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Audit

Looking Forward – reporting and accounting update for Registered Social Landlords

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SORP 2007

The exposure draft of the SORP was published in summer 2006 and it was expected that the final SORP would have been published at the end of this month with RSLs encouraged to adopt early in their March 2007 accounts.

However, the proposals, particularly in respect of **shared ownership accounting**, have met with significant opposition. It seems unlikely that the shared ownership accounting proposals will be dropped completely, but the SORP working party is reviewing the proposals carefully and is likely to come up with a slightly revised consultation draft of the SORP in the next couple of months with another Exposure Draft in the autumn. Although the SORP has not been issued in final form, a number of RSLs are already accounting for first tranche sales through the income and expenditure account and it is likely that more will be adopt this accounting policy in this year's financial statements.

FRS 18 permits this treatment provided that the directors can justify that inclusion of first tranche sale proceeds in the income and expenditure account gives a fairer view of the performance of the RSL rather than the previous treatment. It should not be simply because it would allow the RSL to meet its debt covenants or show a surplus rather than a deficit! FRS 18 requires an RSL adopting this treatment to disclose the rationale for and fact of the departure from the 2005 SORP in their financial statements, and, if this treatment is adopted for the first time this year and the effect is material, to restate the prior year accounts to reflect a change in accounting policy.

If you are looking to adopt the shared ownership proposals early remember the other accounting implications:

- The proportion of shared ownership properties to be sold under a first tranche sale needs to be included within current assets and an analysis given between completed shared ownership properties and those in the course of construction.
- The first tranche sale proceeds need to be included within turnover and the relevant proportion of the development costs as well as marketing and legal costs should be included in cost of sales.

Other key changes in the exposure draft of the SORP include the following:

- Accounting for complex developments – where an RSL is involved in cross subsidy schemes, i.e. properties are being built for sale within a development in order to finance social housing in the same scheme, profits should not be recognised on the properties for sale if the result would be that the social housing would be carried at a value in excess of its EUV-SH valuation. However, complications may arise where the properties for sale are being developed in one entity within an RSL group but the social housing is being recorded in another entity. In this instance, particular care needs to be paid to allocating costs between the two entities and potentially profits in the entity selling the properties may need to be eliminated on consolidation if this results in the social housing being held at a value in excess of EUV-SH in the group accounts.
- Related Party disclosures – the exposure draft appears to require disclosures which go beyond those strictly required by FRS 8. Our response to the exposure draft recommended that the SORP should not include these disclosures. If the Housing Corporation believe that the additional disclosures are required then they should instead be included in the next version of the General Determination.

- Accounting for transfers – the SORP requires that RSLs consider whether large scale voluntary transfers are actually transfers of an undertaking rather than a simple purchase of assets. Key features of the former might be that existing staff are being transferred together with operating systems and other operating assets. The implications are that if the transfer is really an acquisition of a business rather than the acquisition of fixed assets, then the assets and liabilities acquired should be fair valued and accounted for under FRS 7.

Housing Corporation – Accounting Requirements for Registered Social Landlords – April 2006

The Housing Corporation issued a new General Determination in April 2006. This will be first year that RSLs will have to adopt the new disclosure requirements although many voluntarily gave these disclosures in their 2006 financial statements. As a reminder, the main changes are as follows:

- more analysis is required in 'note 3' for 'other costs' where these other costs represent more than 5% of total operating costs;
- the disclosure requirements for Supporting People income have been amended although the detail proposed in the consultation draft of the Determination has been much reduced;
- separate disclosure is required in the fixed asset note of additions to completed properties, differentiating between work to completed properties acquired and works to existing properties;
- there are new disclosure requirements for showing the movement on the disposal proceeds fund and the Recycled Grant fund in order to 'show greater transparency' of how these funds are used;
- payments to directors need to include board members (where remunerated). Separate disclosure needs to be made between amounts paid to executive staff members and those who are not;
- further details are required of proposed financing for capital commitments indicating amount of grant, agreed loans, loans under negotiation, property sales and other sources of funding; and
- some disclosure requirements have been removed including the Chief Executive's pension arrangements, average number of employees (but not the FTE disclosure), disclosure of RSF (now abolished), and average number of days taken to pay purchase invoices.

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The most significant of the changes is the additional fixed asset addition disclosures. This, coupled with the 2005 SORP requirements on accounting for expenditure on existing properties will make any 'aggressive' capitalisation of major repair expenditure very clear to readers of the accounts. For those RSLs who have adopted component accounting it will be important for them to draw readers' attention to their accounting policy as there is a danger that readers may wrongly interpret high levels of major repair expenditure being capitalised as evidence that the RSL is being imprudent in its accounting policies.

Service Charge accounting and reporting

The Commonhold and Leasehold Reform Act 2002 introduced a requirement for fuller and more consistent reporting of variable service charges to tenants and leaseholders, together with new provisions for the holding of service charge payers' monies. The Government's initial proposals for accounting and reporting on service charge statements were particularly onerous and were withdrawn after the initial consultation.

