

Social Housing Technical Update

SPRING 2010



In This Issue

The Broomfield & Alexander Housing Team are delighted to present the Spring 2010 edition of our technical update. Within this edition we will focus on the following hot topics:

1. SORP 2008 update

SORP 2008 has been with us for a relatively short time, but is already receiving a fairly substantial facelift. What should we expect, why is this happening and when can we expect the changes to take place?

2. Component cost accounting

It would appear that for many RSLs a fundamental shift is on the horizon which will impact upon the way fixed assets are accounted for. Should we all be worried?

3. IFRS convergence

International Financial Reporting Standards have had an influence on UK GAAP for some time now. As this influence grows more and more tangible, we also need to acknowledge the possibility that UK GAAP could soon be based around IFRS. What's the worst that could happen? We dissect key IFRSs to uncover which are likely to have an impact upon RSLs, and the extent of any impact.

4. Planning points

Other important changes are afoot. We help to make sure you are up to date with the following changes to:

- audit requirements for service charge statements
- the tax status of caretakers accommodation.

These technical updates are intended to present a reference point for busy professionals which help to identify issues and suggest action points for planning.

If you require further information, please [contact our Housing Team on housing@broomfield.co.uk](mailto:housing@broomfield.co.uk) or call Justin Crowley on 02920 739414 (direct) or 02920 549939 (main office)

SORP 2008 Update

What?

The proposed update to the Statement of Recommended Practice (SORP) 2008 will involve two changes. Firstly, there will be changes to the main body of the SORP that guides the accounting policy adopted by Registered Social Landlords (RSLs). An exposure draft has already been issued in respect of the revised wording, and consultation will close on 4 June 2010. The second change involves revised application notes that will aid interpretation of the SORP by practitioners.

There is likely to be a fundamental shift in the way that RSLs think about, and account for, fixed assets in the future as a result of increased focus on component cost accounting (discussed in more detail later in this update). To this end, revised wording has been proposed that describes how RSLs should account for expenditure in relation to works to existing properties. New references to component cost accounting appear throughout the fixed assets sections of the SORP. The technical guidance notes also provide a very useful example of how RSLs might actually go about adopting component cost accounting.

The changes also address what has until now been an inconsistency between the SORPs stance on the balance sheet treatment of negative goodwill arising on acquisition, and that of Financial Reporting Standard (FRS) 10. The SORP has until now required that residual negative goodwill balances are held in the balance sheet within the capital and reserves section rather than below the goodwill heading at the top of the balance sheet as per FRS 10.

Enhanced guidance on impairment of fixed assets is also now present within the technical guidance section.

Why?

Most finance professionals reading this will already understand why the SORP is required and how it relates to the rest of the accounting world, but here is a quick reminder:

- All UK entities that have to prepare accounts have to prepare them in line with UK Generally Accepted Accounting Practice (UK GAAP);
- UK GAAP consists of a combination of legislation (Companies Acts, I&P Acts etc) and FRSs. These dictate the format and content of financial statements and the way in which a multitude of transactions are accounted for within those financial statements;
- The FRSs are issued and approved by the Accounting Standards Board (ASB) who decide which accounting practices are the most appropriate for UK entities at any one time;
- Things change, and so FRSs need to evolve – changes or revisions are issued by the ASB – the ASB considers the wider economy and international factors;
- The FRSs are written primarily with commercial enterprises in mind and some of their content (and indeed omissions) results in financial reporting practices which are inconsistent with the requirements of certain industry sectors;

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SORP 2008 Update

- We thus have industry-specific SORPs which determine the form and content of financial statements within those sectors. The housing SORP is one such document;
- The ASB approves the SORP for each specific industry sector after being lobbied by the relevant SORP working party. The SORP must still recommend accounting treatment and format which is compliant with UK GAAP but also makes allowances and provides specific guidance in relation to industry-specific matters.

UK GAAP thus evolves on a continual basis. Increasingly, UK FRSs have been aligned with International Financial Reporting Standards (IFRSs). Indeed, there are sound grounds for believing that it is only a short time before IFRSs are the major influence behind UK GAAP.

This is the crux of the matter – the SORP will also have to come in line with IFRSs, and **the more prepared RSLs are for any changes that result, the better**. Component cost accounting is not a ‘should apply’ item within IFRSs, it is a requirement. This, aligned with the fact that RSLs ‘should’ have been adopting this treatment for some time, makes a very persuasive argument for updating the SORP in preparation.

When?

