

Social Housing Technical Update

AUTUMN 2010



In This Issue

The Broomfield & Alexander Housing Team are delighted to present the Autumn 2010 edition of our technical update. Our other 2010 editions have brought you up-to-date with a number of technical matters (including component cost accounting and other forthcoming SORP changes).

Following the publication of the 2010 SORP we now have the finer details of recommended practice with regard to component cost accounting and we are poised to take action. Within this update we therefore consider some of the practicalities of preparing for the changes; VAT also features prominently.

This issue covers:

1. VAT and postal costs

Recent changes to the VAT treatment of many Royal Mail services serves as a reminder of the need to reconsider whether your entity is making the most of VAT on postal costs.

2. Grant or contract – what difference does it make?

For many forms of income, whether you have a grant or a contract will be clear – for others it will not, and there are some key reasons why you should be aware which form of income you have.

3. Preparing for component cost accounting

Some practical considerations for those about to embark on their data collection, modelling and accounting assumptions.

4. Planning points

Other important changes are afoot. We help to make sure you are up-to-date with changes to VAT – with the standard rate due to increase to 20% in January 2011, what can be done to limit the impact?

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)

VAT and postal costs

Until recently, Royal Mail has enjoyed the advantage of exemption from VAT for the vast majority of its postal services. This posed something of a problem for their competitors, as they had to charge VAT on many of the services which Royal Mail did not, and these were services in respect of which they were in direct competition with Royal Mail.

'Social mail' (including stamped mail delivered via the Royal Mail network) remains exempt from VAT. The types of mail for which the exemption from VAT was removed from Royal Mail includes Parcel Force services, other individually negotiated services, door-to-door unaddressed mail services and the provision of 'mail-room services'. With effect from 31 January 2011 such services provided by Royal Mail will be subject to VAT at the standard rate (which by that date will be 20%).

So why is this relevant for RSLs? Well, firstly, most RSLs making use of these services from Royal Mail will be unable to recover any VAT increases as they themselves provide mainly exempt supplies. These RSLs may wish to take this opportunity to re-negotiate service contracts with Royal Mail so that they don't end up having to absorb the extra cost.

More interestingly, it also serves as a timely prompt to consider your mailing arrangements in more detail. It is worth remembering that in certain circumstances, the costs of delivering items that themselves qualify for zero rating can also be zero rated - for this to be the case, the person supplying the zero rated items must also be responsible for their delivery. One useful example might be the provision of literature regarding the RSL itself, such as newsletters and annual reports.

RSLs may also wish to review their arrangements for zero-rating in this respect to ensure that they are taking advantage of the rules wherever they can.

Grant or contract – what difference does it make?

RSLs will be in receipt of a number of diverse income streams – some will very clearly be grant income, and some will very clearly be contractual. Some income streams however, for a number of reasons, may fall somewhere in between.

What are the key terms we need to define?

Contract – a ‘legally binding agreement’ between two parties, where one party makes an ‘offer’ which is ‘accepted’ by the other party in respect of which some ‘consideration’ exists. Covered by ‘contract law.’

Grant – funds which are freely given by a ‘donor’ and for which the timing, amount and frequency of payment is at the donor’s discretion. Grants are usually provided for a specific purpose. Covered by ‘trust law.’

Service level agreement (SLA) – an agreement which sets out the performance standards expected in relation to services being provided – which could relate either to a grant or a contract.

Sometimes, ‘grant income’ is provided to RSLs and it is clear that the funds are not necessarily ‘freely given’ – for example the timing, quantum and frequency of payments might under the terms of a ‘grant funding agreement’ be reliant on the performance of the ‘donee’ and not discretionary – in this case do we have a grant or a contract? And why does it matter?

VAT matters

VAT is derived from transactions. A detailed discussion of VAT would be impossible here, but it is enough to recognise that for VAT purposes, there is a crucial distinction between

business and non-business supplies:

- contractual arrangements usually (but not always) give rise to business supplies for VAT purposes which are usually chargeable to VAT; whereas
- grants are usually (but not always) non-business transactions to which no VAT liability may arise due to their being ‘outside the scope of VAT.’

