

**Kingston University** London



Service charges within the UK office market:  
**evidence on accounting practice, compliance  
and disclosure**

|| Dr Timothy Eccles and Dr Andrew Holt

## Summary

The report offers a detailed analysis of the existing practices concerning the creation and management of service charge budgets and certified accounting statements. It describes the nature of best practice as established by the RICS Code of Practice for Commercial Service Charges and investigates how this has affected accounting practice and disclosure.

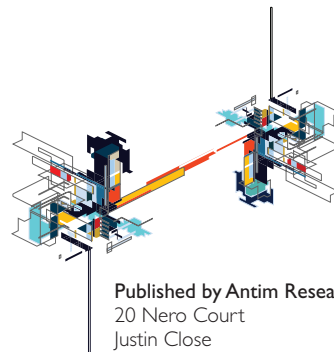
The report establishes an evidence-based approach to gathering data in order to overcome existing hyperbole on the subject. From this, it provides critical analysis and derives conclusions on the current state of accounting practice, compliance and disclosure for commercial service charges. It then provides recommendations on how to improve existing practice as well as offering a conceptual foundation to help understand the technical issues within a wider context.

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Finally, the value of this research is predicated upon the quality of its evidence, and we earnestly thank all those anonymous participants who gave up their time to discuss the many issues covered in the report.



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## Contents

Summary and Acknowledgements.....	2
1.0 Introduction.....	4
2.0 Theoretical Introduction: the Nature of Occupational Knowledge.....	4
3.0 Technical Introduction: the Service Charge .....	6
4.0 Organisation of this Work.....	8
4.1 Methodology .....	8
4.2 Definition of the term ‘service charge’ .....	11
4.3 Some Speculations upon the Nature of the RICS Response.....	13
4.4 The Impact of the RICS Code of Practice on Service Charges .....	18
4.5 Accounting for Service Charges: Code Compliance, Practice and Disclosure .	20
4.5.1 The Accounting Requirements of the Code.....	21
4.5.2 The Qualitative Characteristics of Service Charge Accounting Information .....	22
4.5.3 Timeliness of Service Charge Budgets and Certified Accounts.....	27
4.5.4 Budgets Accuracy and the Information Quality of Certified Accounts.....	28
4.5.5 Accounting for Sinking Funds .....	33
4.5.6 The Sign off Process for Service Charge Accounts.....	42
4.5.7 Summary of the Accounting Issues .....	44
5.0 Conclusions.....	44
5.1 Final Analysis .....	44
5.2 Speculation.....	45
Appendix A: Empirical Evidence .....	47
Appendix B: Other data .....	48
Appendix C: Model “Sign-off” Statements for a Service Charge Certificate .....	49
References.....	52

# **Accounting for Service Charges within the UK Office Market: Evidence on Accounting Practice, Compliance and Disclosure**

## **1.0 Introduction**

This research considers the contested nature of the commercial service charge. It seeks to establish the basis for the widespread complaints (see for example Calvert 2008: 11) through a systematic and defensible methodology so as to respond to those who refer to such claims as “anecdotal” (RICS 2009a). It will then examine whether changes have taken place since the introduction of the RICS Code of Practice on Service Charges, including a discussion of the nature of these changes. It will conclude by examining whether such change is satisfactory in itself, if the Code has been adequately adopted, and whether statutory legislation might force wider and better conformity to best practice. The report focuses on technical aspects of accounting for monies discussed within the Code, predominantly within ‘large’ owner and occupier organisations. Further work will expand the range of participants involved. The report also offers some speculation about the wider issues related to service charges, particularly on the issue of who might be regarded as both an ‘expert’ in the field, and a potential regulator.

## **2.0 Theoretical Introduction: the Nature of Occupational Knowledge**

The wider research problem considers the issue of occupational control. How is knowledge originated, who creates it into specific forms, and how is this commodified and served up as a commercial service within the remit of certain professional groups? In other words, how does the technical knowledge of the service charge come into being? Which groups lay claim to understanding a lease, and are thus able to negotiate over it, thereby excluding others. The sociology of the professions literature refers to the creation of a fictional commodity (Larson 1977) that is artificially created in order that a certain occupation can claim control over it, and thus get paid. Relevant to the issue of service charges, the literature discusses the extent to which the issue of lease charges is organised so as to allow certain groups to claim themselves as ‘experts’ and any others as ‘quacks’ in setting up and managing the service charge process. This idea is weaker today because there is an unwillingness to recognise that any group can dominate, can create such non-market mechanisms. Service charges are

as they are because that is how clients, owners and occupiers wish the system. The immediate response to any notion of control is that it is 'the market' that determines how businesses operate.

The concept of profession is variously identified and described, but one common issue is the creation and maintenance of a discrete body of knowledge; something that only 'experts' can be expected to know. This, then, allows a distinction to come about between those who 'know' this knowledge (the experts) and those who don't (the lay population). This, in turns, requires some form of evaluation of competence between those who are competent and those who are quacks. However, it is difficult to see quite who can establish dominance over either service charges as a core of knowledge or the work of managing them.

Professional firms service clients, but professions (in the property field) rely upon universities to provide training up to qualification. However, universities increasingly serve students as clients, and will provide knowledge that is 'interesting' rather than necessarily useful (see for example Meighan and Siraj-Blatchford 2003). Neither professional associations nor universities are in a position to create or dominate a body of knowledge that is service charges. Neither can create a licensing process of approved practices or certified competent practitioners. However, neither clients nor students are able to amass organised control of these processes either. Clients themselves follow 'the market', and many who pay service charges are not in the business of property, but use property simply as a place to carry out their own occupations. Similarly, students are a mass of disorganised individuals frequently making the sorts of ill-informed choices that can be expected of young school leavers with no knowledge of occupations or the workplace. What is more, who makes a career choice at 18 to deal with service charges? It is hardly vocationally 'sexy'! Even where occupational groups do cluster into authoritative professional associations, these, too, report a lack of dominance over knowledge, how it is used, and who by. Indeed, if they were to admit so, then they might well be guilty of monopolistic activity and be prosecuted for it. The primary cause for this is the lack of political acceptance of the principle of statutory protection for occupations. Surveying, architecture and engineering are all represented by professional bodies, but without any legislative requirement for any practitioner to join.

There is then a wider question here concerning where knowledge originates, and how it takes form. This requires at least a nod in the direction of certain other fields, those of the sociologies of knowledge, education and the professions in order to examine the nature of ‘pure’ knowledge. This is then utilised within the specific situation of service charges as a means of explaining, and not simply describing, the current situation. Put simply, might a Code be used by RICS and its members to help generate exactly this sort of difference? Those working to a Code are clearly professionals, whilst those not become outsiders, quacks and similarly untrusted non-professionals. However, the core of this report remains a technical analysis on the issue of the service charge, and this specific focus will be examined first, in order that later speculative inferences might be added.

### **3.0 Technical Introduction: the Service Charge**

Service charges seem to be generating rather a lot of hyperbole at the moment, whilst more ‘restrained voices’ seem to be oscillating between the positions that much of this is ad hoc and unrepresentative (RICS 2009a) and historic, with improvements deriving from the new RICS Code. Certainly our own primary data endorses the general view that service charge management has improved. Also, RICS has established a Transparency Working Group to investigate the issue, amongst others (RICS 2009a). Similarly, whilst our respondents agreed that change has occurred, there was disagreement in its scale and whether it was sufficient. Jin and Tsourikova (2009) go further and find strong support for legislation.

The primary difference, and cause for a lot of discussion, between residential and commercial service charge positions is that the former is statutorily regulated, and the latter is not. This then leads to a debate whether the legislation is working with residential service charges, or is just expensive form filling. And thence whether the commercial service charge needs such treatment. What is evident from the secondary literature is that no one now defends the pre-Code position, and all parties recognise the need for change. This is endorsed by our own research. It would be interesting to have had longitudinal studies to measure this shift in position, since the Code clearly has not always either been seen as necessary or supported. The differences in opinion

within our research begin when discussion turns to whether the Code is working and if a ‘voluntary’ scheme can ever succeed, and whether statutory legislation would – in practice – make any substantive difference. On balance, few respondents thought so, but our interview size and sample might bias this, and we only report this tentatively here.

We are not prepared at this stage to allocate blame about the causes of problems with implementation, although we will speculate upon the role of RICS later, and both Calvert (2008) and Jin and Tsourikova (2009) see RICS as primarily responsible with the task of enforcing compliance. However, the nature of the lease is also recognised as a historic problem since the lease overrides any Code and is legally superior (Forrester 2008, King 2009 for example). Calvert (2008) also suggests that managing agents cannot be expected to follow the Code if their employers, the landlords specifically, will not allow them to do so. We found no specific evidence for this, but landlords are unlikely to publicly admit to such behaviour, either. Finally, King (2009) describes the paranoia caused by O’May in trying to engage with the Code and modernise leases. Whilst she believes this unfounded, or at least exaggerated, Cattell (2009) believes that this conflict does exist. This might explain landlord behaviour. Certainly, the whole area needs further investigation.

Generally speaking, there are probably two approaches towards the issue of service charges.

1. It is a market-based issue, resolved as part of the negotiation between a potential client and landlord, and their agents. If either side dislikes what they are being offered, then they can simply walk away from the deal.
2. Service charges are a technical issue involved in managing a landlord and tenant relationship. The nature of a tenancy agreement tends to favour landlords because of the costs and difficulties in tenants leaving. This is evidenced by the opaque nature of service charge calculations, lack of clarity in where the money lies and the rather one-sided decision-making nature of where they get spent. For these reasons, a Code of Practice was introduced and the RICS is investigating the issue as part of its ‘transparency’ initiative.

Our work seeks to examine the financial and managerial accounting issues concerned with service charge monies. We are interested in the conceptual and regulatory framework of how monies ought to be accounted for, examining actual practices of companies and illustrating variations in opinions on how to provide accurate, true and fair procedures.

The work also flows from previous research carried out by the authors into the social construction of reality in technical fields (see for example Eccles et al 2005 on the issue of revenue recognition and property companies).

#### **4.0 Organisation of this Work**

The report is divided into the following sections:

- Methodology
- Definition of the term ‘service charge’
- Some Speculations upon the Nature of the RICS Response
- The Impact of the RICS Code of Practice on Service Charges
- Accounting for Service Charges: Code Compliance, Practice and Disclosure
- Conclusions, including both derived conclusions and inferred speculation.

#### **4.1 Methodology**

Researching the issue of service charges contends with two research problems. The first is that data is commercially valuable and hence confidential and difficult to obtain. The second is the issue of the integrity of the data. This falls into the quantitative versus qualitative debate. RICS (2009a) refers to the “anecdotal” nature of the evidence concerning service charge problems, implying that subjective interpretation-based analyses of this area are flawed. RICS (2009g) can also point to a paltry 60 self-selected responses on the general issue of professional fees, which includes those of managing agents, reinforcing arguments of the relative unimportance of the issue. However, self-selecting responses have their own problems, such as whether potential contributors are aware of the existence of the research, and are inherently unrepresentative. At the same time, the available data



sets, OSCAR and Loughborough, present competing arguments over the representative nature of their data, both in a given period and as year-on-year comparators.

