DISCUSSION PAPER

THE NEED FOR DEVELOPMENT OF THE REQUIREMENTS FOR OPERATIONAL AND FINANCIAL REVIEW OF SERVICE CHARGE ACCOUNTS IN THE COMMERCIAL PROPERTY SECTOR

12 December 2014

Introduction

This Discussion Paper was produced as a substitution for a research project that Property Solutions intended to carry out earlier this year, and which required support from the external contributors. The purpose of the research was to understand the profile of the commercial service charge market to be able to develop (cost) bands for the application of different financial and operational review requirements in relation to commercial service charge accounts. We intended to collect a sample of properties that would be geographically representative of the market. For that purpose we aimed to have a sample of 384 properties in London and 384 properties located in the rest of the UK, which would make our research statistically significant.

Unfortunately, for various reasons, we were not able to obtain the required data from external contributors, which prevented us from having a sufficient sample of properties for the research. We have used the data available in the public domain (EGi) instead, thus allowing us to back up the suggestions outlined in this Discussion Paper with some numerical conclusions.

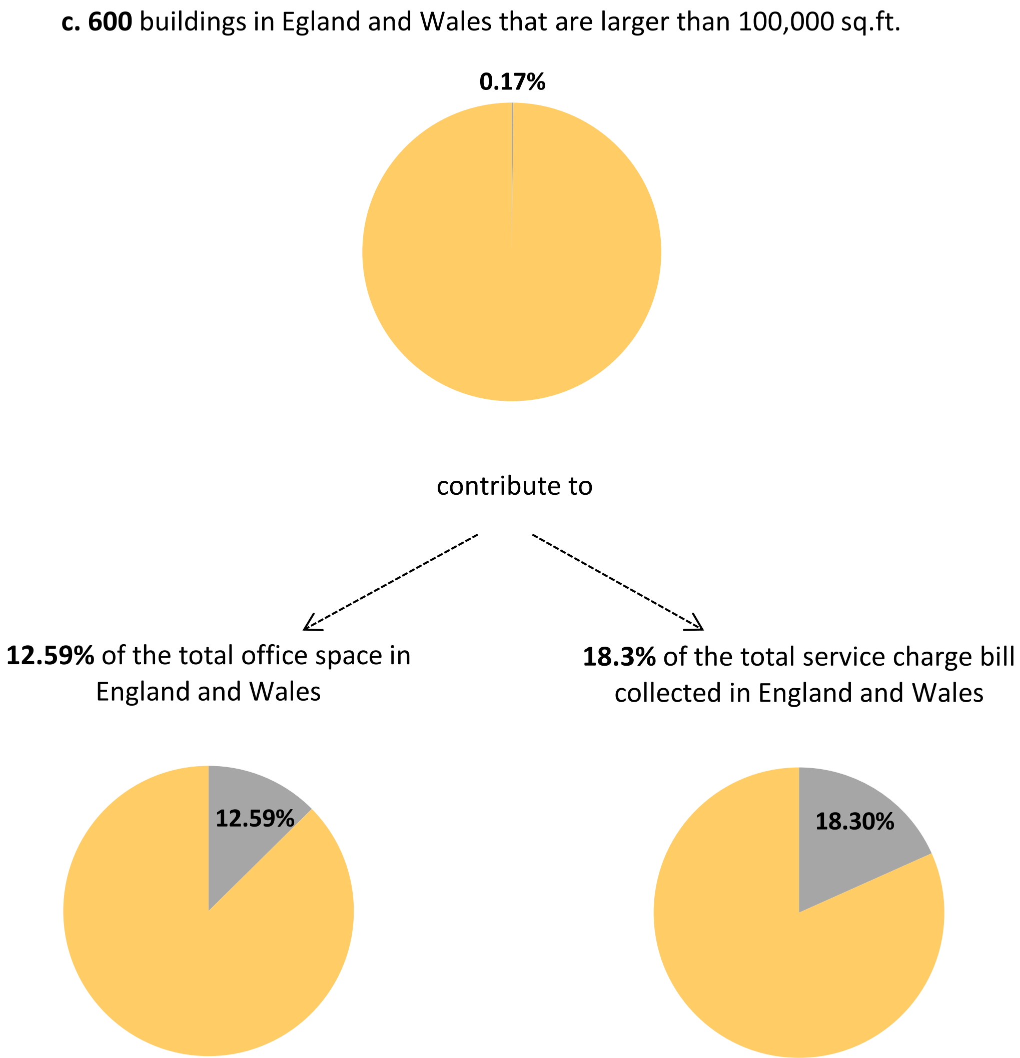
This Discussion Paper presents a brief overview of the office market in England and Wales, current guidelines that exist to help managing companies to account for commercial service charges, and Property Solutions' recommendations as to what steps are needed to improve accounting practices in commercial service charge management.

