

The Service Charge Code

A guide to the second edition of the RICS Code of Practice for Service Charges in Commercial Property

The second edition of the RICS Code of Practice for Service Charges in Commercial Property will come into effect on 1 October 2011. As with the first edition, it has the status of a guidance note and represents best practice. Its use is not mandatory but its contents may be taken into account in determining whether a practitioner has acted negligently. This guide summarises the main provisions of the code and uses practical examples to illustrate how it may be applied in practice.

The Core Principles

The code comprises a list of core principles supported by detailed guidance setting out recommended best practice. The core principles may be summarised as follows:

Service costs

- Services should be procured on a value for money basis using competitive quotations or cost benchmarking.
- Owners should not profit from the provision of services.
- Costs are to be transparent so all parties know how they are made up and management fees should be on a fixed price basis.

Apportionments

- The method of apportionment should be fair and reasonable and reflect the availability, benefit and use of services.
- Full details of apportionments should be available to all occupiers.

Communication and consultation

- Managers are to consult occupiers regularly with regard to the standard and quality of services.
- Managers are to communicate with occupiers regularly to ensure services are delivered effectively and occupiers know what services they will receive and what they must pay.
- Managers are to be transparent in demonstrating compliance with the code.
- Material variances from plans and forecasts should be notified promptly.

Duty of care

- Managers and those certifying accounts have a duty of care to both owners and occupiers.
- There should be clear policies for how the service charge will be managed.

Financial competence

- Managers must be non-partisan when issuing statements of account or certifying expenditure.

- Service charge funds should be held in a discrete bank account and interest earned should be credited to the service charge account.
- The recommended industry standard cost headings must be used.

Occupier responsibilities

- Occupiers must pay promptly and only withhold sums which are disputed.
- Representatives in discussions and meetings should have authority to make decisions.
- Occupiers will assist in operating service charge systems such as recycling and energy saving.

Right to challenge/dispute resolution

- All new leases including renewals should allow either party to require alternative dispute resolution (ADR).
- ADR may be used by agreement even where not provided for in the lease.

Timeliness

- Budgets must be issued at least one month before the start of the service charge year and statements of expenditure within four months of the service charge year end.

Value for money

- Service quality is to be appropriate to the location, use and character of the property.

Recommended best practice

The following is a summary of the main points of the recommended best practice which supplements the core principles, illustrated by examples.

Service standards

- The quality and cost of services and the performance of all contractors, suppliers and management staff should be regularly reviewed against defined performance standards and the standards should also be reviewed regularly.

Management charges

- Management fees should be set on a fixed price basis, rather than a percentage of expenditure, and should be subject to annual review or indexation.
- The management fee should relate only to work carried out in managing the service charge, not asset management and rent collection and this should be stated in the service charge report together with the basis and date of the appointment and the basis of the fee.
- The costs of specialists' reports, such as fire risk assessments or health and safety reports, should not be included in the management fee.
- Management staff training costs may be covered by the service charge.
- Costs associated with changing staffing levels to improve value for money are recoverable under the service charge.
- Notional rent for management accommodation should not generally be included in the service charge where there is no rent foregone because the premises are incapable of beneficial occupation for any other purpose or where the development has not been designed to include provision for facilities management accommodation.

Example: Management charges

- **Examples of management work attributable to the service charge:** Formulating service charge policies, putting services out to tender, negotiating service contracts, monitoring service standards, consulting and communicating with occupiers about services and the service charge, employing management staff, inspecting the property, meter reading, calculating the service charge, preparing service charge statements
- **Examples of management work not attributable to the service charge:** Letting units, rent collection, enforcing tenant's lease obligations, negotiating rent reviews, consents for assignments, subletting or alterations, providing information for a proposed sale, managing activities which generate income which is not credited to the service charge.

Contract procurement

- Copies of all tender documents should be available for inspection if requested but the manager may charge for the time and cost of copying and postage.
- The manager should keep costs under review and require contractors and suppliers to submit competitive tenders or competing quotations where appropriate and at least every three years or, where re-tendering is not cost-effective or practical the manager should benchmark the service standards and pricing.
- Major service providers should be required to demonstrate that their services, methods and processes are continually reviewed to ensure value and efficiency.
- It is not appropriate to request fees from contractors for inclusion in approved contractors lists or contract tendering.
- Costs associated with changing contracts to improve value for money are recoverable under the service charge.
- The cost of a procurement specialist to achieve greater value for money is recoverable if clearly identified.

