</b>                         | <b>£247,950</b> | <b>£6,950</b>     | <b>£120,500</b>       | <b>£120,500</b>       |
| <b>Soft services</b>                    |                 |                   |                       |                       |
| <b>Security</b>                         |                 |                   |                       |                       |
| Security guarding                       | £132,000        | £132,000          |                       |                       |
| Security systems                        | £12,100         | £5,500            | £3,500                | £3,100                |
| <b>Cleaning and environmental</b>       |                 |                   |                       |                       |
| Internal cleaning                       | £91,200         |                   | £38,400               | £52,800               |

| <b>Cost category</b>                      | <b>Expense total</b> | <b>Schedule 1 Estate</b> | <b>Schedule 2 Building 1</b> | <b>Schedule 3 Building 2</b> |
|---|----------------------|--------------------------|------------------------------|------------------------------|
| External cleaning                         | £15,500              | £15,500                  |                              |                              |
| Window cleaning                           | £22,800              |                          | £9,600                       | £13,200                      |
| Hygiene services/toiletries               | £8,180               |                          | £4,500                       | £3,680                       |
| Waste management                          | £9,050               | £9,050                   |                              |                              |
| Pest control                              | £1,600               | £700                     | £500                         | £400                         |
| Seasonal decorations                      | £1,000               |                          | £500                         | £500                         |
| Internal floral displays                  | £9,400               |                          | £4,800                       | £4,600                       |
| Estate cleaning                           | £18,000              | £18,000                  |                              |                              |
| External landscaping                      | £9,000               | £9,000                   |                              |                              |
| <b>Marketing and promotions</b>           |                      |                          |                              |                              |
| <b>Subtotal</b>                           | <b>£329,830</b>      | <b>£189,750</b>          | <b>£61,800</b>               | <b>£78,280</b>               |
| <b>Hard services</b>                      |                      |                          |                              |                              |
| <b>Mechanical and electrical services</b> |                      |                          |                              |                              |
| M&E maintenance contract                  | £151,250             | £20,000                  | £63,000                      | £68,250                      |
| M&E repairs                               | £16,250              | £2,150                   | £6,750                       | £7,350                       |
| M&E inspections and consultancy           | £7,500               | £7,500                   |                              |                              |
| Life safety systems maintenance           | £11,350              | £2,350                   | £5,000                       | £4,000                       |
| Life safety systems repairs               | £1,620               | £750                     |                              | £870                         |
| <b>Lift and escalators</b>                |                      |                          |                              |                              |
| Lift maintenance contract                 | £21,000              |                          | £12,000                      | £9,000                       |
| Lift repairs                              | £3,500               |                          | £2,000                       | £1,500                       |
| <b>Suspended access equipment</b>         |                      |                          |                              |                              |
| Maintenance contract                      | £5,100               |                          | £2,700                       | £2,400                       |
| Repairs                                   | £200                 |                          | £100                         | £100                         |
| <b>Fabric repairs and maintenance</b>     |                      |                          |                              |                              |
| Internal repairs and maintenance          | £50,000              |                          | £35,000                      | £15,000                      |
| External repairs and maintenance          | £6,775               |                          |                              | £6,775                       |
| Redecorations                             | £5,700               |                          | £5,700                       |                              |
| Estate repairs and maintenance            | £32,100              | £32,100                  |                              |                              |
| Car park repairs and maintenance          | £4,750               | £4,750                   |                              |                              |
| <b>Subtotal</b>                           | <b>£317,095</b>      | <b>£69,600</b>           | <b>£132,250</b>              | <b>£115,245</b>              |
| <b>Income</b>                             |                      |                          |                              |                              |
| <b>Interest</b>                           |                      |                          |                              |                              |
| Interest                                  | -£1,068              | -£332                    | -£373                        | -£363                        |
| <b>Income from commercialisation</b>      |                      |                          |                              |                              |

