

Service Charge Operating Report *for*

OFFICES 2015



5th
Anniversary

SCOR
for
OFFICES

CONTENTS	PAGE
1. Introduction	2
2. Five Year Compliance Analysis – Commentary by Professor Andrew Holt	2
3. Findings and Analysis	3
• 3.1 Cost Benchmarking using a snapshot of the most recent year	3
• 3.2 Longitudinal Cost Benchmarking	4
• 3.3 RICS Code Compliance	5
• 3.4 Certificates carrying an Accountant’s Sign-Off vs. Compliance	7
4. Recommendations	7

1. INTRODUCTION

Property Solutions continues its commitment to driving change through the analysis of Service Charge data and sharing the results with the industry. We strongly believe that continuous research and stakeholder engagement can contribute to positive transformation of the market. In producing this Service Charge Operating Report (SCOR) for Offices 2015, Property Solutions is working alongside Professor Andrew Holt, Department of Accounting, Metropolitan University of Denver and Visiting Fellow, Kingston University.

2. FIVE YEAR COMPLIANCE ANALYSIS – COMMENTARY BY PROFESSOR ANDREW HOLT

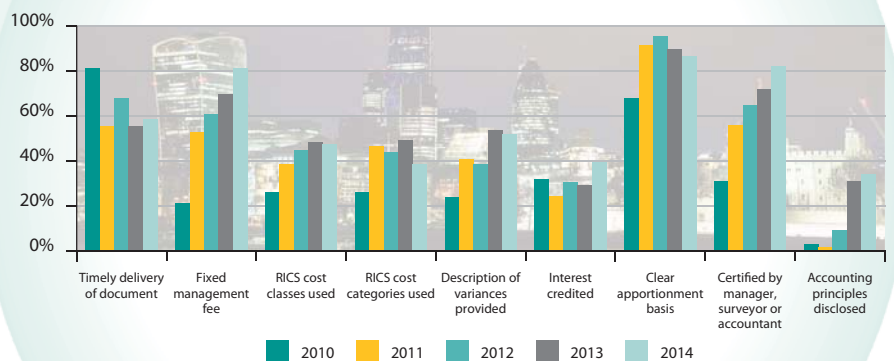
As this year marks the fifth anniversary of the SCOR for Offices publication, it appears an opportune moment to reflect on SCOR’s benchmarking results for compliance to the Royal Institute of Chartered Surveyors’ (RICS) Code of Practice - Service Charges in Commercial Property (Code) during the period 2010-2014. During this period, three different editions of the Code have introduced stringent requirements for the preparation of Service Charge accounting certificates and budgets, in order to improve their presentation quality, usefulness, information content and transparency. The Code’s requirements act as a guide to practitioners, and help to foster best practice within Service Charge accounting.

Since its inception, SCOR has monitored the level of industry compliance with the accounting requirements of the 2006, 2011 and 2014 versions of the Code, which included seven, nine and ten specific elements, respectively.

Data were obtained from an annual analysis of 100 Service Charge certificates supplied to occupiers at UK offices during the period 2010-2014, and the results provide much needed transparency as to whether the Code is being followed by practitioners. Figure 1 illustrates the yearly levels of compliance with each of the nine accounting requirements of the 2011 Code during the period 2010-2014.

While the SCOR analysis identified high levels of annual compliance in terms of certificates providing a clear apportionment basis for occupiers, the results for many of the other accounting metrics prescribed by the Code were mixed. In terms of charging a fixed and transparent management fee, there was a clear trend towards increased compliance, with results increasing from 21% to 82%, in 2010 and 2014, respectively. A similar pattern of increased compliance was evident in terms of annual Service Charge accounting statements being certified by a qualified individual, with compliance levels increasing from 31% to 83%, in 2010 and 2014, respectively. While overall sign-off levels have increased, the type of certification varies, generally being limited to whether a certificate provides an accurate record of Service Charge expenditure, and often silent as to whether the expenditure being recovered is in accordance with the lease. There is a clear