The following research provides both qualitative and quantitative analysis of the issues. It also seeks to establish representative data. First, it utilises a critical literature review in order to establish a foundation for the work. This is then reinterpreted using two distinct sets of data.

1. Interviews with key professionals working within the field. A representative sample of those representing the larger actors in the field of service charges, agents, landlords (owners) and tenants (occupiers) were interviewed. These were asked to explain their individual interpretations of how things work, how they should work, what the Code says and how things might change. A total of 11 interviews were carried out for this preliminary study, detailed in Appendix A. Each took from 1-2 hours. These interviews were reinforced by focus groups and a Kingston University student project.
2. Both accounting and raw data was collected from actual service charge certificates, budgets and accounts records for UK commercial multi-let office premises for the period 2004-8. These documents represent a statistically representative sample (see Krejcie and Morgan 1970) of service charge records covering approximately 5.2% of total UK commercial multi-let office space. As documents typically cover different parts of the same calendar year, the analysis assigned each document to a year on the basis of whether its accounting period covered the majority of that year. For example, if a document covered the accounting period 01/04/07 to 31/03/08, it would be assigned the year 2007 as the majority of its period falls within that year. The researchers were independently allowed access to and the selection of representative data.

Interviews were carried out with a selection of informed individuals, representing owners, occupiers and agents. The value of any research conclusions is predicated upon the quality of the data collected and created for the project. There is nothing inherently wrong with the interview method, but it relies upon the representative

nature of the sample and the comparability of data. Appendix A provides a schedule of the interviews that were carried out; this list is partly selected by the researchers, and partly by respondents. It is evident that parties refusing to participate withdrew themselves from the sample. However, the initial selection of participants was solely made by the researchers, upon the basis of any previous public involvement on the issue or employment within a representative owner, occupier or agency. At this preliminary stage of the work we approached only the 'large players', not because they would necessarily give a 'better' view, but because this initial report concentrates upon the issue of service charges for 'large' owners and occupiers, and their agents. Further work will deepen and broaden the study.

The interview allows respondent and researcher to fully examine the interviewee's views upon a particular issue, to round out answers and to investigate issues thoroughly. Interviewees determine when they feel an answer is fully answered, in what way to formulate answers and how to illustrate and defend their responses. The interviewer responds to this, suggests areas that might have been forgotten and draws out details. However, the interview is always the response of the interviewee, and the interviewer simply manages the process to allow the respondent to fully articulate their views.

A semi-structured interview method was selected. Because of the technical nature of the subject area, we determined which issues to discuss. This allows for comparison of the responses across all interviews very simply. However, the questions are open, and so individual interviewees were allowed to discuss the issues on their own terms and in their own way. We did not artificially construct the questions to lead respondents. The briefing note was presented to all respondents approximately one week prior to interview. This allowed them time to prepare their answers. All interviewees were also allowed to add any further issues to the end of the interview, and these points are also included into the research.

A major disadvantage of the interview method is that it is very time consuming. We are very aware that eleven interviews does not appear representative, although those eleven represented the prime players in each field. Additionally, interviews ranged from an hour to over two, and were thus very detailed. However, in order to add

further bulk to the evidence, and hence improve its representativeness, focus groups were undertaken. These consist of an invited group of participants who are asked to discuss a number of issues as a group in themselves, where the researcher acts more as a manager of the process than an interviewer. Their primary use is to establish issues that can then be investigated in more thorough methods. Direct use of the outcome of the group is problematic since it is impossible to standardise them and difficult to manage the conversations of the participants. This prevents direct comparison of different focus groups since they will quite likely have talked about very different things. If an interviewee does not mention an issue, then the issue is likely to be seen as not relevant, whereas a focus group might simply have forgotten to raise it. The focus group can also be hijacked by a strong personality. None of this renders the data valueless, but it does make direct comparison and analysis more tentative.

Finally, a Kingston University project, referred to as *Kingston Study 1*, was also utilised. A postgraduate student under supervision carried this out. The academic community is rather divided upon the use of students in research. Increasingly, pragmatism over obtaining a mass of data, of the economy of using student labour and the ability to select trusted students overrides the ideal that an academic does their own work in entirety. We utilised a postgraduate student dissertation in order to field further evidence on this issue. Our use of the data is balanced with its origins as a student piece of work.

Together, these have created data on the views of approximately 100 selected participants.

#### **4.2 Definition of the term ‘service charge’**

Forrester (2008a: 1) defines a service charge as “the mechanism by which the landlord recovers from tenants that expenditure which the landlord expends in relation to the repair and maintenance of the building, plant and machinery and the provision of services.” Section 18 of the Landlord and Tenant Act 1985, amended by the Commonhold and Leasehold Reform Act 2002 provides the legislative definition.

This report is concerned with commercial service charges, the primary distinction from residential being the lack of legislative regulation in the sector. *Yet*. That provides the environmental context for this report. Is the current situation working, or is action required? Whilst the initial position, at least of landlords and the Royal Institution of Chartered Surveyors, was that no action was required, mounting tenant pressure has awakened government interest. This has led to the creation of a RICS Code of Practice, in association with BCSC, BCO, BPF, PMA, BRC. This field is an interesting examination into the contested interpretation of how and why things are. Whether, for example, RICS produced the Code of Practice to evade legislation, to protect the position of its own members or to increase the efficiency of the system is just one area of disputed reality. For a professional in the field, it is simply a fact of ‘how things are’, but deeper examination might offer insight into the future and what might be inferred about the development of the service charge.

At core, the service charge is a means of the landlord claiming expenses from the tenant for works that they have carried out in order to keep the building in operation for the tenant’s use. Because of the annual variance in the sum, depending upon what work might be done in any given year, this figure needs to be charged each year, and then predicted and actual expenditure is later reconstituted. Of course, the issue of ‘improvements’, long-term maintenance issues, sinking funds and the like add further complexity. Additionally, a service charge is only payable if the lease specifically requires it. The O’May case also prohibits “introducing any service charge terms that would lead to increased costs”, although King (2005, 2009) believes that the profession is taking a specific case and extending it into an unwarranted generality. This encourages analysis that is less about definition, and more about purpose. Why have a service charge? Why utilise a concept that is quite obviously open to bias, manipulation and opacity? Does it encourage financial efficiency? Is it fit for purpose?

The reasoning behind these questions will determine whether the service charge can be managed transparently, whether it is ‘fair’, if it can evolve to deal with new demands (such as the ‘greening’ of leases), and whether either a Code of Practice or legislation can achieve this – or whether something different is required. It is also important to recognise the context of these issues. Generating legislation, professional

codes of procedures and practical ways of ‘getting the job done’ are not scientifically neutral processes rationally devised within a laboratory. Rather, they are social processes created through discussion by groups and individuals of varying political power. In this case, the RICS exists as a members’ organisation, landlords, though not all, are powerful economic entities, represented by groups such as BPF, and tenants, are perhaps more varied and disparate, though with sectoral differences, such as retail’s powerful BRC (an issue discussed further below). Therefore, it is useful before commencing with a technical analysis to offer some tentative thoughts on the social construction of reality behind the Code. In order to do this, we will focus upon the RICS, as nominal creator (though see below), and how its actions for, and in, developing the Code might be interpreted.

### **4.3 Some Speculations upon the Nature of the RICS Response**

The current situation concerning service charges is recognised as unsatisfactory, but interpretations vary. Like any market-based relationship, the landlord-tenant framework is competitive and antagonistic. At its simplest, one seeks to maximise income, and the other to minimise expenditure. This is then reinforced by a tendency for each to employ a professional adviser to act solely on their behalf. This makes for an interesting study of attitudes, especially of professional associations like RICS, since chartered surveyors act for both parties. Thus the current UK situation consists of four parties established into two sides of a combative negotiation upon what needs doing to a property and how much it should cost. These parties are:

- Landlord
- Tenant
- (Chartered) Surveyors - as managing agents for the landlord
- (Chartered) Surveyors - as service charge consultants to the tenants

One cause for distrust and competitive negotiation is the manner in which managing agents are employed. This process also tends to be opaque, although the Code does offer guidance. However, *Kingston Study 1* found that managing agents were often paid in relation to their performance, and were not unusually forced to tender for work

at a loss in order to obtain future work. This hardly encourages a ‘professional’ service.

A further cause is the cultural fissure originating in UK law. Whilst this is not the place to examine the law of landlord and tenant, it is worth noting the almost feudal nature of the relationship created by it. From a cultural perspective, legislation is derived from the Norman invasion of England in 1066, and still retains the archaic terms ‘landlord’ and ‘tenant’. This all serves to reinforce a cultural divide between the two parties. King (2009) argues that whilst the role of managing agents is to manage costs, they tend to act more as an income generator for their employer, the landlord. This, then, results in tenants employing their own surveyors to represent them and produces a factional and fractious process. UK legislation in the area remains the Landlord and Tenant Act 1985, amended by the Commonhold and Leasehold Reform Act 2002. UK laws differ from wider European and international interpretations that have begun to concentrate on rights to property; the landlord has ownership/proprietary rights to rent, future occupation, and a choice of who can occupy. The tenant has rights to occupy and possession of land for a term. These forms of rights are not only contractual but involve human rights - Article 1 of the 1st Protocol of the European Convention of Human Rights being perhaps the most important.

What is interesting, however, are the nuances to interpreting the situation. RICS (2009b), for example, accepts that “poorly managed service charges are a frequent cause of disputes between owners and occupiers”. However, RICS (2009a) refers to the evidence concerning problems with service charges as “anecdotal”. This, of course, serves to minimise the effect of complaint by suggesting that evidence is neither representative nor methodologically grounded. However, these complaints *are* being sounded, and with greater vigour (see for example Clift 2008). Partly, this is a result of the current recession (*Kingston Study 1*, Jin. and Tsourikova 2009, RICS 2009f, RICS 2009g), but also of the wider work being done in the field. Additionally, residential service charges are not only statutorily controlled, but residential service charge legislation is deemed to have been successful (Edwards 2009a).

From all of this, it appears that RICS seeks to establish a Code of Practice for four co-related reasons.

1. The current situation is indefensible, and there needs to be greater openness and transparency. Transparency is practical and pragmatic. Conflict is expensive to all sides (BPF 2006, Edwards 2007, Edwards 2009a, Edwards 2009c, King 2009).
2. RICS is seeking to evade statutory legislation, which will create a more rigorous environment for its members (Clift 2007, Forrester 2008b, Edwards 2009a).
3. The Code is firefighting, evolving through Guidance Notes to deal with small flash fires as they emerge. And, in the case of retailing, a forest fire and a powerful group, which needs placating (*Interview 6*). There is also the danger that the issue will generate enough of a head of steam to force the creation of a motivated and resentful Tenants Forum (Calvert 2008).
4. RICS also needs to convince clients that it remains the determinant authority in the occupation of managing service charges. Both government intervention and a Tenants' Forum might disrupt this.