| Cost category                    | Expense total     | Schedule 1 Estate | Schedule 2 Building 1 | Schedule 3 Building 2 |
|----------------------------------|-------------------|-------------------|-----------------------|-----------------------|
| <b>Subtotal</b>                  | <b>-£1,068</b>    | <b>-£332</b>      | <b>-£373</b>          | <b>-£363</b>          |
| <b>Insurance</b>                 |                   |                   |                       |                       |
| <b>Engineering insurance</b>     |                   |                   |                       |                       |
| Engineering insurance            | £900              |                   | £500                  | £400                  |
| <b>All risks insurance cover</b> |                   |                   |                       |                       |
| <b>Terrorism insurance</b>       |                   |                   |                       |                       |
| <b>Subtotal</b>                  | <b>£900</b>       |                   | <b>£500</b>           | <b>£400</b>           |
| <b>Exceptional expenditure</b>   |                   |                   |                       |                       |
| <b>Major works</b>               |                   |                   |                       |                       |
| Plant replacement                | £92,483           |                   | £92,483               |                       |
| <b>Forward funding</b>           |                   |                   |                       |                       |
| Sinking funds                    | -£90,000          |                   | -£90,000              |                       |
| <b>Subtotal</b>                  | <b>£2,483</b>     | <b>£0</b>         | <b>£2,483</b>         | <b>£0</b>             |
| <b>Grand total</b>               | <b>£1,039,925</b> | <b>£308,703</b>   | <b>£368,760</b>       | <b>£362,462</b>       |



## CC Example service charge variance report

| Period [dd/mm/yyyy] to [dd/mm/yyyy] |                         |                        |                        |                    |                                 |
|-------------------------------------|-------------------------|------------------------|------------------------|--------------------|---------------------------------|
| Property address.....               |                         |                        |                        |                    |                                 |
|                                     | Previous year<br>actual | Current year<br>budget | Current year<br>actual | Actual v<br>budget | Current v<br>previous<br>actual |
| <b>Management</b>                   |                         |                        |                        |                    |                                 |
| Management fees                     | £60,000                 | £60,000                | £60,000                | 0.00%              | 0.00%                           |
| Accounting fees                     | £1,500                  | £1,600                 | £1,600                 | 0.00%              | 6.67%                           |
| Site management resources           | £66,000                 | £70,000                | £71,135                | 1.62%              | 7.78%                           |
| Health, safety and environmental    | £5,000                  | £15,000                | £10,000                | -33.33%            | 100.00%                         |
| <b>Subtotal</b>                     | <b>£132,500</b>         | <b>£146,600</b>        | <b>£142,735</b>        | <b>-2.64%</b>      | <b>7.72%</b>                    |
| <b>Utilities</b>                    |                         |                        |                        |                    |                                 |
| Electricity                         | £218,700                | £236,000               | £229,900               | -2.58%             | 5.12%                           |
| Gas                                 | £9,700                  | £12,500                | £11,050                | -11.60%            | 13.92%                          |
| Fuel oil (heating)                  |                         |                        |                        |                    |                                 |
| Water                               | £6,880                  | £7,500                 | £7,000                 | -6.67%             | 1.74%                           |
| <b>Subtotal</b>                     | <b>£235,280</b>         | <b>£256,000</b>        | <b>£247,950</b>        | <b>-3.14%</b>      | <b>5.39%</b>                    |
| <b>Soft services</b>                |                         |                        |                        |                    |                                 |
| Security                            | £144,100                | £144,100               | £144,100               | 0.00%              | 0.00%                           |
| Cleaning and environmental          | £176,543                | £180,000               | £185,730               | 3.18%              | 5.20%                           |
| Marketing and promotions            |                         |                        |                        |                    |                                 |
| <b>Subtotal</b>                     | <b>£320,643</b>         | <b>£324,100</b>        | <b>£329,830</b>        | <b>1.77%</b>       | <b>2.87%</b>                    |
| <b>Hard services</b>                |                         |                        |                        |                    |                                 |
| Mechanical and electrical services  | £193,750                | £180,000               | £187,970               | 4.43%              | -2.98%                          |
| Lift and escalators                 | £24,500                 | £24,500                | £24,500                | 0.00%              | 0.00%                           |
| Suspended access equipment          | £5,300                  | £53,000                | £5,300                 | -90.00%            | 0.00%                           |
| Fabric repairs and maintenance      | £34,500                 | £50,000                | £99,325                | 98.65%             | 187.90%                         |
| <b>Subtotal</b>                     | <b>£258,050</b>         | <b>£307,500</b>        | <b>£317,095</b>        | <b>3.12%</b>       | <b>22.88%</b>                   |
| <b>Income</b>                       |                         |                        |                        |                    |                                 |
| Interest                            | -£989                   | -£1,000                | -£1,068                | 6.80%              | 7.99%                           |
| Income from commercialisation       |                         |                        |                        |                    |                                 |
| <b>Subtotal</b>                     | <b>-£989</b>            | <b>-£1,000</b>         | <b>-£1,068</b>         | <b>6.80%</b>       | <b>7.99%</b>                    |
| <b>Insurance</b>                    |                         |                        |                        |                    |                                 |
| Engineering insurance               | £800                    | £1,000                 | £900                   | -10.00%            | 12.50%                          |
| All risks insurance cover           |                         |                        |                        |                    |                                 |