Figure 1: Annual levels of RICS Compliance 2010-2014

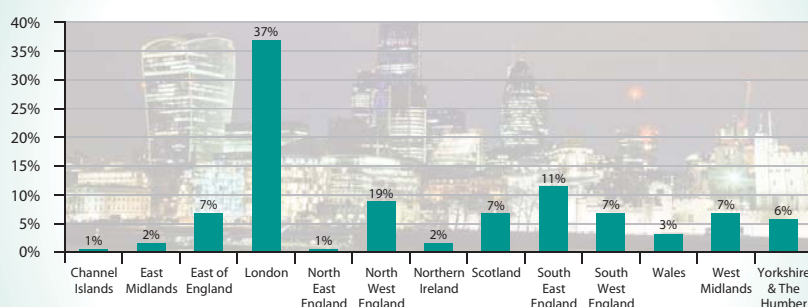


need for improvement in terms of the assurances being provided by current sign-off statements, especially as certification is often achieved through the provision of an independent accountant’s report within the published certificate. In 2014, the Institute of Chartered Accountants in England and Wales (ICAEW) issued TECH 09/14BL Accountants’ Reports on Commercial Property Service Charge Accounts (ICAEW, 2014) to establish best practice in the conduct of any review engagement for preparing a report on the annual statements of Service Charge expenditure, thereby ensuring greater consistency in assurance procedures and reporting. The Technical Release’s guidance was effective for periods starting on or after 1 April 2014, although earlier implementation was encouraged. While it is too early to assess the impact of this technical release in improving the assurances provided by independent accountants’ reports, the new guidance has the potential to increase the overall quality of Service Charge accounting.

While the disclosure of accounting principles and policies (i.e. such as whether the accounts were prepared on a cash or accruals basis) improved significantly during 2010-2014, such information was still only disclosed within 34% of certificates during 2015. For the remainder of the nine accounting metrics from the 2011 Code, there was no apparent trend towards improved compliance. Poor compliance is still evident in terms of the timely delivery of Service Charge documents to occupiers, even though this requirement was part of the original 2006 Code. In all years, no more than 49% of certificates correctly utilised either the cost classes or categories prescribed by Code, a deficiency that restricts the comparison of Service Charge expenditures between buildings. Similarly, no more than 54% of each year’s certificates provided a detailed explanation of significant expenditure variances and no more than 40% credited interest to the Service Charge account.

As the RICS is yet to provide benchmarking data on Code compliance, SCOR’s yearly compliance results have provided the industry with invaluable data about current levels of Code compliance. The results show that the quality and consistency of financial reporting practices for commercial Service Charges are generally poor. Full compliance with the Code’s accounting requirements in the office sector appears some way off and, given that the RICS emphasises the Code as having the status of a guidance note, this raises the question of whether voluntary adoption works, even with the added weight of the legal protection it offers against negligence claims. A more detailed analysis of the compliance results for 2014 can be found in section 3.3. of this report.

Figure 2: Geographical spread of the properties in the dataset, classifying them by their UK Government Office Region (GOR).



3. FINDINGS AND ANALYSIS

3.1 Cost benchmarking using a snapshot of the most recent year

The core data for SCOR was obtained from the analysis of Service Charge documents supplied by occupiers of 199 large-scale multi-let offices owned and managed by multiple entities. The characteristics of the dataset used for the main cost analysis are shown in Table 1 and Figure 2.

Years	No. of buildings	Type of documents	Total Service Charge cost (£)	Total floor area (sq. ft.)
2013-2015	199	Certificates of expenditure / budgets	175,972,864	37,084,576

Table 1: Characteristics of the core dataset used for the main cost analysis

Statistical analysis of Service Charge costs is presented in Figure 3 and Table 2 overleaf with the latter showing the results as selected cost categories were further compared between properties located in London and throughout the rest of the UK.

Median cost (£ per sq. ft.)	London	Rest of the UK
Management fee	0.69	0.46
Site management resources	0.47	0.29
Electricity	1.46	0.45
Security	1.63	0.61
Cleaning & environmental	1.04	0.76
Mechanical & Electrical (M&E services)	1.55	0.64
Lifts & escalators	0.17	0.12
Fabric repairs & maintenance	0.43	0.34
Major works	0.31	0.23

Table 2: Service Charge expenditure comparison between properties located in "London" and the "Rest of the UK"

The results suggest that London properties incur higher costs when compared to locations outside the capital. It is understood that operating a business in London has higher costs associated such as accommodation costs and salary levels. This does not, however fully explain the higher rates per sq. ft. in categories such as Management Fee (50%) and Site Management Resources (62%). Higher rates in items such as M&E Services (142%) and Electricity (224%) could be explained in part by the fact that all London properties in the dataset were air-conditioned (AC), unlike the other properties. In general, offices operating in London will have their doors open for longer periods which would also add to these higher rates. In summary, although we expect rates to be higher in the capital in comparison to the regions, we would not expect them to be so marked on a purely commercial basis. It seems that businesses are paying a premium simply for having a London postcode.

