

Briefing:

Accounting for building safety costs arising from Grenfell: key considerations

17 May 2018

This paper is to provide housing associations with relevant guidance on accounting considerations arising from the costs of building safety works following the Grenfell Tower fire that occurred last year. It has been prepared following discussions between sector auditors and Finance Directors at relevant meetings of both the SORP Working Party and the ICAEW Social Housing Committee.

Housing association's individual circumstances and views on accounting treatment should be discussed with their own auditors.

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1. Introduction

Following the tragedy of the Grenfell fire in London, there has been a lot of activity across the social housing sector to ensure buildings are safe. As a result, there are expected to be material monies spent on health and safety related matters.

For some housing associations, this has involved large programmes of work. The exact nature of work will vary for each organisation, but is likely to include:

- removal, replacement or improvement of physical parts of the structure (such as cladding, work on compartmentation, etc)
- fire systems work (such as smoke alarms, smoke detectors, replacement or upgrading fire doors, installing sprinkler systems).

Additional costs might be expected in the form of:

- providing 'waking watch' patrols with extra staff on-site at buildings
- internal programmes to increase the focus on health and safety including data cleansing exercises, system changes, etc.
- in some cases, more intrusive fire risk and other safety assessments.

Due to these activities, works to buildings are expected, including:

We understand that, for some housing associations, these costs are significant, and could be many times materiality. The reason for incurring costs for works to buildings will also vary depending on the facts and circumstances applicable to each housing association. For example:

- Cladding systems may have failed safety test carried out by the Building Research Establishment last summer.
- Data cleansing, more intrusive fire risk assessment / surveys, and reviews of existing fire risk assessments may have identified new or additional risks that need to be managed
- Boards may have used discretion to undertake building works to improve the safety of their buildings, even though these building are not currently involved in the Government led safety programme.

2. Key considerations

Key accounting considerations that result from such costs are:

a) Impairment: Are the buildings impaired where rectification works are required? An impairment charge would be needed if the higher of Fair Value less costs to sell or the Value in Use (also referred to as 'Depreciated Replacement Cost' for social purpose assets) is greater than the carrying amount of the buildings.

b) Provision: Are costs avoidable (for example by selling the property) or is there an obligation to undertake any works? Legal and regulatory considerations should be made (for example are there unavoidable costs of providing alternative accommodation), as well as whether constructive obligations have been made (for example, by committing to specific costs following communications and commitments to residents on certain buildings).

c) Capitalisation: Are costs incurred replacing existing capital components or parts of components of the building or are they new costs which are integral to operating the asset or meet the capitalisation requirements (increasing rental income, reducing maintenance costs or significantly extending the life)? This requires careful consideration, including if the costs incurred and any subsequent depreciation, would be material. Where components or parts of components are replaced and capitalised, the existing assets should be removed from the balance sheet at the time they are removed. Further, if parts of components need to be removed but have not been at the year-end (such as defective cladding), this should be considered as part of the impairment assessment.

Although there are a variety of facts and circumstances that are specific to each housing association, there will be some common accounting issues faced by the sector when accounting for such costs. The table on the following pages summarises common accounting issues and references to guidance in the SORP and FRS 102. Housing association's individual circumstances and views on accounting treatment should be discussed with their auditors.