Industry background

In the UK, commercial property costs represent one of the largest administrative and general expenses for businesses. Property costs are higher than legal, insurance, or accounting costs (British Council for Offices, 2013). The majority of space occupied by organisations to support their operations is being rented and billions of pounds are spent on rent in the UK every year (British Property Federation 2013). According to the Valuation Office Agency (VOA), the total number of office buildings in just England and Wales is around 356,000, which amounts to c. 1.1 bn. sq. ft. The industry has grown by 33% since 2000 and a 1.3% increase is forecasted for 2016 compared to today, based on the current construction pipeline (EG, 2014).

Businesses are becoming reluctant to commit to real estate through acquisition and therefore the amount of leased property in the market is growing. Based on the above statistics and the IPD's estimation of the proportion of multi-let space in England and Wales we estimate that the total service charge bill paid by occupiers in England and Wales amounts to c. £5.9bn. According to the most recent EG data, the total number of multi-let buildings providing more than 100,000 sq. ft. of office space in England and Wales is c. 600. That includes c. 300 units in London and c. 300 units in other cities.

The numbers suggest that the annual service charge bill for large buildings in London, where the median service charge cost per sq. ft. is estimated at £9.50 (Property Solutions & MSU Denver, 2014), contributes c. 11.7% of the total amount of service charges paid by companies in England in Wales. Service charges collected in large buildings in other cities, where the median cost per sq. ft. is estimated at £5.90 (Property Solutions & MSU Denver, 2014), contributes c. 6.6% to the total service charge bill.



Furthermore, there are at least 293 buildings in London with total sizes varying between 50,000 sq. ft. and 100,000 sq. ft., which provide c. 21m sq. ft. of rented space and estimate to contribute c. 2% of the total commercial floor area available in England and Wales. The number of buildings falling within the same size category in other major cities in the UK is estimated to be over 530, which could potentially contribute to up to 3.5% of the total multi-let commercial space.

These are all significant numbers, which should be considered by the commercial property stakeholders when developing best practice requirements for management of and reporting on the service charge costs.

Accounting in commercial service charge management

At present, there is no statutory legislation regulating commercial service charges. All requirements falling upon the landlord (and the managing agent) are stipulated in commercial leases. Our recent research highlighted widespread variance in reporting obligations in relation to service charge accounts contained within commercial leases (Holt, 2013). The same research revealed widespread inconsistency in levels of service charge review and cost certification and misleading use of the word "audit" within reconciliation statements (Holt, 2013). These are a few examples of independent accountants' reports that are frequently observed in service charge reconciliation packs for office buildings.

"Included in the above figures are provisions amounting to [xxx]. The provisions have been made to account for expenditure where invoices have not been received. We have therefore based the expenditure on reasonable budgets, or agreed project funding, provided to us by the surveyors. We hereby certify from the information and explanation provided by [xxx] that for the purpose of the above lease's service charge the expenditure shown is a fair summary of the costs and expenses incurred by the landlord during the accounting year."

