

Structured Abstract

Compliance of RICS code of practice for commercial service charges

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Category of paper

Literature Review/General Review

Purpose

RICS code of practice 'Service Charges in Commercial Property' was introduced in 2007 with intention to promote best practice guidelines in the provision and management of commercial service charges. The paper seeks to view the compliance of the code after two years from its inception.

Design/Methodology/Approach

The research employs comprehensive literature reviews and documental analysis through various publications retrieved from electronic databases, reports, journals, books and other relevant secondary information. Critical review on the materials gathered is carried out in understanding the key recommendations as set within the RICS code against the current practice.

Findings

Considerable gaps were identified between the RICS as against existing practice involving several key headings such as transparency, value for money, communication and responsiveness.

Research Limitations

Since the code was only introduced in 2006, limited source of data available prevents comprehensive results, underlining further discussions on the effectiveness of the code in resolving the critical commercial service charges aspects within the real estate industry.

Practical Implications

While the paper intends to raise awareness among the commercial properties stakeholders, recommendations that are made in the paper can be utilised to minimise the gaps that exist between the guidelines and the actual implementation by harnessing concerted efforts among the stakeholders in commercial property industry.

Originality/Value

This paper provides an in-depth snapshots of the RICS code of practice to commercial service charges and the progress that are made towards application of the guidelines since its was introduced in 2006.

Keywords

Commercial lease; landlord and tenants; RICS; service charges; sinking funds

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ABSTRACT

RICS code of practice 'Service Charges in Commercial Property' was introduced in 2007 with intention to promote best practice guidelines in the provision and management of commercial service charges. The paper seeks to view the compliance of the code after two years from its inception. Documental analysis through various reports, journals and other relevant secondary information are gathered and analyse in completing this paper. Critical review on the materials gathered is carried out in understanding the key recommendations as set within the RICS code against the current practice. Huge gaps were identified between the RICS as against existing practice involving several key headings such as transparency, value for money, communication and responsiveness. Recommendations are made to minimise the gap by harnessing concerted efforts among the stakeholders in commercial property industry.

Keywords: commercial lease; landlord and tenants; RICS; service charges; sinking funds

UK Commercial service Charges Overviewed

Service charges in commercial properties arise when there is a multiple occupation of the landlord's premise such as shopping centres, office blocks and mixed-used developments. The charges are intended to recover relevant expenditures to upkeep the premise, not only focusing on the physical elements such as repairs, renewal, replacement and improvement but also services like cleaning, security and facilities management related activities (Noor and Pitt, 2009). In addition to the basic charges, another part of service charges are made of sinking, replacement and reserve fund. The purpose of such fund is to cover the cost of repairs and replacement of equipment when necessary (Morley, 2008). Commercial properties service charge is a massive business and according to (Calvert *et al.*, 2009) (in a study that is also known as Loughborough report), the annual value of office sector service charge in the UK and Wales alone is estimated at £4.32 billion.

Unlike residential properties, the commercial service charges are solely governed by the lease or the law of contract without any legislation (Noor and Pitt, 2009, Philpott and Hicks, 1994, Silman, 2007) . Therefore, to prevent any disputes between the landlord and tenant, it is vital for both parties to understand the provision of the service charges since there is no standardised service charge provision that fit all leases. However, it is reckoned that the absence of any legislative instrument for this purpose invites dissatisfaction especially among the occupiers. Issues such as apportionment, value for money, management fees, transparency and administration of service charges are among the critical area of disputes (Noor and Pitt, 2009).

In response to the pressing dilemma, RICS launched the Code of Practice for Service Charges in Commercial Property which came into force on April 2007(Forrester and Gibb, 2008). Interestingly the code which was endorsed as the official RICS material is expected to act on self regulatory basis and not intended to override existing leases (Silman, 2007). The paper therefore intends to at the level of compliance of the code after almost two years since it was introduced.

What is set out in the code?

