



Homes &  
Communities  
Agency

The social housing regulator

# 2013 GLOBAL ACCOUNTS OF HOUSING PROVIDERS

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# Introduction

The primary purpose of the 2013 Global Accounts is to provide a financial overview of the regulated social housing sector based on an analysis of the regulatory financial returns of private registered providers. Within this publication, private registered providers of social housing (primarily housing associations) are referred to as 'providers'.

The social housing sector is diverse in both the size of providers that operate within it and the range of activities each undertakes. In total there are around 1,500 active providers, of which the majority have fewer than 250 homes. This publication is concerned with the financial analysis of the 339 providers which own or manage at least 1,000 social homes, representing more than 95% of the sector's stock.

There are two very clear sub-sectors within the total – traditional and stock transfer providers. The latter are comparatively young, introduced since 1990 to take transfer of stock from local authorities. Stock transfers have financial characteristics, particularly in their early years, which are very distinct from existing traditional providers and are therefore analysed separately within this publication.

The provision of homes for rent is the major activity for the majority of providers. However, many also provide homes for ownership, thereby generating income from the sale of homes. This type of activity exposes providers to a different risk profile to that for traditional renting and has changed the financial profile of a number of providers within the sector.

Further differences exist between providers in their degree of specialism. The majority have some specialist supported, care or housing for older people homes. There is, however, a small but significant number of primarily specialist providers, who are largely contract service rather than property based organisations. These providers face particular challenges in competition from other service providers for local authority commissioned support contracts. Additionally, a small number of providers undertake a significant amount of activity that is not social housing. They increasingly deliver a range of community regeneration and housing solutions through subsidiary or associated companies not registered with the Social Housing Regulator.

The Operating and Financial Review examines the sector's objectives in the context of the operating environment in which providers work. It analyses operating and financial performance of the sector in the perspective of longer term economic and business cycles. This includes examining historic trends as well as factors likely to affect the sector in the future.

The 2013 Global Accounts section introduces the aggregate financial statements, providing a commentary on key movements and trends in the overall financial position of the sector.

The Thematic Analyses section provides commentary on three specific areas of interest. The first, section D1, analyses providers' financial forecast returns. Focusing on the first five years of forecasts, the section examines the sector's future risk profile and analyses the materiality of exposure to key risks. Section D2 evaluates varying performance across the sector against the Value for Money standard, a regulatory requirement, the self-assessment of which was included in providers' accounts for the first time this year. Finally, section D3 summarises the impact and implications for the sector of future accounting changes, specifically the implementation of Financial Reporting Standard 102 (FRS102).

# Part A – Executive summary

The 2013 Global Accounts demonstrate that the sector, in aggregate, remains financially robust. However, providers need to understand and manage an increasing range of risks. Whilst the sector has faced challenging conditions in recent years, it has also benefited from some favourable circumstances - the continuation of historically low interest rates and permitted rent increases linked to Retail Price Index (RPI) inflation significantly outstripping wage inflation. The sector needs to be prepared for changing economic conditions and potentially adverse changes to the operating environment.

The sector continued to grow its asset base and recorded an aggregate surplus of £1.9bn, an increase of 9% from 2012. The sector achieved this increase in surplus through the combination of increased turnover attributable to inflation linked rent increases, increased operating margins, and improved financial performance in housing sale activity.

The entire surplus is taken to reserves, which increased to £23.3bn. However, reserves are not held as cash but are reinvested in providers' businesses. At March 2013, the sector in aggregate had reinvested 82% of its total reserves in the acquisition and development of new supply and improvements to the existing stock base.

Providers continued to raise the significant levels of debt required to deliver their planned growth. The sector in aggregate drew an additional £3.6bn of debt in 2013. As the availability of bank finance remains constrained to shorter terms and comparatively higher margins, new debt is increasingly sourced on the bond market (£3.2bn in year to March 2013), representing over two thirds of all new debt facilities arranged. Gearing<sup>1</sup> has increased by 1% to 87% across the sector. The increase in gearing has been restricted by downward pressure from the stock transfer sub-sector and an increase in reserves largely driven by higher surpluses.

Whilst the financial results indicate the sector in aggregate continues to perform well, this masks weaker performance in some individual providers. It is essential that providers can effectively manage and mitigate an increasingly broad range of risk exposures. In this context, the challenge for providers is to fully understand the interrelatedness of different risks and the interactions between them. They must have strategies in place to mitigate the financial impact of the simultaneous crystallisation of multiple risks.

The analysis of financial forecasts in Section D1 of this report demonstrates the materiality of a number of the key risks, as set out in the Sector Risk Profile published by the Regulator. It is widely forecast that interest rates will rise in the short to medium term. Combined with reduced grant rates and continuing upward pressure on bank lending margins, risks associated with the finance market remain a key concern for the sector.

In the year to 2013, shared ownership and open market sales recorded robust results with increased sales and profitability across both products. The financial forecasts show that the sector is becoming increasingly exposed to the housing market, with revenues from properties developed for sale increasing from 8% of total turnover in 2014 to 14% by 2016.

It is vital the sector continues to manage the operational risks to its income and cost base. Changes resulting from the implementation of welfare reform will affect the certainty of income flows. As reforms are implemented, it is vital that the sector ensures it maintains or improves its current operational performance. Planned investment in new supply is

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<sup>1</sup>Gearing definition used - loans as a proportion of the sum of loans, grant and reserves (excluding revaluation reserves).

concentrated in 2014 and 2015 through the back loaded delivery of the Affordable Homes Programme (AHP) 2011-15. Over the next two years, the sector intends to develop over 128,000 new units of which 32,000 are for sale as shared ownership properties or on the open market.

The continued strong financial performance of the sector is reliant upon providers meeting the challenges associated with the key risks and uncertainties they face. The Regulator will continue to seek assurance that providers are managing these challenges effectively.

# Part B - Operating and financial review

## Overview of the sector

The sector consists of around 1,500 providers owning or managing around 2.7m homes<sup>2</sup>. The sector is characterised by a large number of providers owning fewer than 1,000 homes each. Approximately 1,200 providers own fewer than 1,000 homes and account for just over 4% of the sector's total stock. Within the grouping of providers with more than 1,000 homes, there is a great diversity in size with a small number of very large organisations. At March 2013, 71 providers owning more than 10,000 homes accounted for 54% of the sector's total stock. The category of stock transfer providers own just fewer than 1.2m homes, which is 44% of the total in the sector.

The majority (72%) of the homes in the sector are those for general needs tenants offered at sub-market rent levels. Around 11% of homes are made available as housing for older people and a further 4% for supported housing tenants. The remaining stock in the sector comprises care homes, temporary social housing, key worker accommodation and increasingly leasehold and shared ownership properties. In addition, the sector owns approximately 84,000 homes categorised as non-social housing, including student accommodation, key worker homes, homes for rent on the open market and (non-social housing) residential care homes.

Whilst for most providers the landlord function represents the majority of their activity and turnover, providers do undertake a wide range of diverse activities. This can involve but is not limited to: leading on or contributing to regeneration activities; provision of community centres; training facilities and other services in the community; and the provision of a range of housing tenures including market rent and housing for sale.

## The sector's objectives

The sector is comprised of a large number of diverse organisations, with differing constitutions, ranges of activities, focuses and drivers. However, there are consistent themes in the objectives of many providers, which refer to:

- Developing quality housing; providing affordable homes to those in need.
- Improving customer services; offering choice and high quality services.
- Expanding client groups; delivering products to meet diverse customer needs and aspirations.
- Promoting inclusion; investment in communities to support successful neighbourhoods.
- Asset management; maintaining and maximising the value of existing assets.
- Being a good employer; investing in staff to be a well-run organisation.
- Improving financial performance and capacity.
- Commitment to equality and diversity.
- Delivering value for money; operating efficient businesses to unlock value.

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<sup>2</sup> Figures from the Statistical Data Return (SDR) 2013. The SDR includes providers with less than 1,000 units. The Global Accounts is based on accounts submitted by providers with more than 1,000 units.

## Dynamics of the housing sector

The financial performance of the sector in 2013 demonstrates that, in aggregate, it continues to be financially robust. However, the sector has benefitted from favourable circumstances - the continuation of historically low interest rates and permitted annual rent increases linked to RPI inflation significantly outstripping wage inflation.

The sector needs to be prepared for less benign economic conditions and potentially adverse changes to the operating environment. It is essential that providers can effectively manage and mitigate an increasingly broad range of risk exposures. In this context, the challenge for providers is to fully understand the interrelatedness of different risks and have strategies in place to mitigate the financial impact of the simultaneous crystallisation of multiple risks.

The reduced grant rates available to support the delivery of new affordable homes has placed a greater reliance on debt to fund development programmes. The risk associated with uncertainty and volatility in the finance market remains a key concern for the sector. Whilst banks continue to offer loans to the sector, the number and capacity of lenders is limited. Over £3.2bn was raised on the bond market in 2013 as providers increasingly turn to alternative sources of funding. Whilst providers have been successful in utilising these sources of finance to meet their growth ambitions, they pose different risks and a different set of challenges for the sector to manage.

Total borrowing by the sector is over £52bn. The Bank of England base rate has remained at 0.5% since 2009 and the sector has benefitted from this extended period of low interest rates. Whilst the sector currently fixes around 65% of debt at any one time, over £18bn of debt is subject to variable rates. It remains uncertain when interest rates will rise. An increase in the Bank of England base rate to pre-credit crunch levels of 5% could theoretically increase interest costs by £800m per year. This is equivalent to over 40% of the surplus reported in 2013. It is essential that providers effectively manage interest rate risk.

Exposure to the housing market remains another key risk for the sector to manage. The surplus on the sale of fixed assets in 2013 was £466m, 24% of the total surplus reported by the sector. Sales of current assets (first tranche shared ownership and properties developed for outright sale) generated over £1bn of income in 2013. Dependence on this income stream is particularly significant where future sales cashflows are required to cross subsidise investment in new housing supply and to meet interest costs.

Over 80% of turnover in the sector is attributable to social housing lettings. There are a number of risk factors impacting on the volatility of the sector's cashflow from core business activities:

- The variety of changes brought in by welfare reform pose a particular risk to income collection.
- The Affordable Rent product links an increasing proportion of providers' income to market rent levels, presenting a different risk profile to traditional social housing lettings.
- At the 2013 Spending Round, the Government announced its intention that post 2015 rent setting will be linked to Consumer Price Index (CPI) inflation + 1% rather than RPI +0.5%. Providers will no longer be permitted to increase rents in excess of this where rent levels are below target rents. The Department for Communities and Local Government (DCLG) has recently consulted on these changes to social rent policy beyond 2015 and a new rent direction will be issued to the Regulator in 2014.

These factors, especially in their combined impact, mean that it is essential providers can withstand significant variability in rental cash flow.

Providers continue to diversify into other activities, with 9% (£181m) of the total surplus for the sector attributable to non-social housing activities. Activities include market rent, commercial / community activities and housing management services. In the context of lower public subsidy and less certainty about private finance, such activity is often undertaken to fill the funding gap. However, there is a higher risk involved in activities with potentially higher returns. Providers need to understand these risks and put appropriate structures in place to ensure social housing assets remain protected.

Given the range of risks to which providers are exposed and in order to maintain the financial capacity required to meet future challenges, it is essential that the sector delivers continuous improvement in its value for money (VfM). Providers must demonstrate a strategic approach to delivering VfM in the achievement of their objectives. The Regulator will engage with providers to gain assurance that boards have a clear strategic view on VfM including how to best use the range of resources available to them to achieve their objectives.

## Operating performance

**Table 1**  
**Indicators of operational performance**

<b>Indicator</b>	<b>2013</b>	<b>2012</b>	<b>2011</b>
Stock failing decent homes standard	1.0%	1.9%	2.4%
Voids for the year	1.7%	1.8%	1.8%
Bad debts for the year	0.9%	0.8%	0.7%
Current tenant arrears at the end of the year	4.8%	4.8%	5.1%

The sector has largely met the challenge to bring its stock to the Decent Homes Standard, with only a small proportion of stock remaining non-compliant with this standard.

Bad debts, voids and current tenant arrears are key performance indicators in assessing the impact of welfare reform over the coming years. In 2013, the proportion of bad debts reported as a percentage of gross rent increased by 8.1%. This was before the introduction of significant welfare reforms, such as reductions in housing benefit to under occupying households, which came into force from April 2013. Current tenant arrears and voids have remained relatively stable in comparison with 2012 levels.

## Financial performance

The sector recorded a strong financial result in the year to March 2013 having benefitted from the permitted, inflation linked rental uplift of 6.1% and continuing low interest rates. The table below includes financial highlights and key financial ratios for the sector for 2013 and for the previous five years.



**Table 2**  
**Financial highlights and key financial ratios**

<b>Indicator</b>	<b>2013</b>	<b>2012</b>	<b>2011</b>	<b>2010</b>	<b>2009</b>	<b>2008</b>
Figures in £million						
Turnover	14,860	13,751	12,647	12,280	11,564	10,093
Total operating costs	11,010	10,530	9,943	10,056	9,921	8,517
Operating surplus	3,849	3,220	2,704	2,224	1,643	1,575
Surplus on social housing lettings	3,629	3,057	2,605	2,242	1,643	1,545
Net interest payable	2,339	2,184	1,960	1,894	1,892	1,765
Profit on sales of assets	466	516	321	347	336	577
Surplus for the year	1,930	1,778	1,116	609	203	319
Figures as % or £						
Operating margin	25.9%	23.4%	21.4%	18.1%	14.2%	15.6%
EBITDA interest cover	213.9%	197.0%	162.6%	138.6%	104.9%	105.2%
EBITDA MRI interest cover <sup>3</sup>	138.0%	115.7%	106.4%	81.1%	56.3%	62.4%
Growth in turnover	8.1%	8.7%	3.0%	6.2%	14.6%	10.7%
Growth in total assets	6.3%	5.6%	7.4%	6.2%	11.7%	11.5%
Gearing	86.8%	85.9%	86.1%	90.1%	91.0%	86.7%
Debt per social housing unit	19,913	19,004	17,828	17,616	17,117	15,401
Management cost per unit	952	908	873	884	893	844
Maintenance cost per unit <sup>4</sup>	992	979	1,009	1,011	987	901

Turnover increased by 8.1% to £14.9bn, whilst operating costs (including the cost of sales and exceptional items) increased by 4.6% to £11.0bn. The operating surplus of the sector increased by 19.5% (£629m) to £3.8bn and the operating margin increased from 23.4% to 25.9%.

The surplus from social housing lettings increased by £573m (18.7%) to £3.6bn and the associated operating margin increased from 26.5% to 29.1%. Growth in rental income was largely attributable to the inflation linked guideline rent increase with an average increase of 6.6% per unit. Operating costs as a percentage of turnover on social housing lettings decreased from 73.5% to 70.9%.

The surplus from the sale of first tranche properties increased by £43m (51.7%) and the surplus on non-social housing activities, including properties for sale, increased by £72m (66.2%). This was offset by an increase in interest payable of £166m (7.1%), a decrease in the profit on sale of fixed assets of £51m (-9.8%) and an increased loss on other social housing activities.

Overall, the sector reported a higher surplus in 2013 than in 2012. The surplus after tax for the sector totalled £1.9bn compared to £1.8bn in the previous year. EBITDA MRI interest cover increased to 138.0% from 115.7%. There was considerable improvement in the stock transfer providers, demonstrative of the increasing maturity of the sub-sector, with interest cover moving from 87.9% in 2012 to 118.3% in 2013.

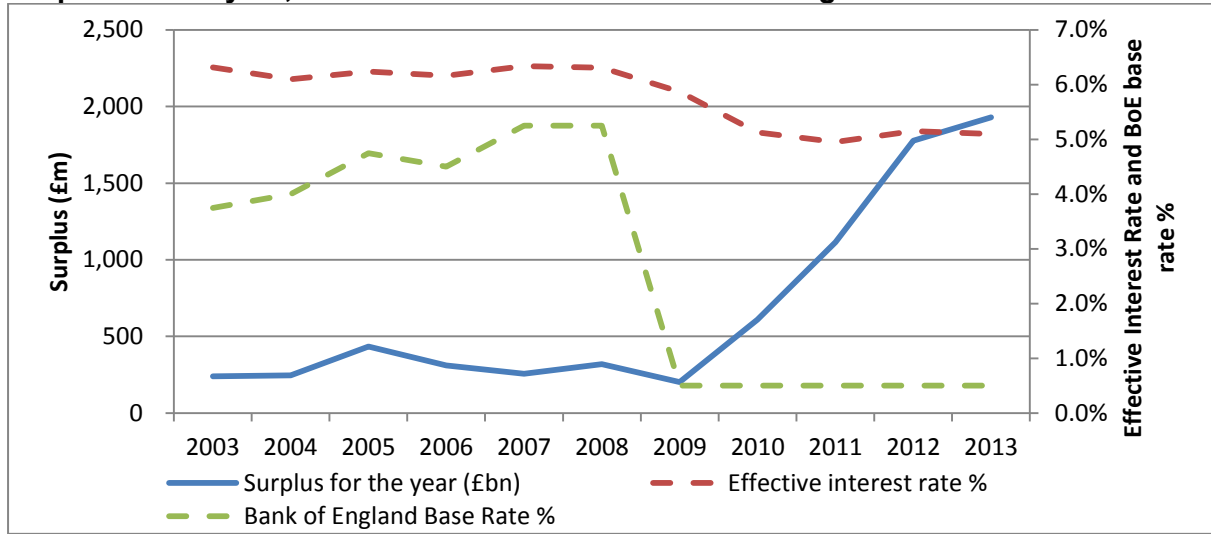
Table 2 shows that aggregate financial performance has strengthened since 2009. Recorded surpluses, operating margins and EBITDA MRI interest cover have improved year on year.

<sup>3</sup> EBITDA MRI interest cover calculation is based on earnings before interest, taxation, depreciation and amortisation with all major repairs spending included.

<sup>4</sup> Routine and planned maintenance cost per unit (£)

However, it is necessary to look at a number of the key indicators in the context of longer term economic and business cycles.