Consultation on the proposed changes ends in June 2010. It is hoped that the revised SORP will be published late in 2010 and the SORP Working Party will be recommending to the ASB that it should be effective for periods commencing on or after 1 April 2011. ***This means that most RSLs (those with year ends dated 31 March) will need to plan for any changes to apply to their year ended 31 March 2012.***

Component Cost Accounting

FRS 15 states that where an asset consists of major components that have different useful economic lives, then those assets should be treated separately for depreciation purposes. The SORP treatment has reaffirmed that of FRS 15 for some time - and with good reason.

Consider an airline which acquires new aircraft. Which components are 'major' may be debatable but for the sake of demonstration, let us consider that there are three – the fuselage, the interior soft fittings, and the engines. It may not be unrealistic to imagine that the life of the aircraft is directly related to the life of the fuselage. The interior and the engines may be completely overhauled or replaced a number of times during the life of the aircraft. If component cost accounting were not adopted by the airline, then the subsequent expenditure on the engines and interiors may qualify as capital only in part, if at all.

Major expenditure required to keep the asset in a state in which it can generate an income may thus end up being expensed to revenue, even though the benefits of that expenditure may span several years.

Does this sound familiar? Theoretically at least, it could be argued that there is a compelling rationale for applying this approach to the development of properties for letting. A structure (the bricks and mortar) can very easily last for 100 years or more – look out of the window of your building anywhere in the UK and you'll see evidence to support this. But what about the roof? Does it last 15 years, 20, 25, more? What about the

boiler, the bathroom, the kitchen or the windows?

If we go back to basics and consider the elementary rationale for capitalising expenditure in the first place, we will recognise that we only capitalise expenditure to the extent that it gives a right to future revenue inflows. We depreciate over the period of time over which we expect those inflows to occur. If all components of the asset are grouped together, can we honestly argue that we expect to generate revenues from our boilers, kitchens and our bathrooms (as they stand at the point of initial letting) over 100 years? Most probably not.

If RSLs had always adopted a component approach and treated major components separately for depreciation purposes, then they would still have recognised costs initially in full, but would also have depreciated all components in line with their appropriate useful economic life (UEL). The impact of this is higher depreciation charges in early years. However, assuming that all components are fully depreciated when they are replaced, we would now be able to capitalise the costs of the replacement revenue costs associated with major repairs.

The overall impact upon an RSLs reserve position depends upon a large numbers of variables, but in short it largely depends upon its relative position in this cycle.

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Component Cost Accounting

So, does a change to component cost accounting amount to a change of accounting policy that would require a prior period adjustment (remember that a prior period adjustment requires that the RSL should restate its brought forward balances for the year to state the position it would be in if it had always adopted the policy – this is likely to deplete the reserves of some RSL's)?

The technical guidance advises that a change in accounting policy *may* occur where costs are capitalised that previously were expensed. This result seems inescapable. So would its effect be material? It's time to start modelling.

RSLs should be working to identify the potential impact that this change could have on their reserves and quantifying the extra resources that may be required to facilitate the changes.

IFRS Convergence

Many senior finance officers who are responsible for financial planning within the sector will have been schooled in the application of UK GAAP, a GAAP which has its foundations in a combination of Statement of Standard Accounting Practice (SSAP) and FRS. Many students now study primarily in the language of the IFRS and its relevance to, and comparison to its FRS counterpart forms a secondary element of that study. For those of us then who are part of the pre-IFRS generation, a brief run through of some of the more significant differences would, hopefully, give us some comfort that the world was not about to change beyond all recognition. While the differences are numerous, and vary in degree, we summarise below some of the more salient differences from the point of view of the sector.

Fixed Assets

1. Component cost accounting

In so far as the revised SORP is paving the way for a much more prescriptive approach to the application of component cost accounting, the worst has already happened. FRS15 and the SORP, have for some time stated that where an asset can be split into its separable major components then the asset **should** be accounted for on a component basis. So what does 'should' mean? Well, without entering into a philosophical debate, consider this – the new auditing standards coming into force (the clarity International Standards on Accounting (ISA)) have replaced the word 'should' when guiding auditors, with the word 'shall'. The reason for this is to avoid any ambiguity around the application of the language used.

But we could identify a more compelling need for change, one routed in International Accounting Standard (IAS) 16 'Property, plant and equipment.' IAS 16 requires that this treatment is adopted. What's more, it does not require that in order to apply a policy of capitalising components and removing the initial expenditure, that the components were identified separately in the first place. Under IAS 16, if part of an asset is replaced, the replaced part is de-recognised regardless of whether it was capitalised separately in the first place. A failure to prepare now, could give rise to some very real issues in terms of future compliance with applicable GAAP (assuming convergence continues).

2. Goodwill, intangibles and impairment

FRS 15 and IAS 16 are conceptually very similar, and the differences between the two relate mainly to the application of valuation methods and the treatment of impairment losses thereon .