However, and related to point 4, the Code can also be seen as a dynamic strategy by RICS, and part of a concerted program to establish technical jurisdictional control over areas of work. The RICS is developing a 'brand' to create good practice and establish evaluated competency and insured and regulated enforcement. This can be seen in valuation (see for example RICS 2009e) and even in project management, not obviously a specifically 'surveying' occupation (Elder 2009). This process establishes a standard of 'approved' practice in each area of work, but approved by RICS. RICS creates in itself the role of quasi-government regulator, and as regulator charges fees; membership fees. RICS has also recognised that other bodies are also regulating slices of the industry, such as BPF's CLS scheme (Jansen 2007), and that RICS needs to work fast to ensure that it is the body that controls and regulates the occupation.

The Code of Practice for Service Charges is created by RICS, albeit in cooperation with others, to maintain control of the business of managing service charges. The Code establishes a unified, 'professional', approach, "the RICS way". It enforces a particular way of operating on its own members, but also extends its control over non-chartered surveyors working in the field through alliance with these other bodies. Clients come to expect RICS procedures and regard them as industry best practice. If

statutory legislation were implemented, then this is done by government, and not by RICS. It will likely involve many other interested parties. This would weaken RICS hegemony. This has already happened in the case of UK residential service charge management (see for example RICS Business 2009a). The point made at the RICS Commercial Property Management Roadshow and elsewhere by RICS, is that the Code must be adopted or legislation will follow in the field of commercial service charges (for example Edwards 2009a, King 2009). The issue is to both accede to the principle of these demands whilst retaining control, through implementing a Code of Practice. Nor is the 'competition' only in government laying down rules, but the Code is client-led and was originally driven by BRC (*Interview 6*) and so RICS needs to convince clients that it is the determinant occupational authority in the service charge field.

RICS produces three types of practice documentation: Practice Statement, Guidance Note, and Information Paper. Practice Statements are mandatory; they must be followed, and are usually approved by the UK government in some manner. Guidance Notes are just that, guidance to good practice. Members do not have to follow them, but they will be expected to be able to provide a good reason not to. Information papers are part informative, part consultative and usually concerned with technical and tactical matters in how to actually carry out the complex tasks discussed in the Guidance Note. The Code of Practice is a guidance note; chartered surveyors are legally required to follow the lease. However, RICS expects leases to follow the advice of the Code over time, and this is likely because of the support for the Code by BCSC, BCO, BPF, PMA, BRC. However, it is RICS that is (now) the lead in this because it is enforced upon their members, and expected of non-members by wider parties – especially UK courts. The Code was originally the idea of BRC and remains client-led. However, respondents for this work saw RICS as the logical authority to manage the Code since it was more neutral than either tenant or landlord-led groups. *Interview 6* offered one qualification, in that RICS enforcing the Code on its members might put them at a disadvantage to non-members. Others, such as *Interview 1*, saw this as a positive competitive advantage, however. This is probably more of a problem for the small practices acting as managing agents than the large agents dealing with big property portfolios. However, the idea of regulating and branding competent



managing agents seems consistent with other areas of the surveying community and a strategic way in which to embed RICS as the controlling expertise in the field.

The Information Papers reinforce a single approach to how to carry out tasks, specifically how to deal with sinking funds, apportionment of charges in mixed use developments, and tenant alterations (RICS 2009c, RICS 2009d). The importance of these, and of creating a single view on the way that work is done, is consistently reinforced by RICS; Information Papers contain the preface that “members should note that when an allegation of professional negligence is made against a surveyor, the court is likely to take account of any relevant information papers published by the RICS in deciding whether or not the surveyor has acted with reasonable competence” (RICS 2009c: 1).

One interesting aspect of the Code of Practice is that it shifts the language away from this archaic ‘landlord’ and ‘tenant’ and to the more rational terms of ‘owner’ and ‘occupier’. This is the first evidence of the interesting perceptual changes being introduced by the profession into the area of service charges. Careful use of language persuades that RICS is producing a fairer and more representative environment, and that the profession is far savvier than the old-fashioned legal terminology.

Pragmatically, the Code would appear to be of double benefit for RICS. Whilst denying that there is a serious issue with service charges, RICS also proves itself to be a ‘modern’ professional association by creating a more efficient, transparent and rational process. In doing so, it avoids potential legislation. By allying with the supporting bodies to the Code, it ensures that both landlords (owners) and tenants (occupiers) expect implementation of the Code, and will look to those approved and regulated as competent as their advisers and managers. It establishes RICS as the leading body in the field, establishes it as the determinant regulator of what is and is not acceptable and builds its own brand. For what? Well, some would say, by simply ensuring that the creation and management of service charges is done in accordance with rather basic principles of communication, honesty and transparency. “The Code is about discussion with tenants, and I mean real discussion” (King 2009).

There is evidence that the very nature of codes is changing. Take another property example, that of the RICS/ ISVA Code of Measuring Practice. The 1993 fourth edition when launched was quite openly described as being optional (Campbell 1993). Individual professionals were trusted to choose their own system based upon their own experience. By 2009, in this Code, the RICS Roadshow is explicitly a warning to change or accept legislation (for example Edwards 2009a). Again, compare the judgement of 1993 with the 2009 construction-related New Rules of Measurement. Not only is the new system promoted, but also those who do not adopt it are described in terms of quackery and foolishness. Certainly the tangible and rational benefits are being pushed (for example Bengé 2009, Harper 2009) and BCIS is enlisted to reinforce the need for these rules (Martin 2009). However, NRM is more than just an issue of ‘best practice’; it is a straightforward issue of ‘professionalism’ (Sullivan 2009) and only a “fool” would not follow RICS guidance. Thus, we have come from trusting members to use their judgement to being fools if they do so against RICS guidance on what is “doing the job properly”. It seems unlikely that service charges and managing agents will not face the same treatment from RICS as their regulating body.

In the case of this Code, the concept of branding and creating a corporate RICS approach to service charges seems to be being weighed against the difficulties of enforcing this across thousands of small practices. Whilst the ultimate competitive advantage to members might be worth it, the potential loss of members unwilling or unable to change is a force against change. Quite whether these members are perceived as “fools” is – as yet – unclear, but RICS is probably leery of further criticism of it being a ‘big practice’ association that does nothing for smaller practices.

#### **4.4 The Impact of the RICS Code of Practice on Service Charges**

The contested nature of the service charge serves to confuse the issue of compliance. The impact of the RICS service charge remains a political and ideological battlefield, biased by the observer’s own economic position. There remain two strong positions, the first a predominantly tenant-led movement for greater enforcement of the Code (see for example Calvert 2008: 11), whilst the second consists of a range of strengths of opinion contesting the principle that the Code is not working (again, RICS 2009a

for example). In our research, all parties seem to adopt a middle ground, that the Code has improved matters and that it can only be seen as part of an evolutionary process:

“I think it is a significant step forward. I think its been a useful document in clarifying basic standards and so I think it has actually taken both understanding and compliance forward. I think that there is a long way further forward in terms of compliance but I think it has raised awareness about standards and the need to comply” (*Interview 1*).

“There’s an almost infantile desire to please and follow the Code” (*Interview 6*).

“You get those who genuinely, British Land is a classic example, want to support the Code, they think it is good for business” (*Interview 6*).

“The question now for the RICS is post that road to Damascus, what now happens?” (*Focus Group 1*).

“We’ve got plenty of improvement still to make but we are being praised for a lot of things we’re doing. What happens next year that’s more interesting than what’s happened at this stage” (*Focus Group 2*).

However, there is also a strong view that, whilst improvements have taken place, deteriorating market conditions are responsible for a more conciliatory approach by landlords (*Kingston Study 1*). Accurately distinguishing the precise causal relationships between the Code, market sentiment and landlord and tenant behaviour is nigh on impossible.

Calvert (2008) describes tenant discontent as a central reason for the creation of the Code, though *Interview 6* thinks this tends to distort the way it is approached. Too often, it is presumed to be a retail-dominated Code, and yet it is equally important to other sectors. None of these directly respond to whether the Code has had (a) any, and (b) satisfactory, impact upon practice. However, Calvert (2008: 5) points to surveys that continue to support the argument that tenants remain dissatisfied. Property Industry Alliance and Corenet Global UK (2009) refers to a “service charge satisfaction gap” with far greater weight towards negative experiences than positive. At the same time, Calvert (2008) shows that improvement *has* occurred and the Occupiers Index appears to support this, but this change is tentative and has some examples of regression. Both the secondary evidence and our own primary evidence strongly

supports the contention that change has occurred. The question is whether it is sufficient and long-lasting?

#### **4.5 Accounting for Service Charges: Code Compliance, Practice and Disclosure**

To this point the report has sought to explore the general reasons behind the Code's implementation and perceptions of its impact so far. This next part of the report focuses on exploring how the Code has tackled long-standing problems within accounting for service charge income. The seriousness of these problems were summarised quite effectively in the words of one large corporate tenant:

“The thing I always quote to landlords is that as a corporate we have to publish our year end accounts to the Stock Exchange within six weeks of our initial year end. I tell my accountant clients that two and a half years after [year end] tens of thousands of Pounds worth of service charge can't be reconciled and they find it astonishing” (*Interview 2*).

Even before the Code was implemented, a number of tenants were very vocal in publicly expressing their dissatisfaction with the disclosure levels and transparency of existing service charge certificates (John and Patel 2008). Part of the problem is believed to be that the accounting aspect of service charges and property management is seen as a “very, very low value activity in property management” and the “accounting piece is the piece that gets done at the very end and is the bit that gets left off because...there's nothing else to do” (*Interview 2*). As a result of this, it is hardly surprising that the preparation of service charge budgets accounts is conducted in an untimely, low cost and largely ad hoc manner.

From the interviews conducted for this current work and our analysis of pre-Code and post-Code service charge certificates, it appears that tenants have identified a number of valid concerns with current accounting and disclosure for service charges monies. The remainder of the report discusses these concerns, and provides empirical evidence on the extent and significance of each one. However, before discussing these problems it is important to firstly outline the accounting requirements that must be complied with under the terms of the Code.

#### 4.5.1 The Accounting Requirements of the Code

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

- an annual budget of likely service charge expenditure one month prior to commencement of the service charge year
- certified accounts within four months of the end of the service charge year, that provide a consistent, detailed and comprehensive summary of items of expenditure with full explanations of material variations against the budget.
- narrative explanation and disclosures about significant individual costs and variances from previous year's budget/accounts
- the use of standard cost codes and a clearly defined apportionment basis
- disclosure on interest earned on service charge monies
- disclosure of the calculation basis for any sinking, replacement or reserve fund contribution and the items to which it relates.
- disclosure of contributions to and expenditure from sinking, replacement and reserve funds, together with the opening and closing balances and the amount of interest earned and tax paid in the relevant period.

For the Code, the aim of these accounting disclosures is to promote transparency, as “being transparent both in the accounts and the explanatory the manager will prevent disputes” (RICS 2007a: 9). Despite these accounting requirements being a fundamental part of the Code, it is apparent that there are still fundamental problems with the content, format and presentation of service charge accounts within the UK multi-let office sector. Evidence obtained from our interviews and analysis of actual post-Code service charge budgets and certificates show that many tenants are still dissatisfied with the service charge documentation they receive and that the Code's accounting requirements are not being complied with on a universal basis:

“The whole of the accounting process in property is appalling” (*Interview 2*).

