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Dear Mr Powell

RSL SORP UPDATE 2007

The Institute of Chartered Accountants in England & Wales ('The Institute') is pleased to respond to your request for comments on the National Housing Federations' *SORP Update 2007*.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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ICAEW representation

THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

ICAEW REP 59/06

RSL SORP Update 2007

Memorandum of comment submitted in October 2006 by the Institute of Chartered Accountants in England & Wales, in response to the National Housing Federation's consultation paper 'SORP Update 2007 published in July 2006.

Contents **Paragraph**

INVESTOR IN PEOPLE

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INTRODUCTION

1. The Institute of Chartered Accountants in England & Wales (the 'Institute') welcomes the opportunity to comment on the consultation paper *SORP Update 2007* published by the National Housing Federation.

WHO WE ARE

2. The Institute of Chartered Accountants in England & Wales is the largest professional accountancy body in Europe, with more than 128,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.

3. The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department of Trade & Industry (DTI) through the Financial Reporting Council. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy.

POINTS WHICH ARE NOT COVERED IN THE SPECIFIC QUESTIONS

Format and Layout of the SORP update 2007

4. The general layout and approach is much improved. It is helpful to users of the SORP for the text to distinguish between recommended practice and explanatory material by the use of bold type and normal print, which is consistent with the format and approach of financial reporting standards. We welcome the attempt to make the SORP more practical and easier to use.

Shared Ownership schemes

5. The treatment of shared ownership schemes has generated considerable debate. What has become clear is that no two shared ownership schemes are the same. Therefore, whilst, the treatment in the SORP update is acceptable in principle, it is important that there is clarity and consistency which is flexible enough to accommodate a wide selection of variables which inevitably exist in such schemes. There are significant differences in the type of schemes and the factors that can affect the quantum of the first tranche which will require more detailed guidance.

6. For example due to the variety of outcomes possible further consideration and guidance is necessary on how the new accounting policy would be implemented and applied in practice, including the following issues:

    - The allocation between fixed and current assets for schemes still under construction at the year end.

- The valuation of land in shared ownership schemes and how it should be allocated, if at all, between fixed and current assets.
- Changes between expected and actual percentages realised through first tranche sales.
- Whether or not the policy should be applied to properties that were previously held as fixed assets (general needs rental), but which are subsequently treated as shared ownership, due to RSL schemes or government policy.
- Whether there should be prior year adjustments on the adoption of the proposed accounting treatment for first tranche sales.
- The level of disclosure required to explain the application of the policy. We feel that disclosure of too much information can be counterproductive and lead to more confusion rather than greater transparency

7. Paragraph 79 appears to be drafted on the presumption that the first tranche sale is prior to the year end. It is not clear how the recommended practice should be applied where there is no sale by the year end. For example, where there is no sale prior to year end at balance sheet date should the valuation be at cost or net realisable value?

8. We suggest that the words "or valuation" in paragraph 79 are deleted. As the assets are effectively stock, a valuation is not appropriate. "*Those properties included as current assets should be shown at the lower of cost and net realisable value, calculated on a scheme by scheme basis"* (wording used in paragraph 81) should be inserted at the end of paragraph 79.

Matters not covered by the SORP Update 2007

9. As discussed above, a wide range of variations on the theme of shared ownership has developed, some of which use the government funded Homebuy scheme. One such variation is Shared Ownership for the Elderly, where it is unlikely or, in some cases, impossible that the shared owner will eventually obtain ownership of the whole of the equity. In some cases relatively high percentages are sold in the initial tranche and no rent is charged on the remainder. Aspects of these arrangements are similar to the equity release schemes offered by banks and insurance companies.

10. It would be helpful if the guidance in the SORP could identify any circumstance in which an accounting treatment other than that proposed for the generality of shared ownership schemes would be appropriate. Similarly, guidance on specific disclosures that may be needed in relation to such schemes would be welcome.