Apportionment

- The owner should meet costs attributed to unlet units, concessions to individual occupiers, and the owner's own use of the property.
- Any separate cost or profit centre which generates income for the owner which is not credited to the service charge account and which benefits from services that form part of the service charge should either be incorporated into the service charge matrix or the owner can make an estimated contribution to the service charge to reflect the use of common services.
- Apportionment based on floor area is the most common and often the simplest method; it is not appropriate to use rateable values even, in the view of the authors of the code, where required by the lease.
- The rationale for the apportionment between occupiers should be set out in writing and periodically re-examined.

- Where the level of benefit from services varies between occupiers, there may be different percentage apportionments for different schedules of costs.
- Details of the apportionment for each schedule for each unit should be available to all occupiers but excluding details of any individual concessions. The code includes an example apportionment schedule.
- Leases should provide for the variation of apportionments to accommodate changes such as additional units or changes of use.

Example: Apportionments – owner's contribution

- **Scenario:** A small shopping centre has six units of the same size plus a large store which has the same floor area as six units. Units 1 and 2 are empty. The leases of the other units provide for payment of a fair and reasonable proportion of the cost of services but do not specify a percentage. However, the lease of unit 3 contains a cap on the amount of service charge payable and the lease of the large store provides for a weighted floor area apportionment as a result of which its service charge percentage is 40 per cent.
- **Analysis:** The service charge should be apportioned on a floor area basis as recommended by paragraph 1.5.5 of the code but this will be subject to the express provisions of the leases of unit 3 and the large store. The owner should pay the proportion attributable to the unlet units 1 and 2 in accordance with paragraph 1.5.3 of the code. The owner should also pay any excess of the proportion attributable to unit 3 above the service charge cap, in accordance with paragraph 1.5.1 of the code. However, in accordance with paragraph 10.3 of the code, a reasonable weighting formula is not usually considered a concession, so the owner is not required to make any contribution for the large store. Therefore the owner will pay 10 per cent each for units 1 and 2, the tenants of units 4, 5, and 6 will each pay 10 per cent, the large store will pay 40 per cent, the tenant of unit 3 will pay 10 per cent but subject to its service charge cap and the owner will pay any excess of the 10 per cent above that cap.

Costs recovered outside the service charge

- The code also applies to any costs recovered outside the service charge, such as insurance and utility costs and any additional services provided.
- Insurance policy terms should be fair and reasonable and represent value for money and policies should be placed with reputable insurers.
- It is accepted that owners may retain insurance commissions but they must always be disclosed.
- Full insurance details should be provided on request.
- Insurance policies should include the ability to note the interest of occupiers and subrogation waiver and non-invalidation provisions.
- There should be separate metering or full sub-metering of utility supplies to occupied premises.
- A reasonable administrative charge may be added to utility costs but should be shown separately and a copy of the original invoice should be included.
- Owners may seek to agree payment of a security deposit to the utility company. Where the lease requires payment of a deposit, it should provide for it to be reimbursed when the lease ends, the owner changes or it is reimbursed by the utility company. The deposit can be included in on-account payments and credited at the year end so when the lease ends the deposit will be credited to the occupier in the final service charge balance.

Example: Sums the owner may retain

- **Examples of sums the owner may retain:** Insurance commissions (paragraph 1.6.1 of the code), a reasonable management fee (core principle 2), a reasonable administrative charge in addition to the cost of utilities (paragraph 1.6.2), income from activities which are not funded by the service charge and do not use services (paragraph 10.2).
- **Examples of sums the owner may not retain:** Interest earned on the service charge bank account (core principle 16), income from activities which are funded by the service charge (paragraph 10.2).

Communication and consultation

- Managers should consult occupiers with regard to the standard and quality of service charge provision required, seek feedback from occupiers on performance management standards and service delivery and hold regular meetings with occupiers.
- Managers should make key contacts information available to occupiers.
- Managers should provide occupiers with a copy of the management policy and inform them of any future plans which have an impact on the service charge.
- Occupiers should be notified promptly and within the current service charge year if significant variances in actual costs against budget are likely. Unforeseen variances in the total annual spend should be notified to occupiers promptly with an explanation of how they are being mitigated at the earliest opportunity. What is a significant variance is not quantified and will depend on issues such as the size, nature and type of property and amounts payable by occupiers.
- When substantial works are planned, occupiers should be given summary details of the results of tenders and the process used and full information on the programme of works, costs and the process for keeping occupiers informed.