3.2. Longitudinal cost benchmarking

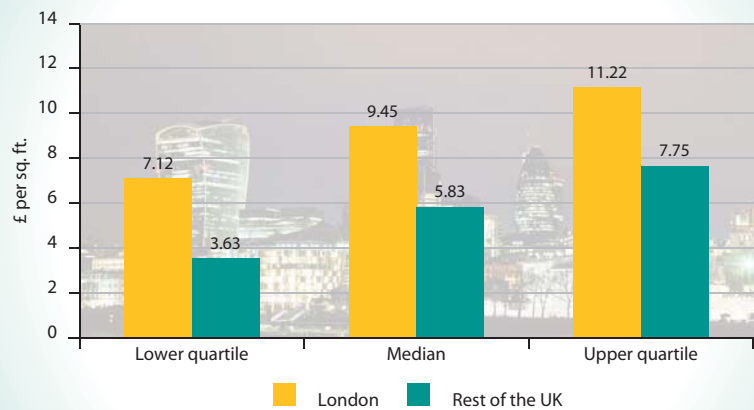
A separate longitudinal analysis over four-continuous years (2012-2015) was performed on a sample of 83 office buildings selected from the total population of 199 buildings based on the availability of documents for each year. The analysis was performed to identify cost trends and provide greater insight into the changing nature and magnitude of Service Charge costs over a period of time. We believe this year-on-year comparison is fundamental in understanding Service Charge expenditure.

Overall the total Service Charge cost per square foot increased, interestingly while the median only increased by 2.5% the Upper and Lower Quartiles increased by 10% and 25% respectively. This general increasing trend is comparable to previous SCOR for Offices longitudinal analyses and reflects the continuing growth in the economy as a whole.

Years	No. of buildings	Type of documents	Total Service Charge cost (£)	Total floor area (sq. ft.)
2012-2015	83	Certificates of expenditure / budgets	59,342,386	9,325,020

Table 3: Characteristics of the dataset used for the longitudinal cost analysis

Figure 3: Total Service Charge costs compared between properties located in "London" and the "Rest of the UK"



The same nine cost categories as used in the main cost analysis have been compared year on year, the results are given in the following table.

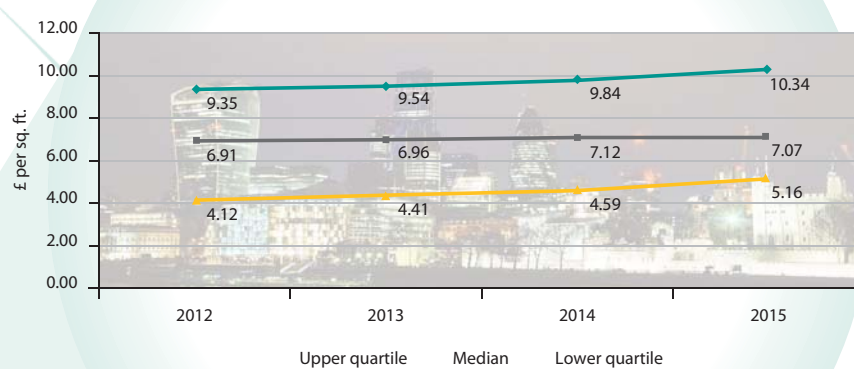
Median cost (£ per sq. ft.)	2012	2013	2014	2015
Management fees	0.52	0.50	0.49	0.51
Site management resources	0.38	0.39	0.37	0.44
Electricity	0.68	0.93	0.87	0.99
Security	1.02	0.78	0.78	0.77
Cleaning & environmental	0.88	0.88	0.89	0.86
M&E services	0.99	1.00	1.02	1.02
Lifts & escalators	0.15	0.15	0.15	0.13
Fabric repairs & maintenance	0.30	0.32	0.30	0.40
Major works	0.01	0.01	0.20	0.05

Table 4: Service Charge expenditure across nine categories compared over four years: 2012-2015

The rise in rates (in £ per sq. ft.) over the four years in this dataset were less marked when looking across the nine cost categories separately. Drilling down into further detail, the differential between the growth in costs in London as compared to the rest of the UK cannot be wholly explained by financial factors. The well-documented foreign interest in the London property market may well be an added driver of these trends. The rise in Management Fees, Site Management Resources and Security in London were especially marked although due to the smaller number of data points, these rises are not statistically significant.