“I have to say that the range of documentation that we get is incredibly mixed. You'll get some people who will give one piece of paper with the budget on it and you will get others who will give you a detailed breakdown. But nine times out of ten, maybe more than that, we have to interrogate it, ask for information, ask for example a staffing breakdown etc” (*Interview 3*).

“I think there is some way to go before it is universally adopted by everyone who is preparing service charge accounts. I think it [compliance] is probably patchy at the moment. Improving but still patchy (*Interview 4*).

“I would liken it to turning a tanker. In an industry that hasn’t been used to providing transparent information, it’s almost counter culture for some people (*Interview 3*).

#### 4.5.2 The Qualitative Characteristics of Service Charge Accounting Information

Seen from the perspective of the end user i.e. the tenant, the Code (together with the terms of the lease) provides a framework that broadly describes the minimum levels of accounting information and disclosures that they can expect from their managing agent and/or landlord. However, what is equally important is to ensure that the accounting data is prepared and presented in a manner that provides *useful* information for the decision making of the tenant. According to the International Accounting Standards Board (IASB), for accounting information to be useful to users it must possess four qualitative characteristics as shown in figure 1.

**Figure 1: The Qualitative Characteristics of Financial Information**

<b>Understandability</b> Should be readily understandable (assumes that users have reasonable knowledge and a willingness to study the information)	<b>Relevance</b> Should be capable of influencing users’ decisions (if information is not <b>material</b> , it is not relevant)	<b>Reliability</b> Should be a complete and faithful representation, neutral and <b>prudent</b>	<b>Comparability</b> Should be timely and prepared on a <b>consistent</b> basis so users can make comparisons
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Adapted from IASB (1989)

As shown in figure 1, **relevance** and **reliability** are the primary characteristics that determine the usefulness of information *content*, whilst **comparability** and **understandability** relate to secondary qualities that govern the *presentation* of the information. All financial information should possess an appropriate ‘balance’ of each of these four characteristics, but should also exhibit an additional ‘threshold’

characteristic of materiality. Material information is information whose omission or misstatement might reasonably be expected to influence the economic decisions of users. If information is deemed to be immaterial, either due to its relatively small size or actual nature, then it should be excluded from the accounts.

Seen through the IASB's framework, it is vital that service charge accounts provide tenants with information that is relevant, reliable, understandable and comparable. From our research, it is evident that the majority of service charge accounts fail to provide information that exhibits an appropriate balance of these essential characteristics. In *all* of our interviews conducted with tenants for this report, concerns were voiced about accounting issues or concerns that effectively questioned the reliability, relevance, comparability and understandability of the content and presentation within service charge accounts.

In order for service charge accounting information to be relevant for a tenant's decision making process, it must be provided on a timely basis and have predictive and confirmatory value. However, as research by Calvert (2008) and this work has discovered, budgets and certificates typically arrive outside of timeframe permitted by the Code (there will be more detailed discussion of this issue below). Furthermore, budgets are typically inaccurate which leave tenants liable for unexpected future balancing charges on their service charge accounts.

The reliability of the information contained in service budgets and certificates is also strongly doubted by most tenants. To be reliable, such information should be free from material error, complete, prudent and a faithful representation of the actual service charge incurred. From the evidence obtained from our interviews with tenants and our analysis of service charge budgets and certificates, in far too many instances commercial service charge accounts contain material errors or inaccuracies, fail to include sufficient narrative explanation and disclosure (especially in terms of the disclosures for the balances of sinking funds and the apportionment basis) and are not signed off by an independent auditor. As a result, the reliability of many service charge accounts is open to question.

From our sample of service charge certificates and budgets, it is also apparent that there is an inconsistent approach to the format, content and presentation used. Whilst landlords or managing agents will obviously use alternative ‘in-house’ styles or formats, each service charge account should, at a minimum, adequately disclose the accounting requirements of the Code in a consistent manner across accounting periods. However, in our analysis of service charge documents from 2004-8, it is apparent that there is little attention paid to the notion of **comparability** when such documents are being prepared.

If comparability levels are to be improved in service charge accounting across the UK multi-let office market, the Code of Practice must provide more prescriptive guidance on the content, format and presentation of each accounting statement and disclosure. In terms of service charge accounts, sections 48-51 of the Code states that they should provide an “adequately detailed and comprehensive summary of items of expenditure, with full explanations of any material variations...against the budget” together with a report providing “a reasonably comprehensive level of detail” about current expenditure and “explanations of significant individual costs” and year-to-year variances (RICS 2007a: 13). The precise meanings of “adequately detailed and comprehensive”, “full explanations”, “reasonably comprehensive level of detail” and “explanations of significant individual costs” are unclear and open to interpretation by landlord, managing agent and tenant, so it is hardly surprising that disputes arise over what service charge accounts should disclose. For example, from a professional accounting perspective an “adequately detailed”, “reasonably comprehensive” and “full explanation” would be seen to require the inclusion of notes to the accounts providing narrative and additional financial disclosures of all material items and variances relevant to the accounts. Unfortunately, additional narrative disclosures and notes to the accounts were seldom in evidence in the service charge accounts that we have examined. This information ‘gap’ requires urgent attention from the RICS, as it is an accounting failure that tenants were extremely concerned about in the interviews and focus groups we conducted.

In terms of a prescribed format for the accounting statements, the Code simply states that the presentation of accounts should be in “reasonably consistent format year-on-year” (ibid: 13). In our opinion, the word “reasonably” should be removed from the



Code in order to enhance comparability levels within UK service charge accounts. As our interviews and analysis of service charge accounts have shown, tenants are being presented with documents that differ in their year-on-year content, format and presentation. Such inconsistencies are especially apparent to tenants where a landlord or management agent changes during the lease even though the Code specifies that “where the owner or managing agent was not responsible for earlier years, they will convert the data into a consistent format for comparison” (ibid: 14). In such situations we have observed, and tenant’s have commented upon, the format, content and even the length of accounting period of the accounts typically change with little to no narrative explanation or detailed disclosure of the impact of the changes. Such inconsistencies clearly hamper the comparability and understandability of the accounts:

“The landlord will change and have a different [accounting] approach. So it’s almost smoke and mirrors type stuff if we’re not careful” (*Interview 4*).

“Our service charge accounting years are constantly changing and therefore it’s almost impossible to analyse accounts because one year it’s nine months and the next year it’s 12 and then they will change the managing agents and their accounting year will be different. I think it would be good if the Code could state that service charge [accounting] periods should not change” (*Interview 2*).

In an effort to promote how its accounting principles can be achieved the Code of Practice provides illustrative examples of a “landlord’s service charge certificate”, “detailed expenditure report” and “expenditure variance report” (see appendices E2-E4 of the Code). These are described as examples of what can be “considered best practice” but they themselves fail to comply with many of the accounting requirements and principles of the Code! For example, the variance report in E4 fails to provide “full explanations of any material variations” as there is no narrative explanation or commentary about the reasons for significant variances in the health, safety and environmental and fabric, repairs & maintenance expenditure. As a second example of poor accounting compliance, neither the service charge certificate nor the detailed expenditure report (see E2-E3) provide an “explanation of significant individual costs” as they fail to disclose the basis for the apportionment of cost and provide no commentary on the nature of the management fee and contract. A final, and perhaps most glaring, failure in accounting compliance shown by the “best practice” appendices in E2-E4 is that none of them provide the required disclosures

for the sinking fund monies. The Code clearly states that “the annual budget and reconciliation accounts will state clearly contributions to and expenditure from the sinking fund together with the account opening and closing balances and the amount of interest earned and tax paid in the relevant period” (RICS 2007a: 15). None of this information is present within the examples of “best practice” accounting in E2-E4. Perhaps such criticisms are unfair, but the Code urgently needs to include detailed examples of Code-compliant accounting and budgetary documents. Such practice is routinely undertaken by accounting standard setters, such as the IASB, as it serves to provide illustrative examples that can be used to encourage a consistent and compliant approach amongst practitioners.

The final characteristic of appropriate service charge accounting information is understandability. Understandability assumes that users of service charge accounts have reasonable knowledge of such issues and have a willingness to study the information provided. Evidence from our focus groups suggests that tenants are sometimes unwilling to study the service charge accounts for many years, and end up continually paying incorrect sums as a result. However, the majority of tenants both understand and use the service charge accounting data, and feel that landlords and managing agents typically treat tenants’ financial queries with disdain:

“You aren’t talking to complete prats. You are talking to people who know numbers and it is truly astounding that in this particular building they’ve got...an administrative assistant being paid £45,000” (Interview 3).

Service charge accounts need to be understandable by tenants, but as highlighted above in the discussion of what makes relevant, reliable and comparable service charge information, many tenants feel that such accounts lack transparency and cannot be understood due to various deficiencies. Whilst it is evident that certain tenants may fail to spend the necessary time studying such accounts, accounting research has shown that accounting statements are typically, but erroneously, seen to convey an objective financial reality that cannot be challenged (Hines 1988). As a result, a tenant may not bother to challenge the accuracy of a service charge certificate, even though it actually presents a reality of service charge expenditure constructed by the accountants and property managers involved in its preparation. Tenants need to expect to question the ‘truth’ of the figures, but they also need understandable data to do so.

### 4.5.3 Timeliness of Service Charge Budgets and Certified Accounts

The Code states that “the manager will issue budgets to occupiers with an explanatory commentary at least one month prior to the start of the service charge year” (RICS 2007a: 5). Table 1 produces a detailed analysis of the timeliness of 112 service charge budgets prepared during 2007 and 2008. The majority of these documents were prepared after the Code came into force on 1 April 2007, and, as a result, should comply with its accounting requirements. Of the 112 service budgets examined for this report, approximately 83% (93 budgets) *failed* to arrive within the time frame permitted by the Code. Furthermore, during the years 2007 and 2008, only 67.4% and 76.8% of budgets arrived within three months of the start of the accounting period, respectfully. These results indicate a fundamental lack of timeliness in the provision of budgetary information, which tenants view as a major source of frustration in terms of their decision making.

Table 1 Timeliness of Accounting Data	2007		2008		Change
	No.	%	No.	%	
Budgets arriving 1 month <i>prior</i> to start of period	3	7.0%	16	23.2%	16.2%
Budgets arriving <i>within</i> 1 month of start of period	22	51.2%	42	60.9%	9.7%
Budgets arriving <i>within</i> 3 months of start of period	29	67.4%	53	76.8%	9.4%
Budgets arriving <i>within</i> 9 months of start of period	38	88.4%	65	94.2%	5.8%
Budgets arriving <i>within</i> 12 months of start of period	40	93.0%	67	97.1%	4.1%
Budgets arriving <i>after</i> 12 months of start of period	3	7.0%	2	2.9%	-4.1%
<b>Total budgets examined</b>	<b>43</b>		<b>69</b>		
Certificates arriving within 4 months of end of period	30	41.7%	11	61.1%	19.4%
Certificate arriving over 4 months <i>after</i> period end	42	58.3%	7	38.9%	-19.4%
<b>Total certificates examined</b>	<b>72</b>		<b>18</b>		

In terms of certified accounts, the Code states that “the owner will submit certified accounting to the occupiers in a timely manner and in any event within four months of the end of the service charge year” (ibid: 13). As the data in Table 1 shows, of the 90 certificates reviewed approximately 45.5% (41 certificates) arrived within the prescribed timeframe. Whilst some of the certificates included within the data for 2007 were prepared before the Code was implemented, all of the data for 2008 should comply with the Code, but as the table shows, 38.9% of the certificates for 2008 failed to arrive in the permitted timeframe.