Leases

- The code cannot override the terms of the lease but the lease should be interpreted as far as possible in line with the code.
- New leases should be drafted to reflect the code and to allow for future changes in best practice.
- If service charge provisions are modernised as leases are renewed two systems may have to operate in tandem until all leases have been modernised.
- The code suggests that unless there is very clear wording to the contrary, a sweeper clause in a short lease cannot generally be used to recover the cost of a service which the owner had in mind but did not specifically provide for. It also suggests that a sweeper clause cannot be used to recover the cost of something that was left out of the lease in error. The sweeper clause is

intended to provide for further services that were not identified when the lease was granted.

Example: Sweeper clause – notional rent for management offices

- **Scenario:** The owner of a multi-let office block proposes to charge notional rent for an office behind the reception area which is used by security and caretaking staff. The list of service charge costs in the leases does not refer to notional rent or the provision of management accommodation but it includes a sweeper clause which refers to any other service which the landlord may in its reasonable discretion provide for the benefit of the building or the tenants.
- **Analysis:** Applying paragraph 1.3.5 of the code, notional rent should not be charged for the office because the premises appear to be incapable of beneficial occupation for any other purpose. The charge is also not provided for by the leases because there is no specific reference to notional rent or to the provision of management accommodation and, applying paragraph 3.3 of the code, costs should not be charged under a sweeper clause if they could and should have been referred to specifically in the lease.

Statements and accounts

- The budgets and accounts should be issued with a report showing a level of detail to enable expenditure to be compared against budgets, explanations of significant costs and variances from the previous year, comparison against the previous two years' costs where appropriate, information on critical core information such as apportionments and contracts, achieved and/or targeted measures of improved management performance, separately identified on-site management team costs, details of previous and next tendering exercise, apportionment matrix showing basis of calculation and total apportionment per schedule for each unit, date of issue.
- Service charge statements should include a comprehensive list of accounting policies and principles including whether on an accruals or cash basis, whether the owner has opted to tax for VAT, full details of any sinking or reserve fund (including its intended purpose, tax treatment, the trust

where the fund is held, contributions and expenditure, opening and closing balances, interest earned and tax paid), an analysis of material variances from budget and sign off statements by the accountant or manager with regard to compliance, financial accuracy and use of appropriate accounting policies. The code includes example service charge reports.

- The Industry Standard Cost Classifications set out in the code must be used in reporting budgets and actual expenditure. They comprise three levels: cost class – for example “marketing and promotions”, cost category – for example “research”, and cost description – for example “research into local market conditions, customer surveys, etc”. Best practice is to use all three levels whenever practicable but for smaller properties or those with limited service charge expenditure cost class and cost category are sufficient. To facilitate benchmark comparison the standard cost classes and cost categories should not be changed but the cost descriptions are only illustrative and can be changed.
- The cost classes are the same as in the previous edition and the cost categories are the same except for the inclusion (in addition to service charge audit fees) of service charge accounting fees and independent accountants' fees and the addition of snow clearance/gritting.
- Managers should certify that annual statements represent a true and accurate record of expenditure incurred in supplying the services and that the expenditure the owner is seeking to recover is in accordance with the terms of the lease.
- The certifier should be an appropriately qualified competent person with experience in dealing with service charges and their status and the capacity in which the certificate is issued should be made clear.
- Annual statements should be reviewed by an independent accountant but this is optional for smaller properties and dependent on the amount of expenditure.
- Leases may require the accounts to be audited but the cost of an audit may be disproportionate and not provide best value for occupiers; if occupiers agree, an independent accountants' report may be prepared instead. If not required by the lease, an audit or independent accountant's report should not be used instead of certification unless agreed by occupiers in

advance. If an occupier requests an audit or independent accountant's report the manager should agree and charge the cost to the occupier.

- Occupiers should be allowed a reasonable period, such as four months, to raise enquiries on the certified accounts. A fee may be charged for supplying copies of documentation.
- On a sale of the property or a change of manager full service charge information for all outstanding service charge years should be provided to the new owner or manager as soon as practicable and within four months.
- Contributions from the owner should be subject to interest in the same way as occupiers' payments.
- The cost of borrowing to fund major non-cyclical expenditure may be charged to the service charge where interest earned is credited to the account.

Dispute resolution

- New leases should provide for alternative dispute resolution (ADR) for service charge disputes.
- It is recommended that ADR is used even when the lease does not expressly provide for it.
- The code explains the different forms of ADR available.
- When a dispute is resolved interest should be paid at base rate for the period during which the relevant amount was underpaid or overpaid.