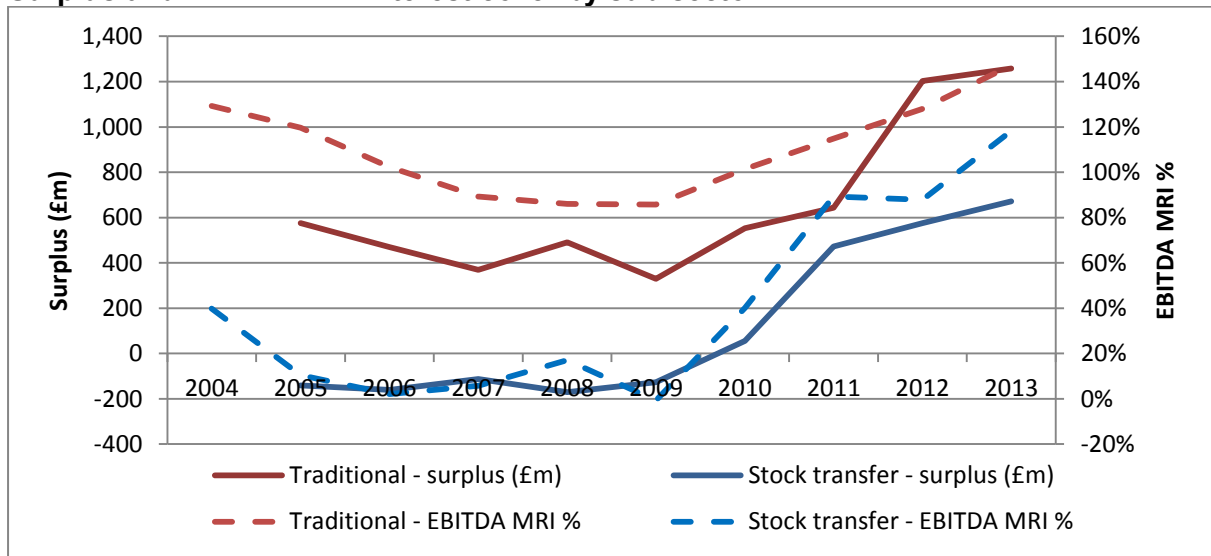
**Figure 1**  
**Surplus for the year, effective interest rate and Bank of England base rate**



Historically, as is illustrated in Figure 1, the surplus for the year remained relatively constant between 2003 and 2009. The increase in surplus recorded by the sector since 2009 is in part attributable to favourable macroeconomic conditions. The sharp increase in surplus post 2009 corresponds with a period of historically low interest rates. This has been reflected in a decrease in the effective interest rate across the sector from a high of 6.3% in 2008 to a low of 5.1% in 2011. The sector has also benefited from underlying movements in inflation, with RPI (4.6% in 2012 and 5.6% in 2013) significantly outstripping average wage inflation (-0.6% in 2012 and -0.1% in 2013<sup>5</sup>).

The increase in surplus in recent years is also partly attributable to the growing maturity of the stock transfer sub-sector. The figure below demonstrates the movement in the sub-sector from deficit to surplus over a ten year period.

**Figure 2**  
**Surplus and EBITDA MRI interest cover by sub-sector**



<sup>5</sup> PRP Average Wages – Weighted Annual Survey of Hours and Earnings.

In their early years, typically over a 5 to 12 year period, stock transfer providers undertake high levels of improvement works. This is reflected in high deficits and low levels of interest cover. Over 75% of stock transfers took place before 2006. Prior to 2010, the surplus from the sector as a whole was reduced by deficits in the stock transfer sub-sector. By 2010, an increasing majority of the sub-sector had completed initial stock improvement programmes and the sub-sector recorded a surplus for the year.

This trend has continued in recent years with the surplus reported by the stock transfer sub-sector increasing from £56m in 2010 to £672m in 2013. In 2013, stock transfer providers were accountable for 35% of the total surplus generated by the sector. In 2013 interest cover for the sub-sector, using the EBITDA MRI ratio, increased from 87.9% to 118.3%. For the first time in ten years, the sub-sector generated sufficient cashflow to meet its interest payments with no reliance on debt or the sale of fixed assets.

Gearing, measured by loans as a proportion of the sum of grants and reserves (excluding revaluation reserves), is widely used as a key measure of indebtedness. At an aggregate sector level, gearing remained broadly consistent over the period 2008 to 2013, varying between 87% and 91%. Despite reduced grant rates available through the Affordable Homes Programme, gearing increased by only 1% in 2013. The majority of development under the Affordable Homes Programme, with its lower grant rates, is not expected until the final two years of the 2011-15 programme.

A key factor in holding down the rate of increase in gearing is the variance between the traditional and stock transfer sub-sectors. For the traditional sub-sector, the level of indebtedness has increased gradually year on year, with the gearing ratio increasing from 53% in 2006 to 67% in 2013.

This increase in gearing in traditional providers, has been offset by the inverse trend within the stock transfer sub-sector. Up until 2010, the stock transfer sector reported negative balances on reserves resulting in high gearing ratios, peaking at 899% in 2006. With the growing maturity of the sub-sector, positive reserves have been reported since 2011. Consequently, gearing has fallen consistently from the peak in 2006 to 205% in 2013. In 2012, this trend was facilitated by the adoption of component accounting by stock transfer providers, resulting in the capitalisation of major repair costs (components of housing properties) that had been expensed in prior years. Prior period adjustments against opening reserves were undertaken to reflect the change, again applying downward pressure to gearing in the sub-sector.

## **Investment for the future**

In 2013 the total grants, Social Housing Grant and other capital grants reported on the balance sheet, increased by £1.6bn (3.6%) to £45.4bn. The increase in grant reported on the balance sheets of providers, is not the same as the level of new grant invested during the year. The difference is primarily attributable to providers switching the basis of valuing properties to cost (therefore reporting historic grant on the balance sheet).

The Gross Book Value of housing properties increased by £7.4bn (6.3%) to £126.0bn. With loan funding of £52.0bn, other long term creditors of £3.7bn and revaluation reserves of £8.7bn, at March 2013 the sector had re-invested £11.9bn, or 82% of its revenue reserves in the acquisition and development of fixed assets.

The Affordable Rent product was introduced in 2011 under the HCA Affordable Homes Programme 2011-15. Affordable Rent tenancies are shorter and for fixed terms, with rents at levels generally above social rent up to a maximum of 80% of market rent. The SDR

reported that 284 providers owned just fewer than 40,000 (2012: 7,000) Affordable Rent homes as at 31 March 2013. This includes homes newly built and conversions from existing social rented homes to Affordable Rent homes.

## **Capital structure & treasury policy**

During 2013, the external debt of the sector increased by £3.6bn (7.3%) to £52.0bn. With pressure on grant rates, the main source of finance for future growth in the housing market is expected to be debt. The average debt per social housing unit increased by 4.8% to £19,913.

The use of bond finance increased during 2012/13 and £3.2bn (2011/12 £1.8bn) was raised on the bond market at rates of between 3.8% and 5.5% (2012: 4.0% and 6.0%). The bond market has continued to be a favoured source of long term finance throughout 2013/14. As at December 2013, over £1.4bn had been raised.

The Bank of England base rate has remained at 0.5% throughout the period, as it has the previous two years. Providers with a higher proportion of variable rate debt have been able to take advantage of the lower cost of finance. The average effective interest rate has decreased from 5.2% to 5.1%, broadly reflecting three month LIBOR<sup>6</sup> which fell from 1% in April 2012 to 0.5% by March 2013. The sector has maintained a roughly consistent proportion of fixed rate debt with approximately 65% being held at fixed rates at March 2013 (2012: 70%, 2011: 65%).

## **Going concern for regulatory compliance**

In overall terms, the sector is financially viable, although performance is variable between providers. The position of individual providers is assessed from the review of statutory and regulatory returns submitted. Where a material change to an assessment occurs, the published regulatory judgements are amended to reflect the current regulatory review.

The financial viability of providers is assessed at group level and is graded as set out below:

- V1 – The provider meets the requirements on viability set out in the Governance and Financial Viability standard and has the capacity to mitigate its exposures effectively.
- V2 – The provider meets the requirements on viability set out in the Governance and Financial Viability standard, but needs to manage material financial exposures to support continued compliance.
- V3 - The provider does not meet the requirements on viability set out in the Governance and Financial Viability standard. There are issues of serious regulatory concern and, in agreement with the Regulator, the provider is working to improve its position.
- V4- The provider does not meet the requirements on viability set out in the Governance and Financial Viability standard. There are issues of serious regulatory concern and the provider is subject to regulatory intervention or enforcement action.

As at March 2014, the Regulator has assessed 85% of providers as V1, 14% as V2. Both of these gradings indicate compliance with the Regulator's standard in respect of financial viability. There is one provider graded as V3. In accordance with its intervention and enforcement powers, the Regulator is working with the provider and other stakeholders to seek a resolution to the financial issues.

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<sup>6</sup> London Interbank Offered Rate (LIBOR)

# Part C – 2013 Global Accounts

This analysis is based on a database of information derived from housing providers' audited financial statements. The database contains data from the annual account regulatory returns (FVAs) which must be submitted by providers that manage 1,000 or more homes.

These regulatory returns are aggregated to produce the balance sheet, income and expenditure accounts for the sector as at 31 March 2013. Comparative figures for 2011/12 and 2010/11 are also provided.

The Global Accounts do not include the consolidated accounts of registered provider group structures, as they would include financial information from unregistered bodies. The accounts of non-asset holding parents of the group are also excluded to avoid double counting of income and costs, where the parent provides centralised corporate services which are recharged to group subsidiaries. However, since individual group member accounts are included, there remains a degree of grossing-up of income and expenditure, and of current assets and liabilities, reflecting intra-company charges and balances at year end.

## **Aggregate balance sheet**

The aggregate balance sheet is the sum of individual private registered provider balance sheets whose financial year ends fall within the period from 1 April 2012 to 31 March 2013.

## **Aggregate income and expenditure account**

The aggregate income and expenditure account reflects the sum of private registered provider activity for all accounting periods ending between 1 April 2012 and 31 March 2013.

## **Additional information**

Additional information is provided on the aggregate income and expenditure on social housing lettings, income and expenditure on other activities, and the number of homes in management.

## **Effects of Accounting Direction**

The financial results for this year are affected in a number of areas as a result of the issue of the Accounting Direction for Private Registered Providers of Social Housing 2012. Changes include the requirement to disclose support services income and costs as other social housing activities. Where figures in the analysis are affected by the direction, the effect is described.

**Table 3**  
**Balance sheet**

	Traditional	Stock	Total	Total	Total
	2013	transfer	2013	2012	2011
	2013	2013	2013	2012	2011
All figures in £million					
<b>Fixed assets</b>					
Housing properties at cost	84,374	20,716	105,090	98,075	84,750
Housing properties at valuation	6,732	14,153	20,886	20,488	24,672
<b>Gross book value of housing properties</b>	<b>91,107</b>	<b>34,869</b>	<b>125,976</b>	<b>118,563</b>	<b>109,423</b>
SHG/HAG	38,635	4,424	43,059	41,616	41,118
Other capital grants	1,652	696	2,348	2,214	2,072
Depreciation	5,567	2,215	7,781	6,783	3,549
<b>Net book value of housing properties</b>	<b>45,252</b>	<b>27,535</b>	<b>72,788</b>	<b>67,950</b>	<b>62,684</b>
Other fixed assets	2,924	644	3,569	3,200	2,720
<b>Total fixed assets</b>	<b>48,177</b>	<b>28,180</b>	<b>76,357</b>	<b>71,150</b>	<b>65,404</b>
<b>Current assets</b>					
Properties for sale	850	180	1,031	1,285	1,351
Non liquid current assets	916	1,262	2,178	1,780	2,054
Cash and short term investments	2,700	1,214	3,914	2,670	2,427
Other current assets	2,078	982	3,060	3,384	3,080
Total current assets	6,546	3,638	10,184	9,119	8,913
<b>Current liabilities</b>					
Short term loans	589	234	823	612	680
Bank overdrafts	19	8	27	27	43
Other current liabilities	3,704	1,934	5,638	5,749	5,568
<b>Total current liabilities</b>	<b>4,312</b>	<b>2,176</b>	<b>6,488</b>	<b>6,388</b>	<b>6,291</b>
<b>Net current assets (excluding pensions)</b>	<b>2,234</b>	<b>1,462</b>	<b>3,696</b>	<b>2,731</b>	<b>2,622</b>
Pension liabilities	(363)	(600)	(963)	(688)	(438)
<b>Net current assets (including pensions)</b>	<b>1,872</b>	<b>862</b>	<b>2,733</b>	<b>2,043</b>	<b>2,184</b>
<b>Total assets less current liabilities</b>	<b>50,048</b>	<b>29,041</b>	<b>79,090</b>	<b>73,193</b>	<b>67,587</b>
<b>Financing and reserves</b>					
Long term loans	33,583	17,632	51,215	47,869	44,373
Other long term creditors	2,800	859	3,659	3,562	3,551
Provisions	183	713	897	1,103	1,306
Accumulated surplus	10,453	3,073	13,526	11,745	7,526
Designated reserves	327	129	456	433	1,091
Restricted reserves	196	389	585	449	500
Revaluation reserves	2,480	6,251	8,731	7,972	9,214
Pension reserves	25	(4)	21	59	28
<b>Total financing &amp; reserves</b>	<b>50,048</b>	<b>29,041</b>	<b>79,090</b>	<b>73,193</b>	<b>67,587</b>

## Fixed assets

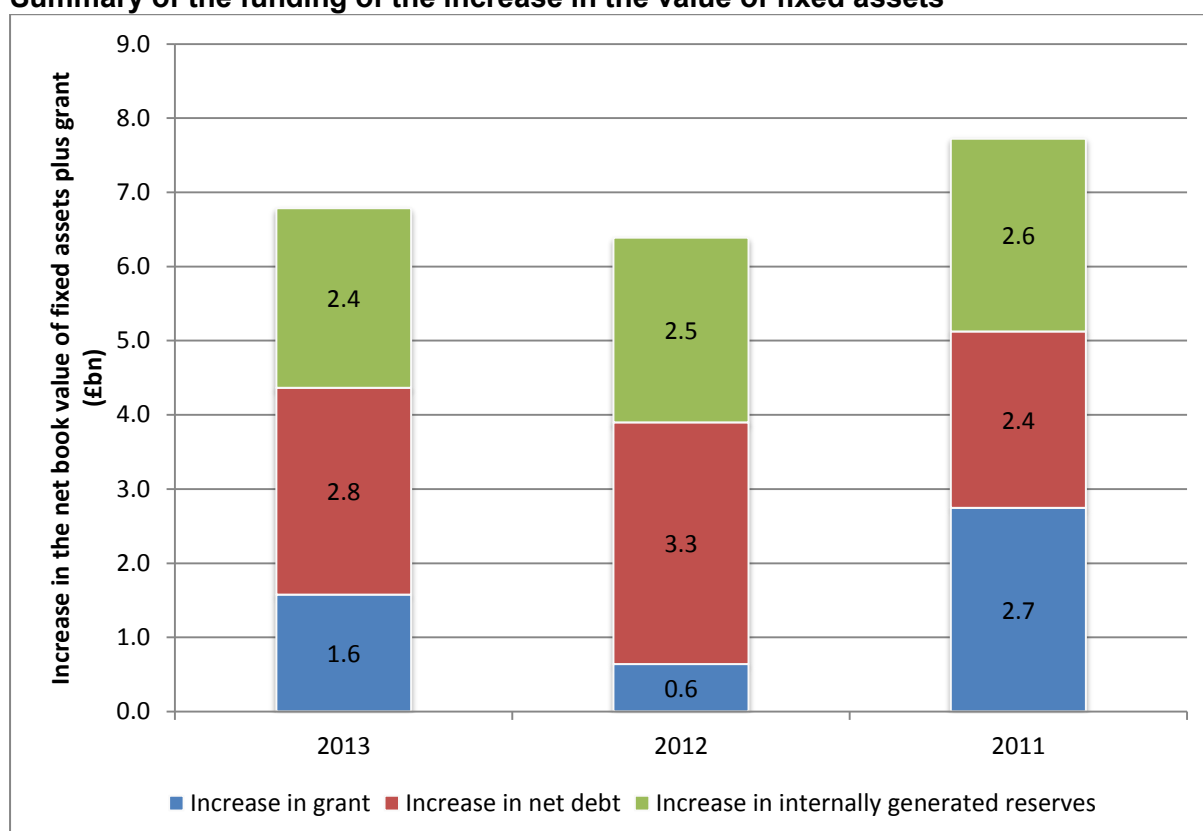
The Gross Book Value (GBV) of the sector's assets (total housing properties at cost and valuation) has increased by £7.4bn to £126.0bn. The increase in GBV has been partly funded by an increase in capital grants of £1.6bn to £45.4bn and an increase in external debt of £3.6bn to £52.0bn.

The growth in GBV (6%) is slightly less than the previous year (8%). There were three new stock transfers from local authorities in 2013. The three new transfers were Byker Community Trust Limited, Rochdale Boroughwide Housing Limited and South Lakes Housing<sup>7</sup>. There was an increase in the proportion of growth attributable to the stock transfer sub-sector from 30% in 2012 to 49% in 2013. In 2013, 51% of the growth was attributable to traditional providers (2012: 70%).

Providers report properties in the balance sheet at either historic cost or valuation. At March 2013, 52 providers reported housing properties at valuation. This equates to 83% of the value of the sector's housing properties being shown in the balance sheet at historic cost (2012: 83%, 2011: 77%).

The net book value of total fixed assets increased by £5.2bn to £76.4bn. This was primarily funded by increased debt and internally generated reserves. The figure below summarises the funding of the increase in the value of fixed assets plus grant. Net debt is calculated as the increase in short term and long term debt minus any increase in cash reported on the balance sheet.

**Figure 3**  
**Summary of the funding of the increase in the value of fixed assets**



<sup>7</sup> South Lakes Housing stock transfer took place in 2011/12. As 2012/13 is its first full year of operation it is the first year the provider has submitted accounts.

Grant reported on the balance sheet increased by £1.6bn (4%) to £45.4bn. SHG/HAG accounted for £1.4bn of the movement, an increase of 3% on 2012. Other Capital Grants reported on the balance sheet have increased by £134m (6%) to £2.3bn.

The aggregate annual increase in grant reported on the balance sheet will not necessarily correspond with new investment by the HCA and GLA for the same period. The latter only represents grant funding invested in the year. The increase in grant reported on the balance sheet by providers is influenced by other factors.

In 2013, approximately £380m is attributable to providers switching the basis of valuing housing properties to cost and therefore reporting historic grant on the balance sheet. Another £100m of the increase is attributable to a single provider that encountered serious financial difficulties in 2012 and consequently did not submit annual accounts to the Regulator last year. Changes to the Global Accounts dataset have resulted in additional grant of approximately £190m being reported.

## **Current assets**

Current assets have increased by £1.1bn (12%) to £10.2bn. The most significant contributing factor is an increase in cash and short term investments. The total cash and short term investments reported in 2013 were £3.9bn, an increase of £1.2bn (47%) from 2012.

It is vital that providers have sufficient access to liquid funds at all times. There are a variety of factors which contribute to the increase in liquid funds in 2013. Approximately half of the increase in cash and bank and short term investments is a result of new bond and private placement issues. Bonds and private placements typically involve a single large drawdown on issue. In total, 2013 was a record year in the bond and private placement market with 22 issues. This has increased the level of cash and short term investment held by providers. Other contributory factors include timing differences between loan drawdown and development spend, stock improvement programmes and increased cashflow from sales activity.

The value of properties for sale decreased by 20% (£254m) to £1.0bn (2012: £1.3bn). This is partly due to a decrease in the number of unsold Affordable Home Ownership (AHO) homes. Levels of unsold AHO are monitored through the Regulator's Quarterly Survey of providers. Between April 2012 and March 2013 the number of unsold AHO homes decreased by 11%. Where responses to the Quarterly Survey indicate material levels of unsold stock, the Regulator will continue to engage closely with providers to monitor the impact of the unsold stock on their cashflow position.

Non-liquid and other current assets have increased marginally by 1% to £5.2bn. As a proportion of total non-liquid current assets, amounts attributable to intra-group balances have decreased from 43% in 2012 to 39% in 2013. Over 90% of intra-group balances are attributable to traditional providers.

