

## **Accounting for UK commercial service charges: the role of accruals, accounting disclosure and audit within the periodic certification process**

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### **Abstract**

**Purpose** – The paper critiques the accounting and audit requirements of the 2011 RICS Code of Practice, *Service Charges in Commercial Property* and examines whether the forthcoming 2013 version of the RICS Code and its associated accounting guidance note provide a “best practice” framework for service charge accounting and audit. This theoretical discussion is then applied to empirical data from a sample of UK commercial office properties to assess whether current practices used for the preparation and review of service charge reconciliation certificates actually embody the principles of best practice.

**Design/methodology/approach** – The paper uses inductive reasoning to theorise about how the accounting and auditing of commercial service charges might be improved. The paper also uses a deductive approach to identify whether current commercial service charges accounting and audit practices achieve a theoretical level of best practice. The paper reviews a range of secondary literature and utilises hand collected data from the service charge documents provided to commercial leaseholders.

**Findings** – The paper finds deficiencies within the Code’s requirements for service charge accounting and audit. As a result, empirical evidence is found suggesting that UK commercial service charge accounting and audit practices are inconsistent, lack transparency and provide poor levels of negative assurance for tenants.

**Research limitations** – Content analysis requires subjective interpretation on behalf of the researcher.

**Originality/value** – Data are original to this research and provide a unique insight on accounting and audit practices used by service charge managers and auditors in the commercial sector

**Keywords** - Service charge, RICS Code of Practice, Accounting, Accruals, Lease, Audit, Best practice

**Paper type** - Research paper

## 1.0 Introduction

The Royal Institution of Chartered Surveyors (RICS) (2011) describes a service charge as the means by which the landlord recovers from tenants all landlord expenditure related to the repair and maintenance of the common parts of the building, plant and machinery and the provision of common services. Because of annual variances in the costs incurred by the landlord, the quarterly demands for this expenditure are initially based upon a budgetary estimate and then reconciled and certified annually. This process creates a unique set of accounting problems, including the recognition and measurement of the periodic costs incurred by the landlord, identifying the appropriate way to present and disclose accounting information to occupiers, and if required, determining the work programme that an audit or independent review of certificated expenditure should follow.

UK Commercial service charges are not subject to statutory legislation, with the requirements related to their management being stipulated in individual lease agreements, and therefore subject to variation across the industry. A service charge is only payable if the lease specially requires it, and each individual lease agreement may or not contain specific lease provisions that describe the financial reporting and audit processes that apply when formally accounting for service charge monies. Where an individual lease is silent in terms of financial reporting and audit provisions, practical guidance comes from the RICS *Code of Practice, Service Charges in Commercial Property*, which came into force in 2007 (RICS, 2011). The RICS Code is non-mandatory but accepted practice as agreed by its constituent parties.

This relative lack of coercion and prescribed accounting guidance is in contrast to the equivalent position in residential service charges, where detailed accounting guidance and requirements have been issued by the RICS (RICS, 2009c) in co-ordination with the Institute of Chartered Accountants in England and Wales (ICAEW, 2007, 2010, 2011) and statutory accounting provisions under the Landlord and Tenant Act 1985, amended by the Commonhold and Leasehold Reform Act 2002.

While there is little doubt that the RICS commercial Code has improved practice in certain areas of commercial service charge management, the extent to which this improvement can be described as an acceptable level of practice is far less convincing (Eccles and Holt, 2009 and 2012). This paper is written at a time when a revised Code is currently undergoing consultation and should come into force in October 2013 (Royal Institution of Chartered Surveyors, 2013a). This will be the fifth, following those published in 1996, 2000, 2006 and 2011 (RICS, n.d.; Guide to Good Practice Working Party, 2000, RICS, 2006, 2011). In addition, the RICS (2013b) has also just issued a draft of a *Service Charge Accounting Guidance Note*, which establishes best practice for the information that managers should provide to the accountants appointed to carry out an independent review of service charges.

## 2.0 New guidance for ‘best practice’ accounting of service charges

While the accounting principles and disclosure requirements within the 2011 version of the RICS Code moved closer towards providing a coherent framework for the preparation of service charge accounts, they still lacked practical guidance for the preparation of transparent “best practice” form of service charge certificate (Holt, Eccles and Bennett, 2011 and Eccles and Holt, 2012). The 2011 version of the Code was the

first to specify that service charge statements should include a comprehensive list of accounting principles upon which the statement is prepared, including whether the statements are prepared on an accruals or cash basis. While the term “accruals” was left undefined and unexplained, its inclusion was an explicit recognition that many service charge accounts were being prepared on a non-cash basis. The 2013 draft RICS guidance paper on service charge accounting also added to the importance of accruals by stating that “best practice recommends all statements of service charges should be prepared on an accruals basis” (RICS, 2013b, section 5.1). This requirement for the use of accruals accounting is a key step forward for commercial services, especially when one considers the widespread acceptance of the accruals concept in *both* general accounting practice *and* the existing endorsement of accruals accounting within the RICS residential Code (RICS, 2009):

“In financial accounting it has long been presumed that merely reporting cash flows is inadequate and that some form of accrual accounting is appropriate” (Beaver, 1989, p. 2).

“An estimate of a liability that is not supported by an invoice or a request for payment at the time when the accounts are prepared” (Law, 2010, p. 11)

“Your accounts should be transparent and reflect all the expenditure in respect of the accounting period whether paid or accrued. This will enable the arrears and cash flow to be seen more easily” (RICS, 2009, p. 31).

As the managing agent is the steward whom tenants entrust with control over a portion of their financial resources, service charge statements provide a report to tenants that “facilitates their evaluation of management’s stewardship” of the service charge process (Beaver, 1998, p. 2). Whilst a number of reporting systems could conceivably fulfil this purpose, accrual accounting is the preferred choice within financial accounting (Bromwich, 1992). From the perspective of the International Accounting Standards Board (IASB), financial statements should be prepared, except for cash flow information, using the accrual basis of accounting:

“Under this basis, the effects of transactions and other events are recognised when they occur (and not as cash or its equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate” (IASB, 1989, para. 22).

Whilst the use of accruals for service charge accounting may appear daunting, the service transactions, costs and income on a building are routine when compared to the complex array of business transactions undertaken by a limited liability company. As a result, accounting for the accrued expenses and prepayments for the services of a building should conceptually require less need for accounting discretion and expertise, assuming that an adequate purchase order and accounting system is used.

While a formal requirement for the preparation of service charge accounts using accruals is a clear step-forward, achieving consistent and objective application of this accounting concept may be far from easy. As commercial service charges are not subject to residential legislation, the appropriate accounting practice may be specified within a building’s lease. However, previous research has shown that the wording used in leases to define the “costs incurred” by landlord during an accounting period vary widely (Holt, Eccles and Bennett, 2011). In the absence of relevant judicial precedent

and statutory regulation on the issue, it is impossible to determine if the “costs incurred” by the landlord on service charges during the period should be accounted for on a transaction basis, cash basis or an accruals basis. Furthermore, from a legal perspective, it might be argued that a cost can be properly incurred, and hence recoverable from tenants, once a contractual commitment for work or services has been made. A detailed analysis of the accounting provisions within commercial leases is provided in section 6.1 of this paper.