Mixed use schemes

- Where the development includes a residential element the statutory provisions relating to residential premises will apply even if the residential element is comprised in a single headlease. The RICS Service charge residential management code is approved by the Secretary of State and has RICS guidance note status.

Anticipated future expenditure

- "Planned preventative maintenance" (PPM) plans should be used to plan for items of major expenditure.

- It may make sense to spread the cost of replacement of major items of equipment, such as a heating system, or major regularly recurring expenditure, such as external decorations, by setting up a sinking fund or reserve fund.
- A sinking or replacement fund allows the owner to build up a fund to pay for repair and replacement of major items of plant and equipment. A reserve fund is intended to equalise expenditure in respect of regularly recurring service items to avoid fluctuations in the amount payable each year. A depreciation charge enables the owner to include an amount to reflect the "cost" of the annual depreciation of plant and equipment based on initial cost rather than the future cost of replacement or repair.

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

- The service charge will not include any initial costs incurred in relation to the original design and construction of the fabric, plant or equipment or setting up costs that are reasonably considered part of the original development cost.
- The cost of replacement or renewal should be included only where the items being replaced or renewed are beyond economic repair, or efficient or economic operation, or where much greater cost might be incurred by postponing replacement or renewal, or where it is a proper requirement of any public or competent authority, legislation or the insurers.
- Replacement by a modern equivalent generally falls within the definition of repair and not improvement.
- The service charge will not include the cost of improvement beyond normal maintenance, repair or replacement, unless it can be justified following the analysis of reasonable options and alternatives having regard to a cost benefit analysis over the term of the occupiers' leases. If it is proposed to include the cost of improvements in the service charge that should be communicated to occupiers before expenditure is committed and any agreement recorded in writing.
- When refurbishment results in higher rental values, the owner should be responsible for the cost of enhancements or improvements beyond maintenance but occupiers may still be liable for any element of the works which

amounts to repair or replacement. Proposed refurbishment should be communicated to occupiers well in advance to explain which costs will be included in the service charge and there should be regular communication to monitor the refurbishment.

- The service charge will not include future redevelopment costs.

Example: Improvements

- **Scenario:** The replacement of a boiler.
- **Analysis:** Under paragraph 8 of the code, if the boiler is broken and cannot be repaired, or if it has reached the end of its economic life because it is more economic to replace it than to maintain it, then it may be replaced through the service charge.

If the replacement boiler is of a higher specification than the old one then it will be an improvement, but if it is the modern equivalent of the old model which is no longer available, then it will count as repair and will be covered by the service charge.

If the replacement is of a higher standard than the modern equivalent of the old boiler then it will only be covered by the service charge if its increased fuel efficiency or reliability or other factors mean the cost can be justified. The proposal should be communicated to the occupiers in advance. Even if the cost can be justified in that way, it might still not be recoverable under the terms of the leases, but the occupiers may nevertheless agree to fund the replacement through the service charge because it is the most cost effective solution.

- Sharing data is essential and there should be a fair and reasonable approach to the apportionment of sustainability costs (but with the emphasis on the polluter pays principle), carrying out works that improve the environmental performance of the building and restricting works by either party which adversely affect its environmental performance.
- Improved sustainability and environmental improvement should be a factor taken into account when considering whether a service offers value for money and in a cost-benefit analysis to justify improvement costs.
- The cost of obtaining an energy performance certificate is not normally recoverable as a service charge cost.

Shopping centres

Marketing and promotion

- Marketing and promotion should be jointly funded, including the costs of specialist staff.
- The budget and accounts should show the gross expenditure and the owner's contribution.
- Marketing plans should be presented to occupiers in advance and it is useful to agree and regularly review them with occupiers.
- Where the service charge bears the cost, all pedestrian flow data should be issued to occupiers.
- Costs incurred in relation to the initial promotional launch or rebranding should be borne by the owner. The cost of re-launching a centre should be split between the parties as agreed between them.
- The cost of entertainments, attractions, Christmas and other seasonal decorations and events are not usually considered marketing and promotional costs.
- Marketing vacant units is not a service charge item.

Commercialisation (non-core income)

- The owner is entitled to receive non-core income (that is income other than rents such as from advertising, photo booths and so on) only to the extent that it is not funded by the service charge either initially

Environmental sustainability

- The code promotes a co-operative and collaborative approach in recognising and managing the environmental impact of the occupation and management of commercial premises.
- The code suggests there may be value in owners and occupiers entering into a non-legally binding memorandum of understanding which provides a roadmap for co-operation on improving the environmental performance of buildings and may be updated to reflect latest business practice.

or through the provision of ongoing services.