Around 33% of non-liquid and current assets are for future works, reflecting contractual arrangements between councils and stock transfer programmes to complete refurbishment programmes. The amount is reported under current assets with a corresponding entry in current and/or long term liabilities.



## **Current liabilities**

Current liabilities have increased by £100m (2%) to £6.5bn. This comprises an increase in short term loans of £211m and a decrease in other current liabilities of £111m. Bank overdrafts have remained constant at just under £27m.

Approximately 54% of other current liabilities were amounts attributable to other group undertakings in respect of monies borrowed from treasury vehicles. A number of large groups provide financing for subsidiaries via treasury vehicles that borrow funds on behalf of the group to on-lend to group members. Some providers report the balances as due to group undertakings rather than as housing loans.

Other current liabilities also include a range of items such as trade creditors, accruals, deferred income tax, Recycled Capital Grant Fund (RCGF), Disposals Proceeds Fund (DPF) and rent and service charges received in advance.

## **Net current assets**

Net current assets at March 2013 were £3.7bn. This is an increase of £965m (35%) on 2012. In conjunction with the increase in cash and short term investments, this indicates a positive position for the sector's short term solvency. However, the sector aggregate masks different provider characteristics and continued cashflow management remains essential.

## **Long term liabilities**

Long term liabilities (long term loans and other long term creditors) have increased by £3.4bn (7%) to £54.9bn (2012: £3.5bn increase to £51.4bn). Of this increase, £1.5bn is attributable to the traditional sub-sector, an increase of 4% on 2012.

The increase is more marked in the stock-transfer sub-sector with providers reporting an additional £2.0bn on the balance sheet, an increase of 12% on 2012. Of the increase, £534m is attributable to other long term creditors disclosed by one 2013 stock transfer provider. These liabilities related to contractual arrangements to complete refurbishment programmes.

The increase in total long and short term debt was 7.3% (£3.6bn) broadly consistent with the 7.6% (£3.4bn) increase recorded in 2012. Refinancing risk can be expressed in terms of the percentage of loans that are due to be repaid in the year. Short term loans have increased by 34% (£211m) to £823m. This represents 1.6% of all outstanding loans (2012: 1.3%).

Despite the increase, the refinancing risk for the sector as a whole remains low. Only one provider has over 50% of loans due to be repaid within one year (2012: four providers). In this individual case, the short term debt disclosed by the provider is actually the revolver element of a long term facility. The financial arrangements of all providers are monitored closely by the Regulator through the Quarterly Survey of providers, and it will continue to engage with the sector to gain assurance that providers have access to the liquidity they require.

Across the whole sector during 2012/13, providers have increasingly accessed the bond market for financing. Twenty two bond issues were completed during the year totalling £3.2bn (2012:£1.8bn and 2011:£0.9bn).

## Reserves

Reserves are not 'cash backed', as the surpluses transferred to balance sheet reserves are reinvested in the provider's businesses, including the major repairs of existing stock and the development of new homes. At March 2013, the sector had reinvested £11.9bn (82%) of its reserves into existing stock and new supply (2012 88%, 2011 83%). Total reserves increased by £2.7bn (13%) to £23.3bn.

The accumulated surplus increased by 15% (£1.8bn) to £13.5bn. In 2012 the accumulated surplus increased by £4.2bn (56%). However, £2.8bn of the increase in 2012 was attributable to prior period adjustments in respect of the adoption of component accounting<sup>8</sup>. In 2013, prior period adjustments accounted for a £112m decrease in the accumulated surplus carried forward.

The revaluation reserve has increased by £759m (10%) to £8.7bn and this represents 37% of total reserves (2012: 39%). Four providers have changed accounting policy for housing properties from valuation (or valuation and cost) to cost. As valuation of properties on an existing use basis is likely to be higher than historic cost, the revaluation reserve reported by these three providers decreased by £157m. The increase in revaluation reserves is almost entirely attributable to the stock transfer sub-sector with revaluation reserves increased by £754m to £6.3bn. The increase is largely attributable to stock improvement programmes and the revaluation of properties at EUV-SH in the year.

Transfers (to) / from reserves totalled £158m (2012: £377m). The actuarial loss on pension schemes totalled £196m (2012: loss of £350m). The loss on pension schemes in 2013 contributed to an increase in the pension liability reported in the balance sheet of 40% to £964m (2012: 57% an increase on 2011 to £688m).

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<sup>8</sup> The effect of the adoption of component accounting has been to increase the amount of major repairs expenditure that is accounted for on the balance sheet. This is depreciated over the estimated useful life of the component. In previous years, a higher proportion of this expenditure was fully expensed through the income and expenditure account in the year which it occurred.

**Table 4**  
**Summary income and expenditure account**

	<b>Traditional</b>	<b>Stock</b>	<b>Total</b>	<b>Total</b>	<b>Total</b>
All figures in £ million	<b>2013</b>	<b>Transfer</b>	<b>2013</b>	<b>2012</b>	<b>2011</b>
		<b>2013</b>			
Turnover	9,375	5,484	14,860	13,751	12,647
Operating costs	(6,267)	(3,880)	(10,147)	(9,846)	(9,569)
Cost of sales	(713)	(138)	(852)	(672)	(491)
Exceptional items	(8)	(4)	(12)	(12)	116
<b>Operating surplus</b>	<b>2,387</b>	<b>1,462</b>	<b>3,849</b>	<b>3,220</b>	<b>2,704</b>
Surplus on the sale of fixed assets	375	91	466	516	321
Gift aid	70	(23)	47	17	27
Other items	(6)	(7)	(13)	223	35
Interest receivable and other income	155	27	182	171	135
Interest payable and other income	(1,698)	(824)	(2,522)	(2,355)	(2,094)
Exceptional items relating to early redemption of loans	(13)	(51)	(64)	(18)	(10)
<b>Surplus before tax</b>	<b>1,270</b>	<b>675</b>	<b>1,946</b>	<b>1,775</b>	<b>1,117</b>
Corporation tax	(12)	(3)	(15)	3	(1)
<b>Surplus after tax</b>	<b>1,258</b>	<b>672</b>	<b>1,930</b>	<b>1,778</b>	<b>1,116</b>
Transfer (to)/from reserves	98	60	158	377	400
<b>Accumulated surplus / (deficit) bf</b>	<b>9,340</b>	<b>2,405</b>	<b>11,745</b>	<b>7,526</b>	<b>5,524</b>
Actuarial surplus (loss) on pension scheme liability	(67)	(129)	(196)	(350)	328
Prior period adjustments	(176)	65	(112)	2,414	158
<b>Accumulated surplus / (deficit) cf</b>	<b>10,453</b>	<b>3,073</b>	<b>13,526</b>	<b>11,745</b>	<b>7,526</b>

## Turnover and operating costs

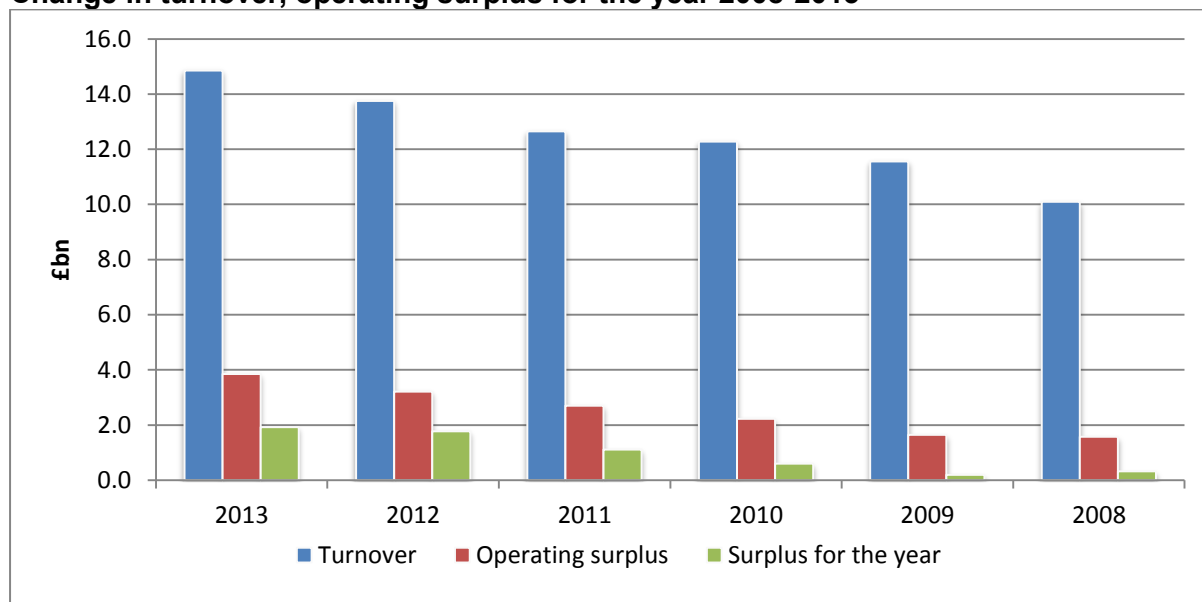
Turnover has increased by £1.1bn (8%) to £14.9bn (2012: £1.1bn and 9%). Of the increase 37% was attributable to stock transfer providers (2012: 31%) and 63% to traditional providers (2012: 69%).

Turnover from social housing lettings increased by £919m (8%) to £12.5bn (2012: £856m and 8%). Income from first tranche shared ownership sales increased by £195m (33%) to £795m. However, turnover from other social housing activity decreased by £92m (11%). Total turnover from non-social housing activities increased by £86m (11%) to £870m.

Total operating costs increased by £301m (3%) to £10.1bn. The increase in operating costs was broadly in line with inflation throughout the period. RPI was 3.5% in April 2012, and this fell to 2.6% in September before increasing back to 3.2% in March 2013. Operating costs for stock transfer providers increased by £147m (4%) and for traditional providers by £153m (2.5%). Exceptional items of £12m are mainly attributed to non-social housing activities within two traditional providers.

The overall operating surplus has increased by £629m (20%) to £3.8bn. As a result, there has been an improved operating margin from 23% in 2012 to 26% in 2013. The operating margin, when adjusted for capitalised major repairs, increased from 9% to 12% in 2013.

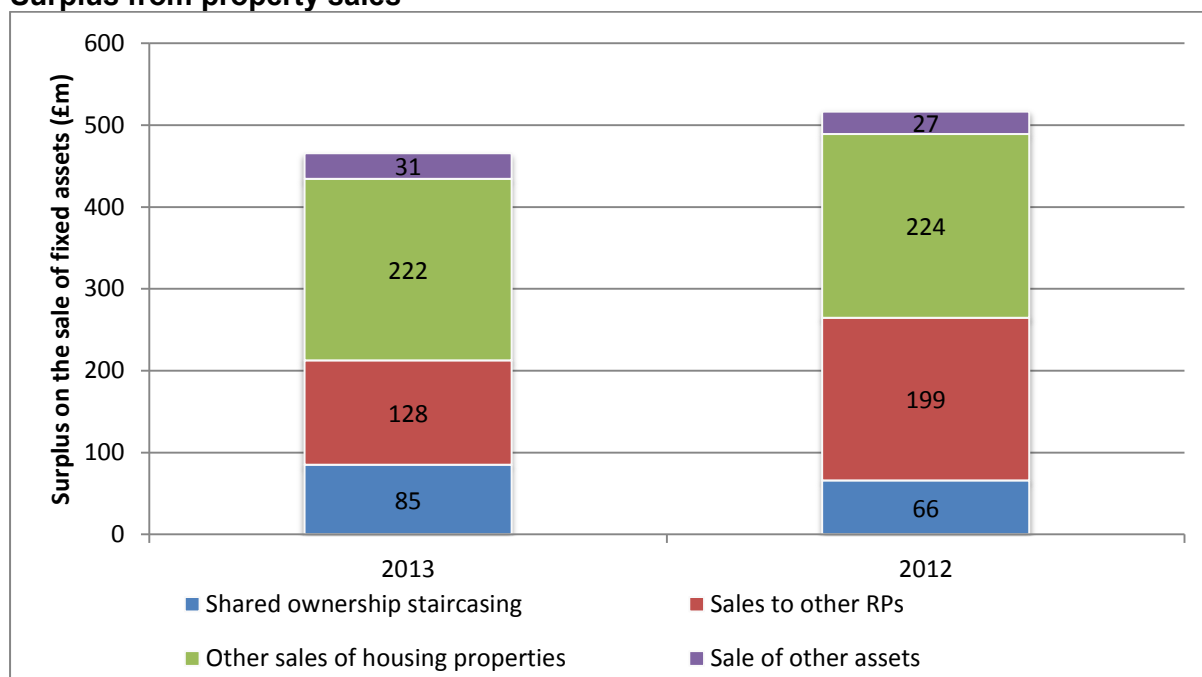
**Figure 4**  
**Change in turnover, operating surplus for the year 2008-2013**



## Surplus from property sales

The surplus on the sale of fixed assets decreased by £51m (10%) to £466m. This was driven by a decrease in surplus on sales to other RPs of £71m to £128m. The surplus attributable to shared ownership staircasing actually increased by £19m to £85m. The surplus attributable to other sales of housing properties and fixed assets remained constant at around £250m.

**Figure 5**  
**Surplus from property sales**



## Interest

Interest payable has risen by £166m (7%) to £2.5bn. Of the increase 54% was attributable to traditional providers (2012: 86%). There has been a marginal decrease in the effective interest rate from 5.2% in 2012 to 5.1% in 2013. The aggregate effective interest rate for traditional providers was 5.3% (2012: 5.3%) and 4.7% for stock transfer providers (2012: 4.8%). The movement in aggregate interest rate broadly reflects three month LIBOR which fell from 1% in April 2012 to 0.5% in March 2013.

Interest capitalised decreased by £10m (7%) to £131m. In 2013, 84% of capitalised interest was attributable to traditional providers (2012: 84%). Traditional providers capitalised 6.1% of total interest costs and the stock transfer sub-sector capitalised 2.6% (2012: 6.9% and 2.9% respectively).

Interest cost (interest payable plus capitalised interest) increased by £156m (6%). The movement in interest cost can be disaggregated by movement in the sector's effective interest rate and increase in total debt. The reduction in effective interest rate would have caused total interest payment to decrease by £27m. This was counteracted by a 7.3% increase in debt which caused interest costs to increase by £183m.

As at March 2013, the sector fixed the interest rate on approximately 65% of its debt on average (2012: 70%, 2011: 65%). Fixing debt gives providers a degree of certainty on forecasting the cost of borrowing. The remaining 35% of debt is subject to less certain rates, either because it is a floating rate, is cancellable by the lender, or is inflation linked. Providers have benefited from low floating rates in recent years. The Regulator continues to monitor the potential impact of interest rate movements and engage with providers on treasury management where risk is identified.

Exceptional items relating to the early redemption of loans increased by £46m to £64m. Over 86% of this was attributable to breakage costs of fixed rate loans for two providers. Interest receivable for the sector increased by £11m (6%) to £182m. This can be attributed to the increase in cash and short term investments held by the sector in 2013.

## Net surplus

The performance of the sector has improved between 2012 and 2013 with an increase in the net surplus of £153m (9%) to £1.9bn.

In comparison the net surplus between 2011 and 2012 increased by £662m. However, the 2012 surplus included a £220m adjustment under other items attributable to the collapse of a group structure in a large provider. An adjustment was made to reflect the value of the net assets transferring into the recipient provider. The impact of the fair value adjustment on the increase in net surplus and other contributing factors are summarised in the table below.

**Table 5**  
**Increase in surplus**

All figures in £m	Traditional	Stock Transfer	Total
Increase in revenues from social housing lettings	145	98	243
Increase in margin on social housing lettings	201	128	329
Increase in net interest costs	(81)	(74)	(155)
Fair value adjustment	(220)	NA	(220)
Other items <sup>9</sup>	11	(55)	(45)
<b>Aggregate increase in surplus</b>	<b>56</b>	<b>97</b>	<b>153</b>

Additional net rental income of £860m from social housing lettings (2012: £905m) has driven an increase in surplus on social housing lettings of £573m (19%). The figure attributable to increase in revenues is derived by applying the operating margin from 2012 to the increase in social housing revenues. The margin on social housing lettings increased from 27% to 29%, further increasing the operating surplus by £329m. This was partially offset by an increase in net interest costs of £155m which was caused by the increase in debt in the year.

The net surplus for traditional providers increased by £56m (5%) to £1.3bn. However, this increase is net of the fair value adjustment of £220m in 2012. Without the fair value adjustment in 2012 the increase in net surplus in 2013 would be just below 24%.

The net surplus for the stock transfer sub-sector increased by £97m (17%) to £672m. The stock transfer sub-sector continues to mature with the number of new stock transfers declining over the past three years. Only three stand-alone organisations reported their first results in 2013.

<sup>9</sup> Other items include first tranche shared ownership sales, non-social housing activities, other social housing activities, surplus on the sale of fixed assets, gift aid, exceptional items relating to early redemption of loans, corporation tax and other sundry items.