The 83 buildings were also split – as far as possible – into those which benefitted from air-conditioning and those that did not and the Electricity and M&E Services categories further analysed. It is clear that in both cases costs are rising but a building having AC remains between 2.5 and 3 times more expensive in terms of Electricity and M&E Services to run.

Figure 4: Total Service Charge cost trends for years 2012-2015- £ per sq. ft.



Median cost (£ per sq. ft.)	2012	2013	2014	2015
Electricity (AC)	0.90	1.14	1.27	1.24
Electricity (Non AC)	0.34	0.35	0.42	0.38
M&E (AC)	1.36	1.30	1.25	1.41
M&E (Non AC)	0.49	0.49	0.44	0.55

Table 5: Electricity and M&E costs compared between air-conditioned and non air-conditioned properties

3.3. RICS Code compliance

Based upon the analysis of a sample of 100 Service Charge certificates, this section provides information about compliance with selected transparency requirements of the RICS Code in relation to the preparation and issuing of Service Charge documents. The summary of the sample is presented in Table 6.

Years	No. of buildings	Type of documents	Total Service Charge cost (£)	Minimum no. of property owners represented	Minimum no. of managing agents represented
2013-2014	100	Certificates of expenditure	55,923,657.22	83	49

Table 6: Characteristics of the dataset used for the compliance analysis

Ten specific accounting requirements from the 2014 Code (released in February 2014) were used to evaluate the level of transparency in Service Charge documents. One additional compliance metric was added to the nine monitored in the previous edition of SCOR, as the 2014 version of the Code requires that a schedule of accruals included in the Service Charge expenditure be provided within the certificate. The results of the compliance analysis for 2014 certificates are shown in Figure 5.

When compared to last year's, the compliance results show there is an improvement in both the charging of a fixed and transparent management fee (82% compared to 70%) and the certificate being signed off by a qualified individual (83% compared to 73%). For the other seven metrics monitored last year, overall results remain relatively unchanged.

In terms of the new metric measuring the provision or listing of accrued expenses, only 1% of certificates provided such a list. As 34% of certificates clearly stated that they were prepared on an accruals basis, it is clear that practitioners are virtually non-compliant in terms of the 2014 Code's requirements to provide a clear account of opening and closing accruals. It is true though, that these accruals (within the one compliant certificate) were handled correctly as per the ICAEW Technical Release on the subject which asks accountants to verify that accruals are correct in that they are for work done in the year in question.

While the analysis for each reporting metric is illustrative of the reporting practices across the commercial office sector, it fails to reveal the extent to which each individual document complies with each of the Code's ten accounting requirements. As a result, each document was individually analysed to provide it with a Code compliance "score" of between 0 and 10. The results are summarised in Figure 6.

11% of the sample achieved a scorecard ranking of "9" or over, which is an improvement on last year. Overall, the level of compliance has improved since last year with 80% of certificates receiving a minimum score of "4" or higher. However, there is still considerable room for improvement, as many of the most recent certificates still fail to comply with the seven accounting requirements first introduced by the 2006 version of the Code. For more information on the use of accruals accounting in commercial Service Charge management, please have a look at the research entitled 'Accounting for UK Commercial Service Charges' on our website.