The RICS code intends to primarily provide ‘best practice’ guidelines for provision and administration of commercial service charges to be adapted by the landlord and tenant. The code of practice was drawn up in response to industry concerns about the cost and quality of service charge provision in multi-let property (Calvert *et al.*, 2009). Silman (2007) defines key elements of ‘best practice’ in the code to include requirement to procure the services on value for money basis, embracing ‘not for profit, not for loss’ principles whilst emulating transparencies in the service charge costs and management fees. (Forrester and Gibb, 2008) added four key objectives of the code as follows:

- to remove service charges as an area of conflict;
- to deliver a budgetable and forecastable part of occupiers’ overheads;
- to ensure service charges that are ‘not for profit, not for loss’ and are cash neutral to the owners income stream; and
- to encourage transparency and communication in relation to the provision of services, their quality and cost.

The code is divided into six main headings with almost 90 recommendations that outline roles and responsibility of relevant parties in service charges specification (Noor and Pitt, 2009). It is noted in Forrester and Gibb (2008) that although the adaptations of the stipulated suggestions are not compulsory, managers are expected to emulate relevant principles as outline in the code and match the delivery accordingly despite any lease constraints that might be present. The code envisage that all new leases and those being renewed will be brought up to the required standard (Calvert *et al.*, 2009). Key elements of each code headings are summarized in Table 1.

Table 1: RICS code key headings

Headings	Key elements
Management	<ul style="list-style-type: none"> • Focuses on the important of duty of care in the management of service charges • Right of the occupier to challenge the expenditure • Sound management procedures by the landlord or its agent to ensure best practice principles are adapted in procuring and delivery of services • Owner responsibility to monitor and review the services provided to assure value for money is achieved. • To assure appropriate competency level of the on-site personnel to achieve agreed service performance standards.
Communication	<ul style="list-style-type: none"> • Effective and ongoing communication between the landlord (or managing agent) and the tenant in harnessing mutual understanding on service charges provision, relevance, cost and quality. • Continuous two-way communication to share views and opinion on the cycle of services to be rendered that focuses on planning, implementation and review of the services. • Obligation of the owner or their managing agent to set up a clear communication structure for ease of information sharing and to hold regular meeting with the occupiers. • Prompt notification by the owner or their managing agents on significant variance (2% above RPI) on the actual annual expenditure against service charges budget. Any significant variances shall be informed to the occupiers on quarterly basis. • Occupiers to be notified on any substantial works to be carried out which shall include detail work programme. In addition, information detail on the procurement process and decision for the proposed works shall also be relayed to the occupiers.
Transparency	<ul style="list-style-type: none"> • Identified as the key to improve relationship with the occupiers thus minimise area of disputes • Owner is required to detail out all of the expenses incurred and notify the occupier of such expenses. • On account service charges should be held separately from other monies and any surplus earned after deduction of financial costs such as tax and bank charges shall be credited back to the account.
Service standards and provision	<ul style="list-style-type: none"> • All services must be professionally performed to the occupiers according to the written performance standards as indicated in Appendix E1 of the code. The level of standards however depends on the nature, type and complexity of the property. • Service providers can be appropriately rewarded shall the performance exceeds the pre-set standards. • Provision of services is based on value for money rather than lowest price and must be beneficial to the premise, owner, occupier and their customers. • The recoverable service charges are specifically constrained to relevant costs and administrative charges incurred by the owner in the operational management of the property. Details of which are indicated in paragraph 29 of