|                                | Previous year<br>actual | Current year<br>budget | Current year<br>actual | Actual v<br>budget | Current v<br>previous<br>actual |
|--------------------------------|-------------------------|------------------------|------------------------|--------------------|---------------------------------|
| Terrorism insurance            |                         |                        |                        |                    |                                 |
| <b>Subtotal</b>                | <b>£800</b>             | <b>£1,000</b>          | <b>£900</b>            | <b>-10.00%</b>     | <b>12.50%</b>                   |
| <b>Exceptional expenditure</b> |                         |                        |                        |                    |                                 |
| Major works                    |                         | £90,000                | £92,483                | 2.76%              |                                 |
| Forward funding                | £25,000                 | -£90,000               | -£90,000               | 0.00%              | -460.00%                        |
| <b>Subtotal</b>                | <b>£25,000</b>          | <b>£0</b>              | <b>£2,483</b>          |                    | <b>-90.07%</b>                  |
| <b>Grand total</b>             | <b>£971,284</b>         | <b>£1,034,200</b>      | <b>£1,039,925</b>      | <b>0.55%</b>       | <b>7.07%</b>                    |

**CD Example service charge apportionment schedule %**

| <b>Period [dd/mm/yyyy] to [dd/mm/yyyy]</b> |                |                |                              |                                  |                                  |
|--|----------------|----------------|------------------------------|----------------------------------|----------------------------------|
| <b>Property address .....</b>              |                |                |                              |                                  |                                  |
| <b>Unit/address</b>                        | <b>Tenants</b> | <b>Area</b>    | <b>Schedule 1<br/>Estate</b> | <b>Schedule 2<br/>Building 1</b> | <b>Schedule 3<br/>Building 2</b> |
| <b>Building 1 (Tower block)</b>            |                |                |                              |                                  |                                  |
| Ground floor                               |                | 10,600         | 7.41%                        | 10.43%                           |                                  |
| 1st floor                                  |                | 15,400         | 10.76%                       | 15.16%                           |                                  |
| 2nd-4th floors                             |                | 46,200         | 32.29%                       | 45.47%                           |                                  |
| 5th floor                                  |                | 4,900          | 3.42%                        | 4.82%                            |                                  |
| 6th floor                                  |                | 4,900          | 3.42%                        | 4.82%                            |                                  |
| 7th floor                                  |                | 4,900          | 3.42%                        | 4.82%                            |                                  |
| 8th floor                                  |                | 4,900          | 3.42%                        | 4.82%                            |                                  |
| 9th floor                                  |                | 4,900          | 3.42%                        | 4.82%                            |                                  |
| 10th floor                                 |                | 4,900          | 3.42%                        | 4.82%                            |                                  |
| <b>Total building 1</b>                    |                | <b>101,600</b> |                              | <b>100.00%</b>                   |                                  |
| <b>Building 2</b>                          |                |                |                              |                                  |                                  |
| Ground floor and first floors              |                | 9,750          | 6.81%                        |                                  | 23.49%                           |
| 1st floor                                  |                | 6,500          | 4.54%                        |                                  | 15.66%                           |
| 2nd floor                                  |                | 6,500          | 4.54%                        |                                  | 15.66%                           |
| 3rd-5th floors                             |                | 18,750         | 13.10%                       |                                  | 45.18%                           |
| <b>Total building 2</b>                    |                | <b>41,500</b>  |                              |                                  | <b>100.00%</b>                   |
| <b>Grand total</b>                         |                | <b>143,100</b> | <b>100.00%</b>               |                                  |                                  |

