A conceptual framework for enhancing 'effectiveness' in the service charge process

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ABSTRACT The RICS Code of Practice for Service Charges in Commercial Property provides *inter alia* best practice guidance on the provision of data to tenants. Developing a conceptual framework concerning the use of these data allows surveyors acting as managing agents to follow four key drivers in creating budgets and final accounts: understandability, relevance, reliability and comparability. The article provides surveyors acting as managing agents (and others providing service charge budgets and accounts) an overview of what they should seek to achieve from the provision of their data in terms of tenants' understanding of the information, its reliability and its comparability across properties and years.

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INTRODUCTION

This article concerns surveyors acting as managing agents for landlords. When a tenant signs a lease and agrees to pay service charges to a landlord or a landlord's managing agent (surveyor), there is an implicit understanding that the service charge process will be managed in a transparent and 'effective' manner. As a result of this, a commercial tenant should expect that any service charge demand for payment will be prepared by the surveyor in compliance with the provisions of the lease, the UK legal framework, relevant taxation rules and the RICS Code of Practice on Service Charges (unless doing so conflicts with the terms of the lease). Additionally, surveyors need to be aware of widespread dissatisfaction from tenants in the current levels of service and that RICS is looking into the issue as part of its wider Transparency Working Group initiative (see, for example, RICS, 2009).

Surveyors preparing budgets and final accounts need to follow best practice, and not simply from within one particular occupational paradigm. Neither landlords nor tenants are inherently interested in RICS or the chartered surveying profession as an abstract conception. What they require is a quality, value for money service, and if chartered surveyors cannot provide it, then others will. There is an agreed requirement for transparency in the service charge process, but the question for practitioners is how to establish and, as important, validate this. Validation would not only provide data required, but also certify this to tenants – and potential future employers. The argument within this article is that service charge budgets, certified accounts and accounting disclosures prepared by the landlord or managing agent-surveyor for the tenant should be prepared to a quality standard in order to provide a ‘true and fair’ view of periodic service charge transactions. This will not only provide appropriate data, but also allow the practitioner to utilise this as a means of establishing fee charges. The Code prohibits fees to be charged on a simple *pro rata* or percentage basis.

As Figure 1 illustrates, if appropriate methods are followed, then tenants should be provided with ‘useful’ service charge information for management decision making. Surveyors are expected to perform all these functions in their role as managing agent, but what this article argues is the imperative, about *how* these are done. Once complete, the landlord or managing agent should ‘sign off’ against the accounting records to state that they have fulfilled their obligations and duty of care to the tenants and that the accounts and relevant disclosures provide a ‘true and fair’ record of service charge expenditure over the accounting period. Finally, managing agent-surveyors can also increasingly expect the service charge accounts to undergo an independent financial audit and/or third-party verification of the ‘value for money’ offered to tenants. By understanding the nature and requirements of the data, this then can be done with confidence.

Taken together, these elements in the service charge process provide a conceptual framework governing service charges, as, in their totality, they guarantee the ‘effectiveness’ of the entire service charge process. For the managing agent, this

Figure 1: Managing the service charge process: The conceptual framework for accounting practice, compliance and disclosure.

potentially requires a paradigm shift in their role; formalising the preparation of these data requires the surveyor to follow something close to the principles of another profession, that of accounting. Figure 1 illustrates this conceptual framework, which involves compliance with statutory and case law, the lease and the Code, but also the adoption of appropriate systems to be able to account for all service charge monies. If each element is followed, the tenant will be provided with appropriate accounting disclosure, content, presentation and transparency. Furthermore, the framework should provide enhanced levels of communication and fewer disputes between landlord, managing agent and tenant.

Although it appears that the framework is for the ultimate benefit of tenants, it must be remembered that landlords increasingly see Code compliance and high levels of occupier satisfaction as a source of competitive advantage in the marketplace. Disputes with tenants are costly in terms of time and management resources, so it is in the best interests of a landlord to use 'best practice' when providing tenants with service charge accounting information. Equally, best practice in providing a management service can be a competitive advantage and premium fee characteristic for surveyors acting as managing agents. In any event, compliance with the RICS Code of Practice launched in April 2007 is going to become an ever greater requirement for chartered surveyors. Not only is it becoming a feature of professional life, but it is also a central aspect within the conceptual framework shown in Figure 1. This provides specific guidance on elements within the conceptual framework, which chartered surveyors are expected to adopt.

PREPARING DATA: THE REQUIREMENTS OF THE CODE

In terms of how surveyors must prepare data, there is a focus within the Code upon the need to 'account' for expenditure. The Code of Practice outlines a number of general principles and requirements for the preparation of the accounting and associated narrative disclosures for service charge monies, including the provision of

- an annual budget of likely service charge expenditure 1 month before commencement of the service charge year;
- certified accounts within 4 months of the end of the service charge year, which 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, 2007, p. 9). For the managing agent-surveyor, the Code is in effect requiring that service charge accounts are dealt with in a formalised accounting system. It is important to examine what the Code is actually inferring about the use of these data

in order to understand why this is so important. This interpretation can be explained through an examination of the qualitative characteristics of the data.

THE QUALITATIVE CHARACTERISTICS OF INFORMATION WITHIN THE SERVICE CHARGE ACCOUNTS

Seen from the perspective of the end user, that is the tenant, the Code (together with the terms of the lease) provides a framework that broadly describes the minimum acceptable levels of information and disclosures that they can expect from their managing agent and/or landlord. However, what is equally important is to ensure that these data are prepared and presented in a manner that provides *useful* information for the decision making of the tenant. Rather than reinvent the wheel, a very useful examination of this can be found in the International Accounting Standards Board (IASB) elucidation upon what makes accounting information useful to users (IASB, 1989). In this context, the surveyor is the accounts preparer and the tenant is the user.