	<p>the code.</p> <ul style="list-style-type: none"> • Appropriate justification must be provided by the owner where service charges include enhancement of the fabric, plant and equipment of the property. • Owner is required to promote value for money principles in procuring all related services. By that virtue, service providers are required to submit competitive tenders or quotations or allow cost benchmarking exercise to be undertaken as part of service provision cost review exercise at a pre set interval period.
Administration	<ul style="list-style-type: none"> • Management fees are levied based on fixed fee for a preset period and benchmarked against the market regularly rather than based on a percentage that is linked to expenditure. • Irrespective of whichever methods that are used for determining service charges, the apportionment shall be on the basis of fair and reasonable. Occupiers shall be informed on the schedule of apportionment with a concise distribution of service charge cost for each unit in the premise. • The owner is liable to cover the cost of unlet premises and bear the cost attributable to their usage within the premise i.e. management office. • Any cost for services rendered to income generated common areas such as car parks, promotional area in the lobby and advertising, shall be borne by the owner unless the income is credited back to the service charge account. • Budget - Owner obligation to make available to the occupier service charge budget and proportion, one month in advance prior commencement of service charge year and to submit certified accounts within four months of the end of service charge year. • Any variations against the budgeted figure shall be comprehensively explained to the occupier on year-on-year format. • A reasonable period (e.g. four month) shall be allowed to the occupier to raise any queries in regards of the certified accounts. The code also specified auditor fees can be levied to the service charge account. However the occupiers' will bear the cost if they requests for an independent audit, • Sinking, replacement and reserve funds- all monies accumulated will be held in an interest-bearing account, held in trust for the occupiers and separate from the owner's own monies. • Owners will be required to make all payments for any void premises. • Owners' obligation to provide clear explanation of the calculation of the funds to the occupier. • All interest earned should be credited to the service charge account after deduction of relevant bank charges and account operating costs.
Additional shopping centre services	<ul style="list-style-type: none"> • Focuses on cost of marketing and promotions to be shared between the owner and occupier. Contribution of each party will depends on commercial factor of each shopping complex. • A clear policy on non-core or commercialisation income that is earned from common part for the mall must be transparently drafted out. If the income is retained by the owner, the space will be included in the service charge apportionment matrix and equivalent credit given for the cost of the space.

Source: (RICS, 2006, Silman, 2007)

In addition to the highlighted key elements, the latter section of the code elaborate more details of best practices in dealing with commercial service charges. The code also provides alternative dispute resolution (ADR) for parties involved in disputes about service charges matters.

What is achieved so far?

It is instrumental for the commercial property industry to support and comply with the code since the occupier business productivity relies heavily on effective provision management and delivery of effective property related services. In tandem, the performance and effectiveness of professionals that manage the property and its related support services are also being measured by the occupiers respectively (Barass, 2009). However Barass (2009) acknowledges that managing agent will only be able to cope and fully adapt recommendations address in the code only if they are empowered by the landlord. Without the support of the owner, it is unlikely that the tenant will enjoy the benefits that the code could offer.

(Calvert *et al.*, 2009) summarises the level of compliance with RICS code since it inception in year 2006 as tabulated in Table 2.

Table 2: Achievement of RICS Service Charge Code

RICS Code Requirement	Achievement 2006 1998 to 2006	Achievement 2008 (Since Publication in June 2006)
Budgets must be delivered one month prior to the start of the year	4%	12%
Certificates must be delivered within 4 months of the end of the year	21%	24%
Management fees must be a fixed cost	18%	22%
Interest must be credited to service charge accounts	13%	26%
Apportionment basis clear	79%	47%
Standard cost headings to be limited to 22	2,341 headings used	2,094 headings used
Budget accuracy- Budget should be within 2% of actual costs	15%	14%

Source: (Calvert *et al.*, 2009)

Based on Calvert (2009) findings it is noted that there is no significance improvement achieved since the code inception in 2006 and implementation in 2007. The current service charges exercise is still below 'best practice' level intended by the code. Calvert highlighted that there are positive signs in the implementation of the code; however, the pace of progress against the code is still unsatisfactory. Self regulatory enforcement as recommended by RICS is yet to gain positive response from the commercial property stakeholders. For example, for standard cost headings and budget accuracy, the achievements

were far below the recommendations as set by the code. Possibly it is too early for the industry to gauge the performance of the code since it has just been introduced for two years.