RESPONSES TO SPECIFIC QUESTIONS

Shared Ownership Sales:

Q1:Are consultees of the view that existing guidance over the treatment of shared ownership properties requires updating in the SORP?

11. Yes.

Q2:If yes, do consultees agree with the proposed amendments in relation to shared ownership properties? If not, why not and what alternatives do consultees support?

12. In principle we support the suggested treatment of shared ownership properties as more accurately reflecting cashflow. However we are concerned that the treatment does not necessarily reflect the underlying, economic realties of such schemes. There needs to be more thought given to the guidance (for example akin to *"guidance on depreciation and impairment" [2nd Ed 2001])* to ensure that there are consistent outcomes and a sensible application in practice (See also paragraphs 5-9 above).

Onerous Contracts:

Q3:Do consultees agree that there is a need for more specific guidance over recognition of onerous contracts in the SORP?

13. No.

Q4:If yes, do consultees agree with the SORP Working Party's view that an onerous contract may arise through a commitment to provide public benefit and that this should be recognised in the financial statements?

14. Please see above.

Q5:If yes, do consultees agree with the proposed amendments in relation to onerous contracts? If not, why not and what alternatives do consultees support (with reasons)?

15. In our opinion paragraph 206 is seeking to respond to material in the proposed interpretation of the Statement of Principles for Financial Reporting for public benefit entities rather than a problem that will arise in practice. We therefore consider that the proposed amendments are unnecessary and that the principles in FRS 12 should be applied.

Accounting for Mixed Development (S106 Agreements):

Q6:Do consultees agree that there is a need for more specific guidance over the accounting treatment of mixed development and S106 agreements in the SORP?

16. Yes.

Q7:If yes, do consultees agree with the proposed amendments in relation to mixed development and S106 agreements? If not, why not and what alternatives do consultees support (with reasons)?

17. We welcome the addition of guidance on accounting for mixed development and S106 agreements. However, we do not consider that the guidance provides sufficient clarity to deal with 'complex schemes' (taken to mean. schemes involving a combination of social rented housing, shared ownership and houses

built for sale) and its application to individual entities is unclear. We consider that the proposed amendments are not sufficiently well developed because:

- The rationale for the proposed treatment in paragraph 156(b) needs further development as it is unclear and confusing.
- We consider that paragraph 157, as drafted, could render the previous paragraph ineffective as, whilst it should be rare, RSLs may well seek to demonstrate that the presumption is invalid in every case.
- Paragraph 158 does not appear to deal with mixed development schemes for individual entities.
- There is not enough guidance on how to attribute costs where these can be split between elements in mixed development schemes parts of which are intended for outright sale. For example higher costs may be attributable to commercial than to social elements which would result in surpluses on commercial being reduced and likewise deficits on social elements being reduced.

Stock Transfers:

Q8:Do consultees agree that scenarios exist where stock transfers should be accounted for as a business combination rather than as an acquisition of assets?

18. Yes.

Q9:If so, are the indicators outlined sufficient to enable social landlords to determine when acquisition accounting should be applied? Are there other indicators that should also be included?

19. Whilst the indicators are acceptable as far as they go we are concerned that the three indicators noted are too simplistic and may be applied without consideration of the individual circumstances of each transaction. This is particularly applicable to Large Scale Voluntary Transfers from local authorities (LSVTs) which would need to have regard to a wider range of factors such as the control and management of the LSVT and the purpose and objectives for the transfer. Further, there should be guidance on whether there is a requirement to consider previous years' accounting treatment and apply prior year adjustments.

Q10:Do consultees consider that any further guidance, beyond that already included under business combinations, should be provided in the SORP on determining fair value of housing properties in respect of stock transfers? If so, what considerations should be included in determining fair value?

20. We agree that EUV-SH is a sensible method of approaching accounting. However the impact of other liabilities should be considered, for example expenditure for renovation as a condition of transfer.

    We also make the observation that Paragraph 240 appears to require some drafting attention. In line 3 should 'total' read 'equal'? In line 4 should 'required' read ‘acquired’? In line 5 there appear to be words deleted - the sentence ends with both a comma and a full stop.