Where an entity receives grant funding which is freely given for a specific service (even though the awarding body may stipulate conditions of grant and the intended purpose) it is often the case that no VAT liability would arise. The recipient would in that event not account for VAT on the income, but neither would it be able to recover any of the VAT on the costs incurred in relation to the funded activity.

Conversely where it is clear that a contract exists relating to the receipt of income, the transactions may be business transactions for VAT purposes upon which VAT would have to be charged in respect of the income (assuming of course that the goods or services supplied are VATable supplies).

Depending on the nature of the recipient and the other sources of income it has, it may be able to recover VAT in relation to any associated costs. For most charitable RSLs however this would be limited due to the partial exemption rules and the fact that much of what that activity does is exempt for VAT purposes.

The distinction could be very important where a funding body has a limited amount of cash available to award and wishes to pass on all of

that cash. For example, Funder A may have £100,000 to give to Recipient B. If the way the agreement between the two bodies is worded suggests that this is a non-business transaction, then all of the £100,000 may be freely given to the recipient to be used for its intended purpose. If however, the agreement is deemed to give rise to a business transaction, then the net amount available to the recipient may be only £83,333 (£100,000 less VAT at 20% - from 4 January 2011).

How do you know if income is considered to be a grant or contractual? There will be black and white cases and there'll be very grey ones. There is no easy answer to this, but the following table illustrates the indications that income is either 'grant' or 'contractual':

Grant income	Contractual income
Often an existing service being offered for which additional funding is being sought	A specific service which is being commissioned by an individual or organisation
The 'benefits' of the funding are sufficiently broad or generic that it is unclear how the funder benefits directly	The services to be provided are 'specified' by the commissioner
'Beneficiaries' receive a service which has been indirectly funded by the awarding body	There is a direct link to the services provided for the commissioning body
Funding is freely given with the timing, amount and frequency of payment at the discretion of the donor	A binding agreement exists between the parties with payments dependent upon performance

When making an assessment of any income stream, HMRC will be concerned with the nature of the agreement regardless of whether that agreement is termed an SLA, contract or grant. Careful thought will therefore need to be given to the nature of the relationships between the parties and not just to the *wording* of any agreement.

Accounting issues

There are often important accounting factors to consider with contractual and grant funding arrangements. Any social landlord that has charitable status may find that it is in receipt of income for which a 'donor' has expressed a preference of exactly how the money should be spent. Doing so creates an obligation on behalf of the charitable organisation under trust law to spend that money in accordance with the wishes of the donor.

In the event that any 'restricted income' is identified, the entity may wish to consider whether such unspent balances at year end are correctly classified within its reserve notes and also on the face of the balance sheet. It may also wish to consider whether the correct revenue recognition policies have been adopted with regard to that income – remembering that sometimes 'gifts' of cash which have no specific performance related provisions attached may be taken fully to income in advance of related spending in future periods. With performance related grants or contracts the entity is more likely to need to match the revenues and the costs in which they are 'earned' and 'spent' respectively.

Preparing for component cost accounting

Quick recap

Before we get into the detail, let's quickly recap on what has been discussed previously in these newsletters about component cost accounting (CCA):

- CCA is nothing new – the SORP has required it since the introduction of FRS15 'Tangible Fixed Assets';
- for a number of reasons, including the lack of any formal requirement to depreciate fixed assets prior to SORP 1999, many RSLs have not adopted CCA as a policy;
- the world is changing – International Financial Reporting Standards (IFRS) require that fixed assets are accounted for on a component basis, where the conditions apply;
- UK Generally Accepted Accounting Practice (GAAP) increasingly comes into line with IFRS, and work is currently being undertaken to pave the way for introduction of IFRS into the SORP for housing – note that the accounts of listed companies and many public sector bodies are already IFRS compliant.

Component cost accounting is upon us. It requires us to re-think the way that we account for, and thus treat assets which have individual components with substantially different economic lives – mainly property assets.