Our evidence is supported by the findings of Calvert (2008) who found that, for the period from 2004-8, 64% of certificates and 86% of budgets arrived in an untimely fashion. For many tenants, this lack of timely filing was seen as unacceptable and all too common:

“your heart sinks when you get service charge balancing accounts that are three or four years out of date or even longer” (*Interview 4*).

However, there was some evidence that where landlords and managing agents endorse the accounting requirements of the code by “more than just lip service” it has “improved the speed of getting things like certificates and balancing service charges” (*Interview 3*).

While a late certificate clearly hinders its usefulness as ‘relevant’ information for tenant decision making, Calvert (2008: 6) provides evidence that lateness may also indicate problems with the ‘reliability’ of the information contained within the certificate, so tenants “should treat delayed certificates with care, fully investigating the reasons for late arrival as well as the cost breakdown in the certificate”. This point is supported by *Interview 2* where the respondent doubts the reliability of untimely service charge certificates:

“Often when it is out of date the information you receive is extremely poor because nobody can remember what on earth they spent and its very difficult for them to answer questions about it, when you raise queries they are unable to answer them.”

Whatever the reason for the lack of timeliness in supplying service charge documents to tenants, it appears that landlords and managing agents have considerable work to do before they can be said to be in compliance with the Code requirements. Until this happens, the reliability and usefulness of service charge accounts will be greatly hampered.

#### **4.5.4 Budgets Accuracy and the Information Quality of Certified Accounts**

While the timely arrival of a budget is fundamentally important, its accuracy is critical for it to be used as a reliable and relevant source of information for the end user. The Code does not prescribe an acceptable level of budget accuracy but it does specify

that “when significant variances (e.g. of more than 2% above RPI) in actual year-on-year costs against budget are likely, the owner will notify occupiers promptly, within the current service charge year” and best practice is to “confirm the half year forecast on an un-audited basis” (ibid: 9).

The selection of the figure of 2% offers an interesting example of the contested nature of decision-making. At face value it offers certainty and a promise of accuracy in budgets. Certainly, given the disputed nature of service charge calculations discussed in this report, then stating that “due professional diligence”, or some equivalent phrase, should be used when calculating budgets simply would not be acceptable; it would be seen by occupiers as an excuse to continue with pre-Code inaccuracies. But the figure of 2% offers accuracy and keeps the budget estimate ‘honest’. Yet where does this figure of 2% come from? Why not 1% or 3%? Given, for example, the arguments over valuation accuracy, can we even reasonably expect a budget to be within 2% when valuation accuracy is trumpeted by RICS for the fact that less than two thirds are within 10% (RICS 2009h).

Similarly, whilst the addition of the retail prices index (RPI) seems to be fair at first glance, allowing for gradual price inflation within the sums budgeted, this is also not quite as precise as first appears. After all, not every item in the budget is paid for at the end of the 12 month period, and so does not accrue a full year’s inflationary price rise. The figure of RPI itself is a constructed figure subject to what might be described as arbitrary changes of items within its calculation (see for example Duncan 2008), especially given that it is used politically as the measure of UK inflation. More precisely one might question why, for example, the Consumer Prices Index (CPI) was not used. After all, does mortgage interest rate (included in RPI) actually affect most commercial budgets? Or does the generally higher RPI offer even greater wiggle room for budgets to be inaccurate. RPI is typically 1% higher than CPI. In a number of interviews with tenants, disputes with landlords and managing agents over the level of the RPI used within budgetary calculations were common:

“I went to a meeting with the managing agents of this building to discuss the service charge account [and] said “You’ve got an RPI of 7% in there” and obviously I’ve looked at the RPIs and I think it was...I don’t know 1.9% or something. And I said “in your account you’re requesting an on account payment which has got 7% inflation in it, yet inflation is only running at 1.9%.

Explain it to me. I don't understand." And they said "oh well we set this six months ago and at that point we had RPI of...I don't know 3.9% or whatever it was and we've added in a bit extra." And it those sorts of conversations that annoy" (*Interview 3*).

Table 2 provides an analysis of the accuracy of 138 service charge budgets for the years 2007 and 2008. As the table shows budgets were typically inaccurate, with only 15.3% and 14.8% of budgets accurate to within +/- 2% of actual service charge in 2007 and 2008, respectively.

Table 2 Accuracy of Service Charge Budgets	2007		2008		Change
	No.	%	No.	%	
Budgets within +/-2% of actual service charge	17	15.3%	4	14.8%	-0.5%
Budgets exceeding +2% of actual service charge	59	53.2%	14	51.9%	-1.3%
Budgets above -2% of actual service charge	35	31.5%	9	33.3%	1.8%
Budgets 10% or more above actual service charge	40	36.0%	8	29.6%	-6.4%
Budgets 25% or more above actual service charge	24	21.6%	4	14.8%	-6.8%
Budgets 10% or more below actual service charge	18	16.2%	6	22.2%	6.0%
Budgets 25% or more below actual service charge	8	7.2%	2	7.4%	0.2%
<b>Total budgets examined</b>	<b>111</b>		<b>27</b>		

All of the 27 budgets included within the data for 2008 were prepared after the Code was implemented. Of these, 29.6% exceeded 10% of actual service charge and 14.8% exceeded 25% of actual expenditure. Whilst this analysis is currently based upon a limited amount of data, it indicates that many budgets are substantially over charging tenants which has a substantial cash flow impact at a difficult time within the UK economy. As worrying is that 22.2% of 2008 budgets were 10% or more below actual service charge, resulting in tenants having to pay substantial and unexpected balancing charges at the end of the period. A budget should be accurate, free from bias and not suffer from excessive prudence. At present, the majority of service charge budgets fail to embody such qualities and, as a direct result, tenants have to rely on unreliable estimates of future expenditure. Clearly then, the Code needs to provide further guidance on the preparation of these documents.

If a budget is substantially over or under budget, then its information content is useless for tenant decision-making. There may be many reasons for an inaccurate budget, but from our research it was rare for a landlord or managing agent to inform the tenant of unforeseen variances or material errors in a timely manner. Communication is severely lacking on this issue, and indicates another area of poor compliance with the Code, which clearly states that “prompt notification of variances to plans or forecasts ensures better relationships between owners and occupier” (ibid: 9).

Whilst the overall accuracy of budgets is critical, the majority of the budgets examined failed to include a clear defined apportionment basis and were normally issued with virtually no accompanying narrative disclosure of significant items of expenditure or substantial differences from prior years (see section 4.5.2 for an earlier discussion of this problem and its impact on the usefulness of service charge accounting information). If such important details and disclosures were missing from service charge budgets, one would assume that they would be present elsewhere within the service charge accounting documents. The Code states that “an apportionment schedule will be made available to all occupiers showing the total apportionment for each unit within the property/complex” (ibid: 13) but fails to prescribe how this information should be conveyed to tenants. Whilst the apportionment basis may be specified in the lease, it appears logical that a summarised version of the information should be disclosed by way of a note somewhere in the service charge accounts. However, as Table 3 shows, from an analysis of 258 certificates for 2007 and 2008, the majority failed to disclose a clear apportionment basis for service charge expenditure. Only 35.4% and 36.1% of certificates disclosed a clear apportionment basis in 2007 and 2008, respectively.

Table 3: Accounting Compliance Levels Comparative Analysis of Disclosure Metrics	2007		2008		Change
	No.	%	No.	%	
Certificates providing a clear apportionment basis	70	35.4%	22	36.1%	0.7%
<b>Total certificates examined</b>	<b>198</b>		<b>61</b>		
Certificates mentioning a fixed management fee	47	34.6%	19	55.9%	21.3%
<b>Total certificates examined</b>	<b>136</b>		<b>34</b>		
Certificate including interest on service charges	62	31.0%	26	42.6%	11.6%
<b>Total certificates examined</b>	<b>200</b>		<b>61</b>		

The same lack of transparency and disclosure is also apparent for management fees. The Code states that “best practice requires that there will be transparency in the management fee charged” and that the total price for the management service will be “a fixed fee for a reasonable period of time” (ibid: 12) Table 3 highlights that of 136 and 34 certificates for 2007 and 2008, respectively, the majority failed to disclose whether a fixed management fee was being levied. That said, disclosure levels did increase by 21.3% over the period. Whilst the number of certificates in the sample is substantially lower, this is an area where the Code appears to have made significant progress in improving good practice. What we did not test, though, was how the new fee was calculated.

If the above examples are not sufficient evidence of the poor information quality and lack of transparency within most service charge accounts, Table 3 also highlights that only 31% of certificates from 2007 and 42.6% of certificates for 2008 included an amount for the interest earned on service charge monies. This is despite the Code stating that “best practice does require this after making due deduction for tax” (ibid: 16).

Whilst our analysis of the information quality within service accounts is still in progress, the results indicate accounts are failing to comply with the Code’s requirements. This view is supported by the work of Calvert (2008: 7), who additionally found “little evidence that the industry is moving towards the use of the 22 cost codes established as best practice in the RICS Guidance” as 6,511 different



descriptions of service charge cost items were used in service charge accounts for the years 2004-8.

From this evidence, it is hardly surprising that many tenants feel unhappy about the quality of the information within service charge accounts:

“There’s stuff that goes on that you think, how they have the nerve to do it is beyond me” (*Interview 2*).

“You don’t get the sort of clarity required on the expenditure. You get lumps of expenditure that you weren’t expecting, all that sort of clarity is bad practice” (*Interview 4*).

“We’ve been fighting a battle for the last, probably six to eight months, to get the sort of information we need to enable us to say – are we getting a decent deal?” (*Interview 3*).

*Interview 2* provided a definition of what he regarded as poor practice in terms of the provision of both budgets and service charge accounts:

“It [the account] arrives very late, has manifest errors, attempts are made to charge which on a brief reading of the lease will clearly show that they are not entitled to. Poor explanation, if any explanations of variances, very significant ones – you know tens of thousands of Pounds worth of variances, if you asked – what happened – they have no idea” (*Interview 2*).

From an accounting perspective, such fundamental problems threaten the integrity of the whole service charge process, and must be urgently addressed by the whole industry and the RICS. Enhanced communication is key here, but there is little evidence of landlords and management agents responding to tenants’ accounting queries in a timely and detailed manner.

#### **4.5.5 Accounting for Sinking Funds**

As the average lease term is six years and a substantial number are shorter than this (RICS 2009d), it is hardly surprising that owners and occupiers have conflicts in terms of providing monies for the long term maintenance, repair and replacement of plant and equipment. According to the RICS information paper *Sinking Funds, Reserve Funds and Depreciation Charges*, a sinking fund is defined as “a replacement fund where the owner builds up a fund to pay for repair and replacement of major items of plant and equipment” (ibid: 3). From the interviews and data analysis conducted for this report it appears that the use of sinking funds is slowing declining

within the industry, as approximately 10% of the certificates examined contained such funds and “only 10-15% of leases provide for them” (*Interview 6*).