On the contrary, there is also possibility that some key recommendations set in the code are too ambitious and lack of operational strategy to enable it to be on self regulatory basis. Barass (2009) supports this view by saying that industry representatives have asked RICS to take steps to enforce the standards set down in the code. In addition, a tenant's forum will be set up to agree a set of actions, including the national benchmarking of costs and code-compliance. The forum will also provides a platform for the tenants' to call for owners' effort in promoting best practice through greater efficiency and cost of services supplied to especially to the office occupiers.

Service charge budget and certification

Key financial aspects in service charges are set under two key themes which are annual budget and budget certification processes (Calvert *et al.*, 2009). Studies revealed that since the inception of the code in 2006 until the end of 2008, only 12% of the service charge budget arrived one month earlier prior to the financial period. The remaining arrived outside the recommended period set by the guideline and some even arrived after the end of the accounting year. Similarly, only 24% of the service charge certificate arrives within the four months period. By expanding the data time frame to the last five years, (Calvert *et al.*, 2009) further identified that 36% of the service charge certificate arrived within the four months of the end of service charges period whilst 27.5% were only arrived in the next 8 months. Remaining 6.5% even arrived more than 20 months after the financial year ended!

Among the identified reasons for the delay may include difficulties certifying the service charge accounts which are due to disputes with suppliers, complex or large projects, unexpected maintenance costs or poor management control (Barass, 2009). Non-compliance with the code triggers dissatisfaction among the occupiers since the delay in obtaining such information hinders them to factor in the service charge costs in their business operation financial commitment.

The code also sets a limitation of up to 2% variance between the service charge budget and the actual service charges expenditure. Calvert *et al* (2009) study reported that 52.6% of the budgeted figures failed to comply with the set guideline. Figure 1 shows the level of compliance of budget accuracy against the RICS code of practice.

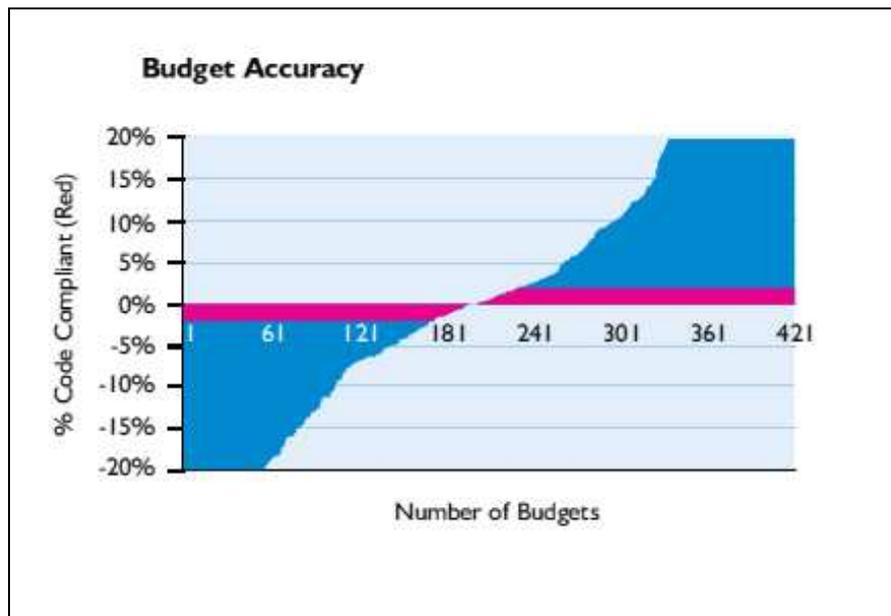


Figure 1: Compliance of service charge budget accuracy

Source: (Calvert *et al.*, 2009)

Tenants might suffer cash flow difficulties due to unbudgeted balancing charges caused by over-budgeting the service charges cost. In addition, the tenants have to wait several months prior to be refunded by the owners for the access of service charges payment made. In most cases reimbursement made by the owners are without any interest (Calvert *et al.*, 2009).