- There should be a clear statement of policy on how such costs and income are allocated and details should be included in budgets and accounts.
- Income from promotional activity should be credited to the marketing budget.
- Where the owner retains income from common parts used on a permanent or semi-permanent basis such as barrows or kiosks in malls, the space should be included in the service charge apportionment matrix or appropriate equivalent credit given for the costs of that space.

Weighted floor area apportionment

- A weighted floor area basis of apportionment provides for a progressive discount to be applied to the service charge percentage for each band of floor area to reflect the different cost of servicing different sized units. For example the first 500 square metres may be charged at 100 per cent, the next 500 square metres at 80 per cent, the next 2000 square metres at 70 per cent, the next 2000 square metres at 60 per cent and the excess at 50 per cent. Ancillary basement and upper floor space may also be discounted in the same way. There is no standard formula.
- A reasonable and fairly administered weighting formula is not usually considered to be a concession.

Example: Non-core income

- **Scenario:** The owner of a shopping centre receives income from advertising, a photo-booth licence, kiosks in malls and charges for occupiers' use of a photocopier.
- **Analysis:** Paragraph 10.2 of the code requires income funded by the service charge to be credited to the service charge and where an income generating item uses services or needs support from staff funded by the service charge a contribution should be made to the service charge. A clear policy on the treatment of such income should be formulated and set out in the service charge budgets and statements.

Advertising on external hoardings erected by and belonging to the advertising company would probably not use any services funded by the service charge and so the income can be retained by the owner. Where the advertising is on structures provided by the owner and maintained through the service charge, the owner can retain the income but should make a contribution to the service charge fund in respect of the cost of the services used. A photo-booth provided and maintained by the photo-booth company would use electricity but no other services. The owner can therefore retain the licence fee but should credit the service charge with the electricity charges paid by the photo-booth company. The owner can retain the income from mall kiosks but should credit the service charge with a contribution based on the floor area of the kiosks. Charges for use of photocopiers funded by the service charge should be credited to the service charge account.

Example: Extension of shopping centre

- **Scenario:** The owner of a shopping centre proposes to build an extension which will add a new mall with six new units, a servicing area and new toilet facilities. The works will also include replacement of some damaged flooring in the main mall.
- **Analysis:**
 - **Cost of works:** The cost of the construction works would not be a service charge item. It would be regarded as the initial provision of fabric, plant and equipment which is excluded under paragraph 8.1 of the code. However the replacement of the damaged flooring would be a service charge item under paragraph 8.2 of the code, assuming that the flooring being replaced is beyond economic repair. The replacement of the flooring should therefore be costed separately from the construction of the extension and competitive quotations obtained to ensure value for money in accordance with core principle 1.
 - **Apportionments:** It will be necessary to adjust the service charge apportionments of the whole centre to accommodate the new units. It might sometimes be possible to avoid recalculating all the percentages by maintaining separate accounts for the additional area if it is a discrete part of the development using completely separate services. However, in this case the new toilet facilities would benefit the whole centre so all apportionments should be adjusted. The new servicing area will only be used by the new units, so, in accordance with paragraph 1.5.1 of the code, there should be a separate schedule of costs relating to that area which will be allocated only to the occupiers of the new units. Costs should be apportioned according to the floor area of each unit as recommended by paragraph 1.5.5 of the code. Any change to the apportionments must be subject to the provisions of existing leases. Leases should be drafted to allow for such variation in accordance with paragraph 1.5.2 of the code. The code cannot override existing leases but in accordance with paragraph 3.1 of the code, existing service charge clauses are to be interpreted as far as possible in line with the principles and practices of the code.
 - **Letting new units:** The owner must pay costs attributed to the new units until they are let, as required by paragraph 1.5.3 of the code. Costs in connection with letting the new units will not be a service charge item in accordance with paragraphs 1.3.2 and 10.1 of the code. Costs incurred in relation to the initial promotional launch of the new part of the centre must be borne by the owner in accordance with paragraph 10.1 of the code.
 - **Communication:** Occupiers of the centre should be informed of the proposals well in advance in accordance with the principles in paragraph 2.1 of the code. The full apportionment matrix should be made available to all occupiers in accordance with paragraph 1.5.4 of the code.

Practice group contacts

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