One of the problems associated with prescribing an appropriate accounting treatment for service charge expenditure is that the service charge account is a unique and specialised form of accounting entity, subject to the legal requirements of the underlying lease. A specific problem relates to the treatment of contractual commitments, which has long been a controversial area of traditional accounting. Under both UK Financial Reporting Standards (FRS) issued by the Financial Reporting Council and International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB), contractual commitments are accounted for according to their specific nature. If the contract is wholly unperformed or there remains something to be done by either party, it meets the definition of an executory contract:

“Contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent.” (FRC, 2013, para 21.2)

Traditional accounting largely excludes executory contracts from being recognized in the financial statements, except:

- in the context of accounting for long-term contracts; and
- where the executory contract is deemed onerous

Where a service charge arrangement results in a long-term contractual commitment, both UK FRS and IFRS require the contractee to recognise, in each accounting period, the contractually agreed progress payments payable to the contractor under the terms of the contract for work or services actually undertaken or performed. From the perspective of the contractee, contractual work or services performed during an accounting period by a contractor fulfil the definition of an accounting liability, which is:

“a present obligation of the entity resulting from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits”. (IASB, 2010, para 4.4)

The IASB makes a clear distinction between a present obligation and a future managerial commitment:

“A decision by the management of an entity to acquire assets in the future does not, of itself, give rise to a present obligation. An obligation normally arises only when the asset is delivered or the entity enters into an irrevocable agreement to acquire the asset. In the latter case, the irrevocable nature of the agreement means that the economic consequences of failing to honour the obligation, for example, because of the existence of a substantial penalty, leave the entity with little, if any, discretion to avoid the outflow of resources to another party.” (IASB, 2010: para 4.16)

A liability should only be recognized when it is *probable* that an outflow of resources embodying economic benefits will result from the settlement of the present obligation and the amount at which the settlement will take place *can* be measured reliably. As most executory contracts do not result in present obligations whose settlement amount can be reliably estimated at the balance sheet date, they are not generally recognised as liabilities under financial accounting practice, as Birnberg, 1965, p. 817) explains:

“In the absence of an objective measure of the direct service potentials [i.e. the changes in market conditions that make the contract more or less desirable] the accountant cannot record the contract. The goods or services to be purchased, the indirect service potentials, cannot be recorded at the time of contract for the goods do not yet exist and the liability for them is not then legally due.”

Where the exact timing or amount of a liability is uncertain, it may still qualify for recognition as a “provision”, if the entity has a present obligation to transfer economic benefits as a result of past events; it is probable (more likely than not) that such a transfer will be required to settle the obligation; and a reliable estimate of the amount of the obligation can be made.

While future contractual commitments appear to fulfil the definition of a “provision”, executory contracts are excluded from being recognised as a provision under both UK FRS and IFRS, unless the contract is onerous. In most instances, a service charge contract entered into by landlord would only be onerous if the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. If the contract is deemed to be onerous, a provision should be recognized for the lower of the costs associated with completing the contract or the penalty from breaking the contract (see IASB, 1998 and FRC, 2013).

For non-onerous executory contracts, the correct accounting treatment is for a contractee to recognise the periodic contractual expenditure as it becomes payable under the terms of the contract, rather than recognising a provision for the total estimated amount of the future contractual commitments when the contract is first signed. Once the contract is complete, any remaining payment obligations should be immediately accounted for as a liability and expensed when payable.

As the above discussion highlights, applying UK FRS and IFRS to contractual commitments related to the recovery of service charges is fraught with difficulties due to the unique characteristics of the reporting entity and the precise wording used to describe the annual service charge expenditure within the lease. Where a lease permits the creation and use of a sinking fund for the replacement of specified non-current assets, the annual service charge may include an annual charge as contributions to these reserves. Similarly, the lease may permit the creation and use of a reserve fund for the payment of pre-planned amounts of refurbishment expenditure. While sinking funds and reserve funds are not “provisions” or “liabilities” according to the accounting definition of the terms, they do, at the balance sheet date, represent a best estimate of future expenditure and liabilities that may result from managerial plans for future refurbishment activities. However, unless such funds relate to a present obligation from past events, they would not qualify for recognition as either a liability or provision under either UK FRS or IFRS.

In order to provide some guidance on this problematic area of service charge accounting, the draft RICS *Service Charge Accounting* guidance note states that:

“Large round sum provisions included to spread the cost of significant works over a period of time are NOT accruals as they do not represent a liability at the end of the period. Accordingly, they should not be included as accruals but should be considered as contributions towards reserve or sinking funds and reported accordingly (RICS, 2013b, section 5.8)

This initial clarification of accruals is admirable. However, it neither provides a clearly defined accounting treatment for potential liabilities arising from *future committed* expenditure nor clarify whether these amounts should be accounted for and disclosed separately from accruals arising from normal works and services carried out during the period. As a result, further specialised guidance is needed to outline an appropriate accounting treatment for commitments to future service charge expenditure.

What is clear is that the RICS explicitly supports the use of an appropriate form of accruals accounting when determining periodic service charge expenditure. In order to support the use of accruals, the RICS’s draft accounting guidance note requires that “a schedule of accruals included in the service charge expenditure” and “a schedule of prepayments included in the service charge expenditure for the period” are provided within the annual reconciliation certificate. (RICS, 2013b, section 5.9). These requirements are admirable, but fall some way short of requiring an end-of-period balance sheet that best practice should theoretically demand (see Holt et al, 2011).

### **3.0 Audit and certification of the service charge accounts**

In addition to providing ‘skeletal’ guidance on the preparation of the annual service charge statement, the 2011 Code also suggests that such accounting statements should be certified by a suitably qualified manager. This certification is intended to provide assurance to occupiers that the accounts:

- represent a true and accurate record of the expenditure incurred by the owner in supplying the services to the building; and
- that the expenditure the owner is seeking to recover is in accordance with the terms of the lease. (RICS, 2011, p. 22)

A UK lease may or may not require certification from a specific type of professional manager, so in the next section of this paper, the accounting, certification and audit requirements within 20 randomly selected commercial leases are analysed. Within this sample of leases, the certification of the annual accounts was required to be performed by a range of individuals, including the “landlord’s surveyor”, “the auditor” or “the landlord’s accountant”. Obviously, the certification should be performed in strict accordance with the lease, but in instances where the lease is silent as to who may certify the accounts, the 2011 Code suggests that the certifier will need to be “an appropriately qualified competent person with experience in dealing with service charges and also needs to recognise that in certifying the service charge they have a duty of care to both owners and occupiers to act with professional care, diligence, integrity and objectivity” (RICS, 2011: 23). The Code does not prescribe a “best practice” recommendation as to who this appropriately qualified certifier should be, but does state that the status of the person issuing the certificate and their official capacity be disclosed.

In addition to certification, a lease may contain a requirement for the accounting statement to be audited. According to the 2011 Code

“the terminology used in relation to the issuing of annual statements of account, particularly in older leases, may be quite generalised and may not reflect modern auditing and accounting standards and practice” (RICS, 2011, p. 22).

The only existing accounting guidance on this issue comes from the ICAEW Technical Release 03/11 on residential service charge accounts, which states that

“where a lease that has been drawn up since 1980 refers to an audit then this is what should be undertaken” (ICAEW, 2011, p. 7).

If the terms of the lease require an audit, then this should be conducted unless the occupiers confirm in writing that an audit is not required. International Standard on Auditing 800 (ISA 800) *Special Considerations – Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*, appears to provide the appropriate framework for the audit work (International Auditing and Assurance Standards Board, 2009), although the Code does not currently specify a specific procedure for this work.

If the lease does not specify that an audit is undertaken or is silent on such matters, the 2011 Code states that:

“Where the lease is silent or audit is optional, managers should not use an external audit or independent accountant’s report as a means of giving credibility to service charge expenditure at the occupiers’ expense, unless agreed with the occupiers in advance.” (RICS 2011, p. 24)

As a result, the preparation of an audit or independent accountant’s report is not seen as a routine part of the annual service charge accounting process, unless occupiers ask for, or agree to, its provision. However, the 2011 Code states that best practice requires that “an independent accountants’ report should be prepared” (RICS, 2011: 23), although this requirement is subject to the materiality of the expenditure involved:

“Annual statements of service charge expenditure should be reviewed by an independent accountant. However, to be consistent with best value principles this requirement should be considered as optional for smaller properties and dependent upon the quantum and nature of the expenditure” (RICS, 2011, p. 24).

According to the Code, an independent accountant’s review differs from an audit, and its procedures *may* include:

- checking whether the figures contained in the information were extracted correctly from the accounting records maintained by the manager; and
- checking ... whether entries in the accounting records were supported by receipts, other documentation or evidence inspected. (RICS, 2011, p. 24)

The reporting independent accountant may prepare such a statement from accounting records maintained by the owner or manager as well as providing the independent accountant’s report. In these circumstances, the Code specifies that the owner or manager will retain responsibility for the certification of the statement.