Q11:Do consultees consider that any specific guidance should be provided on determining the fair value of non-housing assets and liabilities?

21. We believe that the SORP should specifically provide guidance in respect of pension arrangements. Problems arise where there is a deficit under FRS17. There is potential for a liability to be crystallised on transfer. Whilst this may be infrequent the current absence of guidance is unsatisfactory both for practitioners and RSLs. Specific guidance in particular should address pension liabilities where RSLs are SHPS members.

Q12:Do consultees consider that the SORP should be extended specifically to transfers of assets other than land?

22. No, such transfers should be dealt with under existing appropriate rules..

Q13:If the SORP is extended to other assets in what areas do consultees consider further guidance is required in order to determine the fair value of the asset to be recognised?

23. Please see above.

Related Party Disclosures:

Q14:Do consultees agree with the proposed approach to related party disclosures i.e. the inclusion of more of the details of the disclosure requirements in the SORP?

24. We do not consider that the information in paragraph 28 adds anything. In our opinion, disclosure should address related party transactions and not classes of people or connections.

Component Accounting:

Q15:Do consultees agree with the clarification and amendments to the SORP in relation to component accounting?

25. We consider that the content of paragraph 169 needs to be expanded, because a variety of approaches may be acceptable depending on the circumstances. The variations and example situations are discussed in Appendix A, attached.

Endowments and Restricted Reserves:

Q16: Do consultees agree that references to endowment reserves should be added to the SORP’s requirements on restricted reserves?

26. We do not see that special references to endowment reserves are necessary, because endowment reserves are by definition restricted capital reserves. We

recommend that paragraph 71 be amended to remove the words “or endowment” from the second line, and a new sentence inserted after the end of this first sentence along the lines ‘Endowment reserves should be treated as restricted reserves.’ The third and fourth sentences in paragraph 73 could be replaced by a single sentence ‘Income and expenditure of an endowment should be dealt with in accordance with the underlying legal documentation.’ Para 76 should be expanded to show reconciliation with movements in endowment reserve, valuation and income and expenditure.

Designated Reserves:

Q17: Do consultees agree with the proposed amendments to the SORP’s provisions on Designated Reserves?

27. Yes

Housing Property Book Values:

Q18: Do consultees agree with the proposed amendments in relation to housing properties intended to be sold?

28. Yes.

Financial Instruments (FRS 25 Financial Instruments: Disclosure and Presentation and FRS 26 Financial Instruments: Measurement):

Q19: Do consultees agree with the SORP Working Party’s approach to financial instruments in the SORP?

29. Yes.

Q20: If not what areas/issues do consultees consider need specific consideration for social landlords?

30. Please see above.

Date from which Effective:

Q22: Do consultees agree with the proposed effective date for the draft 2007 SORP?

31. Yes, provided that there is enough time to develop and consult on additional guidance as recommended in this response.

Valuation Issues – Housing Properties:

Q23: Do consultees consider that it is appropriate to move to current valuation for all housing properties in the SORP?

32. No.

Q24: If not why not (please give reasons)?

33. We consider that it is unfair to single out RSLs, that the suggestion adds no value but will constitute an additional cost and burden. As this approach is currently permissible, if it did add value when applied to all we consider that it would already have been adopted by RSLs. We suggest there is little benefit in trying to enforce a single approach: RSLs are diverse and, therefore, one size does not fit all. In summary we consider this approach to be impractical.

Q25: If so, what consultees consider would be the most appropriate timescale to move to current values for housing properties?

34. Please see above.

Appendix A

Social Housing Sub-Committee - Paper on the application of Component Accounting

Introduction

The sub-committee considered the topic of component accounting at its last meeting and agreed that some further research into this area, and the application of it in the sector, would be useful.

This paper therefore discusses the accounting regime applicable to RSLs, looks at some specific examples within the sector and sets out the key questions that need to be considered when looking at the applicability of component accounting.