## CE Example service charge apportionment schedule % (weighted floor areas)

| Period [dd/mm/yyyy] to [dd/mm/yyyy] |             |               |             |              |               |             |               |             |                  |           |              |
|-------------------------------------|-------------|---------------|-------------|--------------|---------------|-------------|---------------|-------------|------------------|-----------|--------------|
| Property address .....              |             |               |             |              |               |             |               |             |                  |           |              |
| Unit no                             | Tenant name | NIA [sq. ft.] | Weighting   |              |               |             | Weighted area | Sch 1       | Sch 2            | Sch 3     | Sch 4        |
|                                     |             |               | 0-5000      | 5,001-10,000 | 10,001-20,000 | Over 20,000 |               | All tenants | High street only | Main mall | Offices      |
|                                     |             |               | <b>100%</b> | <b>80%</b>   | <b>70%</b>    | <b>60%</b>  |               |             | <b>14,060</b>    |           | <b>6,900</b> |
| <b>High street</b>                  |             |               |             |              |               |             |               |             |                  |           |              |
| 1                                   |             | 350           | 350         |              |               | 350         | 0.24%         | 2.49%       |                  |           |              |
| 2                                   |             |               | 5,000       | 4,000        | 1,960         | 10,960      | 7.42%         | 77.95%      |                  |           |              |
| 3                                   |             | 300           | 300         |              |               | 300         | 0.20%         | 2.13%       |                  |           |              |
| 4                                   |             | 1,200         | 1,200       |              |               | 1,200       | 0.81%         | 8.53%       |                  |           |              |
| 5                                   |             | 500           | 500         |              |               | 500         | 0.34%         | 3.56%       |                  |           |              |
| 6                                   |             | 750           | 750         |              |               | 750         | 0.51%         | 5.33%       |                  |           |              |
|                                     |             |               |             |              |               |             | <b>14,060</b> |             |                  |           |              |
| <b>Main mall</b>                    |             |               |             |              |               |             |               |             |                  |           |              |
| 7                                   |             | 1,050         | 1,050       |              |               | 1,050       | 0.71%         |             | 0.83%            |           |              |
| 8                                   |             | 7,250         | 5,000       | 1,800        |               | 6,800       | 4.60%         |             | 5.36%            |           |              |
| 9                                   |             | 1,050         | 1,050       |              |               | 1,050       | 0.71%         |             | 0.83%            |           |              |
| 10                                  |             | 1,780         | 1,780       |              |               | 1,780       | 1.20%         |             | 1.40%            |           |              |
| LSU 1                               |             |               | 5,000       | 4,000        | 7,000         | 5,820       | 21,820        |             |                  | 17.20%    |              |
| 11                                  |             | 1,500         | 1,500       |              |               | 1,500       | 1.01%         |             | 1.18%            |           |              |
| 12                                  |             | 1,500         | 1,500       |              |               | 1,500       | 1.01%         |             | 1.18%            |           |              |
| 13                                  |             | 2,700         | 2,700       |              |               | 2,700       | 1.83%         |             | 2.13%            |           |              |
| 14                                  |             | 1,800         | 1,800       |              |               | 1,800       | 1.22%         |             | 1.42%            |           |              |

## Service charges in commercial property

| Unit no           | Tenant name | NIA (sq. ft.) | Weighting |              |               |             | Weighted area  | Sch 1       | Sch 2            | Sch 3     | Sch 4   |
|-------------------|-------------|---------------|-----------|--------------|---------------|-------------|----------------|-------------|------------------|-----------|---------|
|                   |             |               | 0-5000    | 5,001-10,000 | 10,001-20,000 | Over 20,000 |                | All tenants | High street only | Main mall | Offices |
|                   |             |               | 100%      | 80%          | 70%           | 60%         |                |             | 14,060           |           | 6,900   |
| <b>Dept store</b> |             |               | 5,000     | 4,000        | 7,000         | 21,900      | 37,900         |             |                  | 29.88%    |         |
| 15                |             | 3,375         | 3,375     |              |               |             | 3,375          | 2.28%       |                  | 2.66%     |         |
| 16                |             | 2,200         | 2,200     |              |               |             | 2,200          | 1.49%       |                  | 1.73%     |         |
| 17                |             | 6,000         | 5,000     | 800          |               |             | 5,800          | 3.92%       |                  | 4.57%     |         |
| 18                |             | 5,500         | 5,000     | 400          |               |             | 5,400          | 3.65%       |                  | 4.26%     |         |
| LSU 2             |             |               | 5,000     | 4,000        | 7,000         | 3,540       | 19,540         |             |                  | 15.41%    |         |
| 19                |             | 270           | 270       |              |               |             | 270            | 0.18%       |                  | 0.21%     |         |
| 20                |             |               | 5,000     | 4,000        | 1,540         |             | 10,540         | 7.13%       |                  | 8.31%     |         |
| 21                |             | 1,800         | 1,800     |              |               |             | 1,800          | 1.22%       |                  | 1.42%     |         |
|                   |             |               |           |              |               |             | <b>126,825</b> |             |                  |           |         |
| <b>Offices</b>    |             |               |           |              |               |             |                |             |                  |           |         |
| 1st floor         |             | 2,450         | 2,450     |              |               |             | 2,450          | 1.66%       |                  |           |         |
| 2nd floor         |             | 2,450         | 2,450     |              |               |             | 2,450          | 1.66%       |                  |           |         |
| 3rd floor         |             | 2,000         | 2,000     |              |               |             | 2,000          | 1.35%       |                  |           |         |
|                   |             |               |           |              |               |             | 6,900          |             |                  |           |         |
|                   |             |               |           |              |               |             | 147,785        |             |                  |           |         |