Management fees, basis of apportionment and standard cost codes

Management fee is simply defined as the cost of the manager (including an element of reasonable profit) for managing the services comprised in the service charge where the manager can either be the owner, a management company or managing agents (Forrester and Gibb, 2008). They further noted that among the methods that are widely used are fixed rates, percentage of total expenditure, performance related fees, and landlord managed properties and scale fees. However, the RICS code states that best practice fees are set on a flat cash basis rather than percentage of cost in providing the services to avoid any cost discrepancies. Best practice also require for the management service to be regularly tendered or benchmarked against the market and relevant information to be transparently disclosed to the tenant.

Based on Loughborough 2008 study, merely 16.2% or 149 service charge certificates identified follows the guideline by adapting flat management fee. 44.6% or 410 certificates are still using the percentage fee structure whilst the remaining 39.2% did not specifically mention their basis of fee calculation (Calvert *et al.*, 2009). There is slight reduction of compliance in clarity of service charges apportionment method (62% in 2008 as compared to 79% in 2007). The fall is purely attributable to additional dataset that is included in year 2008 study. Tenants are also frustrated for being side lined by the landlord or the managing agents from being actively involved in selection of service providers (Alliance and UK, 2009).

The code recommends 22 headings of service charges cost headings that are to be used to promote uniformity in the delivery of services to the occupiers. Loughborough study revealed that there is very little progress achieved in this aspect since there are 2094 headings that are identified in the findings of study.

Interest and service charge accounts

The RICS code requires advance service charge payments to be held in separate interest bearing account with interest earned reimbursed to the benefits of the occupiers. An on-account service charges results a positive cash flow for the owner to deal with cost in providing property related services thus best practice reckoned that it is reasonable for interests earned to be credited to the service charge account net of any tax (Calvert *et al.*, 2009, Forrester and Gibb, 2008). Table 3 elaborates circumstances where interests in service charge accounts could arise.

Table 3: Description on interest in service charge accounts

Circumstance	Description
On-Account Payments	<ul style="list-style-type: none"> • Tenants pay service charges in on-account however owners or their agents pay the service charge bills in arrears. • The money paid by the tenants sits in the bank account until payment is made earned interest income.
Over-Budgeting	<ul style="list-style-type: none"> • On-account payments are made by the tenants based on the service charge budget. • Surplus of monies collected occurs when actual service charge costs are lower than the budgeted figures. • Remaining cash sits in the account accruing interests until the accounts are reconciled.
Late Payment	<ul style="list-style-type: none"> • Occurs when tenant is delay in payment of an on-account. This is a sort of penalty clause that is usually set in the lease.

Source: (Calvert *et al.*, 2009)

In spite of this, (Forrester and Gibb, 2008) stressed that crediting of service charge interest is always an issue simply because service charge in most of commercial leases is reserve as rent thus, enable the landlords to treat the income according to their own accord. Nonetheless, landlords are still required to reimburse, any surplus of the basic service charges cost that are paid to the tenant.

Loughborough database shows that only 20.5% of service charge certificates show interest credits with an estimate value of £7 millions out of the potential estimated potential interest payment of £65 million (Barass, 2009). He pointed out that the huge gap exists are due to the following;

- A higher proportion of multi occupation premise is managed by the owner that do not maintain separate account for service charges;

- Higher offset costs such as borrowing monies to fund major non-cyclical expenditure for the premise
- Landlords or agents have yet to implement the RICS code best practice recommendations

The study also distinguished that lack of transparency exists in detailing out what constitute refund in service charge interest as indicated in the service charges certificate. Inadequacy of such information prevents the tenants to determine the reasonability of interest received from the landlord and compliance to the best practice as set by the code. Loughborough study put up three recommendations that should be explicitly mentioned as a measure for continuous improvement of the code;

- All owners and managing agents will operate separate, interest bearing bank accounts for all service charge payments;
- All interest received from these will be credited to the service charge account; and
- All costs of operating bank accounts, borrowing to fund shortfall in service charge account and tax are separately identified on the certificate.

