

Briefing Paper

Calculating Service Charges

January 2014

Introduction

Revenue service charges are charged to leaseholders and tenants and charges must reflect actual costs and be reasonable. Capital service charges are charged to leaseholders only and must reflect actual costs and be reasonable. There is also a requirement to carry out specific consultation (including issuing section twenty notices) and demands for payment must be made within eighteen months of works being completed.

What should go into a Service Charge?

Leaseholder service charges must be provided for in the lease – including the capital and revenue items. Tenant service charges must be provided for in the tenancy agreement and include revenue items only. There is a need to decide what items to charge for. For example, many landlords charge for the maintenance and replacement of lifts in blocks of flats. However, in 2002 the then Office of the Deputy Prime Minister issued guidance to local authorities stating that service charges should not be introduced for lifts in flats because being able to use the lift is integral to the tenancy.

In determining what should be included in service charges a social landlord should consider the lease and tenancy agreements, legislation (especially the 1985 and 1987 acts) and case law. In considering the eligibility of particular services within a service charge for secure tenancies a rent officer would consider:

- Whether the item was approved by the tenants
- Whether the cost is reasonable when compared with similar services in similar properties

Service charges are commonly levied to cover the following costs:

- Staffing costs (including scheme managers, caretakers and cleaners)
- Heating and hot water fuel charges
- Light and power to communal areas
- Cleaning and refuse disposal
- Carpets and furnishings
- Laundry equipment, white goods and specialist equipment
- Building plant, equipment and installations
- Television systems
- Leisure facilities
- Gardens and grounds
- Roads and car parking
- Water supplies and sewerage charges
- Local taxation
- Management costs
- Audit fees

The calculation of service charges should include both the direct and indirect costs of the service including appropriate overhead and administration costs. Overhead and administration costs may need to be apportioned or allocated as described below.

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It is necessary to decide the level at which costs will be collected. This can be done at block, estate, scheme or district level. Then there is a need to decide how to apportion costs to dwellings with units, bedrooms and bed spaces being common methods. There is sometimes an intermediate stage of apportionment, for example, using floor space to apportion costs between schemes.

Administration

Administration fees can be based on actual costs or estimated costs. Actual costs can include the cost of the staff employed in administering service charges plus appropriate oncosts. This is the practice, for example, at Northampton Borough Council where I recently provided advice on service charges for leaseholders and tenants. Estimated administration costs are calculated as an on-cost on the cost of the direct service charges. For example, Oldham Borough Council, where I recently provided advice on service charges, decided to use a rate of 10% to recover overheads and administration. This is consistent with the advice of the rent officer who has also said that the use of 15% would be acceptable for housing associations.

The courts have recognised that social landlords can have difficulty in identifying actual costs. For example, in *Mahase v the London Borough of Camden* it was stated that:

“Payment of a management charge based on a percentage of costs is not intrinsically unreasonable, having regard both to the position of the purchaser and of the vendors.”

Schedule 11(4) of the Commonhold & Leasehold Reform Act of 2002 that covers the rights and obligations of service charge payers regarding administration charges is summarised in appendix B.

Staffing Costs

Service charges for staffing costs (including wardens, managers, caretakers and concierges) are usually calculated to include the full salary plus an on-cost less a proportion for general housing management. The costs of caretakers are often apportioned between estates and then between general management and service activities. In 1967 the London Rent Assessment Committee decided that an appropriate appropriation to service charges would be 15%.

The costs of national insurance, superannuation, life assurance and permanent health insurance can also be included in the calculation of the service charge. The cost of sick leave can be included in service charges up to a period of three months.

Certain expenses of staff (if reimbursed by the employer) can be included in the calculation of the service charge, including travel costs and council tax on staff accommodation. The costs of telephones, mobile telephones, broadband connections can also be included.

Warden costs can be pooled between schemes to protect tenants in smaller schemes from relatively high service charges as long as it can be demonstrated that all tenants receive the same standard of service regardless of which scheme they are in. However, it is not always possible to do this in the case of leaseholders because of the conditions that are usually found in the leases.