Whilst leases may expressly provide for the creation of a fund referred to as a ‘sinking fund’, this “is not invariably the case” (Rainey et al 2006: 180) and even in the absence of such a provision “on proper construction of the lease, the landlord may be entitled to establish such a fund” (op cit). When a lease makes provision for the establishment of a sinking fund it may do so in general or specific manner:

“Not infrequently the service charge clause in a lease will simply provide for service charges to include an amount towards “future anticipated expenditure”, or some such very general form of words, but sometimes it will be more specific than this, identifying the subject matter of the future anticipated expenditure, for example, “plant and machinery”. (ibid: 184)

Where the lease specifically identifies the subject matter of the expenditure, the fund can only be used for this purpose. Where the terms of the lease are more general, the use of the fund will be a matter of interpretation in each case. Whilst it is beyond the scope of this report to discuss the complicated legalities of the entitlement to create a sinking fund, it is clear that if a landlord wants to create a sinking fund, the lease should be clearly drafted to allow this, otherwise, future landlord-tenant disputes about the fund may arise:

“The trouble is that people use the phrase ‘sinking fund’ and ‘reserve fund’ when they mean the other thing and there’s this confusion over what its called and I think the only way that we as an industry can start moving forward...is to be very, very clear about what we mean by it. If we’re clear about what we intend to create we can give clear instructions on behalf of our clients to the lawyers who can then draft something which actually reflects what we mean and does what it says on the tin rather than leading to a whole big dispute as to precisely what the draftsman intended when he put that fairly woolly wording into the lease” (Forrester 2009a).

During the research, industry representatives have provided examples of sinking fund monies being collected from tenants even when the lease does not allow it:

“There are a lot of issues now where landlords have accumulated funds, where you look at the lease and the lease doesn’t actually allow them necessarily to accumulate the funds for which they think they are holding it. I think it’s more of a matter of encouraging the landlords and saying “look be clear. You may have collected this money and you don’t know why”.... “you may have accumulated this money but from here on in, state very, very clearly why you

have the money. What's it for? You can't keep amassing money into the sinking fund" (*Interview 6*).

"We challenged landlords on the level of contribution towards them and what funds are actually for, and had sinking fund contributions returned to us" (*Interview 4*).

According to the RICS information paper a sinking fund should have a clear policy that states "the purpose to which the accrued monies are being built up" and the landlord should act "reasonably in estimating the amount of contributions due" and "set out the basis for calculating the charge" (*ibid*: 4). This policy should also describe "how the monies will be held, to whose order and how financial matters including interest and tax will be accounted for". Where sinking fund monies are held for many parties, they should be held "in trust" and "protected from any liquidation or financial arrangements" (*op cit*). For the purposes of the information paper, "in trust" means holding the monies in a "designated professional's client account properly named and designated as such and so recognised by the bank where it is held", or in the case of more substantial funds, "there may be a formal trust deeds setting out the arrangements, trustees, etc" (*op cit*).

If sinking funds are held in a formal trust, it creates a specific obligation on the landlord or management agent to do so in an appropriate way as "incautious dealing with service charge funds held on trust or sloppy accounting procedures may mean that the landlord or other person holding the funds finds that he has left himself open to a claim for breach of trust" (Rainey *et al* 2006: 173). The potential consequences are clear, so it is surprising that virtually no landlords or managing agents provide full disclosure about sinking fund monies held or the activities of the trust itself. Whether sinking fund monies are *actually* held in trust is critical to the tax treatment of sinking fund contributions.

"Well, to keep the Revenue quiet they would expect to see a proper trustee, a properly formulated trust" (*Interview 8*).

According to Rainey *et al* (2006), the tax treatment of the fund and its investment income will depend upon the nature of the fund. If the sinking fund is treated as part of the general funds of the landlord it is simply taxed as part of the landlord's Schedule A income, just like any other type of service charge receipts. However, if a trust fund is created "the Inland Revenue treats receipts as capital. Investment income

is chargeable in the hands of the trustee at the special rates applicable to trusts” (ibid: 296). Payments into the trust that are treated as capital receipts in the hands of the trustee should also “be treated as capital payments by the tenants” (op cit). As a result, if a sinking fund trust is created, a commercial tenant should probably refrain from deducting sinking fund contributions from taxable income, although “the application of these provisions depends to a great extent upon the precise drafting of the lease and the nature of the payments made or fund created” (ibid: 295). In terms of the capital allowances earned through expenditure from the sinking fund trust account, these should “be claimed by the landlord and not the tenant as the common areas concerned will be retained by the landlord” (ibid: 296). As landlords are effectively claiming capital allowances from expenditure funded by tenant contributions to the trust fund, this economic benefit should be passed back to the trust in some manner - but it is open to question whether this happens in practice. The Code is unclear on its advice in this area. On the one hand it states that “income derived from the provision of a service or activity, the finance for which is included in the service charge, will be treated as a service charge credit” (RICS 2007a: 17). This would appear to confirm that the economic benefit of capital allowances obtained from sinking fund expenditure should flow back to the tenant in some way. However, the example given by this advice concerns apparently immaterial amounts, such as photocopying and fax reimbursements. It is unclear whether this advice is meant to apply to the tax benefits obtained from expending sinking fund monies held in trust.

From the interviews conducted for this report, it appears that the Inland Revenue is “quite relaxed” about the treatment of sinking fund monies where relatively minor amounts of money are involved, and the issue is “dealt with on a practical basis” (*Interview 7*) as long as the tax treatment of sinking fund contributions is performed in a symmetrical manner by landlords and tenants, i.e. capital allowances are only claimed by one party and the contributions are accounted for in the same manner by the parties. In many cases, sinking fund contributions from tenants are kept in separate bank accounts and simply treated as part of the landlord’s taxable income, and the interest on the fund is taxed at the company rate rather than the trust rate. However, where large sums of sinking fund monies are involved, such as “£1-£5m”, the Inland Revenue is “a bit more attentive” (*Interview 7*) and requires proof that “an

appropriate and symmetrical treatment” is being used in the accounts of the owner and occupier of the building.

What is clear is that specialist advice should be sought on the appropriate tax treatment of sinking fund monies, and that tenants are currently provided with little information about the manner in which landlords and managing agents are treating such monies. Further research is currently being undertaken about this issue.

Section D8 of the Code of Practice sets out a detailed framework of responsibilities for the owner or managing agent responsible for operating a sinking fund. These include the following accounting-related issues:

- Sinking fund monies will be held in an interest-bearing account, held in Trust for the tenants and separate from the owner’s own monies.
- Clear disclosure of the calculation basis for any sinking fund contribution and the items to which it relates, including a realistic assessment of the anticipated life cycle of the item in question and accounting for the funds accumulated from previous service charge periods.
- Disclosure of movements into and out of the fund, together with the opening and closing balances and the amount of interest earned and tax paid in the relevant period.

According to the RICS information paper, a fund should “set out what is being paid and by whom to what purpose, and what happens once that purpose has been achieved” with “residual monies being disbursed to current and former tenants who have contributed to the fund” (ibid: 4). Whilst this appears a logical approach, it is doubtful whether landlords and managing agents currently maintain accounting records as to the amounts which individual tenants have contributed to a sinking fund:

“If the building gets knocked down and there’s a couple of million quid in the fund you need to know who chipped in what to the fund so that you can distribute back the £2 million between all those people. Now I’ll bet that nobody in the room knows a fund where they would know that all the way back. But if you think it through logically, if it goes with the building and its in common in trust amongst everybody, you do need a record all the way back of who paid what and when so that if you do need to give it back you know to whom and in what proportion” (Edwards 2009a).

Another area of importance for the accounting of sinking funds is their legal ownership as this will largely determine their accounting treatment. The ownership of sinking fund monies is frequently disputed by both landlords and tenants, particularly when the original purpose of the fund has been fulfilled. For Forester (2009a), sinking funds should be seen as being held in trust for the joint benefit of owners and occupiers:

“There’s no specific case law on ownership and therefore what we’re saying is that these funds should be considered to be held in trust jointly for the benefit of the owner and occupiers from time to time which means that the building can be sold and the new owner has an interest in the funds that have accumulated and all of the tenants over a succession of leases also have an interest through the trust fund that is created and set up”

This view was disputed by a number of tenants and landlords interviewed for this report, who believed sinking fund monies belonged entirely to the tenant:

“What some landlords seem to forget is that this is actually tenants’ money” (Interview 4).

A representative of one of the largest UK commercial landlords was clear about whom sinking fund monies belonged to:

“We differentiate the funds and know how much is in the fund. As a result, the principal is clear. The funds do not belong to the landlord. We know it doesn’t really belong to us – it is the tenant’s money” (*Interview 7*).

In terms of assessing the relevance and reliability of the current accounting for sinking funds, 88 service charge certificates (9.33% of the 943 checked) and 169 service charge budgets (17.6% of the 960 checked) for the period 2004-8 were found to mention such funds. Table 4 provides a detailed analysis of sinking fund disclosure on the service charge documents for the years 2007 and 2008.

Table 4: Accounting Disclosures for Sinking Funds & RICS Code 22 Forward Funding	2007		2008		Change
	No.	%	No.	%	
Budgets including RICS Code 22 Forward Funding	32		36		
Certificates including RICS Code 22 Forward Funding	20		4		
<b>Total documents examined</b>	<b>52</b>		<b>40</b>		
Certificates deemed to be clearly referring to a "sinking fund"	7	35.0%	2	50.0%	15.0%
Disclosure of balance & movements on sinking fund	0	0.0%	0	0.0%	0.0%
Additional Disclosure for the sinking fund	0	0.0%	0	0.0%	0.0%
Disclosure of interest earned on sinking fund	0	0.0%	0	0.0%	0.0%
<b>Total certificates examined</b>	<b>20</b>		<b>4</b>		

From both our longitudinal and year by year analysis of service charge documents it is apparent that where a certificate ‘appears’ to include contributions to a sinking fund, levels of disclosure range from poor to non-existent, evidence that was supported by the views expressed by tenants during the interviews. The typical tenant perspective of the accounting disclosures for sinking funds can be summed up by the following quotes:

“The level of disclosure is appalling. In fact the whole of the accounting process in property is appalling” (*Interview 2*).

“I don’t think there’s openness on this at all” (*Interview 3*).

“We don’t even know sometimes what’s in the fund. There is limited transparency. I mean in reality, to my mind, you should almost have a bank account statement in terms of –this is what’s in it, these are the withdrawals, this is the input, this is the output, this is why we spent it and oh, by the way, this is where we put the money” (*Interview 4*).

“I know sinking funds that never went when there was a sale and I know a property that was sold to deliberately strip a sinking fund out of it. I think our track record as an industry on sinking funds is not good” (*Interview 6*).