(Barass, 2009)

However, Loughborough database is solely based on certificate issued for office buildings that only represents 5.24% of proportion of total England and Wales multi-let office space. Therefore, the actual compliance of the code across commercial properties sectors and sub-sectors are yet to be gauged. Collaborative efforts within the commercial properties stakeholders to undertake and adapt similar study will provide a holistic result that can be used to provide an overview of the actual accomplishment of the code.

Compliance of the code highlighted in UK Occupier Satisfaction Index (OSI) 2009

The UK Occupier Satisfaction Index Report measures occupier satisfaction level across commercial property sectors presenting the results of independent opinion poll (Noor and Pitt, 2009). In the latest version of the report, several key issues were highlighted as instrumental elements that trigger major concerns among the commercial property occupiers such as cost control and demand for greater value for money. In the current wider economic climate, organisations exiting leasehold property mainly because of operating cost pressure. Notwithstanding, tenant dissatisfaction over service which involves service level, service charges, speed of response and degree of support are the supplemental reasons for the tenant to leave their business premise. At the end of 2008, the lost of income from voids as a percentage of estimated rental value (ERV) was 8.4% which is 16% higher as compared to 2007 figure of 7.2% (Alliance and UK, 2009).

The occupiers are also call for greater transparency and consultation on the way of how service charge monies are spent (Alliance and UK, 2009). Corresponding to the issue, the study highlighted a key event initiated by a group of retailers and property owners to target reductions in service charges up to 20%. The event has accomplished significant reduction of service charges monies and passed on to retailers such as Meadowhall in Sheffield. Pursuing that effort, the retailers and property owners established a set of guidelines that aimed to formulate a framework for service charge reduction in 2009/10.

Table 4 summarises occupiers' perception on value of money that they have gained from service charges. All of the commercial occupiers are dissatisfied with value of money that service charge delivers .Within the sectors; retailers recorded the highest percentage consistently throughout the three years data.

Table 4: Value for money – service charge

	Positive			Negative		
	2009	2008	2007	2009	2008	2007
All Occupiers	10%	13%	21%	50%	44%	49%
Retail	3%	9%	15%	63%	50%	51%
Not Retail	14%	15%	24%	42%	40%	48%
Small	12%	12%	21%	58%	58%	57%
Large	9%	13%	21%	49%	42%	46%

Source: (Alliance and UK, 2009)

The commercial tenants are also expressing their grievances over variation in the standard of facilities services provided by the industry. Many have quotes that the services provided are over specified, expensive and not in line with value for money principle. The report stressed that occupiers are really frustrated over delays in service charge reconciliation and perceived that some managing agents provide below average quality of service. It is worth to note some of the tenants' response towards this pressing issue.

“Preparation of budget is improving, but there’s still a massive delay between end of the year and service charge reconciliations. There’s no reason, with modern technology, why they can’t be much quicker”

“The code says we have to be given a draft budget at least two months before the start of the financial year, but I have just received a six-line draft budget saying there will be a 17% increase, with no apology and no breakdown.”

“There are often mistakes and I often wonder if landlords realise what poor service their agents are giving”

“It’s too expensive for what we get. There should be more communications on this.”

“Transparency needs improving. This year we will scrutinise it very closely.”

To sum up, majority of commercial occupiers in UK OSI 2009 opines that property owners are not complying inadequately to the recommendations as set in the RICS code with minor exception to some reputable landlords. The code also lacks impetus to stand on its own to be on self regulation basis. Transparency, value for money, lack of communication and poor accountability practice in service charge management remain as major concerns for the commercial property tenants (Alliance and UK, 2009).