**Table 6**  
**Income and expenditure from social housing lettings**

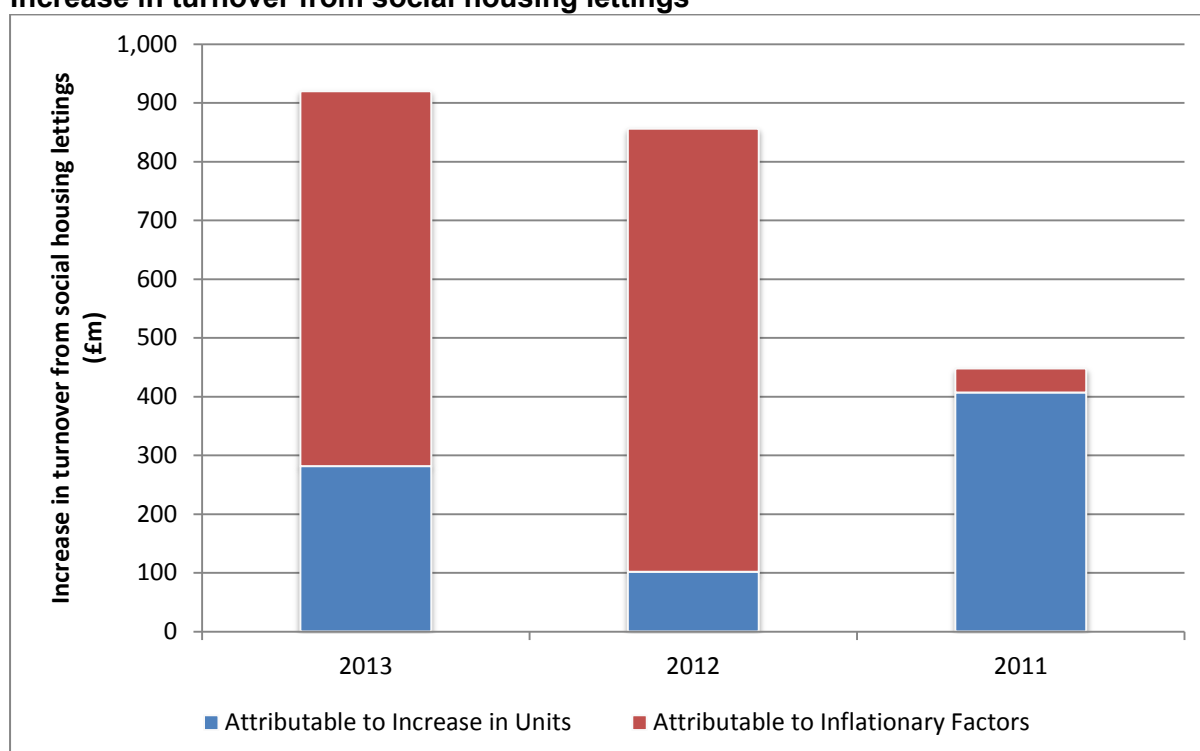
	<b>Traditional</b>	<b>Stock</b>	<b>Total</b>	<b>Total</b>	<b>Total</b>
All figures in £ million	<b>2013</b>	<b>Transfer</b>	<b>2013</b>	<b>2012</b>	<b>2011</b>
		<b>2013</b>			
<b>Income</b>					
Rents	6,350	4,680	11,030	10,100	9,249
Service income	807	255	1,063	941	870
Charges for support services	0	0	0	192	209
<b>Net rental income</b>	<b>7,157</b>	<b>4,936</b>	<b>12,093</b>	<b>11,233</b>	<b>10,328</b>
Other	263	117	380	321	370
<b>Total turnover from social housing lettings</b>	<b>7,420</b>	<b>5,053</b>	<b>12,473</b>	<b>11,553</b>	<b>10,697</b>
<b>Expenditure</b>					
Management	1,473	1,015	2,488	2,317	2,206
Service costs	981	321	1,302	1,175	1,129
Care/support costs	0	0	0	242	198
Routine maintenance	994	832	1,826	1,782	1,671
Planned maintenance	393	374	767	715	880
Major repairs	181	391	572	593	1,011
Bad debts	58	37	96	81	68
Lease charges	0	0	0	139	220
Depreciation of housing properties	778	568	1,347	1,235	652
Impairment of housing properties	34	16	50	16	1
Other	308	89	397	201	57
<b>Total expenditure on social housing lettings</b>	<b>5,199</b>	<b>3,645</b>	<b>8,844</b>	<b>8,497</b>	<b>8,093</b>
<b>Surplus on social housing lettings</b>	<b>2,221</b>	<b>1,408</b>	<b>3,629</b>	<b>3,057</b>	<b>2,605</b>

## Rents and service income

Turnover from social housing lettings increased by £919m (8%) to £12.5bn. Rental income increased by £930m (9%) with the movement attributable to inflationary factors and to a lesser extent, the increase in the number of homes under management.

Service charge income increased by £122m (13%). However, the current Accounting Direction does not require a separate disclosure for charges for support services within income and expenditure from social housing lettings. Some providers have responded to the Accounting Direction by including a proportion of the income previously disclosed as charges for support services under service charge income. This has increased the service charge income reported relative to 2012.

**Figure 6**  
**Increase in turnover from social housing lettings**



The combined rent and service charge per unit increased to £89 per week. Average rent and service charge per unit was £95 per week for the traditional sector (2012: £88 per week) and £82 per week for the stock transfer sub-sector (2012: £78 per week). Service charge recovery rates are broadly comparable to the previous year at 79% (2012: 80%).

The rent per social housing unit increased in 2013 by 6.6% to £81 per week (2012: £76 per week). The increase in rent per unit is marginally greater than the guideline limit for rent increase in 2012/13 which was 6.1% (RPI at September 2011 5.6% + 0.5%). The difference between the guideline limit and the change in average rents is partly attributable to some rents converging upwards by £2 a week in excess of the guideline limit to target rent levels. Also, new units developed and re-lets are likely to be at higher rents, including units let at Affordable Rent, than units that are sold.

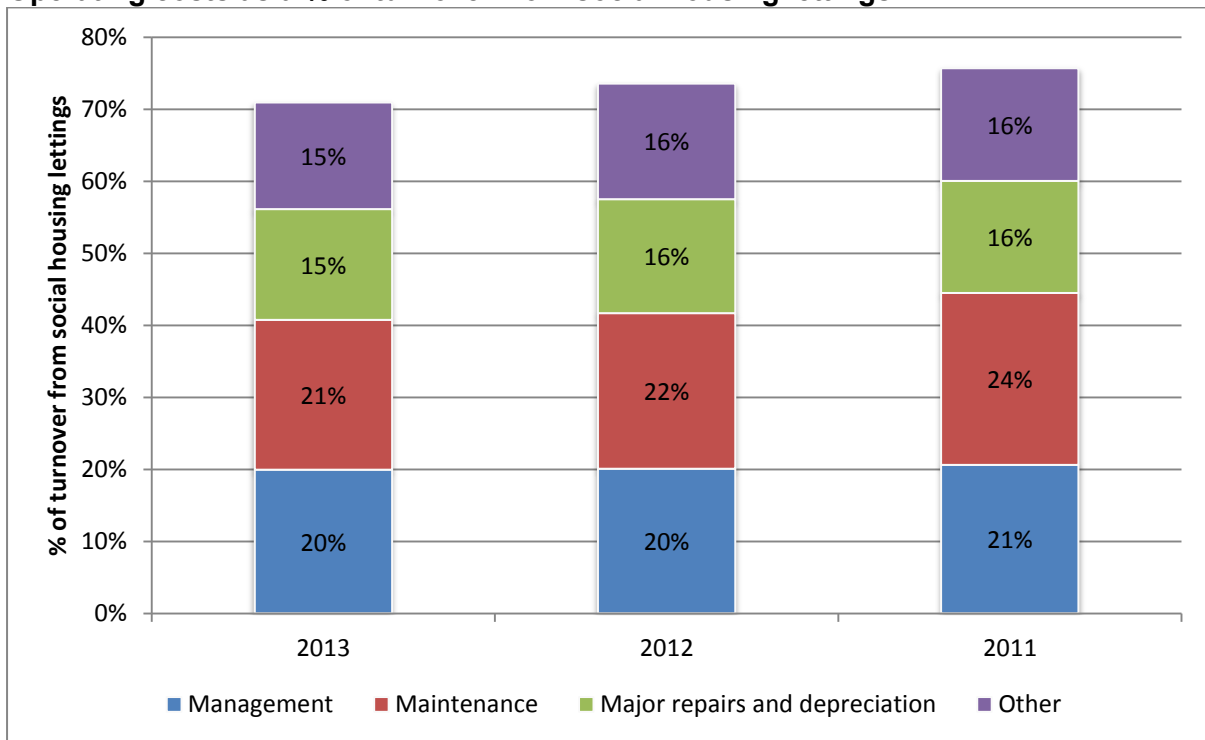
As a result of the 2012 Accounting Direction and amendments to the treatment of charges for support services, a truly comparable year on year analysis of service charge per social housing unit is not possible. According to the accounts submitted by providers, there was a 10% increase in service charges per social housing unit. However, this increase includes an element of charges for support services. Analysis of the SDRs made by providers suggests that, on a like for like basis, the increase in service charges for general needs is approximately 5% per unit per annum.

## Social housing costs

Total expenditure on social housing lettings increased by £347m (4%), to £8.8bn. This resulted in an improved margin on social housing lettings, as costs as a percentage of turnover fell from 74% in 2012 to 71% in 2013. The key drivers in the increased margin were reductions in major repairs costs and maintenance costs as a percentage of turnover.

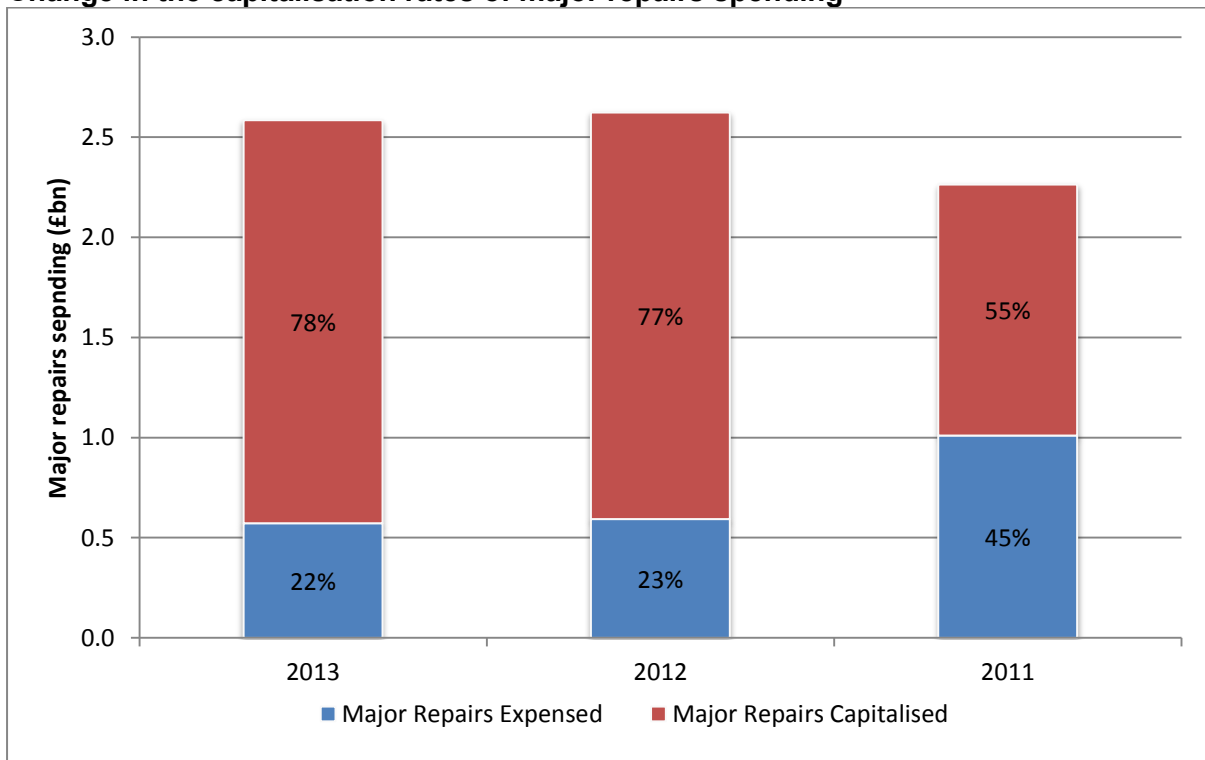


**Figure 7**  
**Operating costs as a % of turnover from social housing lettings**



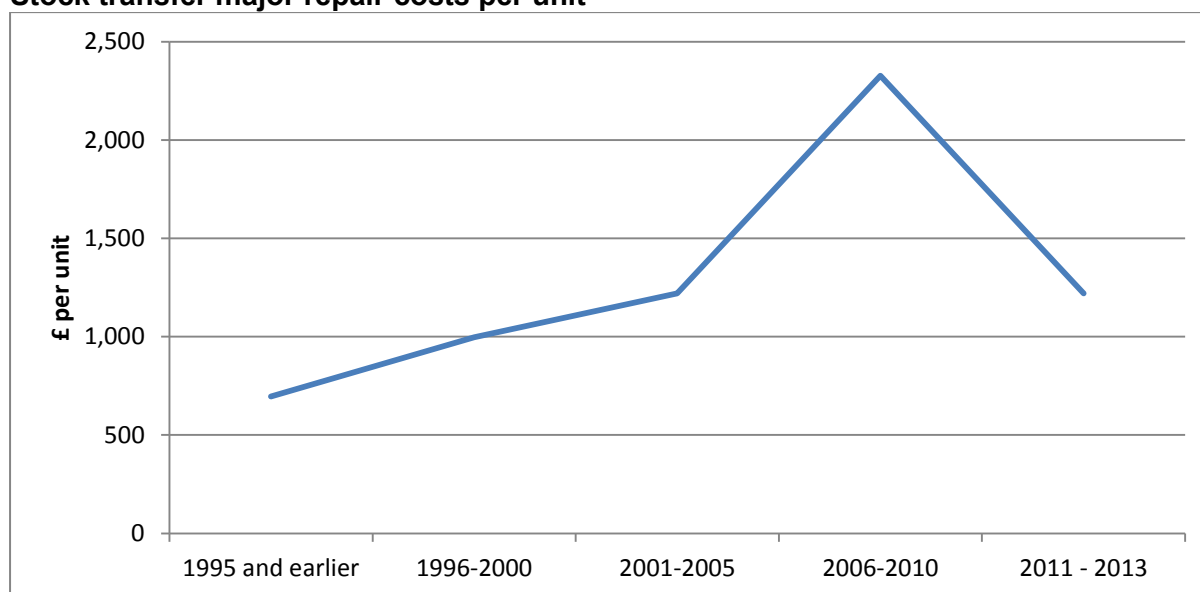
Overall, the total major repairs costs (including capitalised major repairs) decreased by £39m (1%). In 2013 capitalisation rates increased marginally by 1% to 78%, the average capitalisation rate was 74% (74%: 2012) for stock transfers and 83% (2012: 83%) for traditional providers.

**Figure 8**  
**Change in the capitalisation rates of major repairs spending**



Total repair costs per unit decreased by 1% to £1,981 (2012: £2,007). Planned and routine maintenance costs per unit increased by 1% to £992, whilst total major repairs costs per unit (including capitalised major repairs) decreased by 4%. For traditional providers major repairs cost per unit increased by 2% to £744. The overall decrease was driven by the stock transfer sub-sector with a decrease of 8% to £1,297 per unit. Stock transfer providers typically have high major repairs costs linked to initial stock improvement programmes. The chart below shows how, on average, major repairs costs decrease with the maturity of the stock transfer provider.

**Figure 9**  
**Stock transfer major repair costs per unit**



The six new stock transfers which have taken place since 2011 have not reached peak levels of activity in respect of their stock improvement programmes. This is reflected in relatively low major repairs costs for the latest stock transfers. The six post 2011 stock transfer providers account for less than 5% of units in the sub-sector.

Management costs per social housing unit increased by 5% to £952. The increase is in part driven by providers' response to the Accounting Direction of 2012. A small number of providers have included costs previously disclosed as care / support costs as management costs.

As a result of the adoption of component accounting, there was a 90% increase in the depreciation of housing properties between 2011 and 2012. In 2013 the depreciation of housing properties increased by a further 9% to £1.3bn. The depreciation of housing properties now accounts for 15.2% of the expenditure on social housing lettings (2012: 14.5%).

Impairment of housing properties for social housing lettings was £50m, compared to the £15m reported in 2012. The total impairment charge reported by the sector was £56m in 2013 (2012: 31m) and this amount was net of a £10m (2012: £13m) release in the same period. Of the total impairment reported, 64% was attributable to traditional providers. The increase in impairment is largely attributable to land held for development and schemes under construction.

Table 7  
Costs per unit

Indicator	Traditional	Stock transfers	Total
<b>Management costs per unit £</b>			
2013	1,012	876	952
2012	946	860	908
2011	925	809	873
<b>% increase</b>			
2012-13	7.0%	1.9%	4.8%
2011-12	2.4%	6.3%	4.0%
2010-11	-2.4%	0.1%	-1.2%
<b>Routine and planned maintenance costs per unit £</b>			
2013	954	1,041	992
2012	947	1,019	979
2011	987	1,038	1,009
<b>% increase</b>			
2012-13	0.7%	2.1%	1.4%
2011-12	-4.0%	-1.8%	-3.0%
2010-11	0.2%	-0.6%	-0.2%
<b>Total major repair costs per unit £</b>			
2013	744	1,297	989
2012	732	1,406	1,028
2011	598	1,269	896
<b>% increase</b>			
2012-13	1.6%	-7.7%	-3.8%
2011-12	22.5%	10.8%	14.8%
2010-11	-6.2%	-9.6%	-9.0%
<b>Major repair costs per unit (expensed) £</b>			
2013	124	338	219
2012	125	369	232
2011	241	598	400
<b>% increase</b>			
<b>2012-13</b>	-0.7%	-8.5%	-5.8%
2011-12	-48.2%	-38.3%	-41.9%
2010-11	-9.2%	-15.4%	-14.2%
<b>Major repair costs per unit (capitalised)</b>			
2013	619	960	770
2012	607	1,037	796
2011	356	671	496
<b>% increase</b>			
2012-13	2.1%	-7.5%	-3.2%
2011-12	70.4%	54.6%	60.5%
2010-11	-4.1%	-3.6%	-4.4%

## Other activities

Table 8  
Income and expenditure on other activities

All figures in £million	Stock		Total 2013	Total 2012	Total 2011
	Traditional 2013	Transfer 2013			
<b>First tranche shared ownership sales</b>					
Income	644	151	795	600	553
Expenditure	540	129	669	517	504
<b>Result</b>	<b>104</b>	<b>22</b>	<b>126</b>	<b>83</b>	<b>49</b>
<b>Other social housing activities</b>					
Income	609	112	722	814	744
Expenditure	681	127	808	842	780
<b>Result</b>	<b>(72)</b>	<b>(15)</b>	<b>(87)</b>	<b>(28)</b>	<b>(36)</b>
<b>Non-social housing activities</b>					
Income	702	168	870	784	653
Expenditure	568	121	689	675	567
<b>Result</b>	<b>134</b>	<b>47</b>	<b>181</b>	<b>109</b>	<b>87</b>
<b>Total other activities</b>					
Income	1,956	431	2,387	2,197	1,950
Expenditure	1,789	377	2,167	2,034	1,851
<b>Result</b>	<b>166</b>	<b>54</b>	<b>220</b>	<b>164</b>	<b>99</b>

The sector reported a surplus on its other activities of £220m (2012: £164m). Traditional providers generated 76% of this surplus compared to 63% in 2012. The surplus generated by the stock transfer sub-sector fell by 11% following a decrease of 17% in 2012.

Turnover from first tranche sales increased by £195m (33%) to £795m. This increase means that turnover exceeds 2009 levels when first tranche sales were first included within operating surplus in the Global Accounts. The surplus on first tranche shared ownership sales increased by £43m (52%) to £126m. This represents an improvement on the margin from 14% in 2012 to 16% in 2013.

Following the Accounting Direction 2012, providers were required to disaggregate income and expenditure attributable to charges for support services from other social housing activities. The table overleaf summaries this disaggregation.