The 2011 Code's requirement for an independent accountants' report is somewhat surprising, as it includes the following criticism of such statements:

“Independent accountants issuing a report on a statement of service charge expenditure will often carry out differing levels of work and will each sign a different style of report. Consequently there is little understanding of the level of assurance that owners and occupiers can take from the report, and potentially confusion regarding the actual work undertaken.” (RICS, 2011, p. 22)

This criticism is also contained with the 2013 draft Code, and serves to contradict the Code's original justification for the provision of these statements.

While the 2011 Code, together with the drafts of the 2013 Code and the 2013 accounting guidance note, provide general principles for the auditing of the service charge account, they fail to provide a detailed account of the:

- work programme required for providing a factual report on service charge accounts (i.e. preparing an independent accountants report); or
- the procedures required for undertaking an audit of service charge accounts

As a result, it is hardly surprising that there are widespread conceptual and practical problems with the manner by which service charge audits and factual reports are performed, and documented. For example, the empirical evidence reviewed in a later section of this paper highlights misuse of the term “auditors” and also indicates that independent accountant's reports are often used to inappropriately certify service charge expenditure. Quite clearly, there is a need for the RICS to seek guidance from the UK accounting profession in order to provide a robust framework of audit procedures and work programmes when reviewing service charge accounts.

#### **4.0 Guidance from the UK accounting profession on commercial service charges**

In order to assist its members with the preparation of service charge accounts, the ICAEW has issued two technical releases on *residential* service charges that provide guidance on how statements should be prepared and outline the procedures that should be followed when conducting either an audit or independent examination of the accounts (ICAEW, 2011, 2010). The latest 03/11 technical release provide guidance on how to prepare service charge accounts that comply with the lease and also follow the best practice recommendations within the RICS *residential* Code, where appropriate (ICAEW, 2011).

Although the latest ICAEW 03/11 technical release contains accounting guidance that could be used within the commercial sector, this was never its intended purpose. As of October 2013, the ICAEW has not yet issued a technical release on the preparation of commercial service charges. Based upon recent evidence about deficiencies in UK accounting for commercial service charge, such a guidance note is urgently required in order to supplement the RICS commercial code and improve current practices.

The 2011 RICS commercial Code makes direct reference to the ICAEW 03/11 technical release stating that the “document provides useful further reading” for practitioners. Rather more interesting is that the drafts of both the 2013 RICS Code and 2013 service charge accounting guidance note both refer to a new ICAEW technical release on commercial service charges:

“The ICAEW and RICS have issued a draft technical release to provide guidance on reporting on commercial service charges for consultation. This technical release provides good practice guidance on technical and practice issues relevant to the work of accountants and other professionals” (RICS, 2013b, introduction).

As part of the research for this present paper, an enquiry was made to the ICAEW on 29 August 2013 asking about the development of a specific technical release for commercial service charges. The ICAEW’s response was that while there had been discussions about developing such a guidance note, there was no timetable for its imminent release. In light of this information, this paper recommends that the RICS delays the release of the new Code and accounting guidance note until the ICAEW technical release is ready for release as an exposure draft for consultation. All three documents must be compatible in both their wording and accounting guidance; otherwise they will not be fit for purpose.

## **5.0 Reviewing current accounting and auditing practice**

To this point, the paper has critiqued the accounting requirements within the 2011 and 2013 versions of the RICS Code and the 2013 accounting guidance note. However, the paper’s main concern is examining the accounting principles, disclosures and audit processes currently being used during the preparation and review of periodic service charge reconciliation within the UK commercial multi-let office sector. Empirical research to date has shown that tenants are often provided with service charge information that is untimely, inaccurate and inconsistent (Eccles and Holt 2009, 2010b, 2012). As a result, it is unsurprising that the 2012 edition of the RICS’s *annual survey of occupier satisfaction* reported satisfaction with landlords’ service charge arrangements at only 4.7 out of 10 (RICS, 2012). As a vital part of the service charge process is the preparation of the accounting statements and their subsequent certification and audit, this paper examines current accounting practices in order to highlight problems and examine areas where accounting transparency is currently lacking.

### **5.1 Methodology and data utilized**

Using a mixture of quantitative and qualitative data collection and analysis methods, the paper examines the current role of accruals accounting, accounting disclosure and audit within the end-of-period certification process. Previous research in the field of commercial service charges, including Jones Lang Lasalle (2012), RealService (2013) IPD Occupiers (2009), Calvert (2008) and Holt, Zatolokina and Barrass (2012, 2013), has used a variety of data collection methods, although the most compelling research findings come from research derived from data collected from the actual service charge documents issued to occupiers by managing parties (Holt, Zatolokina and Barrass, 2012, 2013 and Calvert, 2005, 2008). Data for this paper were hand-collected from a range of service charge documents:

- 20 lease agreements and 20 matching reconciliation certificates for a random sample of 20 UK multi-let office buildings larger than 50,000 sq. ft. To be eligible for selection, the building’s certificate had to be certified by an accountant or had to include an independent accountants’ report or audit statement.
- Data from the service charge documents issued to occupiers of 266 UK multi-let offices larger than 50,000 sq. ft. The budgets and certificates analysed covered

the period 2009-2012, a total floor area of 24,259,789 sq. ft. and included service charge expenditure of £395,499,923.

- Analysis of the audit and accounting fees at 746 commercial office buildings during the period 2003-2013. The data included £1,719,703 of total audit and accounting fees within £428,657,697 of total service charge expenditure. The data were obtained from periodic reconciliation certificates.

Analysis of the documents took place during 2012 and 2013. As documents covered different parts of the same calendar year, each document was assigned to a year on the basis of where the majority of its accounting period lay. For the period 2009-2012, it was possible to obtain 843 documents, including 436 service charge certificates and 407 budgets for the main 266 building sample. While documents were available for the entire 2009-2012 period for certain properties, missing source documents left the dataset incomplete for other buildings. This was not always because of incomplete archives, as data were still outstanding from the managing party. Despite this limitation, the longitudinal sample allowed for accurate historical comparison and analysis, and the overall size and nature of the sample allowed for reliable generalisations to be made.

Content analysis was used to analyse the data. While this type of research method is orientated towards a positivist approach, the processing and classification of the accounting and auditing data often required some degree of subjective interpretation on behalf of the researcher. As a result, the research method used to analyse the data was a hybrid mixture of quantitative and qualitative approaches. The use of hybrid methodologies is problematic because of the different epistemological and ontological assumptions within each approach but is increasingly accepted as appropriate for applied accounting research (see Collis and Hussey, 2009). In practice, the potential for bias in this type of work is remote as it requires limited interpretation by the researcher. The data codification required is primarily binary in nature and unproblematic where there are explanatory notes to the accounts. Whilst judging the efficacy of such a note might be contentious in theory, in practice the nature of the service charge renders the analysis relatively obvious. Hence, much of the data could be utilised directly, and content analysis only applied to areas such as assessing the quality of the disclosures and audit reports. However, given the poor level of the disclosure within many service charge documents, the difficulty of subjective interpretation is not to be underestimated. Whilst the quantitative data within this paper does rely on certain qualitative judgements, the resulting data are inherently sound and offer a valid examination of current accounting and auditing practices.

## **6.0 Findings and analysis**

### ***6.1 Analysis of the accounting and audit clauses within UK commercial leases***

The analysis of the lease agreements for the 20 UK multi-let office buildings provided evidence of the inconsistent nature and wording used to express the accounting and audit requirements within UK commercial leases. Table 1 provides a detailed summary of the lease clauses relevant to accounting and audit for each lease. Significant findings from Table 1 include the following:

- The sample of leases covered a variety of inception dates, although 95% had a start date after 1980, the threshold year that the ICAEW (2011) defined for the establishment of modern auditing standards and requirements.