Caretakers' costs are typically apportioned between estates and then apportioned between services that are funded by rent and those that are funded by service charges. Examples of activities that are funded by rent include rent collection and accounting and routine repairs. Examples of activities that are funded by service charges include cleaning and gardening. Costs including the running costs of caretakers' vans can also be recovered through service charges including fuel, tax, insurance, maintenance and depreciation.

Supporting People

A distinction must be made between staff who provide housing management services and those who provide housing support services. The former can be funded through service charges while the latter should be funded from Supporting People Grant. Supporting People Grant can fund other services including:

- An element of the cost of the warden / scheme manager
- Warden call system alarm costs
- Internal window cleaning to flats
- Cleaning of tenants' rooms

Pressure on local government revenue budgets following the Comprehensive Spending Review of 2010 and the subsequent reduction in Revenue Support Grant and Council Tax 'freezes' coupled with the end to ring-fencing of Supporting People Grant has led many local authorities to reduce their Supporting People budgets. This has reduced the income of local authority housing revenue accounts and housing associations. Some local authorities have also restructured their Supporting People Grant to focus on supporting housing associations while making up the shortfall in funding in the housing revenue account by increasing service charges.

Heating, Lighting and Energy

Where the landlord provides heating or hot water to individual dwellings this can be recovered through a service charge but such service charges are not eligible for housing benefit. Where the landlord pays the electricity or other utility bill for a building and then recharges the residents this is regarded as a private payment that is outside of the service charges system.

Service charges can be made for heating and lighting of communal areas including staircases, corridors and any communal rooms. This includes communal bathrooms, kitchens, laundries, areas for storing and recharging mobility scooters, guest rooms and the warden's office in a sheltered housing scheme. It also includes external lighting including car parks and street lights on private roads. Replacement of light bulbs and tubes can be included in service charges but not the repair of fittings. Such service charges are eligible for housing benefit.

One option for service charges for the heating and lighting of communal areas is to apportion the total electricity bill between flats and communal areas based on floorspace and to recover the communal element as a service charge.

Cleaning

The cleaning of the outside of a property and the cleaning of common areas inside can be covered by service charges as long as the tenancy agreement or lease does not make it the responsibility of the resident. Where the local authority charges for refuse collection, the cost is recoverable through the service charge. Pest control can also be recovered through the service charge although where a particular resident is considered to be responsible for the infestation because of their lifestyle it is common to make a specific charge to that resident.

The cleaning of communal areas may be done by a caretaker, warden, cleaner or contractor. In calculating service charges there is a need to apportion the cleaners' wages between communal areas and other work and to add appropriate on-costs.

Lifts, Furniture and Equipment

The cost of maintaining, insuring and depreciating lifts can be contentious. It is common for housing associations to include these costs in the service charge for all residents in a building, even those on the lower floors who may not make use of them. In 2002, the government issued guidance to local authorities to say that they should not charge tenants for lifts because the use of the lift is integral to the tenancy and should therefore be funded from the rents. The government also argued that it would be unfair for councils to charge service charges for lifts as this would make it more expensive to live in a high-rise flat than a street property. Consequently, most local authorities have avoided introducing service charges for lifts, although some have done so. Leaseholders are usually issued with service charges for lifts.

Maintaining, cleaning and renewing floor coverings in communal areas can be covered by a service charge. The correct treatment of floorings to corridors is less clear as the landlord has an obligation to provide safe access to all dwellings. A basic floor covering should therefore be funded from the rent while a better quality carpet could be funded from service charges.

If a landlord provides furniture within a dwelling the cost is usually recovered through the rent, but a service charge can be made for maintaining cookers, refrigerators or other 'white goods'. The cost of furniture in communal areas would be included in the service charge including the cost of providing and maintaining equipment in a communal laundry. Any income collected from use of the communal laundry would be deducted from the costs before calculating the service charge.