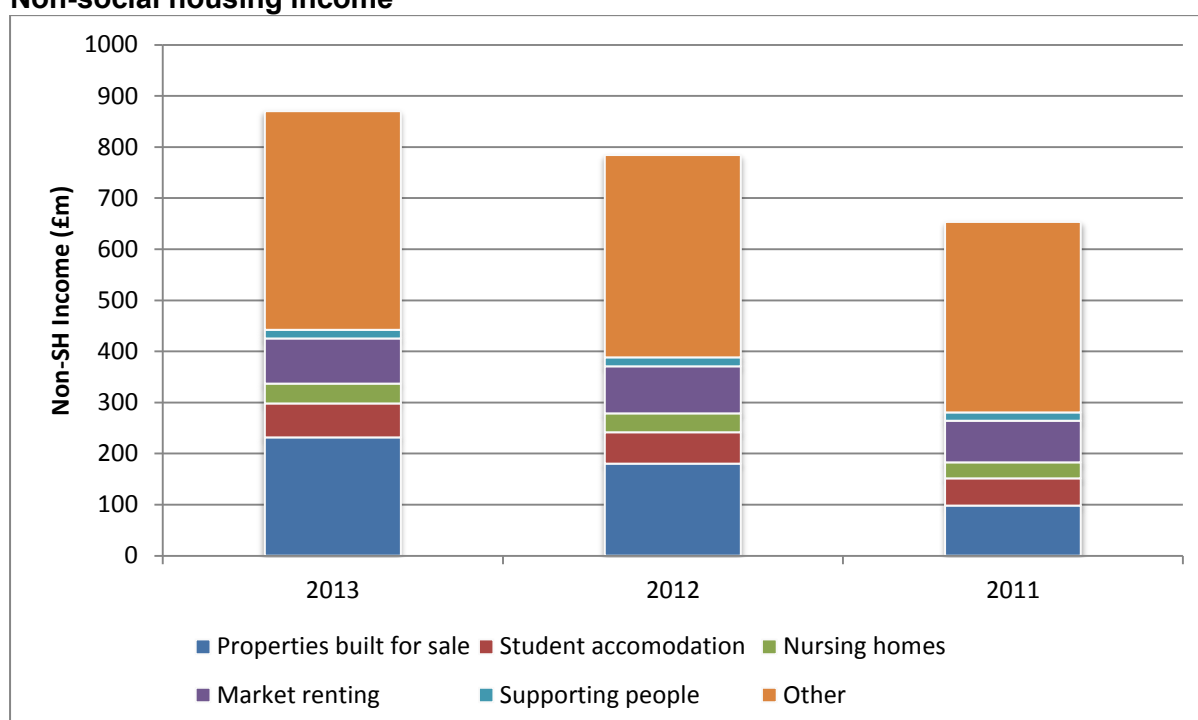
**Table 9**  
**Other social housing activities**

All figures in £million	2013	2012	2011
<b>Charges for support services</b>			
Income	199	NA	NA
Expenditure	230	NA	NA
<b>Surplus / (loss)</b>	<b>(31)</b>	<b>NA</b>	<b>NA</b>
<b>Other</b>			
Income	523	814	744
Expenditure	579	842	780
<b>Surplus / (loss)</b>	<b>(56)</b>	<b>(28)</b>	<b>(36)</b>

The total income for other social housing activities (including both charges for support services and other) has decreased by £92m (11%) to £722m. The total deficit on other social housing activities was £87m - a deterioration of £59m on the deficit in 2012. Activities typically reported in other social housing include expenditure on regeneration, community based activities and development overheads.

The surplus from non-social housing activities has increased by £72m (66%) to £181m. Of the surplus, £49m is attributable to properties built for sale. Overall the margin on non-social housing activities increased from 7% in 2012 to 9% in 2013. The income attributable to non-social housing activities has increased by £86m to £870m in 2013. The graph below breaks down non-social housing income by source over the past three years.

**Figure 10**  
**Non-social housing income**



In 2013, 27% of non-social housing income (£231m) was generated through properties built for sale (2012: 23%). Just less than 50% of other non-social housing activity reflects a mixture of activity grouped together as other.

The type of non-social housing activities varies by sub-sector. Over 80% of all non-social housing income is attributable to the traditional sub-sector. The sub-sector reported 92% of all income from student accommodation and nursing homes. In addition, traditional providers more typically develop properties for sale, with the sub-sector being responsible for 93% of all income from this activity. This activity is concentrated within a small number of providers, with seven traditional providers being responsible for 83% of all income from properties built for sale.

The majority (73%) of non-social housing activity delivered by stock transfer providers is categorised as other activity. Activities represented under 'other' include, but are not limited to, management services, commercial property lettings, community services and employment and training services.

## Social homes in management

Table 10  
Number of social homes managed

	2013	2012	2011
<b>Social housing (number)</b>			
Traditional	1,454,424	1,429,549	1,404,464
Stock transfer	1,158,851	1,121,577	1,122,618
<b>Total</b>	<b>2,613,275</b>	<b>2,551,126</b>	<b>2,527,082</b>
<b>Social housing (% change)</b>			
Traditional	1.7%	1.8%	5.8%
Stock transfer	3.3%	-0.1%	1.8%
<b>Total</b>	<b>2.4%</b>	<b>1.0%</b>	<b>4.0%</b>

The number of social housing homes managed increased by 62,149 (2.4%). Social housing homes managed by stock transfer providers increased by 37,274 (3.4%). This increase followed a small decline in 2012. The number of homes transferring into the sector through stock transfer providers was 18,656 from three providers. Overall the number of social homes managed by traditional providers increased by 24,875 (1.7%) (2012: 25,085).

The percentage of homes managed in the stock transfer sub sector remains at 44% as in 2012 and 2011. In both stock transfer and traditional sub-sectors, the increase reported is net of any sales or demolitions. Also, there are a small number of providers which move in and out of the dataset each year. This is due to changes in accounting periods or changes in the number of homes in management above or below the 1,000 homes threshold requirement to submit the FVA return.

Approximately 36,000 units were developed during 2012/13. This represents a 28% decrease on the number of homes developed during 2011/12 of around 50,000. The growth achieved through this development was offset by a number of sales / demolitions during the period totalling 16,822 (2012: 23,989). The decrease in the number of homes developed in 2012/13 is largely attributable to the timings of the Affordable Homes Programme (AHP). Units developed in 2011/12 include units associated with the end of the 2008-11 National Affordable Housing Programme (NAHP). As is shown in section D1, the delivery of the AHP 2011-15 is back loaded into 2013/14 and 2014/15.

**Table 11**  
**Key financial ratios by sub-sector**

	<b>2013</b>	<b>2012</b>	<b>2011</b>
<b>Growth ratios</b>			
<b>Growth in turnover</b>			
Sector	8.1%	8.7%	3.0%
Traditional providers	8.1%	9.6%	3.0%
Stock transfers	8.0%	7.2%	3.0%
<b>Growth in total assets</b>			
Sector	6.3%	5.6%	7.4%
Traditional providers	4.0%	5.7%	7.0%
Stock transfers	12.7%	5.3%	8.6%
<b>Growth in total debt</b>			
Sector	7.3%	7.6%	5.2%
Traditional providers	5.1%	10.2%	6.3%
Stock transfers	11.9%	2.7%	3.2%
<b>Profitability ratios</b>			
<b>Operating margin</b>			
Sector	25.9%	23.4%	21.4%
Traditional providers	25.5%	22.8%	20.6%
Stock transfers	26.7%	24.5%	22.7%
<b>Effective interest rate</b>			
Sector	5.1%	5.2%	5.0%
Traditional providers	5.3%	5.3%	5.1%
Stock transfers	4.7%	4.8%	4.7%
<b>Debt servicing ability</b>			
<b>EBITDA MRI interest cover</b>			
Sector	138.0%	115.7%	106.4%
Traditional providers	147.3%	128.0%	114.8%
Stock transfers	118.3%	87.9%	89.3%
<b>EBITDA MRI interest cover social housing lettings</b>			
Sector	129.7%	109.1%	102.0%
Traditional providers	138.0%	122.0%	113.6%
Stock transfers	111.9%	80.1%	78.2%
<b>Adjusted net leverage</b>			
Sector	41.2%	41.5%	40.9%
Traditional providers	36.9%	37.2%	35.6%
Stock transfers	52.6%	54.1%	56.5%
<b>Gearing</b>			
Sector	86.8%	85.9%	86.1%
Traditional providers	66.7%	66.3%	62.2%
Stock transfers	205.1%	216.0%	320.9%
<b>Debt per social housing unit (£)</b>			
Sector	19,913	19,004	17,828
Traditional providers	23,495	22,746	21,010
Stock transfers	15,417	14,233	13,846

## Key ratios

The key financial ratios, identified in Table 11, summarise the overall performance trends in the period and assist in understanding the main drivers of financial performance and balance sheet strength in the sector.

The ratios show that the sector has continued to grow with an increase in total assets of 6.3%. Although this growth is an increase on 2012 (5.6% growth), it remains significantly below peak growth levels of 12% achieved in 2008 and 2009.

The operating margin showed an improved performance for the sector at 25.9% (2012: 23.4%). This is mainly due to improved margins on the core social housing lettings business. First tranche shared ownership sales achieved a higher margin and greater levels of activity as did non-social housing activities.

The traditional sub-sector had a higher operating margin on social housing lettings (30%) than the stock transfer sub-sector (28%), caused primarily by lower major repairs and maintenance expenditure overall. However, the stock transfer sub-sector demonstrated higher profitability with an overall operating margin of 26.7%. This is a result of the stock transfer sub-sector generating significantly higher margins on non-social housing activity (28%) compared to the traditional sub-sector (19%).

The effective interest rate decreased by 0.1% to 5.1% in 2013. The movement in rates follows a fall in reference rates during the year (most typically three month LIBOR). The three month LIBOR rate decreased from 1% to 0.5% over the 12 months to March 2013. The effective interest rate for the stock transfer sector fell by 0.1% to 4.7%, whilst the comparable rate for the traditional sub-sector remained at 5.3%. Total interest costs (including capitalised interest) as a percentage of turnover have remained at around 18% from 2010 through to 2013. For the traditional sub-sector this was 19% and for the stock transfer sub-sector this was 15%.

A decrease in the effective interest rate and an improved operating margin led to a stronger interest cover ratio for the sector. The Regulator measures interest cover ratio for the sector using the EBITDA MRI interest cover ratio. Interest cover increased from 115.7% to 138.0% demonstrating that the sector as a whole has generated enough surplus to meet its interest payments with no reliance on the sale of fixed assets. Underlying the overall position is a range of performance, where 80 out of 339 providers (2012: 103 out of 347 providers) had an EBITDA MRI interest cover ratio below 100% - of which 56 were stock transfer providers.

However, it should be noted that this interest cover measure includes less certain cash flows generated from first tranche sales and properties developed for sale. Total other activities contributed to 6% of the total operating surplus (2012: 5%, 2011: 4%). The performance of the traditional sub-sector continued to improve with a growth in interest cover from 128% in 2012 to 147% in 2013.

The biggest improvement in interest cover was in the stock-transfer sub-sector with interest cover increasing to 118.3% from 87.9%. In their early years, stock transfer providers are usually undertaking high levels of improvement works resulting in high deficits and low levels of interest cover. The table below identifies how the increase in interest cover highlights the growing maturity of the stock transfer sub-sector.



**Table 12**  
**Stock transfer interest cover**

<b>Year of stock transfer</b>	<b>No. of SH units</b>	<b>EBITDA MRI per unit (£)</b>	<b>EBITDA MRI Interest cover</b>	<b>Major repairs cost per SH unit (£)</b>
Before 1996	174,231	2,014	160%	696
1996 to 2000	331,992	1,290	144%	997
2001 to 2005	368,017	873	138%	1,220
2006 to 2010	230,210	(478)	-129%	2,327
2011 and after	54,401	175	87%	1,220
<b>Sub-sector average</b>	<b>1,158,851</b>	<b>863</b>	<b>118%</b>	<b>1,297</b>

EBITDA MRI interest cover increases with the number of years since stock transfer. As a result of the completion of stock improvement programmes, typically within a 5-12 year period, major repairs cost per unit (both capitalised and expensed major repairs costs) decreases the more mature the transfer. This in turn partly drives an increase in operating surplus per unit and improved interest cover performance for the older stock transfer organisations. Based on available 10 year data, EBITDA MRI interest cover for the stock transfer sub-sector is above the 100% benchmark for the first time.

Loan covenants related to gearing are common in the loan agreements of the traditional sub-sector. It is calculated in a number of ways; however, all calculations measure the proportion of debt to equity in a provider's financial structure. A common definition is to measure loans as a proportion of the sum of grants and reserves (excluding revaluation reserves). Most loan agreements that use this definition set a maximum gearing level of between 60% and 80%.

Aggregate gearing for the sector increased by 1% to 86.8% in 2013 (2012: 85.9%). This increase is attributable to borrowing rising by 7.6% and reduced grant rates available through the Affordable Homes Programme. However, the increase in gearing has been restricted by a number of contributing factors:

- With the growing maturity of stock transfer providers, gearing levels for the sub-sector continue to decrease. Gearing for the sub-sector has fallen from 518% in 2008 to 205% in 2013 (2012: 216 %). This trend is providing downward pressure on gearing across the sector as a whole.
- Downward pressure on gearing comes from an increase in reserves largely driven by above forecast levels of accumulated surplus. Reserves increased by 15.4% year on year compared to a forecast increase of 9.5%.
- Providers reported an increase of £1.6bn of grant on balance sheets in 2013. However, a proportion of the grant reported on the balance sheet is not additional grant invested in 2013. Approximately 24% of the increase is attributable to providers changing the basis for valuing housing properties in their accounts to historic cost thereby including historic grant on the balance sheet. A further 18% of the increase is attributable to changes to the Global Accounts dataset between 2012 and 2013.

The 7.3% increase in external debt was not matched by the increase in homes which only increased by 2.4%. Therefore, the debt per social housing unit has risen by 4.8% to £19,913 (2012: £19,004). Debt per social housing unit has increased by 3.3% for the traditional sub-sector to £23,495 per unit, and by 8.3% in the stock transfer sub-sector to £15,417.

# Part D – Thematic analyses

## D1 – Financial forecasts and sector risk

### Dataset

The Regulator collects financial forecast returns (FFRs) from all providers owning and/or managing 1,000 units or more. The returns represent the financial basis of the organisation's business plans. Consequently they are completed at the level at which organisations plan their businesses, be that at group or subsidiary level. The majority of providers submit a 30 year FFR, although traditional providers undertaking very little development are permitted to submit a five year FFR.

The following analysis is taken from a dataset of FFRs, excluding returns received at subsidiary level where a group return is also received. Providers' business plans are commercially sensitive, so this analysis focuses on trends in the aggregate data and the underlying data source will not be made publicly available.

The FFRs were submitted prior to two significant policy announcements. Firstly, the new rent settlement post March 2015, linking rents to CPI +1% and removing upward convergence where rent levels are below target rents, was announced in 2013. Secondly, the bidding prospectus for the Affordable Homes Programme (AHP) 2015-18 round of grant funding was released early in January 2014. The impacts of both policy developments on provider business plans are not reflected in the majority of financial forecasts submitted.

### Headlines

The analysis will focus on the first five financial years, the period from 2013/14 to 2017/18. At an aggregate sector level, the analysis shows continued strong financial performance with aggregate EBITDA MRI interest cover of 146% over the five year period. However, this masks variable performance in individual providers. Forty one providers (17% of the sector) have an aggregate interest cover below 100%<sup>10</sup>. Of this group, almost 80% are stock transfer providers.

The back-loading of development into the final two years of the AHP 2011-15 programme has a noticeable impact on forecasts. In aggregate, 128,000 units will be developed by the sector in 2014 and 2015. This has the effect of improving performance in the later years of the plan as projected investment in new supply falls.

The exposure to the housing market is also greatest in the first two years of the forecasts. The sector has forecast the development of 23,000 shared ownership and 8,500 properties for outright sale between April 2013 and March 2015.

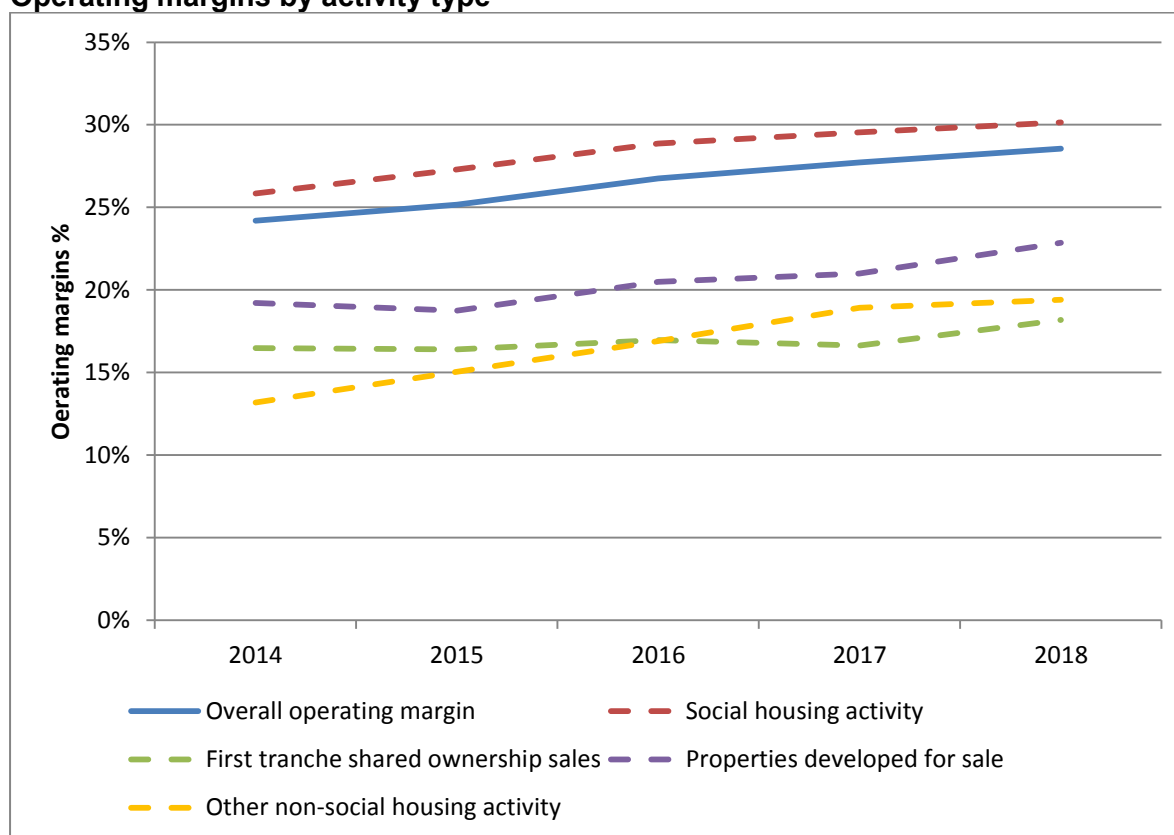
Over the five year forecast period, 78% of turnover is attributable to social housing lettings. At an aggregate level, the sector is not reliant on diverse activities. However, dependence on diverse activities varies across the sector, with the majority of non-social housing activity being delivered by a small number of providers. The forecasts show that diverse activities

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<sup>10</sup> The interest cover calculation is based on earnings before interest, taxation, depreciation and amortisation with all major repairs spending included.

have a lower margin than social housing activities, raising questions as to the extent to which such activities cross subsidise traditional social housing lettings.

**Figure 11**  
**Operating margins by activity type**



The margin on social housing lettings increases from 26% to 30% over the forecast period. The delivery of this margin will be challenged both by the variety of changes brought in by welfare reform and the post 2015 rent settlement. Equally, controlling costs remains a challenge. Forecasts show that the sector will spend circa £2bn a year just to maintain the value of existing stock.