## CF Example service charge apportionment schedule £

| Period [dd/mm/yyyy] to [dd/mm/yyyy] |             |             |                  |            |            |            |
|-------------------------------------|-------------|-------------|------------------|------------|------------|------------|
| Property address .....              |             |             |                  |            |            |            |
|                                     |             | Sch 1       | Sch 2            | Sch 3      | Sch 4      |            |
| Unit no                             | Tenant name | All tenants | High Street only | Main mall  | Offices    | Total      |
|                                     |             | £50,000.00  | £25,000.00       | £50,000.00 | £10,000.00 |            |
| <b>High street</b>                  |             |             |                  |            |            |            |
| 1                                   |             | £118.42     | £622.33          |            |            | £740.75    |
| 2                                   |             | £3,708.09   | £19,487.91       |            |            | £23,196.00 |
| 3                                   |             | £101.50     | £533.43          |            |            | £634.93    |
| 4                                   |             | £406.00     | £2,133.71        |            |            | £2,539.71  |
| 5                                   |             | £169.16     | £889.05          |            |            | £1,058.21  |
| 6                                   |             | £253.75     | £1,333.57        |            |            | £1,587.32  |
| <b>Main mall</b>                    |             |             |                  |            |            |            |
| 7                                   |             | £355.25     |                  | £413.96    |            | £769.20    |
| 8                                   |             | £2,300.64   |                  | £2,680.86  |            | £4,981.50  |
| 9                                   |             | £355.25     |                  | £413.96    |            | £769.20    |
| 10                                  |             | £602.23     |                  | £701.75    |            | £1,303.98  |
| LSU 1                               |             | £7,382.35   |                  | £8,602.40  |            | £15,984.75 |
| 11                                  |             | £507.49     |                  | £591.37    |            | £1,098.86  |
| 12                                  |             | £507.49     |                  | £591.37    |            | £1,098.86  |
| 13                                  |             | £913.49     |                  | £1,064.46  |            | £1,977.95  |
| 14                                  |             | £608.99     |                  | £709.64    |            | £1,318.63  |
| <b>Dept Store</b>                   |             | £12,822.68  |                  | £14,941.85 |            | £27,764.53 |
| 15                                  |             | £1,141.86   |                  | £1,330.57  |            | £2,472.44  |
| 16                                  |             | £744.32     |                  | £867.34    |            | £1,611.66  |
| 17                                  |             | £1,962.31   |                  | £2,286.62  |            | £4,248.93  |
| 18                                  |             | £1,826.98   |                  | £2,128.92  |            | £3,955.90  |
| LSU 2                               |             | £6,610.96   |                  | £7,703.53  |            | £14,314.48 |
| 19                                  |             | £91.35      |                  | £106.45    |            | £197.79    |
| 20                                  |             | £3,565.99   |                  | £4,155.33  |            | £7,721.32  |
| 21                                  |             | £608.99     |                  | £709.64    |            | £1,318.63  |
| <b>Offices</b>                      |             |             |                  |            |            |            |
| 1st floor                           |             | £828.91     |                  |            | £3,550.72  | £4,379.63  |
| 2nd floor                           |             | £828.91     |                  |            | £3,550.72  | £4,379.63  |
| 3rd floor                           |             | £676.66     |                  |            | £2,898.55  | £3,575.21  |
|                                     |             | £50,000.00  | £25,000.00       | £50,000.00 | £10,000.00 |            |

# Appendix D: Commercial property service charge handover procedures

## D1 Service charge accounts – handover procedures

### D1.1 Sale of a property

On the sale of a property, the onus should be on the seller (either themselves or via their managing agent) to provide to the buyer (or their managing agent) all the necessary information about the service charge in a timely manner. Sale contracts and the resulting completion statements may make some provision for service charge monies either in express clauses or using the standard conditions of sale. However, these contract clauses rarely contain sufficient detail. Ideally, they should deal with:

- the reconciliation of any outstanding closed service charge years
- the handover of any credit balance on the service charge account
- the recovery of any shortfall or arrears, including specifically which party (buyer or seller) can pursue the arrears and how and
- the supply to the buyer or its managing agent of adequate records and information to provide continuity in the management and administration of the service charge arrangement for the current service charge year.

Commercial service charges generally fall into two categories:

- i. those where the landlord recovers costs periodically, say quarterly, based on actual expenditure incurred and
- ii. those where the landlord collects on-account sums in advance, usually quarterly, and reconciles the service charge at the end of the service charge year, comparing actual expenditure against the on-account payments demanded and then producing certificates detailing the resultant credit or debit due on the account.