- 0% of leases included a requirement for some form of audit or independent accountants report on the annual certificate. As a result, each lease was silent as to what should be reviewed as part of an audit of the service charge account.
- 50% of leases entitled the Tenant to inspect the service charge records or vouchers and take copies of them. Of these, one lease stated that this inspection could be performed by the “Tenant or its representatives”, which appeared to allow the tenants to appoint their own independent auditor.
- 85% of leases provided a definition of the “service charge costs” recoverable from occupiers. As the third column of Table 1 illustrates, the precise definition of the service charge varied widely. Two leases had identical definitions of the service charge but these were prepared by the same legal firm.
- 0% of leases specified whether the annual service charge accounts should be prepared on either a cash or accruals basis.
- 80% of leases included specific accounting requirements for the preparation of the annual service charge certificate and the types of periodic expenditure that it should summarise. As column four of Table 1 illustrates, the exact requirements of these accounting clauses varied widely. For example, different types of certification were specified (see below for more details) and alternate periods were allowed before the tenant should receive the certificate.
- 25% of leases included specific clauses allowing the Landlord to create “provisions”, “sinking funds” and “reserves funds” for “anticipated expenditure” and “expenditure in any subsequent year”. Of the five leases including such clauses, three referred to an unspecified “provision”, whilst the other two specified a reserve fund and/or a sinking fund. The provision of these lease clauses indicates that some form of allowance for future expenditure will be included within the building’s service charge.
- 45% of leases did not specify that the annual accounting certificate should be certified by a certain individual. Of the 55% of leases including such a requirement, only 18% specifically required certification by “the auditor” or “the accountant”. The remaining 72% adopted an “either or” approach to certification, allowing certification by various parties, including, amongst others, the “Landlord’s surveyor”, “a chartered accountant” and “the landlord’s agent”.

**Table 1: Analysis of the accounting and audit requirements within 20 Commercial Leases**

	Lease date	Definition of the service charge costs	Specific accounting requirements	Account certification	Accounting basis specified?	Audit required?
1	2007	The due proportion of the total cost (service charge)...in any service charge period beginning or ending during the Term of providing the services specified in parts 2 and 3 of this schedule and defraying the costs and expenses relating and incidental to such services	The estate management company will, as soon as may be practicable after the end of each service charge period (and in any event within 3 months of the end of such period), submit to the Tenant a statement duly certified (if so requested) by the estate management company's accountant or surveyor giving a proper summary of the service charge for the service charge period just ended	a statement duly certified <b>(if so requested)</b> by the estate management company's accountant or surveyor	No	No The tenant is entitled to inspect the service charge records and vouchers...and at the tenant's expense take copies of them
2	1989	The costs expenses outgoings and other expenditure reasonably and properly incurred from time to time by the Landlord in connection with the provision of services	As soon as reasonably practicable after the end of the financial year.  The certificate shall contain a fair summary of the Landlord's costs in respect of the Landlord's financial year to which it relates	Signed by landlord or its managing agents (at the discretion of the Landlord)	No	No
3	1989	No definition of the service charge	Unspecified	Unspecified	No	No
4	2002	Expenditure incurred in or about the performance of the obligations contained in the lease	To keep an account of the expenditure properly and reasonably incurred by or for the landlords in respect of the obligations and provisions of this part of the schedule...and to provide the Tenants with a copy of the certified statement  As soon as reasonably practicable after the end of the financial year (but in any event within 4 months)  The landlord may create provisions for anticipated expenditure and financial reserves to meet the future costs of repair and replacement of the common parts of the building. These provisions and reserves shall not be retained by the Landlords but shall be paid to trustees to be appointed by the Landlords.	The <b>auditor</b> should certify the amount of the service charge expenditure. The auditor means the independent accountant or auditor appointed by the landlord to prepare the accounts and certificates	No	No The Tenants shall be entitled...to make any examination or audit which the Tenants may desire for this purpose.
5	2005	The expenses and outgoings reasonably and properly incurred by the landlord in respect of the matters set out in the lease	The amount of the service charge shall be ascertained and certified by a certificate completed as soon after the end of each Accounting Period as may be practicable (time no to be of the essence)  The certificate shall contain a summary of the Expenditure during the Accounting Period to which it relates	Certificate shall be signed (at the option of the Landlord) either by the Landlord's surveyor (who shall be an Associate or Fellow of the RICS and who may be an employee of the Landlord) or the Landlord's accountant (who shall be an Associate or Fellows of the ICAEW or the ACCA and who may be an employee of the Landlord).	No	No The certificate is conclusive evidence of the facts it purports to certify save for any manifest errors.  The tenant is entitled at its own expense to inspect the service charge records and vouchers

*Continued*

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<i>Table 1: Continued</i>						
	Lease date	Definition of the service charge costs	Specific accounting requirements	Account certification	Accounting basis specified?	Audit required?
6	2006	Annual expenditure – the aggregate expenditure actually or notionally reasonably and properly incurred by the Landlord during a Service Year in Providing or in respect of all of any of the Services	<p>The Landlord will as soon as practicable after the end of each Service Year prepare and submit to the Tenant a statements of Annual expenditure for that Service Year containing a fair summary of the expenditure referred to in it and showing the Service Charge for that Service Year year together with such reasonable evidence of expenditure as the Tenant may require.</p> <p>The Landlord may include in any such statement such provision for expenditure in any subsequent year as the Landlord from time to time considers appropriate and acting in accordance with the principles of good estate management</p>	Unspecified, but the landlord shall be entitled to include any cost of the accountants, auditors or surveyors for auditing or certifying the Annual Expenditure or providing similar services	No	No
7	2007	Expenditure means the aggregate of all costs and expenses reasonably and properly incurred by the Landlord in providing the Landlord's Services including bank charges interest VAT and management charges together with such sums as the Landlord reasonably considers expedient to set aside to provide for periodically recurring items of expenditure and such provision for anticipated expenditure in connection with the Landlord's Services as the Landlord may decide.	As soon as convenient after the end of each Financial Year the landlord will prepare and copy to the Tenants accounts certified by the Accountant showing the total Expenditure for the that Financial Year and which contain a fair summary of the various items comprising that Expenditure.	The Accountant	No	No
8	2004	Annual expenditure means all proper costs expenses and outgoings paid or incurred by the Landlord during a Service Year including the Costs in or incidentally to providing all or any of the services after giving credit for any insurance money received by the Landlord under any policy in relation to the Retained Parts which the Landlord is obliged to effect under these Presents.	The Landlord shall as soon as practicable after the end of each Service Year (but in any event within nine months) prepare and submit to the Tenant a statement of the Annual Expenditure for that Service Year containing a fair summary of the expenditure referred to in it.	The statement being certified by the Landlord's surveyor or its managing agents or accountants	No	No The tenant or its representatives shall be entitled upon giving reasonable notice within two months of receiving the Statement to inspect the receipts vouchers and accounts relating to the Annual Expenditure.
9	2003	To pay on written demand all proper and reasonable expenses, costs, charges, fees and outlays by the Landlords	Unspecified	Unspecified	No	No

*Continued*

WORKING PAPER – TO BE SUBMITTED FOR JOURNAL REVIEW

<i>Table 1: Continued</i>						
	Lease date	Definition of the service charge costs	Specific accounting requirements	Account certification	Accounting basis specified?	Audit required?
10	2004	<p>The service cost shall be the total of:</p> <p>a. The total aggregate cost to the landlord in any accounting period in carrying out or procuring the carrying out of the services and providing each item of the services including...the costs and expenses set out in Part 2 of schedule 3 and any other costs and expenses properly incurred by the landlord or with the Landlord's authority in connection with the Services.</p> <p>b. An amount...to be charged in any Accounting Year as a contribution to the establishment and maintenance of a reserve towards the estimated cost to the landlord of the provision of the services such amount to be ascertained on the assumption that the cost of replacement of items of plant machinery equipment and other capital items is calculated on such life expectancy of the said items as the Landlord may from time to time reasonably determine to the Intent that a fund be accumulated sufficient to cover the cost of replacement of the said terms by the end of their anticipated life</p>	<p>As soon as practicable after the expiry of every Accounting Period the landlord shall serve or cause to be served a service charge certificate on the Tenant for the relevant Accounting Period.</p> <p>A service charge certificate shall contain a summary of the Service Cost in respect of the Accounting Period to which it relates.</p>	unspecified	No	No
11	2005	<p>Service Costs means the aggregate of those costs expenses overheads payments charges and outgoings...incurred by on behalf of the Landlord in or in respect of that Account Period in relation to the Category Expenses...to the intent that the Service Costs shall include all costs expenses payments charges and liabilities incurred by the Landlord in connection with the provision of Services</p>	<p>A statement...showing the Total Charge for the relevant Account Period the Due Proportion the Service Charge all sums received on account of the Service Charge in respect of the relevant Account Period and any balance of the Service Charge due from the Tenant or refund due the Tenant</p>	<p>A statement certified by a chartered surveyor or chartered accountant</p>	No	<p>No</p> <p>The tenant is entitled to inspect copies of all vouchers receipts accounts and other relevant documents to enable the Tenant to verify the amount of Service Costs stated to be due from the Tenant in the Account Statement</p>
12	1989	<p>The service charge...shall be calculated as the costs or such percentage as the Landlords may reasonably deem attributable to the leased subjects incurred by the Landlords in providing the services listed...or such of them as the Landlords in their absolute discretion may consider necessary from time to time.</p>	<p>As soon as possible after the end of each financial year being Whitsunday in each year, there shall be an accounting between the parties and should the amount paid by the tenants for the financial year in question exceed the share due by them in respect of the said services, the excess amount paid will be refunded or at the discretion of the Landlords retained to account of the Tenant's share of such charges for the ensuing year and should the amount paid by the Tenants be less than the said share due by them the Tenants will pay the balance due by them.</p>	Unspecified	No	No