As damning in an accounting sense was that in many instances it proved impossible to conclusively ascertain whether contributions were made to a sinking fund rather than some other form of “forward funding” under RICS cost code heading c22, such as a depreciation fund or reserve fund (see appendix E1 of RICS 2007a for full details). Of the 24 certificates examined for the years 2007 and 2008, it was only possible to definitively identify the existence of a sinking fund 37.5% of the time. In total, 52 and 40 various service charge documents were analysed for 2007 and 2008, respectively,

and the forward funding amounts included were variably described as contributions to “sinking funds”, “contingency funds” “reserve funds”, “plant replacement funds”, “depreciation funds” or simply as a “transfer to reserves”. Whilst the definitions of a “sinking fund”, “depreciation fund” and “reserve fund” are clearly defined in an RICS information paper (RICS 2009d), it proved virtually impossible to uniquely ascertain the intention for many forward funding contributions, as the majority were included with no accompanying notes or additional narrative disclosure to explain their purpose. This evidence is especially alarming as the Code states that “care should be taken not to confuse sinking and reserve funds” (RICS 2007a: 28).

Despite reviewing the history of the disclosure on sinking, depreciation and reserve funds in the period both prior to and post implementation of the Code of Practice, there was no evidence of increased transparency or disclosure with regard to any of these funds in certificates or budgets. Of the 92 documents analysed for 2007 and 2008, not one certificate, budget or account formally disclosed whether sinking fund monies were being held in trust in a separate bank account or identified who the trustees actually were. This is a key omission and is critical for tenant understanding of the tax treatment and security of the said monies:

“There’s a shed load of money in some account somewhere, in theory for the benefit of that building and the tenants within that building, the tenants has paid over in good faith, that the tenants know nothing about or very little about it anyway” (*Interview 3*).

“I think there are clear questions of fraud of behalf of landlords in so far as we have asked “where is this sinking fund money that you have been collecting over the last ten years?”. “Ah, spent that” [is the answer from the landlord]. “Not on this building you haven’t,” and you know we queried it and the first thing we had was a letter from the lawyer. And we said “I’m sure you’ll understand, we’re not going to pay the service charge because we think you’ve run away with our client’s money and we’re not going to pay anymore until we get a result”” (*Interview 6*).

In no instance was the current balance or movements on a sinking fund disclosed on the certificate, and only two certificates disclosed even limited information about the specific items that a fund was intended to cover. As a result, service charge accounts are failing to comply with the Code’s requirements. Furthermore they are failing to supply tenants with relevant and reliable accounting information for decision-making.



During a number of interviews, respondents acknowledged examples of poor landlord practice regarding the use and disclosure of sinking fund monies:

“There is great disparity in openness about sinking funds” (*Interview 2*).

“We have a landlord where the sinking fund that’s been built up over the last seven years is over £3 million. Every year, when you ask “how much is the sinking fund?”, you’re given a different figure” (*Interview 3*).

“I know one landlord and he’s sitting on £4.5 million worth of sinking fund and as much goes into it every year as comes out of it every year. This building is likely to be redeveloped fairly soon, so what happens to the £4.5 million that he’s sitting on? Why are they holding £4.5 million? They don’t know. Is it for the lifts? Well they were done last year so why are you holding £4.5 million? They don’t know, which is clearly a ludicrous situation” (*Interview 6*).

More fundamentally, no certificate mentioned whether interest or investment income was being received on the sinking fund monies and how this income was being taxed and distributed. This lack of transparency on the investment returns generated on the sinking fund is an issue for many tenants:

“If you start on the premise that we don’t even know how much the sinking is, we’re never going to know what the interest is are we?” (*Interview 4*).

“When we ask if interest is being put onto the sinking fund, they [the landlord] will say, well, you’ll have 15 different answers – “it is put on it, its not put on to it, it is in a trust vehicle or an Escrow account or whatever, yes, no, maybe”. If we ask to see the account: “oh I’ll have to get back to you on that one” is the reply” (*Interview 3*).

In the interviews and focus groups conducted for this report it appears that many tenants deliberately avoid leases that include the requirement for contributions to a sinking fund:

“You wouldn’t believe what goes on in that area. I mean it is frightening. It’s one of the reasons we fight against them all over the place and in fact we don’t have that many because I don’t agree to sign a lease where they are in there” (*Interview 3*).

Such tenant aversion towards making contributions to sinking funds is hardly surprising given our evidence that the Code of Practice accounting requirements for such monies are currently being ignored. Furthermore, one large corporate tenant commented that landlords can be frightened away from collecting the sinking fund

monies by questioning the manner in which such monies will be accounting for and how the funds will be utilised:

“Very rarely, I would suggest do landlords endeavour to collect sinking fund monies. You only need to ask them how they’re going to account for the money and the tax on the interest that’s going to have to be paid and they usually run a mile” (*Interview 2*).

To summarise then, the treatment of sinking fund monies by the landlord or management agent has important implications for the tax treatment of payments into the sinking fund for both landlord and tenants alike. Without adequate disclosure by the landlord or managing agent concerning the treatment and use of sinking fund monies within service charge accounts, it is impossible for tenants to make informed decision about their significance and impact. Quite clearly, it is apparent that levels of Code compliance on sinking funds is virtually nil and requires considerable attention within the industry. Furthermore, the Code needs to include a specific requirement for certified accounts to include disclosures on the nature of the sinking fund trust and its trustee, together with a statement of the tax treatment of fund contributions and expenditure, if material amounts.

#### **4.5.6 The Sign off Process for Service Charge Accounts**

The analysis so far has identified a number of problems with present service charge accounts. Perhaps surprisingly, there is no best practice requirement within the Code for service charge accounts to undergo scrutiny via independent audit. All this Code states is that “**If** the account is certified by an auditor, such costs will be charged to the service charge account” and “**If** an occupier requests an independent audit, the owner will agree and the audit fee will be charged to the occupier” (RICS 2007a: 14, our emphasis added). The Code takes no view on whether the entire process should be documented by independent audit into whether the records provide a ‘true and fair view’ of the costs incurred and relevant accounting policies have been followed. Obviously cost is a consideration, but our findings suggest that tenants would willingly pay for such a service given the certainties it would offer them over the whole service charge process. Some suggest that paying an auditor would more than pay for itself since they mistrust the current system so much. They would also be saved the expense of continually requiring the landlord to provide more information. Given the financial importance of service charges, it seems obvious that there is a

need to show that the service charge accounts provide a true and fair view of the financial records, their lease compliance, and Code compliance (except where this deviates from the lease).

Of the service charge certificates examined for this report for 2007 and 2008, there was a noticeable variation in the certification and sign off procedure for service charge accounts. This was 'worrying' from a tenants' perspective as many certificates did not appear to be signed off at all, some were signed off by managing agents or the landlord's surveyor, some were signed off by firms of accountants and some were jointly signed off by an accountant and managing agent. In addition, the wording of the opinions attached to such signatures varied considerably, ranging from statements such as "the above figures have been independently checked and verified by", a statement made by a landlord's surveyor, to "I hereby certify that, according to the information available to me, the attached...records the true cost to the landlord of providing the services to the Property...in accordance with the lease", a statement made by an 'accounting services' firm. This evidence helps to reinforce the doubts expressed by tenants about the quality and accuracy of the service charge information they receive. It also indicates a need for the Code of Practice to include some form of 'pro-forma' statement of opinion that a certificate should include, with specific sign off obligations on behalf of both management agents and auditors. This would then clearly establish who is responsible for ensuring that the service charge is in accordance with the lease, and that charges are fairly incurred as two separate audited processes.

Tenants voiced concerns consistently over issues of value for money and the transparency of the process. Notwithstanding the various problems discussed within this report, it would seem that benchmarking performance and standardising presentation would greatly assist the process of transparency. Where agents sign off on clearly outlined performance indicators and obligations, improved governance ought to follow. However, once again the Code's example (schedule E2) in helping the parties to develop best practice is problematic. Appendix C includes model sign-off statements and obligations for the independent auditor, managing agent and a third party verification of the duty of care owed to tenants, which includes an opinion on value for money.

#### **4.5.7 Summary of the Accounting Issues**

In summary, whilst our research to date highlights similar concerns raised elsewhere about the low level of compliance with the Code of Practice, it highlights specific accounting shortcomings that plague service charge accounting. While the Code of Practice provides much needed direction on the preparation of service budgets and accounts, its accounting guidance often uses vague and imprecise wording and fails to provide detailed examples of fully compliant accounting documents. Despite the Code's inherent limitations, its accounting guidance does provide landlords (owners) and managing agents with a 'basic' framework for improving the content, format and presentation of service charge accounts. However, empirical evidence contained within this report suggests that landlords and managing agents appear to be failing in their professional duty to provide "best practice" service charge accounts. Since 1 April 2007 the quality of service charge accounts has failed to improve in a number of key accounting areas, hampering the usefulness of these documents for tenant decision-making.

### **5.0 Conclusions**

It is possible to engage in two forms of concluding remarks to this analysis. First, there are conclusions that can be derived directly from the evidence that we have created here. Second, there are speculations, which we shall infer from the evidence, but lack the same concrete certainty.

#### **5.1 Final Analysis**

There is no doubt that all parties, at least formally, accept that the pre-Code situation was unacceptable. Of course, this does raise the question as to why it then took so long to resolve. Whilst our respondents offered no consistent explanation over the pre-Code position, this is probably to be expected. As professionals operating in the field, they are obviously more interested in the existing situation as they find it on a daily basis than engaging in a discourse to explain how we ended up here.

The Code of Practice is a RICS guidance note and consequently is expected practice from its members. The fact that it is also endorsed by owner and occupier associations reinforces this expectation of its adoption. However, does the evidence support this supposition? The evidence suggests not, or, at least, that implementation has been patchy with some improvements, but also regression, over the last year.

One interviewee described the Code as “aspirational”, but the rules are in reality very straightforward governance issues. Whilst “bad tenant practices” (another interviewee) coupled with the way in which some managing agents are employed do contribute to the problem, the fact remains that the preparation of a ‘code-compliant’ set of service charge accounts is far from difficult. In the specific examples of accounting practice covered here, there are serious issues that need attention.

Since the RICS has created a Code of Practice, it follows that it ought to monitor it for compliance and whether it is successful. After all, if the Code is not followed then why implement it, as one tenant asked. Similarly, RICS needs to provide further detailed direction and specification within the Code on the format and content of service charge accounting information. The information papers provide a start, but more, and with greater detail, are needed. Whilst it is not mandatory, RICS members are being potentially disadvantaged in law should the Code not be fit for its purpose since RICS states in the preface to all its Guidance Notes that the Courts will expect compliance. Therefore, the Code has to work, and work well.

## **5.2 Speculation**

The obvious response to the wider situation with leases and the management of service charge is the adoption of an all-inclusive rent. This is economically rational and avoids the need for any discussion or managerial action. It is also the position suggested by the RICS Roadshow, or at least one speaker there (King 2009). Of course, this would then create different problems to resolve.

