Leasehold Excellence Network Guidance: Administering service charges efficiently

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Introduction

It is likely that very few social landlords recover all of the service charges due to them from their tenants, leaseholders and freeholders. Efficient administration and collection of service charges for landlords with a large stock of mixed tenure properties is not easy, and there are a good number of circumstances that occur which can lead to errors and miscalculations which have a negative impact on service charge collection.

This guidance looks at the main areas which can be contributing factors to a shortfall in service charge income.

Tenancy agreements

These need to be checked thoroughly to determine what services can be charged for and what can't. The first consideration is whether the tenancy agreement states that the service charges are fixed or variable. If they are fixed, then just estimates for the expenditure will be calculated and charged to the tenant. There will be no balancing carried out at the end of the relevant financial year. This means any under-estimation in the service charges cannot be carried forward and the shortfall will be lost. It also means that any over-estimation will result in the tenant paying more than they should which is also an unsatisfactory situation. Therefore, the estimation of the charges should be as accurate as possible.

If a tenancy agreement states that the service charges are variable, then a balancing exercise after the end of the relevant financial year has to take place and any credit or surplus from the estimates carried forward to the next financial year after the balancing has taken place. Also, for tenancy agreements with variable service charges, tenants can apply to the First-tier Tribunal (FTT) for a determination for any service charge dispute. Section 20B notices have to be served where required and Section 20 consultation has to take place for any potential Qualifying Long Term Agreements.

The second consideration is in respect of new service charges. Does the tenancy agreement allow for service charges to be added if a new service is introduced? Some don't, or state that a notice period that has to be given to tenants following a consultation process. Care should be taken at the start of a tenancy when the tenancy agreement is issued to ensure that the tenant is informed of all the service charges they are going to be charged for. Failure to do so can lead to challenges and costs not being recovered.

Leases

As with tenancy agreements, the lease must be checked to ensure that all the service charges that are to be made are recoverable under the terms of the lease. It should not be taken for granted that the lease will allow charging for all the services.

Some leases, especially older ones, do not contain clauses that allow charging for the most common services. If it is found that a service charge you need to make is not recoverable under the terms of the lease, then consultation should take place between landlord and leaseholders to vary the lease. If any leaseholder refuses to agree to vary the lease, then an application to the FTT should be considered (Sections 35-37 Landlord & Tenant Act 1985).

Service charges must be apportioned in line with the apportionment method set out in the lease. For example, if the lease states that the apportionment method is based on floor area, or a percentage linked to the size of the unit, then to just equally divide the service charges between the number of the units in the building would be a breach of the lease and challengeable at the FTT.

If you wish to make improvements to a building then the lease will need to be checked to ensure that an improvement clause is present within every lease for the building. It cannot be assumed that if one lease in a building contains a clause which allows for improvements to be charged that all the leases in the building will too. In mixed tenure blocks where units have been purchased under the Right To Buy scheme at varying times, it is not unusual for some leases to contain the improvement clause and others not.

If a lease doesn't contain the improvement clause, then the leaseholder's share of the costs cannot be collected. If leases are not checked for this before a project is undertaken and it is subsequently found that not all or any of the leaseholders can be charged for the cost of the works after the work has taken place, then large losses (for the landlord) can be incurred. If the leases had been checked before the work took place, then the landlord would have had the choice whether to consult with leaseholders over a variation of the lease and have the option of whether to undertake the project or not.

Service charges can only be demanded in line with the terms of the lease. For example, if the lease states that service charges are due on four dates within the year, it would be a breach to demand it in one sum at the start of the year. The summary of the rights and obligations must be sent with any demand of service charge, in the prescribed format set down in legislation (Section 153 Commonhold and Leasehold Reform Act 2002) otherwise the leaseholder is legally entitled to withhold the service charge payment until they receive the summary.

Major works charges must be treated in the same way as all other service charges and charged/invoiced at the same time as all the other service charges for the financial year to which the work relates. Indeed, this was confirmed by the Upper Tribunal in the *LB Southwark v Woelke* case in 2013.