It is also likely that the change in treatment will amount to a change in accounting policy

which, if material, would require a prior year adjustment to restate the accounts to show the position each entity would be in if it had always adopted that practice (note that when FRS15 was introduced, the ASB issued a UITF abstract stating that any change to accounting on a component basis amounted to a change in accounting policy). Much work will need to be done therefore to determine the impact of this change.

So how do we prepare?

The method of preparation that is best for each entity will depend upon a large number of factors, including previous accounting treatment, nature and type of assets and the availability of resources. The following is a generic guide of the steps that are likely to be appropriate:

Obtain support – the potential impact could be significant. Board members, staff, lenders and even tenants will all need to understand why the change has come about and what exactly is the impact. If you haven't already done so, providing your Board with some training or briefing on the change would be a valuable exercise. Open a dialogue with anyone who might be directly affected – such as lenders whose loan covenants may be affected.

Be clear about what you are trying to achieve and the potential limitations that exist in re-creating a position with 100% accuracy.

Assess your historic data – you will need to think carefully about how far back your modelling can be taken. Reliable data may only be available for a finite number of

recent years – the use of estimation to some extent is almost inevitable. It is worth remembering that the SORP contained no specific requirement to depreciate assets prior to SORP 1999, and so this may be a convenient reference point for many in determining how far back to calculate component depreciation.

Consider how far back you have reliable asset management plans, management information, financial statements, annual reports, accounting records and other useful information.

Identify resource requirement - don't under-estimate the level of human (and possibly IT) resource that will be required. For the majority of entities, the task will require significant amounts of data collection. And this is not just an exercise for finance staff. Technical officers will need to be involved in the process so that the correct historic data can be collated and so that the most appropriate data drives your assumptions. For example, finance staff may be best placed to tell you the cost of a boiler installation at today's prices, but what about 6, 7 or 8 years ago, or even 16, 17 or 18 years ago?

Prepare a project plan – it is unlikely that this work can be done overnight. You will probably feel the need to revisit assumptions, consult internally and externally with regard to the appropriateness of, and consistency of assumptions and methodologies. Planning and identifying key milestones as well as allocating responsibility for tasks will be a useful way of ensuring that staff, other than finance staff 'buy into' the process.

You should also allow sufficient time for the assumptions and methodology to be put before the Board, remembering that the Board has ultimate responsibility for ensuring that the entity has adopted the accounting policies that are 'the most appropriate for giving a true and fair view'.

Develop preliminary assumptions – your assumptions are key, but they are unlikely to be perfect. Remember what you are trying to achieve – a restatement of the position that the entity would have been in had it always accounted for fixed assets in this way. We are retrospectively applying accounting estimates and judgements with the added complications that we may not have full, accurate data which tells us exactly when specific, relevant events occurred.

One of the assumptions which is likely to require the most thought is the split of previously capitalised assets between land, buildings (structure) and then the other individual components, the lives of individual components and the timing of any replacements.

It is worth remembering that the assumptions you apply in respect of historical data will have an impact upon your current and future results. This does of course assume that you don't change those assumptions (or estimates) going forward. While a change in accounting estimates (such as the useful economic life of an asset) does not amount to a change in accounting policy, it should nevertheless be made because you believe that the new estimate is required in order to present a true and fair view.

Note also that if you make very aggressive assumptions today, which may limit the detrimental impact upon reserves of increased depreciation, you may pay for those in the future if the flip-side is a reduced ability to capitalise expenditure.

Model the impact – this is critical. It is only by playing with the numbers, the assumptions and the outcomes that you will be able to determine the impact of the change. Modelling is also a key way of tweaking the methodology so that you tailor all of the assumptions to your specific entity and in working through problems as they arise.

Your modelling will be a fluid exercise, and you will need to ensure that your finance department is not working in isolation – there will be a number of parties who will have an interest in the outcome.