Where specialist equipment is installed in an individual dwelling – for example for disabled people – it would be usual to amend the tenancy agreement to make it explicit that the cost would be recovered through a service charge.

Other costs that can be met from service charges include electrical inspections, ventilation systems in common areas, emergency lighting in communal areas, fire fighting equipment, fire detection and smoke dispersal systems, fire risk assessments, sewage pumps, door entry telephones and CCTV.

Grounds Maintenance

Costs of managing and maintaining open spaces can vary greatly and work can be carried out by contractors, staff or residents. Sometimes there is a need to include the maintenance and / or depreciation of plant. There can also be non-recurring costs such as tree surgery. There is often a lack of information on which to base the calculation of apportionments. One local authority recently resolved this question by dividing the borough into three zones and calculating a service charge for grounds maintenance in each zone per bed space. This is probably not an ideal approach and a more specific method would probably have been better if one could have been devised.

Depreciation

Depreciation is commonly used in accounting and is a method of covering the costs of an asset by writing off its costs over its estimated life. Its potential use in calculating service charges was confirmed in the Regis property case (1958). Landlords are therefore able to collect depreciation as part of the service charge to recoup what they have already spent on a capital asset or to make provision for its replacement where the initial cost has been met by grant. In the latter case housing associations will often credit depreciation to a provision to which interest can also be added. This is distinct from establishing a sinking fund.

The former Institute of Rent Officers published guidance on the life of various assets and pieces of equipment that is still used by Rent Officers in establishing a fair rent and by social landlords in calculating depreciation for inclusion in service charges as well as for other purposes. The recommended lives are as shown below:

- Central heating boiler – 10-20 years
- Lift – 25-30 years
- Paladins – 10 years
- Lawn mowers – 8 years
- Communal carpets – 10-12 years
- Laundry equipment – 8 years
- Cookers and refrigerators – 8 years
- Emergency lighting – 20 years
- Fire detection alarms – 15-25 years
- Firefighting equipment – 10-12 years
- Warden call – 10-15 years
- Door entry telephone – 15-20 years
- Television aerial – 20 years

The National Housing Federation suggests that ventilation systems should be depreciated over ten years and that satellite dishes should be depreciated over twenty years.

Usage Charge

The 'usage charge' is commonly used in calculating service charges in sheltered schemes for smaller items of equipment that are provided to tenants. The principle is that the charge is based on 'fit for purpose' rather than a precise depreciation calculation. The landlord guarantees that the equipment will work at all times and will be replaced when required rather than in accordance with the estimated life used in calculating depreciation. The usage charge is based on depreciation but is also increased annually in line with inflation with the intention that it will generate sufficient resources to replace the equipment when required.

What should not be included in Service Charges?

The former Institute of Rent Officers Educational Trust published a list of items of expenditure that should not be funded from service charges in 1994. This is still considered to be a definitive list and is as follows:

- Repair, maintenance and insurance of the dwelling structure, fixtures and fittings and of the installations within the dwelling as specified in section eleven of the Landlord and Tenant Act 1985.
- Provision, repair and maintenance of communal halls, stairways and passages.
- Provision of fixtures and fittings, including radiators, pipes etc. within the dwelling.
- Refrigerators, cookers and washing machines within the dwelling, if only provided by the landlord with no covenant to keep in repair or to maintain, would usually be treated as furniture. Cookers in communal facilities should be treated as a service.
- Voids.
- Decoration of common parts, other than communal rooms.
- Interior decoration of dwellings, including provision of decorating materials.
- Management costs for other than service items.
- Staff training levies.
- Deficits and surpluses arising from previous years' costs.

Designing-out Service Charges

Service charges should be considered at the inception of the development process rather than being treated as an afterthought. At the scheme approval stage it should be clear what the service charges would be. High service charges can deter prospective tenants and owners especially when they are on low incomes and can create problems with affordability and income collection once the homes are occupied. The size, type, design and future management of the development all need to be considered.