"We planned and performed our Independent Review so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the Schedule is a fair summary of the accounting records relating to the Premises for the year [xxx], and is sufficiently supported by accounts, receipts and other documents which have been made available to us and is free from material misstatement. These procedures did not constitute an audit in accordance with International Standards on Auditing (UK and Ireland) and were not designed to provide any assurance regarding whether the amounts charged are a reasonable amount for the services, or whether those services were provided efficiently."

"We hereby certify that the amount shown above is the proportion applicable to your premises of the expenditure reasonably and properly incurred by the landlord in respect of the above period and in accordance with the relevant provisions of the lease."

"Based on our examination of the records and documents made available to us by [xxx] in our opinion the Statement is a fair summary of the expenditure of [xxx] for the year."

"We were not required to, and did not, form an opinion as to either the reasonableness of the costs included within the Statement or the standard of the services or works provided. […] In view of the purpose for which this Statement has been prepared we did not evaluate the overall adequacy of the presentation of the information which would have been required if we were to express an audit opinion under Auditing Standards issued by the Auditing Practices Board. In our opinion the statement represents a fair summary of the expenditure for the year [xxx] and has been prepared in accordance with the lease between the tenant and the Landlord."

Other statements tend to be prepared in a similar style. What follows from this analysis is that the following important activities do not fall within the accountants' scope of work:

a) review of leases
b) checking invoices against service contracts
c) checking invoices against recoverability

d) analysis of opening and closing accruals for the year

The lack of the above procedures means that at present in the majority of instances tenants cannot be assured of the appropriateness, correct apportionment, and recoverability of service charge costs, as well as of the thorough management of incoming and outgoing cash flows by the managing party. Service charge certificates of expenditure are generally prepared on a cost schedule basis with no requirement for provision of a balance sheet, which exacerbates the problem when service charges are measured in hundreds of thousands pounds.

The *Model Commercial Lease*, a project that was commissioned by the British Property Federation and was published this summer, is also silent on the accounting requirements for service charge management. It contains an important clause allowing the tenant *"to inspect evidence of the Service Costs at the Landlord's head office or any other location the Landlord specifies"* within four months upon receipt of the service charge certificate of expenditure, but as for the rest it requires the landlord to comply with the RICS Code of Practice – Commercial Service Charges 3rd Edition (**the RICS Code**):

"[Landlord] must take into consideration the administrative, accounting, procurement, management and operational provisions of the Service Charge Code for so long as it is in effect insofar as it is:

(a) reasonably practicable to do so;
(b) consistent with the Landlord's obligations under this Lease; and
(c) consistent with the economic and efficient management of the Building (taking into consideration all the circumstances including the terms of the leases of other Lettable Units)"

The latest addition of the RICS Code suggests that *"[m]anagers should ensure that annual statements of service charge expenditure are issued strictly in accordance with the procedures and requirements as set down under the terms of the lease"*, which again suggests that there is no unified approach as to how service charge accounts should be managed and accounted for. However, should the managing party decide to include an Independent Accountants' report, the latter has to be produced in lines with the best practice guidelines laid out in the ICAEW Technical Release on Commercial Service Charge Accounts (the **ICAEW Technical Release**), which came into force on 1st April 2014.

The ICAEW Technical release reinforces the need for better disclosure of information and clarifies the role of the accountant and managing agent and the scope and limitations of the accountants' report accompanying the annual accounts. It recommends that:

"Procedures that may be performed to address all material items in the annual statement of service charge expenditure, including disclosures, and areas in the annual statement of service charge expenditure where material misstatements are likely to arise include:

(a) detailed review of material transactions (the review may consist of comparison to prior periods or budgeted amounts, estimates, and/or correspondence, as applicable)
(b) identification and review of items outside the date range of the service charge statement
(c) review of expenditure for completeness (reviewing for completeness may consist of comparison to prior periods and/or budget, or checking that the full number of periodic transactions due to take place in the course of the accounting period have been recorded)
(d) review of expenditure for duplicate transactions

(e) *review of a random sample of transactions*

Types of procedure that may be performed, depending on the circumstances, include inspection, re-calculation, re-performance, observation and confirmation."