The Department for Communities and Local Government has been working on new proposals and we understand that these are due to be published for consultation shortly. An audit of individual service charges is unlikely to be required although an accountant's report will be needed for each service charge scheme. There will also be a prescribed format for the service charge statement, setting out the minimum disclosure required. We understand that there may be some minor concessions for RSLs but overall the new reporting regime is likely to add significant cost to most RSLs. In particular, the implications of the new reporting regime need to be carefully considered at an early stage to ensure systems and processes can generate the required information, including potential changes to the split of charges in the trial balance. It is likely that the earliest application date will be for years beginning on or after 1April 2008.

Charities Act

The new Charities Act was passed in November and its various provisions will come into force over a staggered timetable. One of the main areas of contention is the new proposals for the public benefit test. The Charities Commissions published their detailed proposals for consultation earlier this month and whilst at first glance it is difficult to envisage a social housing charity having problems meeting the provisions of the new test, it is well worthwhile formally reviewing the proposals to ensure that there are no adverse implications for some of the entities within your Group.

The concept of an exempt charity has gone and charitable RSLs will need to comply in full with charity law. It is yet to be seen how the Housing Corporation intends to carry out its role as regulator on behalf of the Charities Commission for the sector. It is possible that the Housing Corporation will look to introduce additional disclosure requirements in order to assist their monitoring of the sector.

Companies Act 2006

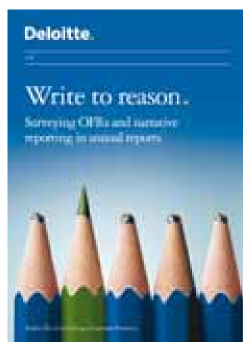
The provisions of new Companies Act will impact most companies within RSL groups going forward. Key areas of substantial change in the Act include:

- Directors' duties and derivative claims.
- Shareholder rights.
- Electronic communications.
- Business Review for quoted companies.
- De-regulation of private companies.
- Limitations on directors' and auditors' liability.

The deregulatory provisions of the Act will be welcomed by RSLs with many corporate subsidiaries. However, some work will be needed to take advantage of these as many of them will require changes to articles of association. For a useful summary of the new provisions and answers to commonly asked questions please consult the Deloitte publication "CompAct – Q&As on the 2006 Companies Act" which can be found at www.deloitte.co.uk/corporategovernance

There has also been a degree of confusion as to the extent to which recent changes to the old Companies Act 1985 affect Industrial and Provident Societies. Company directors' reports for financial years beginning on or after 1 April 2005 must include a statement that, in the case of each person who is a director at the time when the directors' report is approved:

- so far as the director is aware, there is no relevant audit information of which the auditors are unaware; and
- they have taken all the steps that they ought to have taken as a director to make themselves aware of any relevant audit information and to establish that the company's auditors are aware of that information.



Some RSLs have asked whether the requirement is strictly relevant to their organisation, given that they are incorporated under the Industrial and Provident Societies Acts; others have questioned what their directors need to do in order to be able to make the statement. The requirements are only binding on entities incorporated under the Companies Act and are therefore not strictly required by those which are Industrial and Provident Societies. However, RSLs may see such a statement as representing good governance and are therefore encouraged to make the disclosure. RSL boards should not take this disclosure lightly however and need to carefully consider what additional reassurances they should seek in order to feel confident that they can make this disclosure. In our last issue of 'Corporate Governance Update' we set out some suggestions for the steps that Directors should take and a copy of this can be found on the corporate governance section of our website at http://www.deloitte.co.uk/corporategovernance

Financial reporting in the longer term

After a flurry of activity over the last three years things have gone rather quiet, with the ASB deciding there will be no new standards before 2009. They are carefully reviewing their options for future accounting standards and are considering introducing a three tier approach to standards:

- Full IFRS compliance for quoted companies and public interest entities. The term "public interest entity" has not been defined but is likely to include RSLs with quoted debt.
- A middle band of entities – these might be large private companies, or other medium sized organisations. The idea here is that they might be subject to a regime of 'IFRS minus' or 'FRSSE plus'. This may will take the form of the recently issued exposure draft **International Financial Reporting Standard for Small and Medium-Sized entities** which includes both simpler measurement and disclosure requirements than full IFRS.

  A final IASB standard is expected in mid-2008, at which point the EU may well allow individual member states to adopt it for all entities other than those for whom full IFRS compliance is required.
- The FRSSE – similar to the current Financial reporting standard for small entities.