## Financial statements

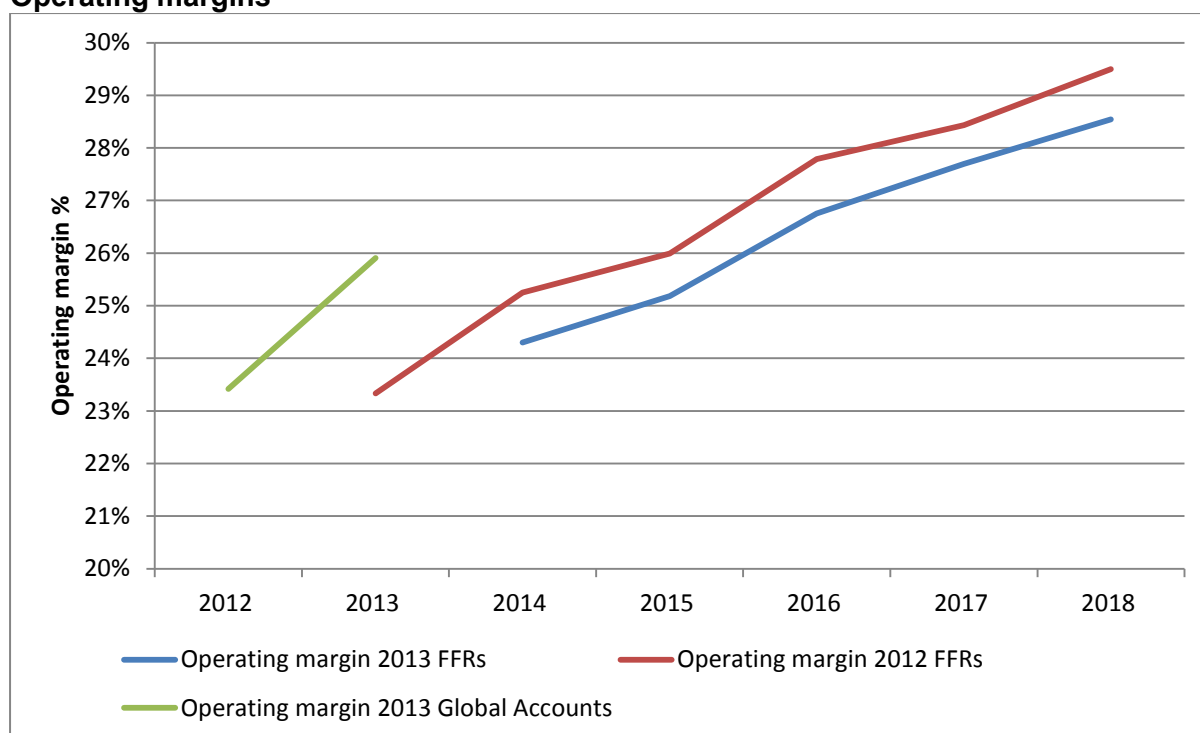
**Table 13**  
**Summary income and expenditure account**

All figures in £million	2014	2015	2016	2017	2018
Turnover	16,178	17,898	18,989	19,211	19,640
Operating expenditure	(12,251)	(13,386)	(13,907)	(13,885)	(14,031)
<b>Operating surplus</b>	<b>3,928</b>	<b>4,512</b>	<b>5,083</b>	<b>5,326</b>	<b>5,610</b>
Profit/(loss) on the sale of fixed assets	332	238	232	222	221
<b>Surplus before interest &amp; tax (SBIT)</b>	<b>4,260</b>	<b>4,749</b>	<b>5,315</b>	<b>5,548</b>	<b>5,830</b>
Interest and other finance costs	(2,626)	(2,862)	(3,168)	(3,366)	(3,528)
<b>Surplus for the year before tax</b>	<b>1,634</b>	<b>1,887</b>	<b>2,146</b>	<b>2,182</b>	<b>2,302</b>
Tax	(9)	(10)	(13)	(15)	(15)
<b>Surplus for the year</b>	<b>1,625</b>	<b>1,880</b>	<b>2,134</b>	<b>2,169</b>	<b>2,288</b>

As outlined elsewhere in this report, the sector has demonstrated a strong financial performance in recent years. This is projected to continue in the future, with a forecast retained surplus of over 10% of revenues in each year. The sector is forecast to continue to grow its surpluses with revenues rising at a faster rate than operating costs. This offsets the impact of increased interest costs as a result of an anticipated increase in effective interest rates and additional borrowings.

The aggregate operating margin is expected to increase from 24.2% in year 2014 to 28.6% in year 2018. Projected interest cover, on a revenue basis, is very strong being above 160% in each year. The assumptions made by providers in their business plans build in a degree of prudence. This is illustrated in figure 12 below, with actual margins exceeding forecast margins for 2013.

**Figure 12**  
**Operating margins**



Operating margins forecast in this year's returns are lower than comparable figures from the previous year's dataset. The more prudent forecasts are partly indicative of providers' interpretation of risk exposure and changes in the operating environment.

**Table 14**  
**Summary balance sheet**

All figures in £million	2014	2015	2016	2017	2018
Total fixed assets	83,962	90,488	94,704	98,088	100,981
Net current assets incl. pension assets	4,952	4,211	3,172	2,891	2,729
<b>Total assets less current liabilities</b>	<b>88,914</b>	<b>94,699</b>	<b>97,876</b>	<b>100,979</b>	<b>103,711</b>
Long term loans and provisions	64,035	67,515	68,232	68,708	68,658
Reserves	24,879	27,184	29,643	32,271	35,053
<b>Total loans provisions and reserves</b>	<b>88,914</b>	<b>94,699</b>	<b>97,876</b>	<b>100,979</b>	<b>103,711</b>

The projected aggregated balance sheet of the sector shows that there is an expected significant increase in the asset base driven by investment in new supply and existing stock. This is being financed by debt, internally generated reserves and, to a lesser extent, grant funding. Loans peak in 2017 at £67.8bn. However, these forecasts pre-date the forthcoming bidding rounds for AHP 2015-18 and in reality long term loans and provisions are unlikely to tail off as projected.

Retained surpluses are expected to total £10.1bn across the first five forecast years, with reserves further bolstered by £2.2bn of anticipated upward revaluations of the fixed asset base.

Capital grants recorded on the balance sheet increase from £46.3bn in 2014 to £47.9bn in 2018. At an aggregate sector level, gearing peaks in 2015 at 89%. For the stock transfer sub-sector, gearing levels decrease from 145% in 2014 to 119% in 2018 as reserves increase. In the traditional sub-sector, gearing peaks in 2015 at 78%, reflecting projected investment in new supply. Net debt as a percentage of turnover peaks in 2014 at 377%, falling to 339% in 2018.

**Table 15**  
**Summary cashflow statement**

All figures in £million	2014	2015	2016	2017	2018
Operating cashflows	3,405	4,327	5,129	5,477	5,852
Interest cashflows	(2,838)	(3,099)	(3,328)	(3,491)	(3,633)
Payments to acquire or develop properties	(8,393)	(6,584)	(3,865)	(3,156)	(2,507)
Fixed asset sales	940	606	583	538	508
Grant	945	879	340	263	210
Other cashflows	(500)	(458)	(98)	(71)	(53)
<b>Cash flow before resources and funding</b>	<b>(6,441)</b>	<b>(4,329)</b>	<b>(1,239)</b>	<b>(440)</b>	<b>379</b>
Increase in debt <sup>11</sup>	7,300	4,868	2,881	3,072	2,393
Loan repayments	(1,528)	(1,432)	(1,639)	(2,515)	(2,713)
Other financing cashflows	(236)	186	129	(60)	79
<b>Financing cashflows</b>	<b>5,536</b>	<b>3,622</b>	<b>1,371</b>	<b>496</b>	<b>(241)</b>
<i>Cash increase / (decrease)</i>	<i>(905)</i>	<i>(707)</i>	<i>132</i>	<i>56</i>	<i>138</i>

Operating cashflows take into account capitalised major repairs spending and depreciation and therefore differ from operating surplus. Interest cover on this cash basis increases from 120% in 2014 to 159% in 2018. This equates to a total free cashflow from operations of £7.8bn over the period with an increase from £0.6bn in 2014 to £2.2bn in 2018. This free cashflow is projected to support a total of £24.5bn investment in new supply over the same period.

Development activity is concentrated in the two years to 2015, the remainder of the AHP 2011-15 period, with around £15bn of expenditure projected. Grant funding (net of repaid grant) is £1.8bn to 2015. Medium and long term debt is expected to increase by £12.2bn with loan repayments of £3.0bn. Cashflows in later years show a reduced level of development expenditure and, consequently, a reduced requirement for capital funding.

<sup>11</sup> Medium and long term debt

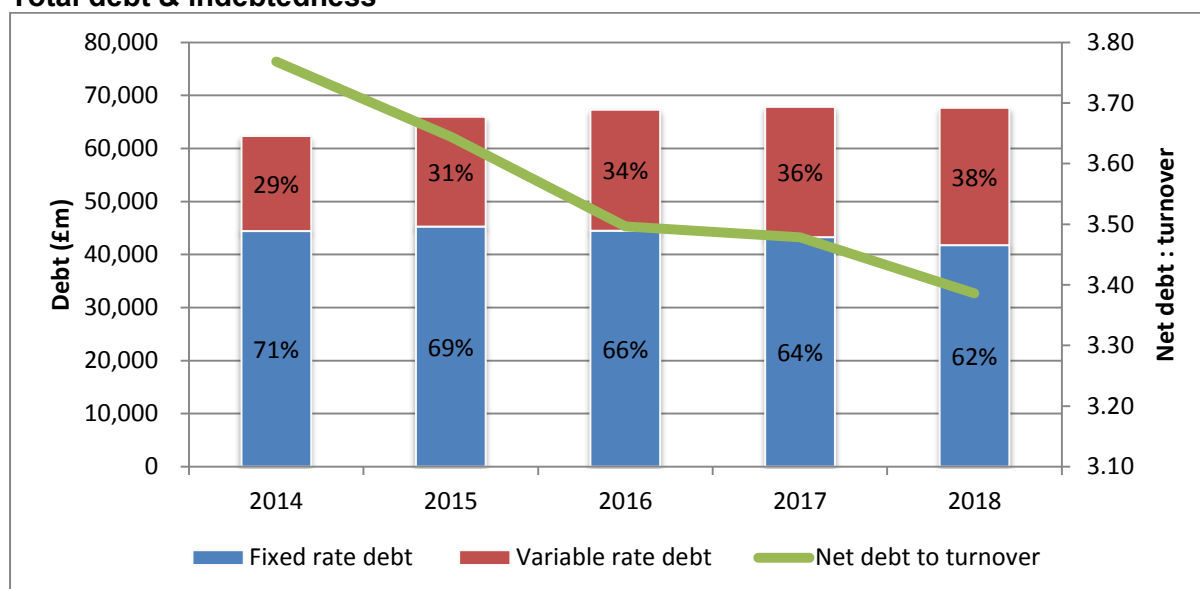
## Sector risks

The Sector Risk Profile, published by the Regulator in 2013, identifies the key risks to the financial viability of the sector. The purpose of this section is to examine the materiality of a number of the key risks to the delivery of the cashflows summarised above.

The implications and risks associated specifically with changes to accounting standards and the adoption of Financial Reporting Standard 102 (FRS102) are evaluated in section D3 – Accounting Changes.

### 1. Debt & finance market risk

Figure 13  
Total debt & indebtedness



At the end of March 2014, the sector is expected to have total debt of £62.3bn. This increases to a peak of £67.8bn in 2017. Data collected through the Quarterly Survey (QS) of providers identifies the sector's total existing borrowing facility as £70.6bn. However, over the first five years of the forecast, providers are reporting a £20.5bn increase in medium and long term debt with repayment of £9.8bn.

In the figure above, net debt (borrowing inclusive of other long term creditors and net of cash and short term investments) to turnover is used as a measure of indebtedness across the sector. Net debt to turnover decreases across the sector as a whole, however forecasts are highly variable amongst individual providers.

The higher the net debt to turnover ratio, the higher operating margins and lower the interest costs need to be to generate positive cashflow from operations. To compensate for this exposure, providers may have to sell stock which in turn diminishes their asset base. The Regulator will continue to engage with providers with high levels of indebtedness and monitor available facilities through the QS.

The amount of debt held at variable rates as a percentage of total debt increases from 29% in 2014 through to 38% in 2018. In practice, the proportion of variable rate debt will reflect the fixing arrangements in place at the time of the plan. The Regulator expects providers to consider exposure to interest rate risk on an on-going basis as part of an active treasury management policy.

Providers have benefitted from a period of historically low interest rates with the Bank of England base rate remaining at 0.5% for over five years. Although frequently subject to adjustment and the subject of much speculation, it is widely forecast that interest rates will rise in the short to medium term. The risks associated with the finance market remain a key concern for the sector. It is essential that providers' business plans are sufficiently robust to withstand volatility in the financial markets. Figure 14 below compares providers' assumptions on LIBOR over the first five years of forecasts relative to the central forecast published by HM Treasury<sup>12</sup>.

**Figure 14**  
**LIBOR forecasts**

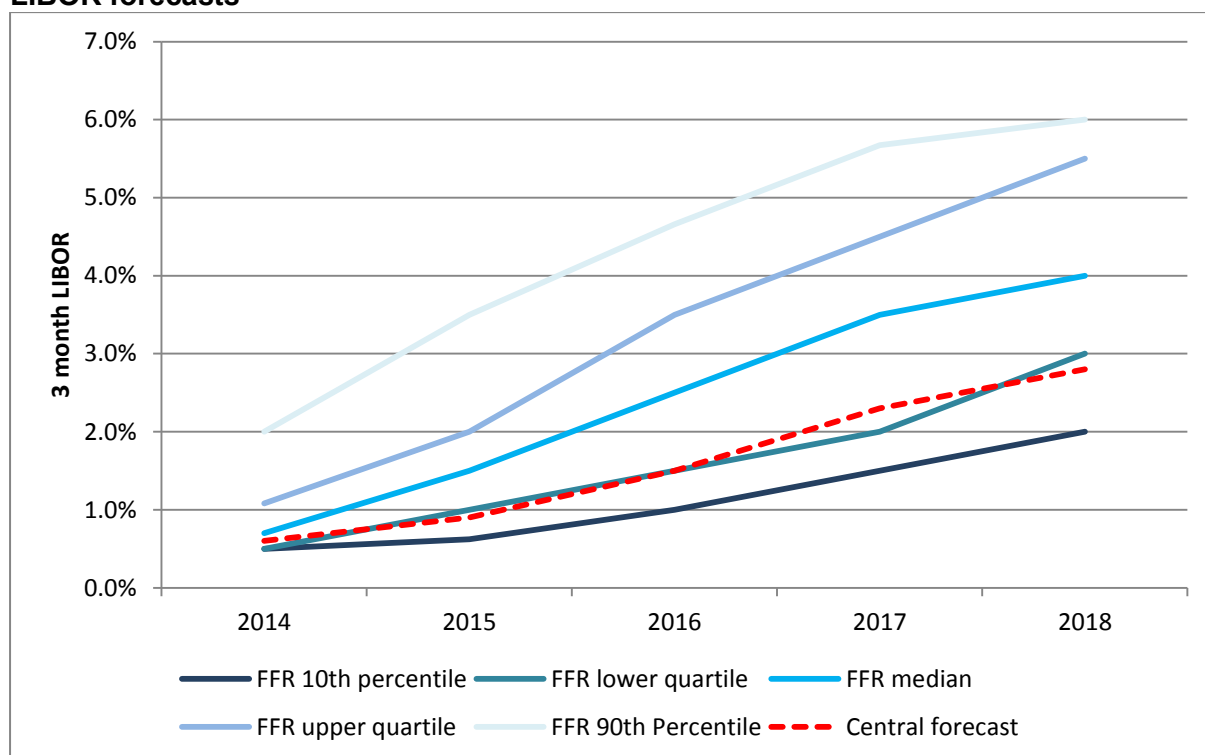


Figure 14 shows that in the short term, the majority of providers have adequately planned for increasing interest rates. The graph compares provider assumptions against the latest central forecast published by HM Treasury. The comparison is favourable due to recent downward adjustments in the short term forecast increase in interest rates. At the point where the majority of providers prepared their business plans, contemporaneous central forecasts indicated a sharper rise in interest rates.

Individual providers with a high proportion of variable rate debt and those who have not made reasonable interest rate assumptions are at high risk. The Regulator continues to engage with providers where business plans are not sufficiently robust to withstand an above forecast increase in interest rates.

Potential interest rate volatility also affects providers who make use of free standing financial derivatives. The risk is concentrated in 50 individual providers and uncertainty on interest rates means that collateral requirements remain a long term exposure.

<sup>12</sup> Source: 3 month LIBOR HM Treasury compiled forecasts, JCRA and Canaccord as at February 2014.

The effective interest rate for the sector as a whole, based on the Global Accounts data is currently 5.1%. However, when LIBOR was at a pre credit crunch high of circa 6% in 2008 the effective interest rate for the sector was 6.3%.

Approximately 83% of sector borrowing is traditional bank debt (as opposed to the capital markets). It is estimated that a significant amount of this finance is 'underwater' i.e. it is costing banks more to borrow the cash than they receive from lending. As banks now lend at higher loan margins and shorter terms, the opportunity for lenders to re-price existing debt remains attractive.

The Regulator, informed by market opinion, believes that loan margins for new or re-priced debt are likely to be between 2% and 3.5% over the period to 2017. This compares to historic margins of 0.3% to 0.5%. These higher margins will affect new debt raised and also any historic debt that is re-priced. LIBOR historically averaged 5.6% between 1993 and 2008. Future increases in the rate of LIBOR will affect all variable rate debt and the interest rate at which providers can secure fixed rate debt in the future.

It is very difficult to forecast the future path of LIBOR. However, it is possible to demonstrate how sensitive provider business plans are to movements in interest rates and lending margins. If the effective interest rate were to increase by just 1% from the level assumed in provider forecasts, then total interest payable would increase by an average of £660m per year. This would reduce the overall forecast level of surplus by around one third.

## 2. Housing market sales exposure

Providers' financial forecasts include a significant amount of revenue from housing sales. In total, £13.7bn is forecast from sales receipts between 2014 and 2018, generating a surplus of £3.3bn.