The correct wording for the sale contract will vary between these two, but the service charge code states that in both cases reconciliation of the current years' service charge should be achieved within four months of the year-end. Where appropriate (and/or required), allowance should be made for an audit or review by an independent accountant within this timetable.

The sale of a property can occur at any point during the service charge year. Although some leases permit a change to the service charge year end, it is recommended best practice not to do so save in exceptional

circumstances. So, the sale usually occurs part way through (rather than at the end of) a service charge year. The buyer or its manager will be responsible for reconciling the service charge for that year. In order to do so properly and on time it is essential that the seller, or their manager, provides full information within a relatively short time frame of the sale.

Where there are prior service charge years for which the closing accounts have not yet been issued, the seller, or its manager, should be obliged in the sale contract to fully reconcile any outstanding service charge accounts for those prior years within a specified period (certainly no later than two months after completion of the sale). Often, it is the buyer or the buyer's agent that will actually issue the demands for any balancing charges, credits or certificates (whether to existing or former tenants) once the reconciled accounts are available. Whether the buyer accepts responsibility for pursuing payment will be a matter for negotiation.

In some transactions the buyer is not prepared to deal with previous years. The buyer will insist that the seller reconciles these and issues the accounts before completion.

Where possible, buyers should ensure that sale contracts contain measurable sanctions if information, certification and/or service charge credit balances are not provided within the time frames set. Ideally, the buyer should make a retention from the sale price pending satisfactory receipt of the relevant details. Alternatively, the sale contract could impose liquidated damages, although to be enforceable under contract law the amount of the liquidated damages should reflect a reasonable measurement of the anticipated loss. Otherwise, it may be considered a penalty clause and prove unenforceable.

#### D1.1.1 Property financial information

The following information would usually be requested under standard enquiries before contract. If not, such information should be required to be passed to the buyer (or their agent) prior to completion, or within five working days of the completion date:

- service charge accounting period
- service charge apportionment basis
- details of void areas, landlord's liability and landlord's funding
- details of any tenant direct charges
- current service charge budget
- copies of the last three years' reconciled service charge accounts

- details of commercialisation income and interaction with the service charge accounts
- details of any sinking funds, reserve funds or depreciation charges, including current valuation statements, assets, contribution, schedules and expiry dates of funds and
- a statement of funds currently held in the service charge account along with a list of creditors.

#### **D1.1.2 Tenant financial information**

The following should also be provided to the buyer within five working days of the completion date:

- demand addresses, agency arrangements, trading names and contact details
- tenancy details, including occupancy and vacancy dates, and an up-to-date tenancy schedule
- details of all tenant arrears including disputes, payment plans and breaches
- details and copies of the last tenant on-account demands both for service charges and direct charges
- for direct charges involving utilities, the basis of collection and up-to-date meter readings should be provided and
- an interest summary showing credits to the service charge account.

#### **D1.1.3 Financial transfer**

This is the physical movement of funds between the buyer and seller in the sale process. At completion, the service charge bank account may contain monies that have not yet been expended. The amount will depend on the level of service charge tenant arrears and the amount owed to suppliers for services rendered. The amount to transfer may be very small.

The sale contract should provide that prior to completion, the seller should supply a full statement of tenant service charge arrears and also within five working days after completion, an updated statement of arrears as at the completion date. The buyer will then be responsible for collecting from the tenants any outstanding or future on-account payments or balancing charges covering the current open service charge year.

Unless otherwise agreed in the sale contract the seller remains able to collect any arrears for previous service charge years. In practice, the buyer may agree to pursue arrears for any past service charge years and to account to the seller for what is recovered. Such an arrangement usually excuses the buyer from taking proceedings against their tenants to recover the arrears. In some cases the buyer may not agree to do this at all and the seller will have to collect in the arrears prior to completion.

If there are extensive arrears for the currently running service charge year, the buyer may adjust the purchase price to deduct these to avoid the risk of non-payment.

The seller should ensure, so far as is practicable, that all supplier invoices and credit notes are issued and paid from the service charge account prior to completion. In some

cases the buyer may be willing to allow the seller to pass to the buyer, after completion, any supplier invoices for works carried out prior to completion, and the buyer will settle these.

Where the closing balance on the service charge reconciliation for the current service charge year will be a positive sum, the seller should transfer the estimated credit balance to the buyer within five working days of completion. Note that if historic arrears reduce the cash balance held by the seller's agent, the seller is to ensure his/her agent is put in sufficient funds to transfer the full cash balance appropriate to the service charge period current at the date of sale.

The buyer may have to fund the service charge account in the period between the completion date and the date when the service charge account is credited with funds from the seller or its manager, or payment by the tenants of on-account sums.