Circumstance / costs	a) to d) accounting considerations	Key considerations to make
<p>Building is found not to be compliant with building regulations and rectification works required. This may lead to additional costs and / or void properties.</p>	<p>a) Impairment: A building with known deficiencies (such as not meeting current building regulations, long term voids, in disrepair) should be reviewed for impairment. Where the recoverable amount is less than the carrying value, an impairment charge should be recognised. Following SORP para 14.26 to 14.28, Depreciated Replacement Cost (DRC) could be used to estimate the recoverable amount of social housing properties. The impairment assessment must be done in the property's current state without factoring future improvement works.</p> <p><i>Reimbursement of costs relating to impairments:</i> If an impairment loss is recognised, if costs are to be reimbursed by third parties (such as via insurance claims), such compensation should be separately accounted for in profit or loss (FRS 102 para 17.25).</p>	<p>A situation may arise whereby the additional costs to rectify works, when added to the carrying amount of the building, would not result in an impairment (because the carrying amount is less than DRC). However, whether the costs should be capitalised in the first place should be separately considered (see below).</p> <p><i>Reimbursement of costs relating to impairments:</i> In light of Theresa May's announcement in PMQs on 16 May 2018, any formal commitments made by the government and how these apply to the housing association's circumstances need to be carefully considered in-light of the guidance in paragraph 17.25 of FRS 102. In particular, any post balance sheet event disclosures should also be considered.</p>
	<p>b) Provision: A provision should be recognised when the following criteria in FRS 102 21.4 are met: (a) the entity has an obligation at the reporting date as a result of a past event; (b) it is probable (ie more likely than not) that the entity will be required to transfer economic benefits in settlement; and (c) the amount of the obligation can be estimated reliably.</p> <p>Criteria b) and c) are likely to be relatively straight-forward to assess, albeit, housing associations need to apply the criteria to their own individual facts and circumstances.</p>	<p>This consideration will be specific for each housing association's own circumstances.</p> <p><i>Legal obligations:</i> An important consideration is whether it is possible or practical for a housing association to <i>change its future actions (changing its method of operation)</i> to avoid meeting legal or regulatory requirements, for example, the requirements of the <u>Tenancy Standard</u> and the <u>Home Standard</u> (where costs of providing alternative accommodation may be</p>

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	<p>Consideration of whether criteria a) is met is likely to require the most attention to determine whether or not a provision should be recognised. In particular, the consideration of whether a legal or constructive obligation to incur costs exists at the balance sheet date. FRS 102 paragraph 21.6 states:</p> <p><i>‘Obligations that will arise from the entity’s future actions (ie the future conduct of its business) do not satisfy the condition in paragraph 21.4(a), no matter how likely they are to occur and even if they are contractual. To illustrate, because of commercial pressures or legal requirements, an entity may intend or need to carry out expenditure to operate in a particular way in the future (for example, by fitting smoke filters in a particular type of factory). Because the entity can avoid the future expenditure by its future actions, for example by changing its method of operation or selling the factory, it has no present obligation for that future expenditure and no provision is recognised.’</i></p> <p>In the commercial sector, it could be argued that costs can be avoided by simply stopping operations. However in the social housing sector, other considerations are needed, for example:</p> <ul style="list-style-type: none"> - If there are any legal or regulatory obligations that mean it isn’t possible for certain costs to be avoided. - If a constructive obligation has been created for costs meaning they cannot be avoided. <p><i>Reimbursement of costs:</i> FRS 102 paragraph 21.9 states: <i>When some or all of the amount required to settle a provision may be reimbursed by another party (eg through an insurance claim), the entity shall recognise the reimbursement as a separate asset only when it is virtually certain that the entity will</i></p>	<p>unavoidable). In addition, if a housing association did choose to avoid costs by selling or repurposing affected properties, implications for grant would need to be considered, such as whether a ‘relevant event’ has been triggered per <u>The Recovery Of Capital Grants And Recycled Capital Grant Fund General Determination 2017</u>).</p> <p>Any legal obligations where the housing association has lease obligations and does / does not own the property, should also be closely considered.</p> <p><i>Constructive obligations:</i> Further, consideration should be given to whether a constructive obligation may arise with residents or leaseholders by making certain representations or commitments to such third parties for particular costs that cannot be avoided. This includes communications via various mediums, and/or from consultations.</p> <p>If a provision is to be recognised, key considerations with respect to whether the costs are capital in nature should be made. This is in order to ensure accurate accounting entries for initially recognising the provision and its subsequent measurement, as required by FRS 102 17.10 (c), are made.</p> <p><i>Reimbursement of costs:</i></p>