The issue of the need for statutory regulation remains a highly divisive issue. Jin and Tsourikova (2009) suggest that there is a strong appetite for legislation within sections of the market. Our evidence is far less conclusive. At the least, the RICS Roadshow

on service charges is, at least in part, an exercise in rallying chartered surveyors to the Code in order to avoid the need for such government intervention (see for example Edwards 2009a). There is also a wider trend within the property industry to 'badge' competency and offer non-statutory evaluation of competence, regulation, and fee-free arbitration and resolution. This includes both professional and trade associations; for example BPF's Commercial Landlords Accreditation Scheme (CLS) accreditation scheme for landlords (Jansen 2007). What is more, even where these schemes fail or are only partially successful, there is a commitment to 'try, try and try again': CLS was launched in 1995 and again in 2002 prior to 2007, for example. Constructing a formalised professional register through best practice and eventual institutional regulation and enforcement seems a plausible outcome for service charge management. It satisfies all demands for accountability and fairness, whilst protecting consumers of the service without cost to government. Conforming practices will be distinguished from their 'cowboy' competitors and a charter, kite or 'safety' mark will become accepted as the sign of these, as with so many goods and services these days. There is a clear message to be developed from this: adopt the Code and modern best practice techniques, and be 'badged' as competent - or lose clients.

## **Appendix A: Empirical Evidence**

The following respondents were interviewed. A short synopsis of the individual and their company is offered to allow the value of their opinions to be evaluated. It was decided to interview only senior professionals in the field. The difficulty of obtaining interviews and the resulting restricted number of interviews was thought to outweigh the simple desire to produce a mass of data. These interviews, on average of one and a half hours in duration, offer a high quality opinion based upon extensive and rounded experience. Note that the wording of the description is taken from each business' own descriptions.

Interview 1: Director of one of the UK's largest REITs.

Interview 2: 'Group Property Manager' of an international retail financial services company.

Interview 3: 'Corporate Development Director' of the world's largest provider of outsourced workplaces.

Interview 4: A senior chartered surveyor for an investment and services company with assets of £4 billion.

Interview 5: Managing Director of the UK's leading commercial service charge consultancy.

Interview 6: Director of one of the leading real estate advisors in the world.

Interview 7: 'Corporate Taxation Executive' for one of the UK's largest REITs.

Interview 8: Independent taxation consultant and visiting lecturer to two London universities.

Interview 9: Director of a taxation consultancy.

Interview 10: Accountant dealing in taxation with a large accountancy consultancy practice.

Interview 11: A national taxation expert, currently head of department at a UK university.

Additionally, focus groups were run with a number of interested parties. The focus group is not an ideal research vehicle since it is difficult to control. Structuring interviews allows for comparison, but the very nature of the focus group is anarchic and individual. However, it does allow researchers to draw out themes and establish a

basis for further study. These groups were used to obtain ideas that we later developed upon, and to test our preliminary findings out to a panel of selected experts for their opinions and views.

Focus Group 1: Bristol, in the offices of a service charge agent.

Focus Group 2: Kingston University, to invited individuals from commercial practice.

Focus Group 3: Kingston University, to selected academic participants.

Finally, we utilised a student project to obtain views upon the issue. This work utilised 21 completed questionnaires (from a sample of 60) and 6 semi-structured interviews. The advantage in utilising students to carry out work is that it generates more evidence. The downside, of course, is that it removes direct control of the work from the researchers and relinquishes some interpretation to a third party, albeit one under supervision.

Kingston Study 1: supervised postgraduate work.

## **Appendix B: Other data**

RICS *Commercial Property Management Roadshow*, Bristol, 19 March 2009:

Chris Edwards (MD, Commercial Property Advisors Ltd)

Peter Forrester (Director, Savills)

Vivian King (consultant, Bond Pearce)

RICS Conferences: *Capital Allowances – Back to Basics*, London, 25 March, 2009

RICS *Commercial Property Management Roadshow*, London, 6 May 2009:

Chris Edwards (MD, Commercial Property Advisors Ltd)

Peter Forrester (Director, Savills)

Vivian King (consultant, Bond Pearce)

Henry Stewart Conference Studies: *The Corporate Real Estate Executive's Contribution to Improved P&L Figures and Shareholder Value*, London, 23 October 2009



## Appendix C: Model “Sign-off” Statements for a Service Charge Certificate

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### Service Charge Certificate

Certification Period: 1 January to 31 December 2008



**Landlord:**  
**Managing Agent:**  
**Tenant:**  
**Building:**

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#### Independent Auditors ' Report to the Tenants of (building)

We have audited the service charge certificate on behalf of.... (Managing Agent).....for the year ended 31 December 2009.

We report to you our opinion as to whether the service charge certificate gives a true and fair view of the costs incurred and whether it has been prepared in accordance with relevant accounting policies.

In addition, we report to you if, in our opinion, the Managing Agent has not kept proper accounting records, if we have not received all of the information and explanations we require for our audit, or if details of other transactions are not disclosed.

#### Basis of Audit Opinion

An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the service charge certificate. It also includes an assessment of the significant estimates and judgements made by the Managing Agents in the preparation of the certificate and whether the policies adopted are appropriate to the circumstances of the building, consistently applied and adequately disclosed.

We planned and performed our audit 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 certificate is free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of the certificate.

#### Opinion

In our opinion:

- the service charge certificate gives a true and fair view of the costs incurred at ..... during the year ended 31 December 2008
- the information provided is consistent with the amounts contained in the service charge certificate

Signed

.....  
A N Accountant  
Service Charge Accountant  
For and on behalf of Property Solutions (UK) Limited

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## **Service Charge Certificate**

**Certification Period: 1 January to 31 December 2008**



**Landlord:**  
**Managing Agent:**  
**Tenant:**  
**Building:**

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### **The Managing Agent's Obligations**

In order for the Managing Agent to confirm that these statements are a true and fair reflection of the transactions that have taken place during the period, they are required to:

- a) select suitable accounting policies and apply them consistently;
- b) make judgements and estimates that are reasonable and prudent;
- c) prepare the service charge certificate on a 'going concern' basis (unless it is inappropriate to presume that the Landlord will continue to trade these premises in the near future);
- d) Ensure that the service charge costs are recovered in accordance with the terms of the lease

The Managing Agents are responsible for keeping proper accounting records, which disclose with reasonable accuracy at any time the financial position at the property.

### **Managing Agent's Statement of Compliance**

(MA's firm)... are the Managing Agent's responsible for the production of the service charge certificate for the year ended 31 December 2008 in respect of.....(building)....

I can confirm that this service charge certificate has been produced in compliance with the terms set out in the lease (see appendix 1) and, where this does not deviate from the lease, in accordance with the RICS Service Charge Code of Practice.

I hereby certify that, according the information available to me, the attached statement of service charge expenditure records the true cost to the landlord of providing the services to the property for the period.

Signed

.....

A N Agent

Managing Agent

For and on behalf of Managing Agents (UK) Limited

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## **Service Charge Certificate**

**Certification Period: 1 January to 31 December 2008**



**Landlord:**  
**Managing Agent:**  
**Tenant:**  
**Building:**

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### **Third Party Verification**

In accordance with the RICS Code of Practice, both the Landlord and the Managing Agent are required to recognise a duty of care to occupiers, *'who entrust the spending of their own business overhead and cash flow by funding the services'*.

Further, The Code requires that:

- a) *'Occupiers have the right to reasonably challenge the propriety of expenditure'*;
- b) *'The owner will ensure that standards of services provided are monitored, that the quality and cost of the services provided are regularly reviewed and, where possible, demonstrate that service standards are being delivered and value for money is being obtained'*;
- c) *'Owners will operate sound management procedures to ensure the respective obligations of owner and occupier are discharged and services are provided efficiently and economically'*;
- d) *'The owners will inform occupiers of the plans for the property in so far as they have an implication on the service charge'*
- e) *'On-site management staff need to have a sound knowledge of modern business practices and be adequately skilled to provide best and agreed performance standards'*.

Services should be commercially and professionally procured, with regard to the requirements of property, the Landlord and the Tenants.

The principal aim of the Agent is to manage the building on behalf of the Landlord, whilst ensuring value for money and effectiveness for the Tenants.

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### **'Value-for-Money' Statement of Compliance**

(MA's firm)... are the Managing Agent's responsible for the production of the service charge certificate for the year ended 31 December 2008 in respect of.....(building)....

We have analysed the certificate to ensure that, as far as is reasonably possible, the Agent has adhered to the provisions of the Code outlined above and can demonstrate that the building has been managed to an appropriate standard of economy, efficiency and effectiveness.

I therefore certify that the services procured at this building are:

- a) Appropriate for the location, use and character of the building;
- b) Of an appropriate quality standard; and
- c) Value for money and cost effective for the Tenants

Please note that, where there has been a deviation from the Code, we have enquired as to the rationale for such deviation and made reference to it in our findings at the back of this report.

We are satisfied that any deviation from the Code is either appropriate for the circumstances, or in accordance with the lease provisions and therefore gives us no reason to qualify this audit.

Signed

.....

For and on behalf of Property Solutions (UK) Limited

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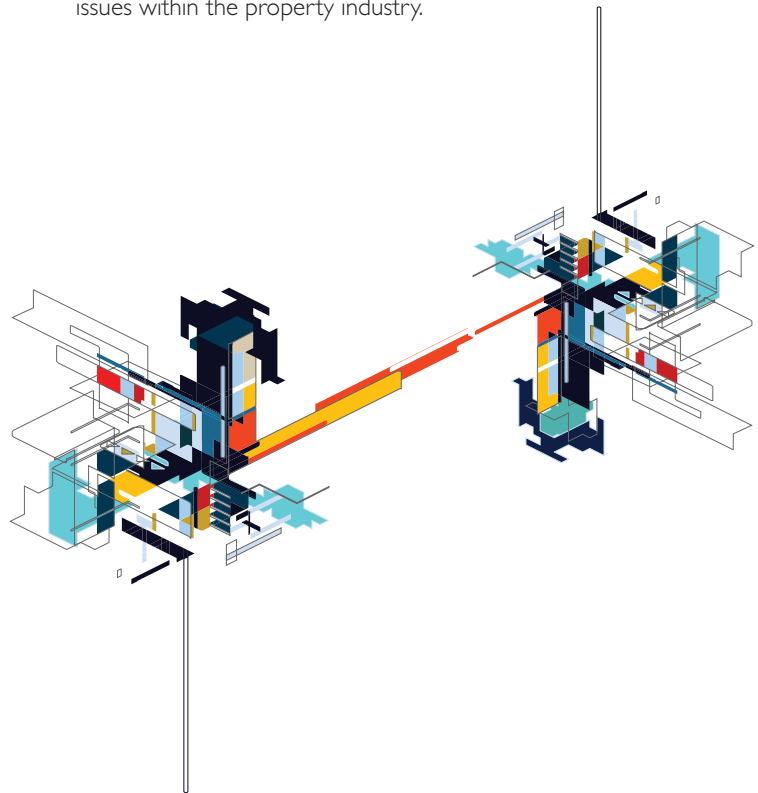
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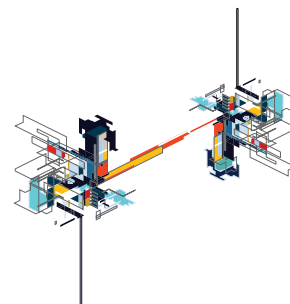
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