*Continued*

WORKING PAPER – TO BE SUBMITTED FOR JOURNAL REVIEW

<i>Table 1: Continued</i>						
	Lease date	Definition of the service charge costs	Specific accounting requirements	Account certification	Accounting basis specified?	Audit required?
13	1989	The service charge...shall be calculated as the costs or such percentage as the Landlords may reasonably deem attributable to the leased subjects incurred by the Landlords in providing the services listed...or such of them as the Landlords in their absolute discretion may consider necessary from time to time.	As soon as possible after the end of each financial year being Whitsunday in each year, there shall be an accounting between the parties and should the amount paid by the tenants for the financial year in question exceed the share due by them in respect of the said services, the excess amount paid will be refunded or at the discretion of the Landlords retained to account of the Tenant's share of such charges for the ensuing year and should the amount paid by the Tenants be less than the said share due by them the Tenants will pay the balance due by them.	Unspecified	No	No
14	2006	An amount equal to a fair and proper proportion of the reasonable and proper costs and expenses incurred or paid by the Landlord in carrying out the services set out on the Fourth Schedule hereto together with a sum equal to ten per cent of such amount for the cost of the Landlord's administration charge and for the management of the Landlord's Premises and for the supervision and control of the said services such proportion to be determined by the Landlord's Surveyor.	as soon as may be practicable after the end of each Service Charge Year submit to the tenant a statement (duly certified (if so required) by the Landlord's surveyor insofar as it relates to expenditure reimbursable...giving a proper summary of the amounts payable ...for the Service Charge Year just ended together with a copy of the certificate of the Superior Landlord's professional auditors.	Duly certified (if so required) by the Landlord's surveyor	No	No The Tenant is entitled on reasonable prior notice to: (a) inspect the service charge records and vouchers of the Landlord forming the basis of the certified service charge statement...and at the Tenant's expense take copies of them.
15	2004	Service cost means, for any Service period, all expenditure incurred by the Landlord in providing the Services and in discharging the costs specified in Part II of schedule 5.	The Landlord shall, following each Account Date, cause an account to be prepared showing the Service Cost for the relevant Service Period and containing a summary expenditure referred to and the account, certified by the Landlord's agents, shall be conclusive evidence for the purposes of this lease of all matters of fact referred to, except in case of manifest error	Landlord's agents	No	No The Landlord shall on request provide such information as may be reasonably required by the Tenant and answer all enquiries reasonably raised by the Tenant in relation to the Service Cost, subject to meeting the reasonable costs properly incurred by the Landlord in providing such information
16	2000	No definition of the service charge	Unspecified	Unspecified	No	No
17	1959	No definition of the service charge	Unspecified	Unspecified	No	No

*Continued*

WORKING PAPER – TO BE SUBMITTED FOR JOURNAL REVIEW

<i>Table 1: Continued</i>						
	Lease date	Definition of the service charge costs	Specific accounting requirements	Account certification	Accounting basis specified?	Audit required?
18	2009	<p>The total costs means the proper expenditure incurred by the landlord in:</p> <p>(a) Providing the services specified in parts 2 and 3 of this schedule</p> <p>(b) Engaging managing agents</p> <p>(c) Valuing the Estate for insurance purposes</p> <p>(d) Providing and supplying such other services or facilities making such payments or carrying out such other repairs improvements and works (including the provision replacement or improvement of plant and machinery ) as in the reasonable opinion of the Landlord may be necessary...to maintain the building as a first class office building.</p>	<p>As soon as practicable after the end of each service charge period, the Landlord shall submit to the Tenant a summary of the total costs for such period.</p> <p>The Landlord may include in the total costs for any service charge period an amount which the Landlord determines appropriate to build up and maintain a sinking fund and a reserve fund in accordance with the principles of good estate management.</p> <p>Any such sinking fund shall be established and maintained to provide for the renewal and replacement of lifts, boilers, plant, machinery and equipment.</p> <p>Any such reserve fund shall be established and maintained to cover and applied towards prospective and contingent costs of carrying out repairs, decorations, maintenance and renewals and of complying with the requirements of any statute, by-law, or regulation...relating to the use occupation or enjoyment of the Building.</p>	Unspecified	No	<p>No</p> <p>At any time within two months from the date such summary is submitted, the Tenant may after reasonable prior notice have access to the accounts, invoices and other materials from which such summary is derived and at its own expense be provided with copies</p>
19	1992	<p>The Service Charge means the total of the costs and expenses reasonably and properly incurred or for which provision is made by the Lessor in accordance with the provisions hereof during a Maintenance Period for the items specified in the Second Schedule.</p>	<p>That a certificate in writing obtained by the Lessor from an Accountant Surveyor or other suitably qualified person showing the amount of the Advance Maintenance Payment Service Charge and/or Maintenance Contribution shall for the purpose of this covenant be conclusive evidence of the amount to be paid.</p> <p>The provision of any sinking fund which the Lessor's surveyors reasonably...consider should be set aside for or towards any particular items of expenditure within this Schedule which are likely to arise during the unexpired part of the Term but so that due regard shall be given to an unexpended balance of any reserve made when the expenditure for which the reserve was intended has been incurred.</p>	Accountant, Surveyor or other suitably qualified person	No	<p>No</p> <p>The Lessee shall be entitled to receive details of how such amount [the service charge] has been calculated and to verify the same.</p>
20	2006	<p>Service costs means all expenditure incurred by the Landlord (calculated on an indemnity basis) in providing all or any of the Services and discharging the costs specified in this Lease</p> <p>Includes: The cost of making such provision (if any) for anticipated expenditure in respect of the Services as the Landlord shall in its absolute discretion consider appropriate</p>	<p>As soon as practicable, the Landlord shall submit a statement certified by a duly qualified surveyor or accountant (and in the absence of manifest error to be accepted by the Tenant and the Landlord as conclusive) showing: the Total Charge for the relevant Account Period; the due proportion ; the Service Rent; details of all Service Rent Payments received in respect of the relevant Account Period; and any balance of Service Rent due from the Tenant or refund due to the Tenant.</p>	Duly qualified surveyor or accountant	No	<p>No</p> <p>If reasonably requested by the Tenant the Landlord will provide a written explanation of the calculation of the Due proportion [of the service charge].</p>

For each of the 20 commercial leases reviewed in Table 1, the matching service charge certificate for each building was analysed for its certification and whether it included a section classified as an “audit report” or “independent accountants’ report”. All of 20 certificates included some degree of certification by an accountant or included some form of independent accountant’s report or audit statement. Table 2 provides a summary of the certification and audit statements contained within the 20 certificates.