There are also some key differences in relation to intangible fixed assets (IAS 38), although these are of limited interest to many in the housing sector and relate primarily to the conditions for recognition and subsequent amortisation of goodwill. Accounting for impairment is also broadly similar with some differences in terms of the order in which losses should be recognised and the prohibition of reversal of impairment losses under IAS 36.

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IFRS Convergence

3. Government grants

The treatment of government grants is dealt with in IAS 20. Under IAS 20, grants should be recognised in the income account to match the periods in which expenditure related to the grant is recognised, and hence identification of the purpose of the grant is paramount. Although a little more prescriptive and comprehensive in its guidance on the different scenarios in which grants are received, it is likely that current SORP treatment would be as contrary to IAS 20 as it is to SSAP 4, although IAS 20 does describe the need for entities to provide for repayment of grant if it is not clear that all terms and conditions of grant have been met.

4. Capitalisation of finance costs

FRS 15 allows a choice of policy with respect to the capitalisation of finance costs. IAS 23 on the other hand requires all directly attributable costs of acquisition or development, including borrowing costs, to be capitalised and hence form part of initial cost. RSLs not opting to capitalise related borrowing costs, a very significant item for many, may have to in future.

Investment properties and leased assets

Where such properties are held (and for many this would be rare), SSAP 19 requires that they are held at open market value – IAS 40 on the other hand allows a choice of fair value and depreciated cost.

In respect of lease classification, SSAP 21 requires quantification of the cost borne by the lessee to determine the nature of the lease – IAS 17 provides greater insight into the relevant factors to consider.

Cash flow statements

The CFS is far simpler under IAS 7, with only three main headings required, to detail cash flows arising from operating results, financing and investment. There is no requirement under IAS 7 to reconcile movements in cash to movements in net debt.

Related party disclosures

FRS 8 and IAS 18 are consistent in their approach to the disclosure of such transactions. One key difference is the extent of the scope of IAS 18. IAS 18 requires disclosure of 'key management compensation.' Although directors are clearly key management and would hence already be caught under the General Determination Order, 'key management' under IAS extends also to other employees who have responsibility for planning, controlling and directing the entities affairs. This could also encompass senior management.

Pension costs

IAS 19 'Employee benefits' is much wider in scope than FRS 17 'Retirement benefits' and covers all aspects of employee benefits. We should remember that FRS 17 has always been a controversial standard (not helped by the fact that it was introduced at a time when many schemes were faltering) and contains much harmonisation with US treatment. Unsurprisingly then there are relatively few differences between the two standards. The differences that do exist relate mainly to the treatment of actuarial gains and losses arising on revaluation, with

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IFRS Convergence

IAS requiring them to be spread over the remaining lives of employees, whilst FRS 17 requires them to be taken to the Statement of Recognised Gains and Losses (STRGL) during the period.

Planning points

There are a number of important new changes that RSLs may wish to start planning for:

Audited service charge statements

Under the Housing and Regeneration Act 2008, RSLs are required to issue audited statements for all arrangements under which variable service charges are levied, with an effective date covering all periods commencing on or after 6 April 2010.

This means that any RSL which was previously not required to produce audited statements with a year end of 31 March would have to produce audited statements for its year ended 31 March 2012 (and not 31 March 2011, which is a period commencing pre-6 April 2010). This is subject to the regulation proceeding through parliament, which in turn has been delayed due to the general election—RSLs will need to watch this space.

Tax status of caretakers accommodation

Many RSLs have wrestled with HMRC in recent years about the tax status of individuals (wardens/caretakers) living in the accommodation in respect of which they are employed. By concession, HMRC had previously allowed a relaxation of the rules in respect of this issue.

It should be remembered that this concession ended with effect from 6 April 2009 with the effect that unless the caretaker is ***contractually*** on call for 24 hours a day, a taxable benefit arises on:

- living accommodation provided to them (which may be reduced for rent paid by the caretaker);
- the cost of related utility bills met by the employer and the use of furniture

Class 1 NI will also be due from the employer (and in some cases also from the employee for utility bills paid). ***Under pressure from the Nat Fed and KPMG, HMRC has extended this concession to 6 April 2010. On this basis, unless there is further change, these benefits in kind will need to be reported on P11Ds to HMRC on or before 6 July 2011.***

If you require any further information on the matters included within this technical release or if you would like to speak to one of our specialists, please call 02920 549939, or email housing@broomfield.co.uk



Pendragon House

Caxton Place

Pentwyn

CF23 8XE

Tel: 02920 549939

Fax: 02920 739430

www.broomfield.co.uk