The ICAEW Technical Release also states that the accountant must report issues that require adjustment to the annual statement even if those issues come to light subsequent to the year in question. If when working on certification of the annual statement (within the 4 months after the end of the period in question) the accountant realises that an accrual was overstated because of an invoice that has come in during the time of their investigation, the accountant is expected to "*request management to correct those statements*". The accountant is also bound to "*modify*" their conclusion and to use the words "*materially misstated*". The paper proceeds to explain this more fully and in the Basis for Adverse Conclusion section indicates that this is specifically applicable to "*substantial accruals in the sum of £x [that] have been made for costs that do not appear to have been incurred during the year*." This is very important as the responsibility for making sure that any accruals in the annual statement are only those that have been "*incurred during the year*" falls on the managing party. It is not quite clear what effect an "*adverse conclusion*" would have on the tenants should they read such a statement but it is clearly more desirable to have a modified "*clean*" annual statement of service charge expenditure to show to the tenants.

Changes proposed by Property Solutions

There is a general acceptance that the scale of services and accounts should determine the scope and rigor of operational and financial review requirements. The nature of the requirements should be set after a considered assessment of the administrative cost of implementation against the risks of non-compliance. The RICS Code has not yet developed different requirements for annual review of service charges at properties of different sizes and complexities.

Buildings that provide more than 100,000 sq. ft. of office space tend to employ more services and more complex operational models. Space also attracts companies that are looking for headquarters, which often creates additional requirements for expensive services and fit-outs. Amenities that are common for such buildings include the following:

- ✓ air-conditioning
- ✓ parking
- ✓ suspended ceilings
- ✓ raised floors
- ✓ storage
- ✓ VAV
- ✓ several lifts
- ✓ building reception
- ✓ 24 access
- ✓ security personnel

Refurbishment of large properties often turn into high-cost projects, which further complicates commercial service charge management and require tighter scrutiny over finances.

We believe that the market would benefit from imposing stricter review requirements for properties that fall within certain criteria (e.g. above the established threshold for the total service charge cost per year or a certain size of the building) and requiring the following activities to be included in the annual (or bi-annual) reviews:

- ✓ review of leases;
- ✓ review of all material transactions against invoices;
- ✓ review of invoices against contracts;
- ✓ review of contracts against leases;
- ✓ review of opening and closing accruals;
- ✓ review of sinking funds and utilities deposits;
- ✓ preparation of a balance sheet.

There has to be a collaborative discussion held among representatives of different stakeholder groups to agree on the criteria as well as consider and agree on the requirements themselves. We believe that a more detailed review of service charges at particularly large/operationally costly buildings would create greater transparency in service charge management, improve operational practices at properties and provide tenants with much needed assurance that service charge monies are properly recovered and accounted for. Higher scrutiny would also help to identify and address procedural, operational, and managerial issues that can have a long-term negative impact on the tenants' financial position.

In light of the absence of statutory regulation, we believe that best practice advocates the following elements of service charge management to ensure that commercial tenants are sufficiently protected:

- ✓ full disclosure and comprehensive presentation of costs;
- ✓ appropriate sign-off assurance;
- ✓ proper management of service charge accruals;
- ✓ compliance with service contracts;
- ✓ adherence to contract KPIs.

Proper service charge analysis and review of service contracts, accounting procedures, and management practices should not only focus on cost reduction, but encourage managing parties to periodically reassess their internal policies and operational processes. This can have a very positive long-term impact on service charge management at buildings, including improved operational efficiency and better service delivery.

Further work

We believe that further work is required to properly examine and address this subject, and we are happy to carry out a study based on the previously developed research proposal with the support of external contributors.

Should you have any queries or comments, please contact:

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