Figure 5: RICS Code compliance result

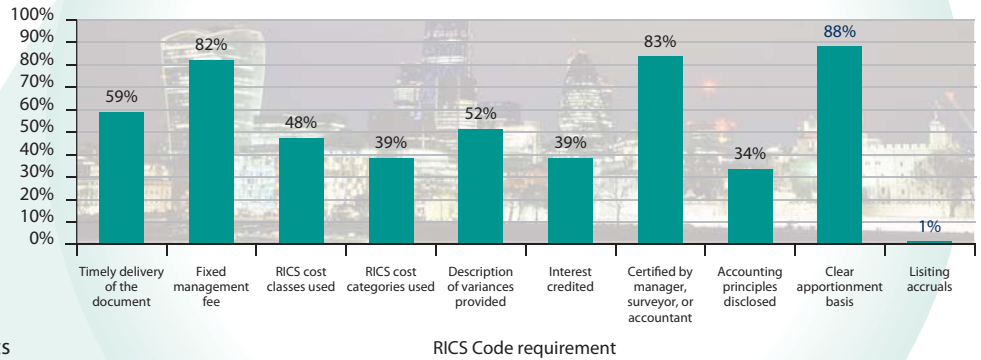


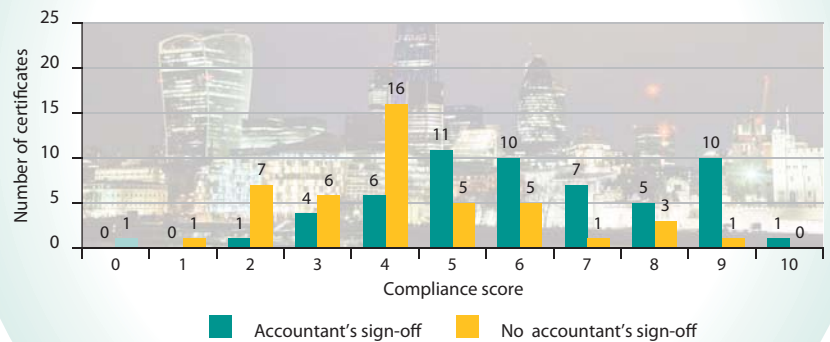
Figure 6: Service Charge management compliance scores



3.4. Certificates carrying an Accountant's Sign-Off vs. Compliance

After analysing the compliance scores it was observed that those certificates including a sign-off by an accountancy firm generally achieved a higher compliance scorecard ranking. Of the certificates scoring a "4" or less only 26% included an accountant's sign-off. However, for those achieving a score of "5" or more, 76% had an accountant's sign off. These results could be due to several factors; certificates prepared for the scrutiny of an accountant are better prepared, landlords or managing agents who employ an accountant for such a task already have higher standards of compliance or the accountants themselves prepare the certificate and thereby aid its overall level of Code compliance. Figure 7 illustrated the relationship between compliance and accountants' sign-offs.

Figure 7: Accounting sign-offs vs Enhanced compliance



4. RECOMMENDATIONS

Based on the analysis presented in this Report, our recommendations are summarised below:

- Occupiers should review Service Charge budgets and certificates in detail, especially when the costs incurred are higher than the industry average featured in this report.
- Overall accounting transparency remains an issue and we recommend that managing parties pay more attention to this element of property management and aspire to best practice.
- Managing parties should improve the consistency of the accounting sign-off and certification process, including a much clearer explanation of the specific assurances being provided to tenants.
- Accountants who aid in the sign-off process should engage with other property professionals in validating compliance of costs with leases and service contracts in order to improve the level of assurance offered by the certification process.

Should you wish to discuss any aspect of this analysis or, if you would be interested in including your properties in future studies, please do not hesitate to email us at research@property-solutions.co.uk.

SERVICE CHARGE OPERATING REPORT for Offices 2015

Published by Property Solutions (UK) Ltd, July 2015. Copyright of Property Solutions (UK) Ltd.

Should you have any questions, please contact the authors directly:

Professor Andrew Holt Department of Accounting, Metropolitan State University of Denver and Visiting Fellow, Kingston University
E: aholt7@msudenver.edu T: (001) 303 556 4565

David Barrass Managing Director, Property Solutions (UK) Limited
E: david.barrass@property-solutions.co.uk T: 01454 332217

Olisa Pal Marketing Assistant, Property Solutions (UK) Limited T: 01454 332205

Claire Bendall Sales & Marketing Assistant, Property Solutions (UK) Limited T: 01454 332234

Nigel White Associate Director, Sales & Marketing, Property Solutions (UK) Limited T: 01454 332219

ACKNOWLEDGEMENTS

We would like to thank all the companies which have agreed to provide data for this Report, including:





Service Charge Operating Report for
OFFICES 2015