According to the IASB, accounting data is only useful to users of accounts if it possesses the four qualitative characteristics shown in figure 2. Thus, service charge accounting information must embody these four characteristics if it is to provide a tenant with decision-relevant data.

As shown in Figure 2, *relevance and reliability* are the primary characteristics that determine the usefulness of information *content*, while *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 owing to its relatively small size or actual nature, then it should be excluded.

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 existing research in the area (Eccles and Holt, 2009), it is evident that the majority of service charge accounts fail to provide information that exhibits an appropriate balance of these essential characteristics. Tenants voiced concerns within that work (Eccles and Holt, 2009) about the reliability, relevance, comparability and understandability of the content and presentation of their service charge accounts. Hence, this article suggests that in order to help remedy this state of affairs, surveyors acting as managing agents consider the provision of service charge data from these first principles.

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

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

Figure 2: The qualitative characteristics of financial information.

confirmatory value. Tenants should not find themselves liable for unexpected future balancing charges on their service charge accounts, nor should they have to pay heavily over-budgeted service charge demands.

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. Additionally, the accounts should include sufficient narrative explanation and disclosure (especially in terms of the disclosures for the balances of sinking funds and the apportionment basis) to enable tenants to make reliable judgements from and upon them. Ideally, this should be confirmed and signed off by an independent auditor. This would ensure that the reliability of service charge accounts is not open to question.

There needs to be a consistent approach to the format, content and presentation used in the accounts. While 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. Attention must be paid to the notion of *comparability* when such documents are being prepared.

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. Tenants should be expected to understand and use the service charge accounting data, and landlords need to allow for this by providing complete data.

While it is important that service charge accounts need to be understandable by tenants, all the parties also need to realise the nature of any financial data. Because it concerns numbers, users might presume that it is producing certainty. In reality, service charge data are only an interpretation of what has happened, rather than a definite reality itself. Personal judgement goes into creating any set of service charge accounts. This explains the need for transparency and additional disclosures where possible. However, any set of financial data needs to be understood as an interpretation, albeit a fair one. 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 surveyor involved in its preparation. Tenants need to expect to question the 'truth' of the figures, but they also need understandable data to do so. Surveyors acting as managing agents need to respond positively to this, rather than see it as a criticism. However, by understanding the qualitative characteristics of data, the managing agent-surveyor is establishing their credibility as the honest broker in their management of the service charge.

THE EXISTING CODE'S REPORTING REQUIREMENTS

The Code of Practice does outline the general requirements for service charge accounting statements and budgets, but it also fails to provide detailed and comprehensive prescriptions and examples of the exact content and presentation that each accounting statement and associated disclosure should embody. While following the Code, the managing agent-surveyor is advised to consider how to present their charging data very carefully.

In terms of service charge budgets and 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, 2007, p. 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-surveyor 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 are seldom in evidence in service charge accounts (Eccles and Holt, 2009). Managing agent-surveyors are advised to remedy this in future.

In terms of a prescribed format for the accounting statements, the Code simply states that the presentation of accounts should be in a 'reasonably consistent format year-on-year' (RICS, 2007, p. 13). The word 'reasonably' should be noted. It is not acceptable to present documents that differ drastically in terms of their year-on-year content, format and presentation. This is especially so where a landlord or managing agent changes during the lease term. Surveyors taking over new clients should take particular note of this. 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, p. 14). The format, content and length of accounting period of the accounts cannot change with little to no narrative explanation or detailed disclosure of the impact of the changes. Such inconsistencies would clearly hamper the comparability and understandability of the accounts.

In an effort to promote how its accounting requirements can be achieved, the Code of Practice does provide 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'. However, they should be used with caution. 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 and 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 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, 2007, p. 15). None of this information is present within the examples of 'best practice' accounting in E2 – E4. Although the examples are an incremental step in the right direction, the Code urgently needs to include better detailed examples of Code-compliant accounting and budgetary statements, together with exhibits of the necessary explanatory disclosures and notes. 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 among practitioners. Without such examples, surveyors acting as managing agents are urged to utilise a conceptual framework and, by understanding the use made by tenants of the data, provide transparent service charge data.

CONCLUSION

Tenants have a right to expect useful information for decision making within the service charge data they are provided with. This places specific obligations upon the landlord or managing agent. If the landlord or managing agent fails to discharge these obligations in an appropriate manner, the resulting service charge data will be inaccurate and misleading, and certainly not provide a 'true and fair' view of service charge transactions. This article has described a conceptual framework for an 'effective' service charge process that ultimately influences the content and presentation of service charge data. Surveyors acting as managing agents are urged to engage with this in order not only to assist tenants, but also to render competitive advantage to themselves and their employers. While chartered surveyors are expected to follow the Code of Practice, others are not. However, rather than regard this as a disadvantage, the surveying profession will need to engage with modernising the service charge process at some point. Too much money is at stake, and too much is paid out by tenants in charges for this issue not to be increasingly questioned in future years. And although service charge managing agent is often seen as a 'Cinderella' part of the profession, that, too, will change. Engaging with preparing transparent data benefits everyone. Tenants have greater control over their finances, landlords have happier tenants and fewer disputes. As for the surveyor, they bring this about and can expect to reap a financial return as a reward. If this seems overly idealistic, the alternative is that the profession is likely to face fiercer complaints from ever more powerful tenants, government involvement and greater competition from other occupations. After all, if this is an article to the surveying profession, it could equally be one to an accounting profession looking for new markets.

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