Properties developed for sale are expected to contribute half of all sales revenues to 2018. Providers are increasingly reliant on sales activity to cross subsidise development of properties for rent. Margins on properties for sale increase steadily throughout the period but it is the increased activity level that represents a step change for the sector:

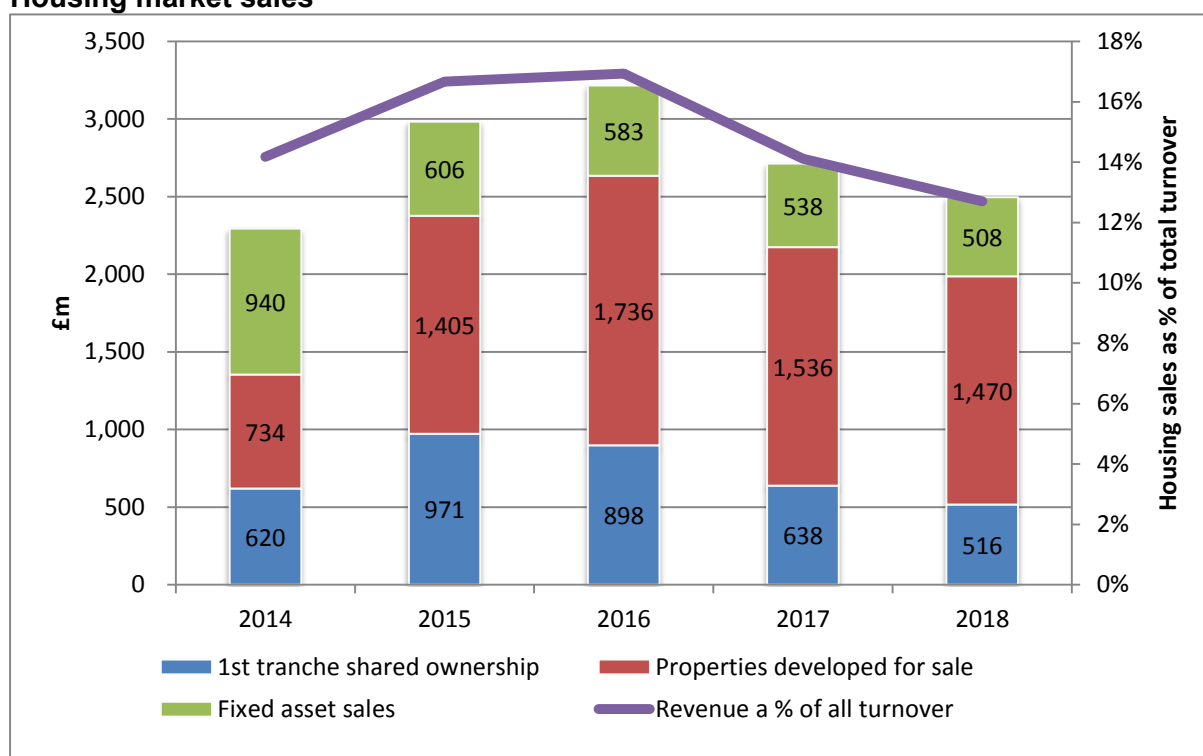
**Table 16**  
**Properties developed for sale**

Figures in £ million & %	2014	2015	2016	2017	2018
Receipts from properties developed for sale	734	1,405	1,736	1,536	1,470
Year on year increase %	6%	<b>92%</b>	23%	(12%)	(4%)
Contribution from properties developed for sale	141	263	356	322	336
Year on year increase %	7%	<b>87%</b>	35%	(9%)	4%
<i>Margin on properties developed for sale</i>	<i>19%</i>	<i>19%</i>	<i>20%</i>	<i>21%</i>	<i>23%</i>

As shown in figure 15 overleaf, this market is expected to increase in importance to the sector. In 2014 the sector expects to generate 32% of its sales revenues from properties developed for sale, rising to 59% of all sales revenues in 2018.



**Figure 15**  
**Housing market sales**



Providers have historically offered shared ownership properties as their predominant new build sales offer. Forecasts show this activity peaking at £971m of sales in 2015 and decreasing thereafter. These forecasts pre-date the forthcoming bidding rounds for AHP 2015-18 and The Mayor’s Housing Covenant (THMC) 2015-18, in which shared ownership is expected to play a significant part in the overall programmes. In reality, shared ownership is unlikely to tail off as projected.

In respect of shared ownership sales activity, there is a clearly identifiable peak in 2015. Although the sector is currently benefitting from an upturn in the housing market, the lessons from 2008 and 2009 should not be forgotten. A downturn in the housing market left some providers exposed with significant numbers of unsold shared ownership properties. Government intervention, through additional grant, was required to remedy the situation.

House prices are forecast to increase, however there is significant regional variation and high levels of uncertainty. In addition, Help to Buy equity loans and the mortgage guarantee scheme provide an element of competition to the traditional shared ownership model. Business plans must be sufficiently robust and have mitigation strategies in place to cope with a downturn in the housing market. Where providers have a high proportion of shared ownership sales activity, unsold stock is monitored by the Regulator through its Quarterly Survey.

Figure 15 shows sales of fixed assets of £3.2bn over the five year period. Sales of fixed assets include staircasing sales of shared ownership properties, Preserved Right to Buy / Right to Acquire sales, sales of tenanted stock to other registered providers, sales of void properties and sales of non-housing fixed assets. In 2014 fixed asset sales are significant at £940m, 41% of all sales revenue for the year. In later years, sales values average £560m at around 20% of total sales. Sales of fixed assets tend to be highest in the first year of financial forecasts as providers include sales for which they are at an advanced stage of negotiation before taking a more prudent approach to more uncertain sales in later years.

### 3. Development programme

Figure 16  
Spend on new properties & new units<sup>13</sup>

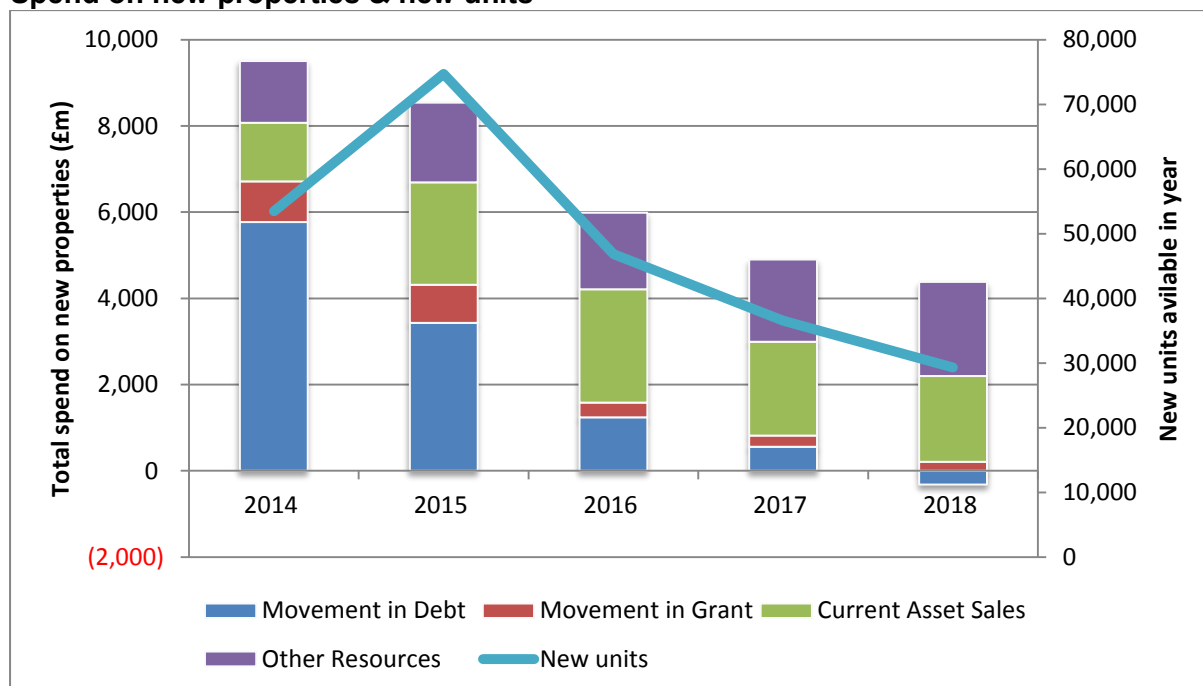


Figure 16 shows that most of the development activity takes place in the first two years of the forecast, corresponding with the delivery of the AHP 2011-2015. The back loading of the AHP into the final two years is to be expected. Total spend on properties peaks in 2014 and 2015 at £9.5bn and £8.5bn respectively. The discrepancy between peak expenditure and new units available reflects the timing of cashflows with a proportion of spending relating to properties completed and made available for sale or rent in later years.

The management of a development programme carries significant risk in its own right, with the sector forecasting to develop 128,000 units in the first two years of the forecast. Peak levels of development in the housing market over the first two years of the forecast could force construction prices up. Effective management and monitoring of often volatile development cashflows over this period is essential.

An increasing reliance on debt to fund new development increases exposure to finance market risk. In 2014, 61% of the activity will be funded through borrowing. Over the initial two year development peak, £9.2bn of the total spend will be financed through debt. Other resources become an increasingly significant contributor to the financing of new development, moving from 15% of all funding required in 2014 to 54% in 2018. A high proportion of other resources relates to surpluses reinvested into development programmes.

The risk increases with the extent to which providers are reliant upon cashflow from property sales to cross subsidise further development. The sector is forecasted to deliver 23,000 shared ownership properties and 8,500 properties for outright sale in 2014 and 2015. With the concentration of activity over this period, exposure to the housing market is particularly significant.

<sup>13</sup> Total spend on properties includes payments to acquire or develop properties, cost of sales: shared ownership first tranche and cost of sales: properties developed for sale.

The forecasts show development activity peaking in 2015. However, the forecasts were completed prior to the announcement of the AHP 2015-18. It is expected that development activity will be extended beyond 2015 in next year's aggregate forecasts.

## 4. Diversification

In the FFR, income and costs of non-social housing activities are split between properties developed for sale and other non-social housing activities. Properties developed for sale and the risks associated have been considered above. The sector undertakes a diverse range of other non-social housing activities including market rent, housing management services, student accommodation, care homes, commercial and leisure activity and regeneration.

In total, other non-social housing activity comprises around 6.5% of overall turnover in each of the first five forecast years. Operating margins on these activities are expected to increase steadily from 13% in 2014 to 19% in 2018. These margins are significantly lower than the overall operating margin and, consequently, these activities contribute around 4% of operating surplus. The Regulator will continue to engage with providers to ensure they are clear on the control mechanisms between the regulated and non-regulated elements of non-social housing activity to ensure social housing assets are not unduly put at risk.

Whilst non-social housing revenue is not material to the sector as a whole, activity is concentrated in relatively few providers meaning that some business plans are reliant on these activities. In over 90% of providers, non-social housing represents less than 10% of turnover.

The ten providers forecasting the largest non-social housing revenues are forecasting a total of £4.3bn over the first five years, 72% of the total non-social housing revenue in the sector. This group of providers are forecasting that 29% of its total turnover for this period will derive from non-social housing.

In aggregate over the first five years, these providers forecast a surplus of £437m on these activities, representing around 36% of total surpluses. At 9%, these activities are clearly providing lower margins than the core social housing lettings activity. However, it is not possible to determine whether these activities provide a positive cross-subsidy to social housing without knowing the proportion of interest cost attributable to each.

## 5. Existing stock

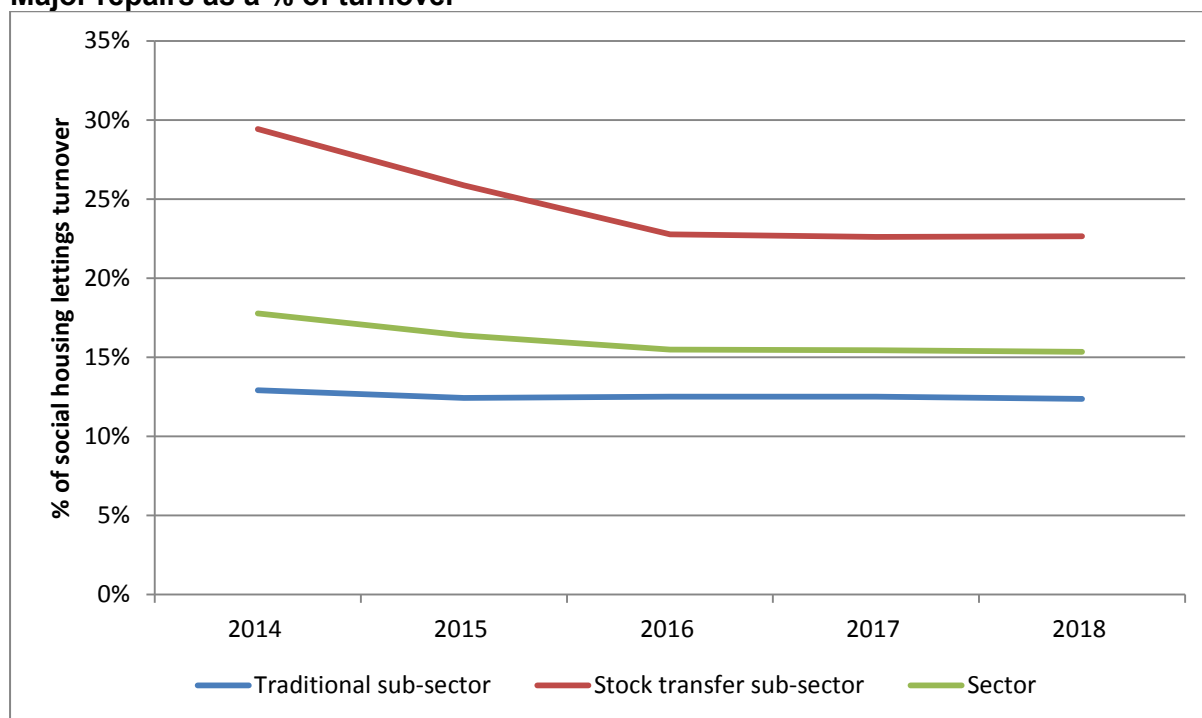
Whereas the sector has successfully met the challenge to bring its stock to the Decent Homes Standard, there is a continuing requirement to invest in existing stock.

**Table 17**  
**Major repairs**

Figures in £million and %	2014	2015	2016	2017	2018
Major repairs (£m)	814	792	750	767	749
Capitalised repairs and maintenance costs (£m)	2,061	1,855	1,753	1,730	1,731
Total major repairs (£m)	2,875	2,648	2,503	2,497	2,481
<b>Total major repairs per unit (£)</b>	<b>1,090</b>	<b>991</b>	<b>918</b>	<b>905</b>	<b>892</b>
Capitalisation rate (%)	72%	70%	70%	69%	70%
Depreciation (£m)	1,538	1,671	1,799	1,881	1,974

Over the five year period, total expenditure on major repairs is forecast to decrease by 14%. Total major repairs cost per unit decreases by 18% over the same period. The figure below shows major repairs as a % of turnover by sub-sector.

**Figure 17**  
**Major repairs as a % of turnover**



In early years, stock transfer providers typically have high major repairs expenditure linked to stock improvement programmes. As the sub-sector matures, major repairs as a percentage of turnover are gradually moving closer to the comparable figures in the traditional sub-sector.

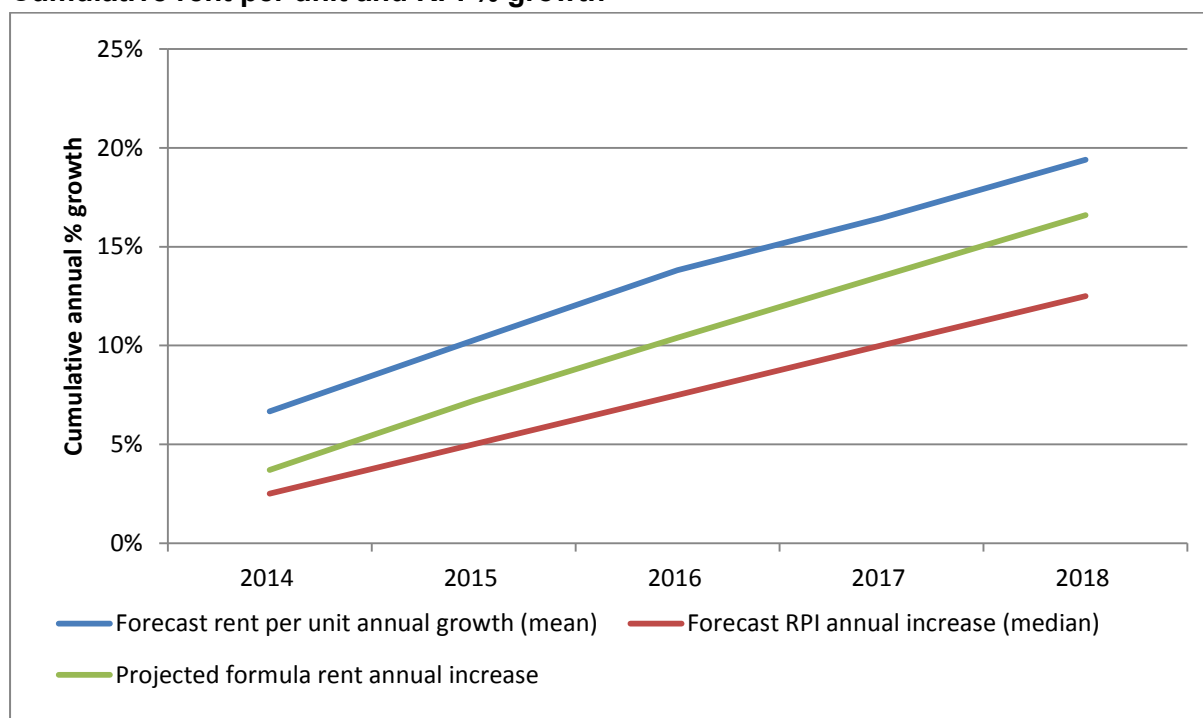
The capitalisation rate in the aggregated forecasts of circa 70% is below that reported in the Global Accounts (78% in 2013). This is partly attributable to providers adopting conservative assumptions in their forecasts. In the stock transfer, sub-sector covenants are often cashflow based and therefore the distinction between capitalised and expensed major repairs in business plans is not so relevant.

Between 2014 and 2018, depreciation of social housing properties exceeds capitalised major repairs for 53% of providers. For 29% of providers depreciation outstrips total major repairs. Providers need to ensure that they invest appropriately in their stock to maintain properties at a sufficiently high standard.

## 6. Rental market exposure

Between 2003 and 2015, social rents increased annually by RPI +0.5% plus up to £2 a week convergence towards no more than 105% of formula rents. The details of a new rent settlement post 2015, will be the subject of a revised rent direction in 2014. However, permitted increases in rent will be linked to CPI +1% for 10 years from 2015 and the ability to converge towards formula rent will only be available on re-let.

**Figure 18**  
**Cumulative rent per unit and RPI % growth<sup>14</sup>**



Over a five year forecast period, average rent growth is greater than the projected increase in formula rent (based on RPI +0.5% pre March 2015 and CPI +1% thereafter). This is partly a result of increasing numbers of Affordable Rent properties (let at 80% of market rent) and new social rent units let at higher rent levels. Furthermore, the majority of FFRs were submitted prior to the rent settlement announcement with forecast rents post 2015 tracking RPI +0.5%, and a number of providers assuming upward convergence of rents of up to £2 a week.

In practice, annual rent increases will continue to reference inflation rates from September in the previous year. This gives providers a degree of certainty over forecast rent revenues and allows them to mitigate this risk by planning their cost base in line with income projections. However, over the next five years, the opportunity for most organisations to increase rents is forecast to be more constrained than under the previous regime. In addition to the loss of convergence, the long term CPI +1% is expected to be 0.8 percentage points lower than RPI + 0.5%<sup>15</sup>. It is important that business plans are subject to appropriate sensitivity analysis in order to assess whether they can withstand the impact of different inflation scenarios.

The Affordable Rent product (AR) links rents to market levels and generally involves shorter fixed term tenancies. The SDR reported that 284 providers owned just fewer than 40,000 (2012: 7,000) AR homes as at 31 March 2013. Over the first five years of the forecast, the sector will develop or convert an additional 160,000 AR homes. The product is forecast to account for approximately 7% of all social housing stock managed by the sector in March 2018. Although AR accounts for only a small proportion of stock and activity in the sector, the risk profile, including levels of voids and arrears, is different to traditional social rented properties. Where providers have a high proportion of AR properties, risk needs to be understood and effectively managed.