**Table 2: Analysis of the certification within 20 Reconciliation certificates**

Types of certification and content within the annual reconciliation certificate		Certificates including content	Certificates excluding	Total
1	Certified that the expenditure for the year was recoverable in accordance with the terms of the lease	2	18	20
2	Certified that the accounts <i>either</i> : provided a true and accurate record of the expenditure incurred during the period <i>or</i> provided a fair summary of the expenditure incurred during the period	3	3	20
		14		
3	Certified that the financial statements were prepared in accordance with the accounting records maintained by the landlord / managing agent	5	15	20
4	Certification types (2) and (3) undertaken by a chartered accountant	19	1	20
5	Disclosed whether the accounts were prepared under an accruals or cash basis	0	20	20
6	Independent accountants’ report provided at the request of the landlord / managing agent	4	16	20
7	Independent accountants’ report for unnamed parties	1	19	20
8	Report of the Auditors to the Landlord	1	19	20
9	Report of the Auditors to the Tenants	7	13	20
10	Report of the Independent Auditors to the Tenants	1	19	20

Significant findings from Table 2 include the following observations:

- Only 10% of certificates included a signed certification that the expenditure was recoverable in accordance with the lease. This highlights a poor level of compliance with the requirements of the 2011 Code.
- In terms of certification types 2 and 3 included in Table 2, 100% of the certificates included at least one form of these certifications. 10% of certificates included both type 2 and 3 certifications.
- 0% of certificates disclosed whether the statement was prepared using an accruals or cash basis. Merely stating that the certificate represents a “fair summary of the landlord’s periodic expenditure” is clearly inadequate and lacks transparency.
- 25% (5 of 20) of the service charge certificates included some form of independent accountant’s report. Of these, 80% were provided at the request of the landlord/managing agent and not intended for the tenants. 90% of these reports provided an account of the engagement process and the basis for the accountant’s opinion. None of these reports stated that the landlord had confirmed that all expenditure was in accordance with the lease. Similarly, none of the reports specified whether the accountant had obtained a copy of the lease and identified the expenses that may be charged to the tenants under the terms of the lease.
- In terms of the 25% of certificates that included an independent accountants report, 75% appeared to be using the independent accountants report as an alternative

means of certifying the expenditure in contravention of the RICS Code. Within this 75%, the certificate was not formally certified and signed off by the landlord's surveyor, the managing agent or the landlord's accountant.

- Approximately 45% of certificates included a section whose title included “report of the auditors” within it. On the basis of the information presented, none of these “audit reports” appeared to be describing the results of an external or internal financial audit. As a result, these incorrectly titled sections were misleading to the tenants as they failed to specify whether an audit under accepted auditing standards had been undertaken.

This in-depth analysis of certificates reveals widespread inconsistency in levels of certification and misleading use of the word “audit” within reconciliation statements. In addition, the annual audit fees on the 20 buildings ranged between £612 and £13,500 with a median audit fee of £1,680. The magnitude of a building's audit fee did not appear to correlate with the size of the property. Neither did it appear to be affected by whether the building's certificate included an independent accountants' report or “report of the auditors”. As a result, it is impossible to ascertain what causes the variability in audit fees as none of the reports provided a precise account of the activities undertaken by the accountants.

The analysis of the 20 certificates also reveals that certain documents included an “independent accountants' report” or a “report of auditors” even though 0% of the building's leases specified that an audit report should actually be provided (see Table 1). This indicates that these reports were either provided as a result of an agreement with Tenants or designed to provide negative assurance that the accounting data reviewed was deemed correct.

## **6.2 Analysis of service charge documents published during 2010-12**

Although the RICS Code requires that service charge accounting statements indicate whether they are prepared on an accruals or cash basis, very few service charge certificates provided a clear description of the accounting basis used during their preparation. Of the documents analysed during 2010-2012, Table 3 provides an overview of those that provided a clear description of the accounting principles used during their preparation

<b>Table 3: Evidence of a clearly defined and disclosed accounting policy</b>		
	Documents 2010-11	Documents 2011-12
Clear statement as to whether the certificate was prepared under a cash or accruals basis	3% (3 documents)	9% (9 documents)
Unclear or no statement of accounting basis	97% (97 documents)	91% (91 documents)
Total	100% (100 documents)	100% (100 documents)
Detailed statement of opening and closing accruals or provision of end-of-period balance sheet	0% (0 documents)	2% (documents)

While there is a noticeable improvement in the disclosure of accounting principles between 2011 and 2012, the results provide evidence of continued non-compliance with one of the main accounting principles of the RICS Code. Furthermore, even when a document clearly stated that the reconciliation certificate was prepared using an accruals basis, it proved difficult to identify the actual form of accruals accounting being

used as only 2% of documents provided a detailed statement of opening and closing accrued amounts, or an end-of-period balance sheet of assets and liabilities on the service charge account.

Analysis was also conducted to see whether reconciliation documents were being certified as per the requirements of the RICS Code. Table 4 provides the results of this analysis, which shows that current levels of certification fall well short of the Code's requirements.

<b>Table 4: Certification of documents</b>		
	Documents 2010-11	Documents 2011-12
Certification of the certificate by either an accountant, landlord's surveyor or manager	39% (39 documents)	66% (66 documents)
No certification or sign-off within the certificate	31% (61 documents)	34% (34 documents)
Total	100% (100 documents)	100% (100 documents)

Based upon data from 2010-12, it was apparent that a growing number of reconciliation certificates routinely included some form of "independent accountant's report" as part of the formal disclosures. However, without any clear best practice guidance or legislative requirements, it proved difficult to ascertain the work programme used during their preparation and their ultimate value. As their presentation and content varied considerably it proved difficult to adequately classify them by type, so no detailed account of their yearly occurrence is provided here.

### **6.3 Analysis of audit fees within service charge documents 2003-13**

The market for audit services is recognised to be segmented in distinct sub-markets (Beattie *et al*, 2001). While a sizeable literature exists on the determinants of audit fees in both the private and voluntary sectors, no study has explored the audit fees payable in either commercial or residential service charge markets. As a result there is little understanding of the factors that influence the magnitude of the audit fees included within the average service charge reconciliation certificate.

In research regarding the determinants of private sector audit fees, findings suggest that the most important variable is the size of the auditee (Simunic, 1980). Other important determinants include levels of engagement risk, the work programme required and the ability the auditors have to provide other services to the auditee (Barkess and Simnett, 1994). As a result, estimating audit fees is far from easy as:

"The estimation of audit fees is part science and part art. Researchers have long attempted to tip the scales toward the science side of the estimation process by identifying variables that are correlated with fees. For example, audit fee models proposed by researchers include many variables intuitively related to fees, including client size, number of segments, amount of inventory and receivables, and opinion type. However, models also include variables that some may consider intuitively related to audit fees" (Dickins *et al*, 2008, p. A9).

According to Dickins *et al* (2008) audit pricing in the private sector is normally a function of three factors:

- (1) The estimated effort to perform the audit; and
- (2) The rank of the personnel required to execute the audit; and

## (3) The audit firm's perceived risk and reward

In addition to these expected drivers of audit fees, research has shown that the quality of the client's internal controls and attitude to risk can play a major role in the size of the audit fee. Applying the above analysis to the private sector audit of UK service charges, the determinants of a building's audit fee may theoretically be influenced by:

- The engagement risk of the auditors
- Whether a financial audit or independent auditors report is required
- The size of the auditee and its contractual complexity
- The ability the auditors have to provide other services to the auditee, such as the preparation of the periodic service charge accounts.
- The quality (or lack thereof) of the managing parties accounting and internal control systems.

It would obviously require a separate research study to fully explore these issues. However, in order to provide greater insight as to the audit fees payable on UK commercial service charge accounts, audit and accounting fee data from the service charge certificates for 746 multi-let office buildings during 2003-13 were analysed. The data included £1,719,703 of audit and accounting fees within £428,657,697 of total service charge expenditure. A key problem encountered during this analysis is that the 2011 RICS Code only requires the disclosure of *Cost Category 2: Accounting fees* within the budget and certificate. As a result, a budget or certificate may not provide the cost descriptions necessary for separately identifying audit fees and independent accountants' fees from general accounting fees. Where available, the analysis of audit fees used the audit fees identified within the document. Where this data was unavailable and the certificate included an audit statement or independent accountants' report, the total accounting fee was used as a proxy for audit fees.