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	<p>receive the reimbursement on settlement of the obligation. <i>The amount recognised for the reimbursement shall not exceed the amount of the provision. The reimbursement receivable shall be presented in the statement of financial position as an asset and shall not be offset against the provision. In the statement of comprehensive income (or in the income statement, if presented) the expense relating to a provision may be presented net of the amount recognised for a reimbursement.</i></p>	<p>Consideration needs to be given to the timing of when provisions and separate assets for reimbursement are recognised, for example, when any past event for the provisions take place and when any assets for reimbursement become virtually certain. In particular, any post balance sheet event disclosures should also be considered.</p>
	<p>c) Capitalisation: <u>New costs</u> For new costs to be capitalised, they need to be ‘<i>directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.</i>’ (FRS 102 17.10(b)). This may be the case where costs are required to ensure the property meets building and regulatory requirements, in which case they should be capitalised. <u>Replacing existing components</u> FRS 102 17.6 requires that where parts of PPE are replaced, the cost is added to the carrying amount of PPE only ‘<i>if the replacement part is expected to provide incremental future benefits to the entity.</i>’ Cladding on housing properties was not previously separately identified as a separate component and instead would have been included within the structure component of the property when it was constructed. Although the replacement of cladding does not clearly fit the description of providing ‘incremental benefits’, it could be argued that such costs are directly attributable to allowing the building to be operated in its intended manner by</p>	<p>A housing association should consider the costs incurred in the light of the accounting rules, depending on the nature of the costs incurred.</p> <p>As mentioned in the section above with reference to recognising provisions, the accounting requirements of FRS 102 17.10 (c) should be considered for any capital costs relating to provisions.</p>

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	<p>management (ie providing social housing to residents) and therefore would be capital in nature.</p> <p>FRS 102 17.6 also requires the carrying amount of those parts that are replaced to be derecognised. Therefore if major costs of replacement of items (such as cladding or fire doors) are to be capitalised, an estimated amount of the items replaced would need to be derecognised (which may need to be estimated by management), even if the previous items were not previously separately recognised.</p> <p>With respect to individually low value assets that may be material in aggregate, such as fire doors and smoke alarms, consideration could be given to grouping certain assets together in a “low value pool”.</p> <p>If costs are capitalised, the housing association would need to consider if the asset is impaired.</p> <p><u>Leaseholder considerations</u></p> <p>Guidance in SORP 8.16 to 8.17 and FRS 102 17.6 and 17.7 apply to the consideration of whether the costs relate to separate components of the building.</p> <p>It may be the case that, where a block of flats has leaseholder properties (in part or in full), the freehold structure of the block may not be separately recognised on the balance sheet. For example the original accounting treatment when the leasehold properties were sold may not have been to retain the structure of the block for leasehold units. In such circumstances, this may mean that the cost of replacing new cladding is capitalised and there are no costs to derecognise for such properties.</p> <p>Where costs are incurred that would be the responsibility of leaseholders, we don't believe these should be capitalised and these should be expensed.</p>	
	<p><u>Impairment</u></p>	

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<p>Property is compliant with building regulations, however the Board make a discretionary decision to undertake works to properties to improve health and safety (for example, retro-fitting sprinklers, replacing all fire doors and smoke alarms).</p>	<p>The same considerations as detailed above would be relevant for impairment.</p> <p><u>Provisions</u></p> <p>The key considerations are whether a constructive obligation exists. For example, by communications with residents and leaseholders.</p> <p><u>Capitalisation</u></p> <p>If <u>new</u> costs are to be capitalised that are not yet required as part of building regulations or were not previously capitalised, such as the retrofit of sprinklers or capitalising new components not previously installed on the building (such as additional fire breaks), one argument could be that such costs would have been capitalised if they were incurred when the building was original constructed.</p> <p>However an alternative argument would be that such costs (ie retrofit of sprinklers) don't meet the recognition criteria in SORP paragraphs 8.13 to 8.18, which requires there to be incremental future benefits (increase in the rental income over the life of the housing property, a reduction in future maintenance costs or a significant extension of the life of the property). SORP 8.17 also states that any works to housing properties which do not replace a component or result in an incremental future benefit of a housing property must be charged as expenditure in the Statement of Comprehensive Income (including expenditure to ensure that the housing property can maintain its existing level of net rental income).</p>	<p>As noted above, the individual facts and circumstances relevant to each housing association should be considered and discussed with auditors.</p>

Theresa May announced on 16 May 2018 the intention of the government to fund the removal and replacement of cladding systems that failed safety tests carried out by the BRE. At the time of writing this guidance, the exact details of this intention were not yet known. Housing associations should consider the guidance in FRS 102 referred to above (paragraphs 17.25 and 21.9) with respect to the reimbursement of costs, along with their own facts and circumstances, and any specific conditions attached to any funding.

There may also be stakeholder expectations that the financial statements of housing associations may contain some impairment charges, or will at least provide appropriate disclosures in the strategic report and financial statements regarding any works planned or undertaken to their property portfolios, following the Grenfell Tower fire.