#### **VAT**

Where a building is elected for VAT a shortage in the service charge funds can often arise as a result of an issue with regard to the recovery of VAT in respect of service charges for landlord void premises.

Payment requests issued in respect of the landlord's service charge liability for void premises cannot include VAT as this is contrary to HMRC guidance. However, landlord clients are usually responsible for preparing their own VAT returns, which would include the VAT element in respect of void premises. The transfer of the funding for VAT between landlord and agent should therefore be normal operational practice throughout the course of the management instruction.

However, a shortfall in the management accounts can occur if the client does not remit back to the managing agent the recoverable VAT included in its VAT return.

Practitioners are advised to be aware of this potential problem and sellers are to reimburse the service charge account if there is a shortage of funds on transfer resulting from a difference between output and input VAT.

#### **D1.1.4 Statements of service charge movements**

##### **Current service charge year**

As described in section D1.1, as soon as practicable but in any event within four months of the completion date the seller (or their agent) should provide a statement of service charge movements for the period from the start of the current accounting period up to the completion date. The statement should include:

- the income received on account of the service charge, with copy demands
- the statement of service charge expenditure incurred with copies of vouchers/invoices
- an analysis of seller landlord's liabilities and tenant direct charges, marketing and commercialisation



accounts. These should be separately identified and where tenant direct charges apply these should be treated separately to the service charge

- a service charge cash reconciliation (calculated as detailed in appendix B)
- an up-to-date arrears statement (if changed from the statement issued within five working days after completion), together with explanatory notes on any disputes and
- explanatory notes on major variations from the original budget for that service charge accounting period.

Where the closing balance on the service charge cash reconciliation is a positive sum, the seller shall transfer to the buyer within five working days of the issue of the service charge cash reconciliation, the positive balance (after deduction of any interim payment already made on account of such credit balance under section D1.1).

Where the closing balance on the service charge cash reconciliation at the date of transfer is negative (this will occur when the expenditure exceeds the income), the buyer should reimburse such negative balance to the seller within five working days of the issue of the service charge cash reconciliation.

The buyer or its manager should then be responsible for completing the full year service charge reconciliation. This is to include certifying the accounts and arranging for their independent review or independent audit, where required, in accordance with the latest edition of the service charge code.

The buyer or its manager should then issue the statement of expenditure and any balancing service charges to the tenants at the end of the service charge year in the usual way.

### **Prior service charge years**

If there are prior service charge years for which the closing accounts have not yet been issued, the contract should set out what is to happen. See section D1.1 for various options.

#### **D1.1.5 Sinking and reserve funds**

In all instances where the seller operates sinking or reserve funds, the information about these will normally be provided in response to standard preliminary enquiries before contract. If not, the sale contract should provide for the following information to be supplied before the completion date (or at the latest within five working days after completion):

- details of all funds and assets covered
- details of the term of the fund, expiry date and life expectancy of the assets
- a full statement showing fund values broken down between each asset and details of landlord and tenant contributions, tax and interest
- a statement of expenditure from each fund, if applicable and

- details of tax liability and any trust status applicable to each fund.

#### **D1.1.6 Depreciation charges**

If the service charge included depreciation charges, but details have not been provided in response to standard enquiries before contract, the sale contract should provide for the following information to be supplied, before the completion date (or at the latest within five working days after completion):

- details of all assets covered by the charges
- details of the period of cover including start date and cost of asset and
- the final book value of each asset and details of the charges recovered from each service charge year, from each tenant up to the completion date.

#### **D1.1.7 Security deposits for utilities**

There has been a growing trend over recent years for utility companies to request a security deposit from owners as a condition of the supply agreement.

If that utility supply agreement is to be novated to the buyer the seller should obtain confirmation that the supplier recognises the buyer as the beneficial owner of the security deposit, and the security deposit will roll over with it. The sale contract should then provide for the buyer to reimburse the seller an amount equivalent to the deposit. This could be included in the financial transfer procedure set out in section D1.1.3.

If the utility supply agreement is to be terminated on completion (and the buyer is to arrange its own in substitution), the seller can arrange direct for the refund to it of the deposit.

If the original deposit was included as a 'cost' in any previous service charge period, the buyer should account for the return of the deposit as a credit item as part of the service charge reconciliation up to the date of sale.

### **D1.2 Change of manager**

A change of manager will often occur as a result of a sale of property, in which case, the procedures outlined in section D1.1 should be adopted. Where a change in manager occurs for any other reason, the following procedures should apply (and the obligation to comply with them should form part of the management contract).