Management fees and administration fees

The management fee charged to leaseholders should cover the cost of delivering the leasehold service. Leases will not usually state the method of calculating the management fee and it is down to the landlord to decide. Historically, many social landlords have chosen a 'percentage' calculation (eg, 10% or 15% of the total amount of the service charges is added). A number of landlords are now moving away from the percentage of the service charge to a calculated or flat fee in order to be more transparent over costs. This is calculated from working out the salaries of the staff providing the service plus facilities, staff training, postage, stationary, telephone, and all other reasonable costs, etc. This is the most efficient way of working out the fee and is likely to mean that most of the cost of management is recovered. The FTT is known to prefer this approach.

Administration fees which are charged to leaseholders should be calculated to cover the one-off costs they are set up to collect. These should be set up at the start of the financial year by the landlord and reviewed on an annual basis.

When a demand for payment is sent out to leaseholders, a summary of rights and obligations should be sent as well. It must be set out in the prescribed format as set down in the legislation; Section 158 Commonhold and Leasehold Reform Act 2002.

Section 20 consultation

Errors made with Section 20 consultation process for major works have frequently been area where large sums of money have been lost by landlords. Failure to consult correctly in line with legislation can lead to challenges at the FTT and determinations awarded against landlords. Prior to the ruling at the UK Supreme Court in 2013 in the *Daejan Investments Ltd v Benson* case, landlords faced having the total costs they could recover from leaseholders if there was a defect in the section 20 consultation process limited to £250. The Daejan v Benson ruling meant if there was a defect then the landlord would apply for dispensation and if the leaseholders objected they would have to show how they had been prejudiced.

In its determination, the FTT would then decide the prejudice (if any) and is likely to grant dispensation with a more relevant cost reduction in line with the prejudice. The award cannot be guaranteed however, and every effort should be made to consult correctly and not rely on a dispensation application to the FTT.

Section 20 consultation needs to be carried out if the landlord wishes to enter into a contract for services which will last longer than a year and cost any leaseholder more than £100. If this isn't carried out, then the maximum sum that could be collected from leaseholders and tenants (who pay variable service charges) would be £100. For major works it is important that consultation is carried out correctly as a challenge several years into a contract could result in large losses.

Section 20B notices

This is another area where landlords have lost sums of money due to failing to serve Section 20B notices, either at all or with incorrect information on them. If a landlord is not able to give leaseholders the final accounts within 18 months of incurring the costs, then they must serve a section 20B notice which details all the costs expended to date. If a section 20B notice is not served (or done so incorrectly) then a leaseholder need not pay the service charges. If charges have been paid on an estimate, then the amount not payable would be the shortfall from the actual costs if one exists. If there was no estimated service charge demand made, then the amount lost would be the entire service charges due.

There isn't a set format for the Section 20B notice and has been the subject of debate with some landlords interpreting it differently. If you have to serve a section 20B and am not sure what you need to include, legal advice should be sought.

Managing agents' charges

Managing agents' service charges can be an area where money is lost not only in service charges but in other costs as well. These will mostly be encountered by social landlords on schemes where they are not the freeholder. There will usually be a managing agent managing the scheme on behalf of the freeholder.

The managing agent will arrange the services for the estate and charge the leaseholders (including the social landlord) on the scheme for the costs of the services plus management and other fees. The costs will be apportioned as stated within the lease.

The managing agent will send invoices for estimated charges at the start of the financial year and then balancing statements for the actual costs after the end of the financial year, with a demand for any deficit.

The financial year in which the managing agent operates is often different to that of the social landlord which can cause more work using the costs over two years and apportioning them appropriately when calculating the actual costs for the leaseholders. It may mean having to serve a Section 20B notice on the leaseholders if the final costs are not available from the managing agents in time.

The administration of invoices sent from managing agents to landlords can be another area where there is a potential for income to be lost. If the invoice is not dealt with and paid (or disputed if necessary) within the timescale as stated in the head lease, then interest can become due to the managing agent for late payment. This can escalate if the invoice continues not to be paid and the outstanding service charge debt is passed by the managing agent to a debt collection agent - which incurs more costs. In the worst case scenario, the managing agent could apply to court and a money judgement awarded against the social landlord.