Accounting standards

The application of component accounting is considered in both FRS 15 and the RSL SORP.

An asset may consist of several different physical components. FRS 15 states that, if a tangible fixed asset comprises two or more major components, with substantially different useful economic lives, then each component should be treated separately for depreciation purposes (that is, as if each component was a separate asset in its own right) and depreciated over its individual useful economic life. It follows, therefore, that when a component is replaced or restored, the old component is written off, to avoid double counting, and the new component capitalised. There is, therefore, a need for entities to review whether or not an asset has such separable components. If it decides it has, then separable components should be depreciated individually over their useful lives.

This approach arose in response to FRS 12 which considered the question of whether future maintenance constitutes a liability of the entity. The FRS concluded that even where there will in due course be a legal or constructive obligation, the appropriate accounting treatment is to recognise depreciation to take account of the actual consumption of the asset's economic benefits. Thus, for example, where a separate component of an asset wears out more quickly than the rest, it is depreciated over a shorter period and subsequent expenditure on restoring the component is then capitalised. This replaced the previous general practice of depreciating such components over the same period as the rest of the asset, but providing in advance for the maintenance/replacement of the component.

Where the depreciation of an asset does not allow for the wearing out of a component of the asset, subsequent expenditure that restores or replaces a component is recognised in the profit and loss account as incurred. This approach, however, could result in a lumpy charge to the profit and loss account and does not match the expense of replacing a component with the benefit of the use of that component.

Whether to identify separate components of an asset will be a matter of judgement and will depend on:

- The degree of irregularity in the replacement expenditure required.
- The materiality of the component.
- The materiality of the effect of separately depreciating the component.
- Whether the useful economic life of the component is substantially different from that of the rest of the asset.

In practice, a commonsense approach should be applied, so that separate components will only be identified where there is a material impact on the income and expenditure account.

The FRS goes on to consider that some assets may require periodic major inspections or overhauls. The FRS applies a similar ‘component’ approach to major inspection and overhaul costs, even though the cost of a major inspection or overhaul is not a physical component of an asset. In such a case the FRS permits a proportion of the cost of the asset equivalent to the expected overhaul cost to be depreciated over the period to the next overhaul. If this is done the actual cost of the overhaul or inspection is then capitalised (because it restores the economic benefits, usage of which has been reflected in depreciation). This overhaul cost is then depreciated over the period to the next overhaul. The cost and depreciation attributed to the overhaul originally is removed from the balance sheet once the cost of the new overhaul has been capitalised to avoid double counting. The remainder of the asset is depreciated over the full useful economic life of the asset, on the basis that the appropriate overhauls will be carried out as they are due.

The decision to adopt this approach to overhaul expenditure may depend on:

- Whether the period until the next overhaul is substantially different from the useful economic life of the rest of the asset.
- The degree of irregularity in the level of expenditure on overhauls.
- The materiality of the expenditure in the context of the financial statements.

Where the 'separate components' method has not been adopted or part of the asset is not depreciated over a shorter timescale to allow for major overhaul expenditure as described above, the cost of replacements or overhauls should be charged to the profit and loss account as incurred. This approach, which is a form of component accounting, is probably less relevant to the RSL sector.

The 2005 SORP gives some guidance on component accounting that essentially says FRS 15 should be applied. The 2007 SORP consultation draft includes a slight amendment on component accounting to make clear that component accounting should be applied on a consistent basis.

Examples of application in the sector

There is a wide variety in the capitalisation policies within the sector, including works to existing properties. As such there is no consistent approach to the application of component accounting. Some examples are considered below:

RSL 1

Maintenance expenditure
Expenditure incurred by the Association on general repairs to its housing stock is expensed to the income and expenditure account in the year in which it is incurred. Expenditure which results in an increase in the net rental stream is treated as an improvement to the housing properties concerned and is capitalised. Capitalised improvements, which enhance the economic benefits of the asset, are depreciated over the expected useful economic lives of the properties. Where an improvement has been capitalised any subsequent replacement of that improvement is expensed to the income and expenditure account.