If a scheme is being funded by the Homes & Communities Agency or Greater London Authority there is a need to comply with the funder's procedures. In particular, there is a need to ensure that the calculation of service charges is accurate since rents and service charges at the practical completion of the development must be equal to or less than those agreed at the grant confirmation stage.

Fixed and Variable Service Charges

A fixed service charge is where the landlord estimates the cost of providing services to a property at the beginning of each financial year. The tenant pays the service charge throughout the year and at no point will there be additional amounts to pay or refunds due back. This is the usual approach when making service charges to tenants.

Variable service charges occur where the landlord sets an estimated charge at the beginning of the financial year, and then produces a final account once the year is complete. The final account compares the actual costs in delivering services to a property against the estimate that was set, and may result in a credit back or an additional amount due from the resident. This is the usual approach when making service charges to leaseholders.

Section eighteen of the Landlord & Tenant Act 1985 defines a variable service charge as follows:

“Service charge means an amount payable by a tenant of a dwelling as part of or in addition to the rent-

- (a) Which is payable... for services, repairs, improvements, maintenance, insurance or the landlord’s costs of management and*
- (b) The whole part of which varies or may vary according to the relevant costs.*

“The relevant costs are the costs or estimated costs incurred or to be incurred by or on behalf of the landlord... in connection with matters for which the service charge is payable.

“For this purpose costs includes overheads and costs are relevant costs in relation to a service charge for which they are incurred, or to be incurred in the period for which the service charge is payable, or in an earlier or later period.”

The Commonhold & Leasehold Reform Act 2002 amended provisions for variable service charges under the 1985 and 1987 Landlord & Tenant Acts. Section 152 outlines the information that must be provided to tenants and allows for tenants to withhold service charges if inadequate information is provided (however this has yet to be enacted). Section 153 provides for an accompanying notice. Section 154 entitles a tenant to inspect documents.

In defining best practice the National Housing Federation states that:

“The decision between a fixed and variable service charge regime is one for each housing association to make, and often will be finely balanced. A variable regime means much more stringent procedures but in exchange it guarantees that the landlord... can recover every penny spent on services. Generally, the larger the service charge in relation to the net rent, and the likelier it is to vary unpredictably from year to year, the stronger the case for a variable charge. However, in general needs housing, where service charges are relatively low and reasonably stable, a regime of fixed charges may well be adequate.”

Impact Housing Association recently consulted with residents on service charges and decided to ‘keep it simple’. They found that tenants wanted to know how much they would have to pay and what they were paying for. They also found that administering variable service charges would cost £40,000 a year more than administering fixed service charges. It was therefore decided to make fixed charges but to give tenants information about the services provided and their costs.

Service Charge Accounts

There are five main pieces of legislation regarding service charge accounts of which the most significant is the 1985 Landlord and Tenant Act. The others are:

- Landlord and Tenant Act 1987
- Housing Act 1996
- Commonhold & Leasehold Reform Act 2002
- Housing and Regeneration Act 2008

A tenant or leaseholder, who pays a variable service charge and is one of four or more people paying the charge, can request the landlord to provide accounts (called a 'written summary of costs') that must be certified by an independent accountant. However, the landlord is not obliged to provide this statement if it is not requested.

When demands for variable service charges are sent to leaseholders or tenants, landlords must provide the information specified in the 'Service Charges (Summary of Rights and Obligations and Transitional Provision) (England) Regulations 2007'.

Any rights that tenants enjoy in their tenancy agreement or that leaseholders enjoy in their lease are in addition to these statutory requirements.