The Statement of Accounting Principles – Interpretation for Public Benefit Entities is still being considered by the Accounting Standards Board. This is an Accounting Standards Board project which has been going on for some time now since the first consultation draft appeared back in 2005. The idea behind it was to set out some common principles for all public benefit entities so that accounting across the sectors could be more consistent. Probably the greatest area of difference is how capital grants are accounted for. Under the current SORPs, charities take capital grants as income at the stage they become entitled to it. In contrast, an RSL would treat the grant as a deduction from fixed assets and a university would carry the grant on the balance sheet as deferred income amortised over the life of the asset which it funded.

The RSL sector is very against the proposal that the charity treatment be adopted for all public benefit entities, believing that it will distort the income and expenditure account. There are also significant complications of adopting such a policy in practice – if the grant is taken through Income and expenditure account you are likely to suffer impairment of the property which the grant funded. Shared ownership properties get even more complicated – if an RSL believes shared ownership properties will be staircased there is an argument that related grants will have to be repaid and therefore showing the grant as a liability is more appropriate.

Our feeling is that this change may not come in for some time, if at all. The Statement of Principles is not an accounting standard and SSAP 4 – accounting for government grants will still be in force, so it is difficult to see how RSLs could be forced down the path of taking capital grants to revenue in the short term. The ASB intend to review SSAP 4 at the same time as the equivalent IASB project, which will not be in the short term, and this therefore has to be an area which will need to be kept under review.

It is still very difficult to predict what the **International Financial Reporting Standards** ('IFRS') regime will look like after 2009, which aspects of IFRS are likely to be incorporated into UK accounting standards and particularly those in the 'middle way' band. There are one or two standards and projects which are of particular interest to RSLs and could make a big difference to RSL accounting. These include:

- **IAS 40 – accounting for investment properties**. The definition of investment properties in IAS 40 is slightly different to that of the current UK accounting standard. On the face of it, it could mean that an RSL's properties would fit into this definition, with the result that RSLs could have the option of carrying properties at valuation with no requirement for depreciation. This might make life simpler, but it could make interpretation of an RSL's results even more difficult as gains and losses on revaluation would be taken directly to income and expenditure account with surpluses and asset values fluctuating significantly between accounting periods.
- Another area that could signal change is **accounting for leases**. Current accounting standards differentiate between operating leases (where the lessee does not have the majority of risks and rewards) which are not recognised on the balance sheets and finance leases (where the opposite is true). The IASB's initial thinking for their lease accounting project is that interests in assets acquired under operating leases should be valued and shown on the balance sheet. This is going to be particularly relevant for those social landlords who rent temporary housing under short leases. A discussion paper is expected in 2008.
- IAS does not recognise **merger accounting** believing that all combinations consist of one party effectively taking over another – something that many RSLs would dispute.

International Public Sector Accounting Standards are used in some countries for public sector accounting and adopt the concepts of IFRSs for public sector purposes. Adoption in this country is probably some way off and in any respect, some of these standards are not suitable for Registered Social Landlords, given the 'half way house' status of the sector. However, they may well influence SORP setters and some of the concepts may well surface in the sector in the future.

Accounting for Pension Costs

The ASB has recently issued two documents relating to pensions:

- Firstly, an amendment to **FRS 17 Retirement** benefits which aligns the disclosures required for defined benefit schemes not taking advantage of the multi-employer exemption with those in the equivalent IAS 19 **Employee Benefits**, as well as requiring that bid-price (rather than mid-price) is used for quoted securities. The amendment is applicable for periods commencing on or after 6 April 2007 although the ASB encourage early adoption.
- Secondly, the ASB has published a **Reporting Statement: Retirement Benefits – Disclosures**. This statement is best practice only, not an accounting standard and as such has no effective date. It recommends disclosure in six areas: the relationship between the entity and trustees/managers of the defined benefit scheme; the principal assumptions used to measure scheme liabilities; the sensitivity of the principal assumptions used to measure the scheme liabilities; how the liabilities arising from defined benefit schemes are measured; the future funding obligations in relation to defined benefit scheme; and the nature and extent of the risks arising from financial instruments held by the defined benefit scheme. One significant recommendation is that in disclosing the assumptions details of the mortality tables used should be given.

For those RSLs who are members of the **Social Housing Pension Scheme ('SHPS')**, the impact of FRS 17 has not been significant. As a multi-employer scheme where the assets and liabilities of the scheme cannot be attributed on a reliable basis to individual members, RSLs have been able to continue to account for their contributions as if they were contributing to a money purchase scheme i.e. contributions are taken directly to the income and expenditure account. This fairly relaxed situation was in danger of being upset last year, when SHPS notified employer members of the total cost they would incur if they withdrew from the scheme. This seemed to imply that SHPS were able to allocate assets and liabilities to individual members but further investigation showed this not to be the case. However, a number of RSLs have disclosed the penalty amount as a note to their financial statements under 'contingent liabilities'. Our view is that, whilst this may be one of the risks recommended for disclosure by the best practice Reporting Statement, this is not required for a true and fair view unless there is a real prospect of the RSL withdrawing from the Scheme and triggering the exit penalty, an outcome which in most cases will be remote.

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