A key observation from this analysis was that "audit fees" were included as cost descriptions on certificates even when the external audit report or independent accountants report failed to provide a comprehensive account of the specific work programme undertaken or adequately justify the basis for the factual opinion given. As a result, the audit fees payable appeared to deliver poor value for money in terms of the assurances and relevant information they provided to occupiers and landlords alike. Figures 1 and 2 compare annual audit fees during the period 2003-213 to building size and total service charge, respectively. The size of the audit fee appears to have little relationship with either the size of the building or the total annual service charge expenditure. In order to statistically test these relationships, a multiple regression of the audit fees at the 746 buildings was conducted using building size and total service charge (excluding audit fees) as independent variables. At a confidence interval of 95%, the regression produced an adjusted  $R^2$  of 0.099044943, which means that only 9.9% of the variation in audit fees was explained by building size and total service charge (excluding audit fees).

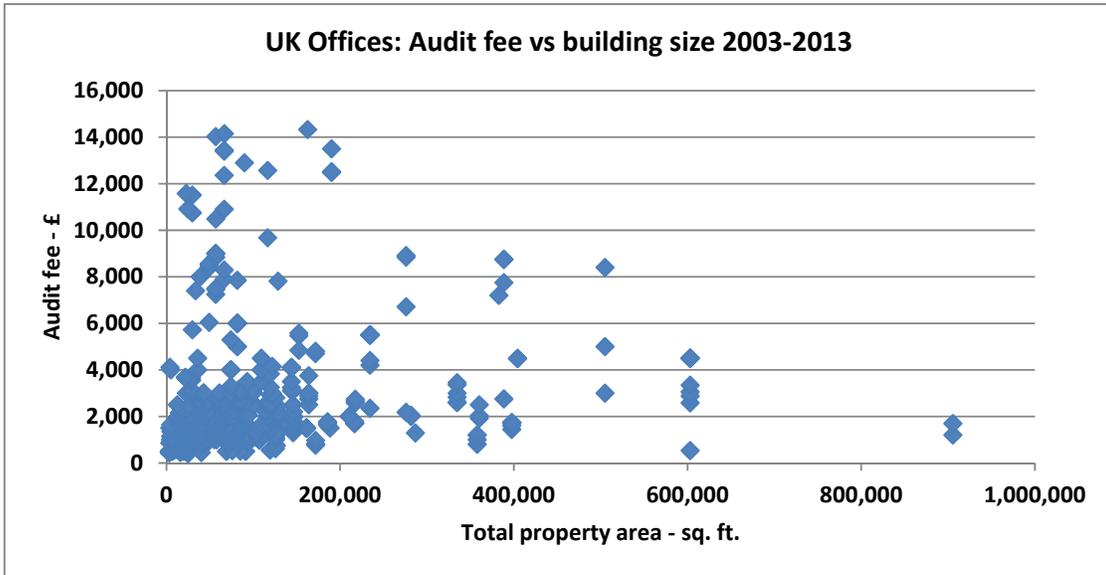


Figure 1- Audit fees v building size 2003-2013 for 746 UK buildings

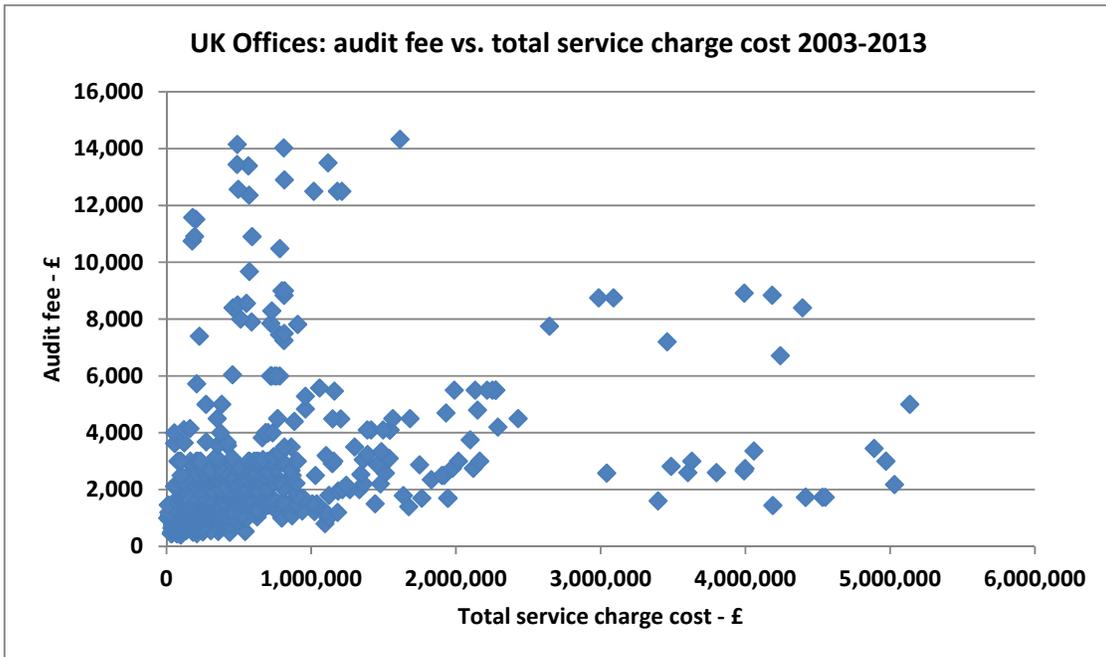


Figure 2 - Audit fee v Total Service Charge 2003-2013 for 746 UK buildings

In order to provide a more focused analysis of audit fees, the audit and accounting fees within the certificates for 186 buildings during the period 2009-2012 was analysed for their relationship with building size and total annual service charge. Figures 3 and 4 illustrate the results of this analysis for total service charge cost and building size, respectively. This results illustrate a same pattern of relationships between audit fees, building size and total service charge as the larger sample of 746 buildings.