#### **D1.2.1 Property financial information**

The same information listed in section D1.1.1, together with VAT election paperwork where applicable, should be provided to the new manager no later than three weeks before the management handover date.

#### **D1.2.2 Tenant financial information**

The same information listed in section D1.1.2 should be provided to the new manager no later than three weeks before the management handover date.

#### **D1.2.3 Financial transfer**

On the management handover date, the old manager should provide to the new manager a full service charge arrears list, together with tenant history reports and details of disputes, payment plans and bad debts. It is recommended that the old manager transfers to the new manager an amount equal to its reasonable estimate of the credit balance on the service charge account, within five working days of the management handover date. The old manager should provide to the new manager (within two months of the management handover date) a final service charge cash reconciliation (calculated as detailed in appendix B), together with a transfer of funds equating to the cash balance analysed in the service charge cash reconciliation (less the earlier sum transferred, if any).

#### **D1.2.4 Statements of service charge expenditure**

A change of manager is likely to be known in good time, unlike completion of sales that can take place at short notice. Consequently, it should be possible for the transfer timetable to be quicker. However, it is recommended that the same timetable as in a sale (as set out in section D1.1.4) is adopted in the management contract as a backstop.

#### **D1.2.5 Sinking and reserve funds**

The same procedures apply as in section D1.1.5, but all statements and transfers should be made to the new manager no later than the management handover date.

#### **D1.2.6 Depreciation charges**

The same procedures apply as in section D1.1.6, but all statements should be issued to the new manager no later than the management handover date.

## **D2 Supplier information**

A lack of communication between buyer and seller, or between old and new manager, concerning suppliers can lead to a failure to terminate or novate supplier contracts and result in unauthorised work being carried out and incorrect invoices being issued.

In the course of a sale, a buyer would normally ask for details of the supplier contracts before exchanging the sale contract. In particular, the buyer will be focusing on the novation or termination provisions. The buyer can then decide whether to request novation, assignment or termination of individual contracts, and will provide for this in the sale contract. If the supplier contract is to be terminated, the period of notice may overrun completion, meaning the seller has to pay supplier invoices for the period after completion or handover, so attention should be paid to this early on during the sale process.

Where there is a new manager appointed, the owner should consider, in advance, which supplier contracts (held in the name of the outgoing manager) are capable of novation or assignment by agreement, into the name

of the new manager, and obtain any necessary consents. If the supplier contract cannot be novated or assigned, the owner/manager is to assess what notice should be given to terminate it, and a new contract may need to be established with a new supplier.

It is important to focus on this early to avoid unnecessary duplication of payments to old and new suppliers. In some cases, the supplier contract will actually be with the owner (the client) so a change of manager will not precipitate any need for novation, assignment or termination.

Where no arrangements are made for novation, assignment or termination of the supplier contract, the seller or previous manager will be responsible for any costs arising under the contract following completion/handover.

If the supplier contract has been novated, assigned or terminated, the old manager should not give instructions or order works from that supplier following completion/handover.

## **D3 Example reconciliation statements**

### **On completion of sale**

|   |          |
|---|----------|
| Income received from tenants for current open service charge year                                 | £        |
| <b>Less:</b> Expenditure incurred/paid for current open service charge year                       | £        |
| <b>Add:</b> Vendor's liability at the date of completion for the current open service charge year | £        |
| <b>Add:</b> Accruals at the date of completion for the current open service charge year           | £        |
| <b>Service charge cash to be handed over on completion</b>  | <b>£</b> |

### **On handover**

|   |          |
|---|----------|
| Service charge demanded from tenants for current open service charge year   | £        |
| <b>Less:</b> Expenditure incurred/paid for current open service charge year | £        |
| <b>Less:</b> Service charge arrears for current open service charge period  | £        |
| <b>Less:</b> Arrears from past service charge years                         | £        |
| <b>Service charge cash to be handed over on transfer</b>                    | <b>£</b> |



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### Americas

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**Latin America**

ricsamericalatina@rics.org

**North America**

ricsamericas@rics.org

### Asia Pacific

---

**ASEAN**

ricsasean@rics.org

**Greater China (Hong Kong)**

ricshk@rics.org

**Greater China (Shanghai)**

ricschina@rics.org

**Japan**

ricsjapan@rics.org

**Oceania**

oceania@rics.org

**South Asia**

ricsindia@rics.org

### EMEA

---

**Africa**

ricsafrica@rics.org

**Europe**

ricseurope@rics.org

**Ireland**

ricsireland@rics.org

**Middle East**

ricsmiddleeast@rics.org

**United Kingdom RICS HQ**

contactrics@rics.org

**rics.org**