In this case, the RSL has made a case that some improvements, such as new specifications kitchens and bathrooms, should be capitalised, because it results in reduced maintenance costs on an ongoing basis. The value of the improvement which is equated to the capitalised cost of reduced maintenance expenditure is then written off over the remaining life of the whole asset. Any further expenditure on this 'component'' is charged to revenue as incurred.

This does not amount to component accounting, but a case has been made to recognise expenditure on the asset or a component of the asset which 'provides an enhancement of the economic benefits of the asset in excess of the previously assessed standard of performance.'

RSL 2

Housing properties
Improvements are works which result in an increase in the net rental income, such as the ability to charge increased rents, a reduction in future maintenance costs, or result in a significant extension of the useful economic life of the property. Only the direct overhead costs associated with new developments or improvements are capitalised. Depreciation of buildings is charged so as to write them down to their estimated residual value on a straight line basis, over their estimated useful

economic lives. The Trust's housing properties are depreciated at 1% per annum. Capitalised major repairs (windows) are depreciated at 3.33% per annum.

In this case, the RSL, which is a recent LSVT, has identified that windows only represent a 'separate component' and where they have been replaced they have been depreciated over a shorter life e.g. 30 years. When a subsequent replacement window is needed this first cost will be written out and the second cost capitalised and depreciated in the same way. The RSL rationale supporting this treatment for only one component was that this reflected a major improvement programme, involving a significant component carried out over a relatively short period and that to charge to revenue would distort the results. The LSVT analysed expenditure on other components and presented a rationale for not accounting for replacement expenditure on those on the grounds that, in aggregate, the planned expenditure would not result in an irregular pattern of expenditure which would distort results.

This is a form of component accounting but which has been restricted to a single component which meets the test in respect of a material impact on the profit and loss account.

RSL 3
A component accounting policy has been adopted in respect of property fixed assets so as to clearly reflect the cost and investment of managing the property portfolio. On acquisition/completion, expenditure on separate components is analysed (land, structure, roof, windows, kitchen, bathroom, central heating, boiler, electric systems and lifts). Grant is allocated to land and structure only. Component asset lives are set for each component and depreciation is based on those lives. Subsequent replacement of components will be capitalised.

In this case the new Group has reviewed the differing policies for capitalisation within the former groups (i.e. historic cost with R&M expensed as incurred in one group as opposed to valuation with capitalised improvements, which enhanced the economic benefits of the asset, depreciated over the expected useful economic lives of the properties). After merger the new Group has opted to move to a full component basis of accounting. It has concluded that this will require a PYA for the part of the group which accounted for assets on historic cost and had expensed all R&M, but no PYA is required for the rest of the group as these are already revalued annually. The rationale for adopting component accounting is to standardise accounting policy across the group and to adopt a policy which clearly reflects the cost and investment of managing the property portfolio and allows group member performance to be assessed consistently.

Conclusion

FRS 15 is clear on the key questions that should be considered over the use of component accounting. These are as listed above:

- The degree of irregularity in the replacement expenditure required.
- The materiality of the component.
- The materiality of the effect of separately depreciating the component.
- Whether the useful economic life of the component is substantially different from that of the rest of the asset.

Each question requires judgement to be applied both by the RSLs themselves and their auditors. As set out in the SORP, this judgement needs to be applied to the assumptions made when the assets were originally acquired or constructed. Any subsequent expenditure needs to be considered in the light of these original assumptions.

Example 1 above presents a rationale for capitalising work to existing property without any form of component accounting. Example 2 presents a rationale for a form of component accounting which, based on analysis of the pattern of planned expenditure, is restricted to a single separate component. Example 3 presents a rationale for full component accounting. Each case would need to be considered on its merits against UK GAAP and the SORP. In practice, a commonsense approach should be applied, so that separate components will only be identified where there is a material impact on the income and expenditure account.

CB/ September 2006