A frequent cause of the non-payment is usually because the invoice is sent to an office (eg, head office) of the social landlord where the invoice is not dealt with. By the time it finds its way to the right office location, considerable time has been lost before the invoice is authorised and paid.

Some social landlords have a small team or individual staff members to deal specifically with managing agent accounts. This can save money for the landlord in the longer term.

Service charge modules and spreadsheets

Administering the service charges for a large number of mixed tenure tenants and home owners effectively is not easy and having efficient systems in place is critical. This can mean using a service charge module that interfaces with the database of the main computer system as well as the main financial system.

Having a module that can both apportion the service charges accurately for tenants and home owners and produce invoices together with any reports or statistics required will make a massive contribution to collecting the service charges due in an efficient manner - which will lead to fewer disputes and complaints from tenants and leaseholders. There are a small number of service charge modules on the market but not all will be suitable to work with existing systems. Research needs to be undertaken of what is available in the market place and where possible liaise with other social landlords on the systems that they have.

Should a landlord decide that they wish to purchase a service charge module (or change the one they have) then a dedicated project manager needs to be appointed to work on the set up as how it is set up at the beginning is key to how efficiently it will work.

There are social landlords that choose to calculate and administer their service charges manually using spreadsheets. Some smaller landlords prefer this method and if the spreadsheets are well set up, held in an organised way, and are easy to find and access with consistent formulas then they can work well. Care needs to be taken when information is downloaded or entered manually because errors here may not get picked up and incorrect invoices produced for tenants and home owners.

A downside to spreadsheets is that they can be time-consuming to update and not as quick or efficient as producing the figures and invoices from a competent well-programmed system. Also, the scope for errors is higher.

Coding invoices

This is another area where income is often lost. Usually, within its finance system, a social landlord will have a chart of accounts. This is a coding structure so that both income and expenditure can be correctly allocated and monitored. The chart of accounts should always as a minimum have a code for the estate or block (they may be separate) and a code for the type of work - although there are very likely to be more elements than this. Having a chart of accounts which works for the landlord is crucial, as payments made will be coded to show the estate or block to which the invoice relates, and the kind of work or service to which it relates as well.

It is from this information that the service charge actual costs will be calculated, either by spreadsheet or a service charge module which is interfacing with the finance system.

If an invoice is coded to an incorrect block, then it will be that block that gets charged a service charge for a service it did not receive. The residents of that block may well pick this up (if the landlord hasn't done so during checks before sending out) and, rightfully, complain and demand the charges removal. The landlord will remove the charges from the resident’s accounts but it will then be too late to re-charge the residents of the block that should have received the charge -which results in a financial loss for the landlord.

Having costs coded correctly by using a well-structured chart of accounts is important for monitoring service charge budgets by the budget holder during the financial year.

Service charge recovery

Having a well-structured arrears recovery policy or process is very important for maximising the service charge collection. Social landlords tend to be more understanding towards leaseholders by allowing them more time to pay their service charge arrears than private landlords or managing agents. However, having a good 'firm but fair' policy, where current as well as potential future arrears actions are explained to the leaseholder, is essential.

If court action is required, then the landlord should look to recover all its costs as well as any interest due on the arrears. This should form part of the court action. There needs to be a well thought-out strategy on repayments.

Conclusion

Administering and collecting payment for service charges is a challenging process for social landlords when taking mixed tenure into consideration as well as the varying tenancy agreements and leases that also have to be taken into account. It is crucial to have clear and concise policies and procedures in place. Staff should be well-versed in understanding them, with the appropriate guidance provided through training. This will give social landlords the best opportunity to recover the service charges that are due to them.

If a social landlords finds that having an external independent service charge review carried out advantageous in order to help identify areas where improvements can be made, then the cost of the review can be recovered by more by running an efficient service charge system which maximises the collection of the charges due.