Conclusion

The abovementioned scenario obviously illustrate that there are still huge gap exists towards full compliance of the RICS code. Even though some positive progress were made by the commercial property stakeholders to adapt recommendations as set by the guidelines, the speed of response are way lagging behind even after two years of its introduction. Occupiers of business premises are still unhappy with the sub-standard quality of services that are delivered by the landlords or the managing agents despite sometimes, incur expensive service charges that are levied to them. Value for money,

transparency, lack of communication, speed of response and lack of flexibility remain the same concerns of the tenants. Best practice recommendations as set in the code provides the answers to the tenants apprehension, however, the current state of poor compliance forbids significance improvement in resolving the dilemma. With the current pace of reaction, it is only practical to assume that the base line set by the code will take up to five years before significant levels of the code compliance will become reality (Calvert *et al.*, 2009).

Loughborough report repeats similar recommendations as proposed last year and call for the industry to appreciate and support the value of benchmarking exercise to show compliance level and progress with the RICS code of practice. Table 5 recaps the proposal that can be adapted by various stakeholders in the commercial property industry.

Table 5: Recommendations by Loughborough study

Parties	Recommendations
RICS & OTHERS	<ol style="list-style-type: none"> 1. Implement a centralised data collection system of uniformly coded service charge data and make this data publicly available to allow industry analysis and benchmarking. 2. Integrate and publish annual progress reporting against the performance benchmarks set out in the Code 3. Publish a policy document on the use and benefits of sinking and reserve funds 4. Promote a Law Society/Inland Revenue initiative on taxation of sinking funds to resolve the problem highlighted in the O'May & others v City of London Real Property Co Ltd case (1982). 5. Publish a standard management contract for managing agents. 6. Instigate a Law Society/RICS initiative on model service charge clauses in new and renewed leases. 7. Monitor and review the effectiveness of ADR for service charges disputes. 8. Consider appropriateness and industry perception of independence of referrals to the RICS and Chartered Institute of Arbitrators (CI Arb). 9. Review selection criteria and process for experts sitting on the RICS service charge panel.
LANLORDS	<p>Carry out an audit of each building that they own. Each audit should consider:</p> <ol style="list-style-type: none"> 1. How well each building meet the Code – not just in those areas measured above, but across the range of requirements set out in the Code. 2. What changes need to be made for each building to meet the Code 3. What changes need to be made for each building to meet the Code 4. What the impact might be on both services and service charge as a result of the changes necessary to meet the Code. 5. Develop a costed proposal and programme for implementing the necessary changes. 6. Provide tenants with copies of these audits 7. Discuss and agree the necessary changes before they are enacted
TENANTS	<ol style="list-style-type: none"> 1. Request service charge code compliance audit report from the landlord for each building. 2. Seek proposals from the landlord for action to remedy any shortcomings against the RICS Code of Practice. 3. Monitor service charges over £ 5.34 per sq.ft. 4. Investigate service charges over £7.78 per sq.ft. 5. Prepare for increased communications with landlords.

Source: (Calvert *et al.*, 2009)

In addition to the above recommendations, Calvert *et al* (2009) also stressed it is pre-requisite for all new and renewed leases drafted in accordance with code. This can be achieved by educating the lawyers and managing agents and the agreement of their landlord clients to comply with the code suggestions. Therefore in order to safeguard the interests of the tenants, they should always be represented by a chartered surveyor or solicitor in lease negotiation so that the service charge terms are reasonable.

Tenants in OSI 2009 cry for enforcement of the code through a proper legislative platform since the current self-regulatory and voluntary compliance is yet to show significant accomplishment in resolving

the long outstanding issue. Responding to the call, a seminar which carries a theme “change we can all believe in” will be organised in November 2009 with a prime objective to propose a practical and workable solutions for all stakeholders in dealing with commercial service charge. Conceivably this attempts could be a solution in expediting the pace of the code compliance since frustrated tenants will empty or opt not to renew their leases and landlords will suffer lost of income in their investments by having voids and unlet premises.

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