Re-consider your assumptions – when you've taken your model as far as you can, then step back from it – take a deep breath and challenge your own assumptions – taking all elements and factors together, do your assumptions represent the most appropriate outcome for your entity?

Remember that the purpose of the exercise is to state with as much accuracy as you can the position that the entity would currently be in if it had always adopted the approach. This will involve the use of assumptions that affect not just the past but also the future. Taking a stance on your assumptions about the past that generates a certain position today may have unwelcome future consequences. You might at this point be thinking about

changing your assumptions a year or so after implementation (which in itself may well not result in a change in accounting policy) – you should still remember that any change in accounting estimate needs to be taken on the basis that it better reflects the circumstances of the entity – auditors, board members and bankers may need to be convinced of this.

Take advice – Speak to your bankers, your auditors (internal and external), your solicitors (who may be holding valuable information which might help), surveyors – there are a variety of sources of assistance and advice to be used which may improve the overall appropriateness of the assumptions.

Planning points

Changes affecting VAT

The standard rate of VAT is due to increase to 20% with effect from 4 January 2011. Most RSLs, in common with many organisations in the third sector, will find themselves in a position of absorbing all, or most of the additional VAT costs within their budgets. So, for organisations that are unable to recover the increase, what steps can be taken to reduce its impact?

Remember that for VAT purposes, most transactions occur or become VATable at the earliest point when goods or services are delivered and when an invoice is raised.

Plan effectively

1. The first and most obvious action may be to bring forward any planned purchases of goods and services **before 4 January 2011**.
2. For any purchases you anticipate being conducted prior to 4 January 2011 for which invoices are received after delivery, make sure that the delivery date is taken as the **'relevant tax point'** – in fact, it is worth alerting your finance and operational staff to the benefits of increased vigilance around the issue of identifying 'delivery dates'.
3. Subject to the anti-avoidance measures below, also consider requesting that **invoices are issued prior to 4 January 2011** for goods and services delivered after that date – but be aware that if you do this, you may need to pay on or before the date of the increase also.
4. For any goods and services that are 'in progress' at the date of the increase, be careful that related **costs are**

apportioned correctly between the pre and post increase date to ensure that you only pay for goods and services delivered prior to 4 January at the lower standard rate. RSLs may wish to communicate the importance of this issue early with maintenance contractors and their own staff to ensure that you achieve the most advantageous position on both planned and reactive maintenance works that straddle the date of the change.

Other considerations

Not all the decisions RSLs make in this respect will be driven by the rate of VAT, which for some may make only a marginal difference. Some of the actions suggested above will also impact upon cash flow, budgets and forecasts.

And then there are the **anti-avoidance factors**. The change in rate is accompanied by anti-avoidance provisions which would do away with your ability to take advantage of the rate change and apply where:

- You and the supplier are connected parties;
- The value of any supply which has been brought forward exceeds £100,000 and this is not normal commercial practice; and
- The supplier (or their connected parties) effectively funds your purchase – so you would be usually be required to pay for the brought forward transaction under normal commercial terms of credit. Also be aware that payment of the relevant supply must be due within 6 months of the invoice.

Broomfield & Alexander 2010

It is also worth remembering that the increase occurs at a time when many of your suppliers may be concentrating on factors other than the increase in the rate (especially where they recover all of their VAT, and so it doesn't affect them.)

Quite apart from the excitement of a Christmas break, or dealing with the issue of ensuring business continuity over a holiday period, some of your contractors may have a year end of 31 December, and their priorities (for example revenue recognition) may be different to yours. They may also have a vested interest in the date upon which transactions are recorded. Indeed, some of them may not be aware of the importance of, or ability to, account separately for work and transactions that straddle the date of the change.

Suppliers may also be more concerned with valuing works conducted to 31 December than 4 January and may need to be convinced of why they should help you with the latter date (acknowledging that for most, there is unlikely to be a significant difference between the two).

RSLs should also remember that there is little time allowed for correcting errors after the date of the change. Suppliers will have only 45 days in which to issue credit notes in respect of invoices that have incorrectly charged the higher rate.

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**