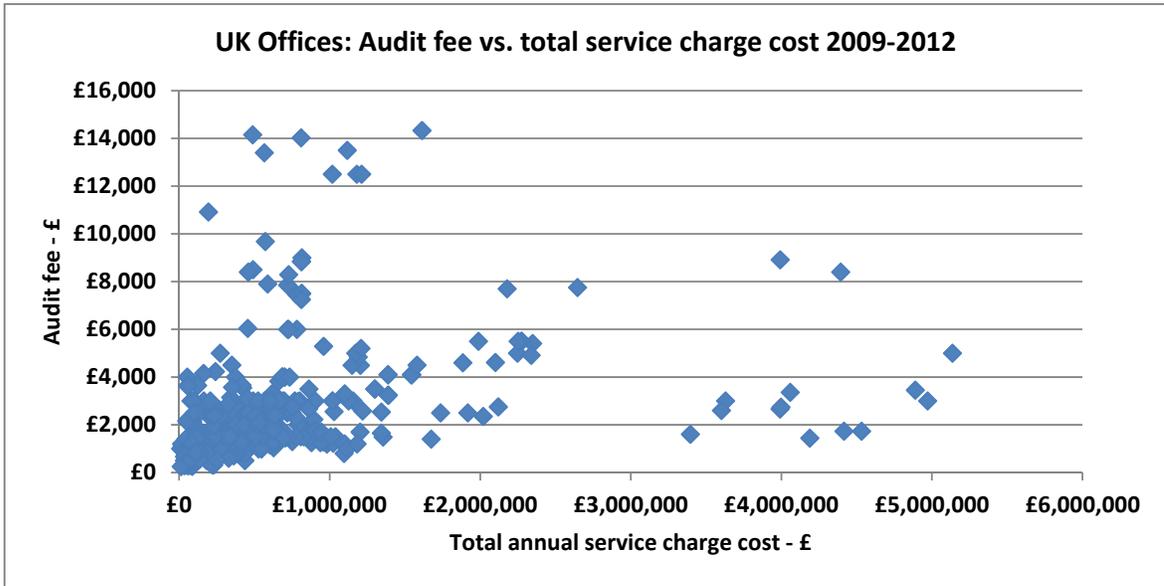


Figure 3 Audit fee v Total Service Charge 2009-2012 for 186 UK buildings

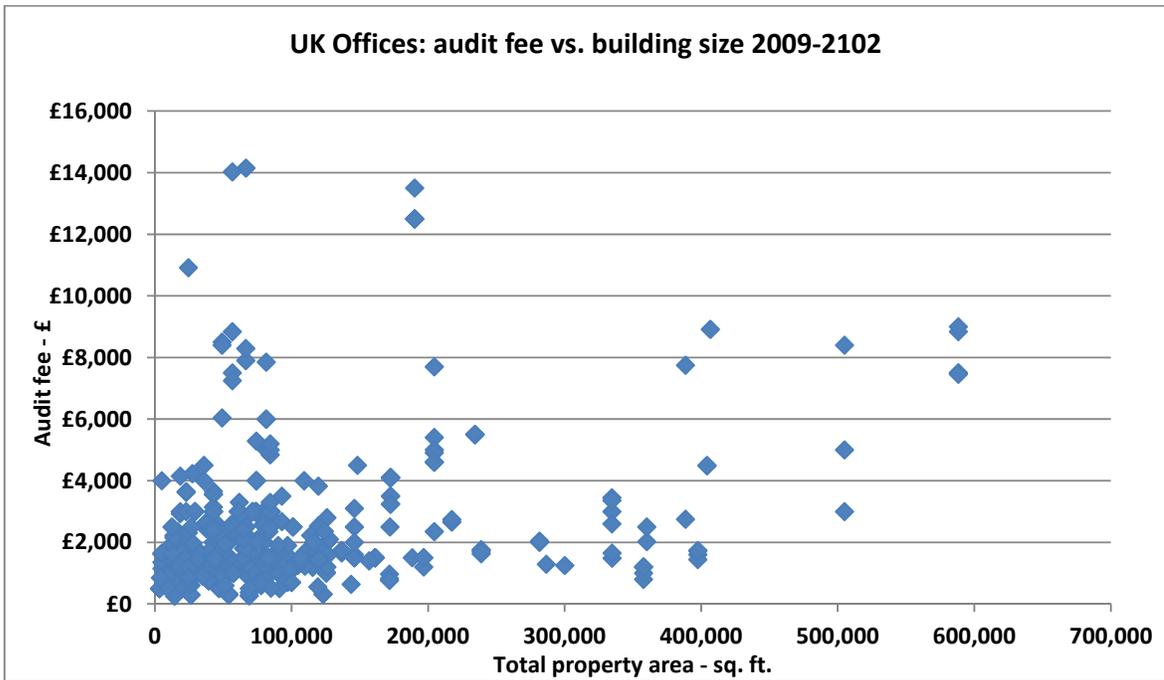


Figure 4 Audit fee v Building Size 2009-2012 for 186 UK buildings

#### 6.4 A need for an extended scope for service charge audits

At the 746 multi-let commercial office buildings analysed, the average annual service charge expenditure was £572,303, and average audit fees were £2,305, with a median of £1,601 per annum. These extremely low audit fees suggest that they were not incurred as a direct result of a full financial audit performed by a registered auditor. As a result, it is uncertain whether these services provide value for money for tenants in terms of the assurances they provide. As further support for this assertion, Barrass (2013, p. 19) even suggests that the expectations and obligations of a service charge

audit should extend beyond the confines of the work programme undertaken during a financial audit:

“Service charge audits are not the same as financial audits; they include detail over and above financial considerations. Forensic audits involve four strands of analysis, namely financial compliance, lease compliance, the value for money of services and compliance with the RICS Code of practice”

As a result of this increased scope, a forensic audit of service charge costs should verify that:

- i. Costs are compliant with financial requirements
- ii. Service charge costs are recoverable under the terms of the lease
- iii. Costs are properly recoverable under the terms of the service contracts
- iv. Costs offer value for money and are compliant with the RICS Code.

This “best practice” form of forensic service charge audit should theoretically provide assurance that building management and service charge management is appropriate and offers value for money for the occupiers. The expertise needed to conduct such a forensic service charge review goes beyond accountancy, as it requires extensive experience in the interpretation of commercial leases, commercial service contracts and service charge certification. As a result of this increased complexity, the professional costs necessary to conduct this broader audit review will exceed those incurred to conduct a comparable financial audit.

### ***6.5 Additional insights about the use of accruals accounting within commercial service charge accounting***

There is a misconception within the property industry that commercial service charge accounts are prepared on a cash, rather than accruals basis. As Table 3 illustrated, it is virtually impossible to ascertain the accounting basis used by reviewing published documents, as the majority fail to disclose details of the accounting principles used or provide an opening and closing balance sheet for the service charge account. As a result, archive research can only be used to proof that there is a widespread failure to adequately disclose the basis used during the preparation of service charge certificates. As these reconciliation certificates are the legal basis for demanding payments from tenants, knowing the basis of their preparation is vital for understanding whether periodic service charge expenditures are fair and reasonable.

During the course of analysing the service charge documents for this research, a number of documents were supplied with additional accounting disclosures that provided additional insight as to whether accruals accounting was used during their preparation. For example, 2% of the certificates from 2011-12 provided a list of opening and closing accrued balances for certain forms of service charge expenditure. This is clear evidence that some form of accruals accounting was being used on those buildings. Combining this evidence with data obtained from interviews with tenants and landlords (Eccles and Holt, 2009), it does appear that some form of accruals accounting is being used within the commercial service charge sector. Calculations of annual service charge expenditure may include accrued amounts to cover future refurbishment costs, irrespective of whether they are formally recognised as a contribution to a sinking fund or reserve fund. Furthermore, there is evidence that prepaid energy deposits are

often collected through the service charge account without being formally disclosed on the service charge certificate. As a result, greater transparency is needed within service charge accounts so that tenants can measure the true impact of accruals accounting on their annual service charge demands.

## 7.0 Conclusions

The management of commercial service charges, and the treatment of accounting and auditing issues within that process, operate within a unique position within the chartered surveying occupation. Managing parties are allowed to act unregulated with only an advisory non-mandatory RICS Code of Practice to guide them. While it is true that the 2011 version of the Code, its 2013 update and associated accounting guidance note provide a skeletal framework of accounting and audit principles for use when preparing and reviewing commercial service charge accounts, this guidance lacks detail. This paper has highlighted a number of these omissions, including the Code's failure to adequately explain how accruals accounting should be applied to service charge costs and its inability to clearly specify an appropriate work programme for an independent accountants review or audit.

It does appear that the RICS requires specific assistance from the UK accounting profession before it can provide a coherent framework for commercial service charge accounting and auditing. The ICAEW provided a technical release for residential service charge accounting and a similar document is urgently required in the commercial sector. In the absence of such a document, managing parties are primarily guided by the RICS Code, subject to the specific requirements of the lease. As this paper's analysis of 20 commercial leases has highlighted, clauses relating to accounting and audit are inconsistent and lack specificity. For example, service charge costs may be defined differently and the requirements for the preparation and certification of the periodic service charge certificate varying widely. As a consequence, it is no surprise that this paper's empirical analysis of accounting and audit practices reveals poor levels of accounting disclosure, certification and reporting.

Current accounting and audit practices for commercial service charges are inconsistent and fail to embody the principles of best practice that are typically found within mainstream private sector financial accounting and auditing practice. As this paper and other research has shown, there appears to be an "expectations gap" between what commercial tenants might expect to receive in terms of service charge accounting and audit quality and what managing parties actually provide. Nowhere is this more evident than in terms of the audit fees payable on service charge accounts. These fees are extremely low when one compares them to the cost of a typical financial audit, and it is often difficult to establish the exact work programme that was undertaken. Furthermore, the presentation of an audit report often misrepresents the assurances it provides. For example, this paper's analysis of reconciliation certificates found that 45% included a section entitled "report of the auditors", which implied that a full financial audit had been undertaken when this clearly was not the case. Closing this expectations gap will have a clear benefit to tenants, but such a development in 'best practice' might also be a source of competitive advantage to landlords in improving the long-term efficiency of the service charge process.

Despite the forthcoming publication of the new 2013 RICS Code and its associated accounting guidance paper, there is a need for further consultation within the

commercial property sector to establish 'best practice' principles and practice in both the initial accounting for service charges and subsequent audit process. Once established, these principles will represent the UK property industry's view of the most desirable structure for statements of account and may be incorporated within a further version of the RICS Commercial Code. These principles can also be implemented within new leases and at lease renewal, leading to improved accounting and auditing practices and enhanced transparency within the annual service charge certificate.

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