In 2011 the Institute of Chartered Accountants in England & Wales issued guidance on the preparation of service charge accounts. This provided that:

- If the lease / tenancy agreement sets out the way in which service charges are to be accounted for, who shall certify or approve the accounts, the costs that can be recovered and the periods of time for which accounts should be prepared, then the requirements of the lease must be followed.
- Service charge monies paid by lessees are trust monies and should be held in ring fenced designated bank accounts (s42, Landlord and Tenant Act 1987).
- A landlord or managing agent need not have a separate bank account for each property/scheme unless the lease requires one. But the funds for each property or scheme must be separately identifiable as it is a breach of trust to use service charge monies from one property / scheme to pay the bills of another or of the landlord.
- All lessees paying variable service charges should receive an annual service charge statement from their landlord within six months of the end of the accounting year.
- The annual statement should include an income and expenditure account and a balance sheet and be prepared on an accruals basis.
- All annual statements of account should be subject to an examination by an independent accountant before issue to lessees.

The National Housing Federation advises that in presenting its accounts to residents, landlords should take the following steps:

- The summary should include the income and expenditure accounts for the last year together with a budget for the following year.
- The housing manager should send the summary to each tenant / resident advising that a meeting will be held on a particular date, say in two to three weeks' time.
- At the meeting, the housing manager, with appropriate support from technical services, should outline the income and expenditure account for the previous financial year, explaining whether the scheme has made a surplus or deficit.
- Particular reference should be made to any changes in maintenance contracts or staff changes, which may have affected the service charge.
- The housing manager should introduce the budget for the following year, commenting on any new proposals which were not included in the previous year, and their financial effect.
- The tenants / residents should be invited to comment upon the previous year's figures and also the proposals for the coming year.
- If the tenants / leases agree generally with the proposals, then the revised service charge should be implemented at the earliest opportunity, in accordance with the review mechanism laid down in the agreement.
- If the tenants / leases do not agree with the proposals for the revised service charges, then it will be necessary to modify them by agreement. While it may often be impossible to obtain 100% acceptance of any particular item in the service charge, the majority view should prevail.

Conclusions

In calculating service charges, social landlords should:

- Decide what to charge for based on statute, case law and the provisions of leases and tenancy agreements
 - Decide between fixed and variable charges
- Identify all appropriate costs
- Apportion costs between schemes and tenants based on the best available information
- Ensure charges represent Value for Money
- Keep it Simple
- Consult and provide complete information

Adrian Waite
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All You Want To Know About Service Charges

April 2014

We are holding our seminar and workshop 'All You Want to Know about Service Charges' in April. This seminar and workshop is designed to give an introduction and overview to this important subject and is fully up to date with all developments.

Service charges are an integral part of landlords' work in financing value for money services and sustaining customer satisfaction. They have always been relatively complex but with landlords, leaseholders and tenants facing increased financial challenges and with increased legal complexity there is an increased need to understand how service charging works.

This seminar and workshop is presented mainly from a financial point of view and is designed for people who are not experts in service charges, but who need to understand the basics and achieve an overview of what is going on. It is suitable for councillors, board members, housing managers, finance staff, tenant representatives, members of the service charges team who have limited experience and others who realise that an understanding of service charges can place them at an advantage!

We believe in quality rather than quantity and so numbers at each session are limited to twenty people to permit the maximum possible interaction and participation.

The session will answer the following questions:

- How do Service Charges work:
 - In Housing Associations and Local Authorities?
 - For Leaseholders and Tenants?
- How are service charges calculated?
- How to de-pool service charges?
- When are service charges eligible for housing benefit?
- How to ensure excellent customer service?

The session includes a participatory case study and is accompanied by a very useful book that is designed for reference after the session entitled: **"All You Want To Know About Service Charges"**

Venue and Date:

London: Novotel Hotel, Waterloo – 29th April 2014.

This seminar and workshop is also available in-house. For further information about in-house sessions, please contact Adrian Waite on 017683-52165 or adrian.waite@awics.co.uk

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Our mission statement is 'Independence, Integrity, Value'. We therefore provide support to clients from an independent standpoint that is designed to help the client to achieve their objectives. We are passionate about working with the utmost integrity. We believe that we offer the best value for money that is available today!

For more information about us and our services please visit our website at www.awics.co.uk or contact Adrian Waite at Adrian.waite@awics.co.uk

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