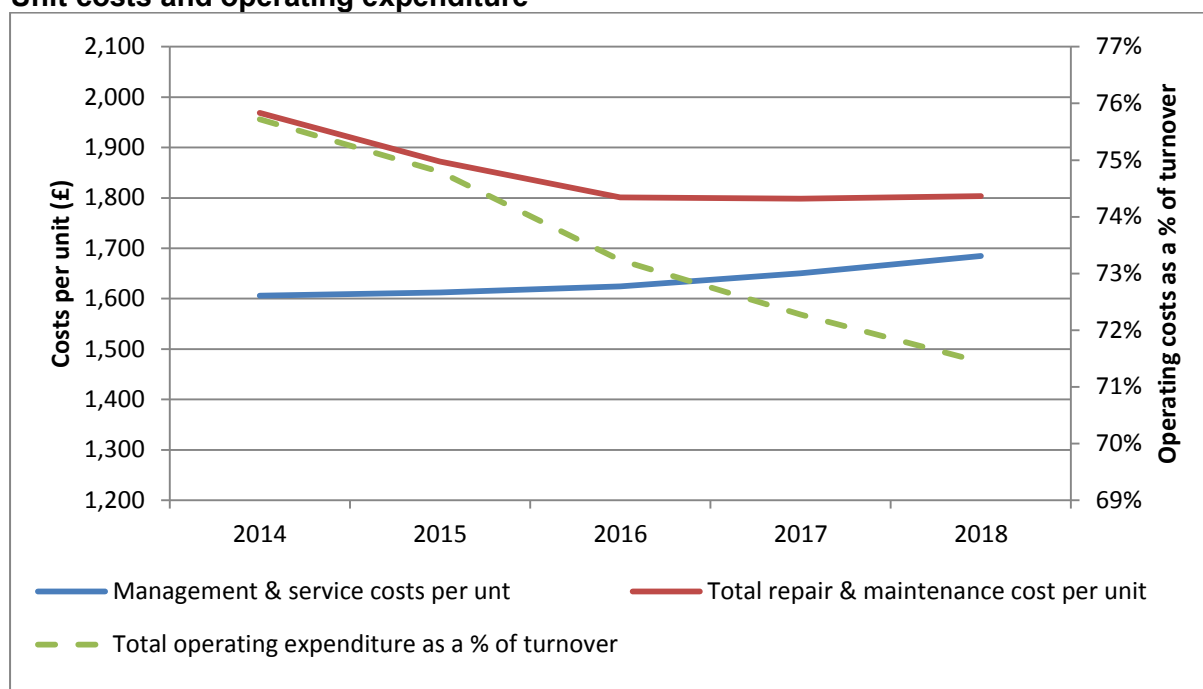
<sup>14</sup> Increase in formula rent is based on RPI+0.5% up to the year ending March 2015 and CPI +1% thereafter. RPI and CPI forecasts are HM Treasury compiled central forecasts as at Nov 2013.

<sup>15</sup> HM Treasury compiled central forecasts as at Nov 2013

## 7. Cost risks

With increased focus on diversified activity, welfare reform, new funding streams, income volatility and Affordable Rent, it is important providers continue to control their cost base. Delivering efficiency savings or providing enhanced services for the same money will be increasingly challenging for the sector, especially as it comes under greater scrutiny.

**Figure 19**  
**Unit costs and operating expenditure**



Total operating costs as a percentage of turnover decrease from 76% to 71% over the first five years of the forecast. Over the same period, management and service costs per unit increase by 5% and total repairs and maintenance costs decrease by 8%. Both cost indicators represent real savings with average cumulative RPI forecasts at 12.5% over the five year period.

Where efficiencies are built in to forecasts, it is essential they are reasonable and that there is a credible and deliverable plan for achieving them. Providers should plan, and allow flexibility in their financial forecasts, for fluctuations in their running costs which may be linked to macroeconomic conditions and cyclical changes.

Pensions continue to exert an upward pressure on costs. Many providers have defined benefit pension schemes on which deficits are expected to be high. Providers need to plan carefully so that they mitigate their exposure to rising pension costs and appropriately evaluate the costs of continuing to provide these benefits.

## 8. Welfare reform risk

The Welfare Reform Act (March 2012) confirmed a number of changes to the benefits system to take place between 2013 and 2017. Together they spell a significant reduction in housing-related and other benefits for many social housing tenants, which could impact on their ability to pay rents. Providers' business plans must be able to withstand any volatility caused by these changes.

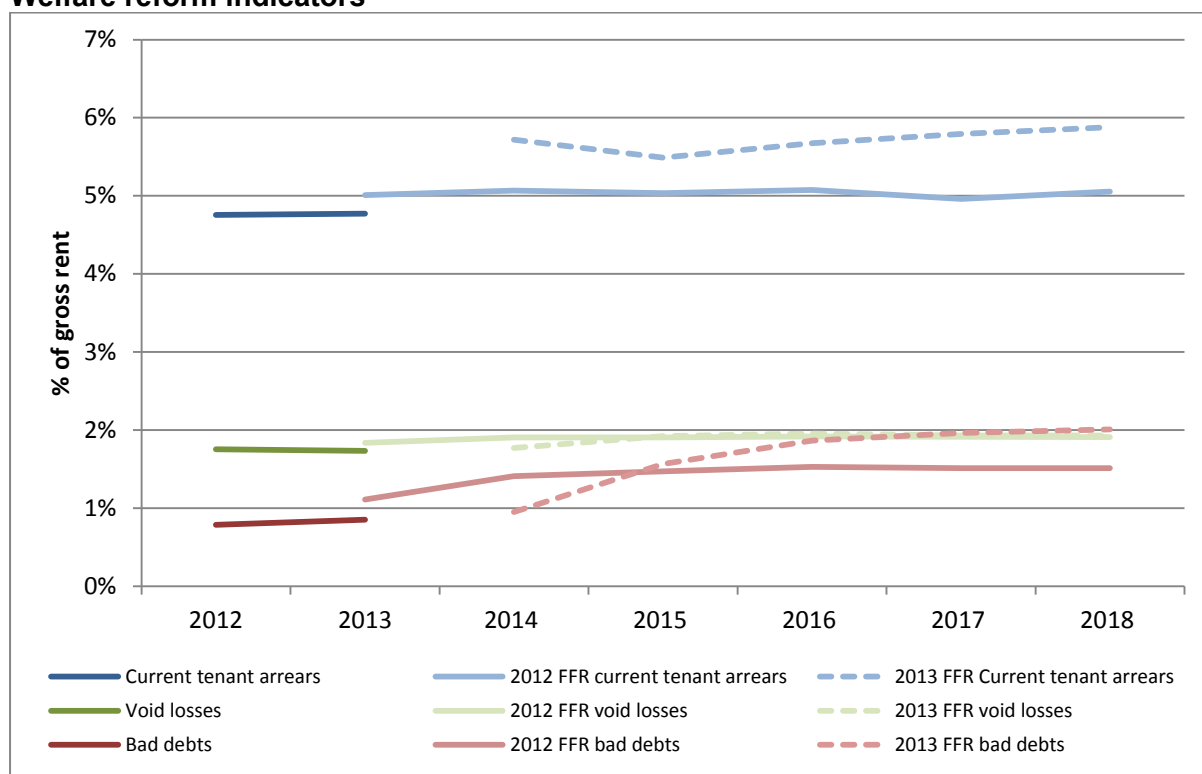
**Table 18**  
**Welfare reform indicators**

% of gross rent	2014	2015	2016	2017	2018
Void losses	1.8%	1.9%	2.0%	1.9%	1.9%
Bad debts	0.9%	1.6%	1.9%	2.0%	2.0%
Current tenant arrears	5.7%	5.5%	5.7%	5.8%	5.9%

The forecasts show that in aggregate, the sector has made some provision for the impact of welfare reform. Rent losses from bad debts increase by 112% over the first five years of the forecast. Increases in void losses and current tenant arrears are relatively minor.

Assumptions vary significantly across the sector and it is essential that all providers have planned adequately for the potential impact of welfare reform.

**Figure 20**  
**Welfare reform indicators**



The figure above shows that in aggregate, the sector forecasts greater levels of current tenant arrears and rent losses from bad debts than it has historically experienced. Furthermore, in 2013 providers have been more prudent in respect of both indicators than in the previous year's forecasts.

In respect of void losses reported historic performance, 2012 forecasts and 2013 forecasts are closely aligned at just under 2% of gross rent. The Regulator will continue to monitor key indicators through the Quarterly Survey to assess whether providers remain within the parameters of their business plans.

# D2 – Value for Money

## **The Value for Money standard and self- assessment**

The Regulatory Framework, published in April 2012, included a new Value for Money (VfM) standard. This standard requires registered providers to articulate and deliver a comprehensive and strategic approach to achieving VfM in meeting their organisation's objectives. Boards are also expected to demonstrate to stakeholders how they are meeting the standard. As part of that process, on an annual basis, they should publish a robust self-assessment which sets out in a way that is transparent and accessible to stakeholders, how they are achieving VfM in delivering their purpose and objectives. The standard sets a specific expectation that the assessment shall:

- Enable stakeholders to understand the return on assets measured against the organisation's objectives.
- Set out the absolute and comparative costs of delivering specific services.
- Evidence the value for money gains that have been and will be made and how these have and will be realised over time.

Different providers have taken different approaches to communicating their approach to VfM to stakeholders, and many providers have produced discrete, detailed self-assessments.

However, the 2012 Accounts Direction stipulated that all providers should undertake and publish within either their board report or Operating and Financial Review (OFR), an assessment of the performance for the year. The assessment should set out to stakeholders how the provider is achieving VfM in delivering its purpose and objectives, in accordance with the Regulator's standard on VfM. Where providers publish further detailed material relating to the self-assessment, this should be clearly signposted within the OFR and published at the same time.

The first such self-assessments were included in providers' accounts for 2013. Some also produced additional material in separate public statements, with links from OFRs. These have now been analysed by the Regulator. The Regulator does not prescribe a particular approach to meeting the requirements of the VfM standard. The standard does not seek to direct where providers apply their resources, dictate organisational form, or encourage providers to focus on costs at the expense of quality of services. However, it does set out an expectation that self-assessments should be transparent to stakeholders and address the specific requirements set out above.

This section provides global commentary on the sector's first self-assessments, drawing out common themes and issues. The main focus of this commentary is on the assessments provided as part of providers' accounts (or linked to said accounts), and the extent to which they considered the specific transparency requirements of the standard rather than all aspects of providers' response to the VFM standard.

## **Considering the specific requirements of the self-assessment**

The majority of providers sought to address the specific requirements of the standard to some degree. However, the extent to which they did so varied significantly. Some self-assessments provided external stakeholders with sufficient information to reach an informed judgement about all aspects of a provider's performance against the expectations of the standard. However, many others were less transparent, and had evidence gaps which would



make it more difficult for an independent observer to reach an informed conclusion on one or more of the standard's requirements.

## **Return on assets**

In general, the self-assessments provided least evidence to demonstrate providers' understanding of the return on their assets. The self-assessments that provided the greatest degree of assurance showed an understanding of the value of assets in the context of delivering the organisation's own objectives. This could include details of the financial, social or environmental return on those assets at a granular level, showing an appreciation of the differing values of different properties according to location or type of stock. Consideration was also given to how this information was used to inform business decisions and support delivery of the provider's objectives. For example, showing how their understanding of costs and asset values informed decisions on maintenance and capital investment, or decisions on retention, conversion or disposal of stock.

Self-assessments that provided less assurance on this aspect of the standard commonly did consider the value of assets, but often only for the organisation as a whole. For example, by citing the balance sheet valuation of the asset base. Many provided much less evidence of understanding variations in the performance of assets across their stock (for example by considering variations in the Net Present Value of their stock holdings, differences in the social return to tenants or the variations in environmental performance of their assets). Or, of how their understanding of the return on their assets informed the organisation's decision making.

A number of providers acknowledged in their self-assessments that the publication of the VfM standard in 2012 had prompted them to take a fresh look at their approach to understanding their asset base. It was common for self-assessments to cite on-going work to appraise providers' return on assets in more detail, but to note that this had not been completed in time to inform the first self-assessments. The Regulator expects that this will allow more providers to provide a more transparent assessment of the return on their assets in future years.

## **Absolute and comparative costs of delivering services**

In general, providers' responses on costs were significantly more detailed and comprehensive than those on return on assets.

The self-assessments that provided a significant degree of assurance on this requirement of the standard were more numerous. These self-assessments provided quantified absolute cost data for a range of specific named services, and provided comparisons with the provider's performance in previous years, and with the performance of a relevant peer group, sometimes, but not exclusively, using third party benchmarking services.

Comparisons were systematic, transparently allowing external stakeholders to identify areas of performance where the provider compared unfavourably with its peers as well as those where it compared well. Commentary was provided alongside the data which provided a balanced and reasonable interpretation of the results. Cost data was also clearly linked to output and effectiveness data on performance in delivering those services, allowing stakeholders to reach judgements on the efficiency of delivery of these services as well as economy.

Other self-assessments shared some, but not all of these characteristics. Providers often included some quantified cost data, but did not always provide meaningful comparative data,

either with the provider's own past performance or with other providers. Some providers did provide comparative data, but it was not clear who they were comparing themselves with, or whether this was a relevant comparison given their location and nature of their business. Others provided comparisons selectively, only showing data on services where they compared favourably with other providers, denying external stakeholders the opportunity to reach a judgement on their performance across the full range of their activities. Not all specialist providers publish peer comparator analysis, although a number did so, making use of qualitative as well as quantitative analysis. It was common for providers to cite use of benchmarking tools, to gain an understanding of the relative cost of delivering their services, but without providing much actual cost data to transparently demonstrate this understanding to stakeholders.

## **Evidence for past VfM gains and how these have and will be realised over time**

The sector's response on past and future VfM gains was again mixed. In general, responses were more detailed with regard to past gains than future ambitions.

The responses that provided greatest assurance provided evidence of past VfM improvements; performance management and scrutiny functions to deliver further progress; and clear, measurable targets for future improvements. Evidence of past improvements demonstrated either or both cost savings and/or improved service efficiencies, with specific examples of savings or efficiencies placed in the context of the wider business performance and objectives. Where cost savings were identified, these were considered in relation to the service outcomes that were delivered, demonstrating a focus on efficiency and effectiveness, not just economy. Measurable targets for future gains were set out, allowing stakeholders to hold providers to account on the delivery of these ambitions, and judge whether continuous improvements are being made.

Providers for whom the Regulator had less assurance generally only covered some of these areas. It was common for providers to cite specific examples of a cost saving generated by a past decision (e.g. a specific contract renegotiation or organisational restructure), but these were often isolated examples, not placed in the context of the provider's wider business or objectives. There was not always clarity about how significant such savings were in the context of the provider's overall cost base, what impact it had had on delivery of key outcomes, or how any savings had been utilised elsewhere to deliver the provider's objectives. It was more common for providers to set out information of specific cost savings, than to set out systematic evidence across the business. Relatively few providers set out significant details of future ambitions for improvements, and often these were not measurable.

## **Future self-assessments**

The Regulator considers the assurance it has for providers' compliance with all aspects of the standard and the key focus is that providers should seek to deliver value for money throughout every aspect of their business. In regulating the VfM standard, the Regulator will consider a range of evidence from regular engagement with providers. However, the self-assessment remains a key element of the VfM standard and will continue to be a key source of (potential) assurance for the Regulator. Providers will need to be increasingly transparent in articulating their response to the standard to their stakeholders.

For future self-assessments, the Regulator will expect providers to more transparently demonstrate how they are addressing all of the specific requirements of the standard. The Regulator does not prescribe the precise form of providers' responses or mandate the

inclusion of particular data or specific metrics. However, the level of detail included in the self-assessments should be sufficient for any stakeholder reading the assessment to reach an informed view of the provider's performance against all elements of the standard. In particular, the Regulatory Framework makes clear that providers should seek to deliver continuous improvement in both running costs and the performance of their assets. It should be clear to stakeholders from reading a provider's self-assessment whether or not this improvement is being achieved, and what the provider plans to achieve in future.

# D3 – Accounting changes

## Sector accounting changes

The sector is in the middle of a process that will result in a very significant degree of accounting changes. This arises from the introduction by the Financial Reporting Council (FRC) of Financial Reporting Standard (FRS) 102. FRS102 is planned to come into effect for accounting years commencing 1 January 2015 and achieves the introduction of International Financial Reporting Standards (IFRS) for small and medium sized enterprises. Public Limited Companies and the public sector have already introduced IFRS, so this fills in a gap, ensuring that all sectors report their accounts in a consistent and transparent method.

The interpretation of FRS102 for the social housing sector is achieved through the publication of a Statement of Recommended Practice (SORP). This is undertaken under the auspices of the various housing federations, but is primarily led by the English National Housing Federation (NHF). The consultation process for the SORP 2014 has been long and full of debate, but the results are moving towards finalisation as this document goes to press and are due for publication in the summer of 2014. Implementation will come into effect for accounting periods commencing 1 January 2015 – so will mainly apply to the large number of PRPs with accounting periods ending 31 March 2016.

## Main changes

FRS102 covers almost every aspect of the reported financial performance of providers, but there are four main changes that have attracted particular interest:

- Housing properties and impairment
- Government grants
- Financial instruments
- Reporting of pension deficits and participation in the Social Housing Pension Scheme (SHPS).

## Housing properties and impairment

Under the new SORP, providers can continue to account for properties at either historic cost or valuation. The vast majority of properties are currently held within provider accounts at cost. Providers can also bring the properties onto the balance sheet at valuation when reported for the first time under FRS102. That valuation can subsequently be treated as the historic cost. If many providers take this approach it will result in a significant increase in the size of providers' balance sheets. This is because many properties are currently reflected in the accounts at values that date back 10 to 20 years.

Grant will no longer be deducted from properties at historic cost, but instead will sit as a liability within creditors. This will have the effect of making the depreciation charge higher for providers and further increasing the size of the balance sheet. However, higher depreciation will be offset by the amortisation of grant into the income and expenditure account.

The most significant change for providers will be the nature of possible impairment calculations that need to be carried out. The importance of this issue was uncovered during the drafting of the SORP, following discussion with the FRC. It remains something that is causing considerable debate amongst providers and auditors.

At the time of writing, the outcome of the SORP consultation, and in particular the potential for impairment of new and existing stock, is unclear. However, the Regulator will increasingly look for assurance that providers understand the potential risks and are well-prepared for potential changes.

## **Government grants**

As with the current UK Generally Accepted Accounting Practice (GAAP), the treatment of government grant depends on whether properties are held at valuation or cost, but with both methods there are significant changes proposed under FRS102.

If properties are held at cost, then the grant will no longer be netted off the value of the asset, but instead will be shown as a liability within creditors and amortised over the life of the property. In other words, the grant will be written off over the same period the structure of the property is depreciated (the accrual model). This will have the effect of increasing the carrying value of the properties on the balance sheet and also increasing the depreciation charge in the income and expenditure account, although this will be partially offset by the amortisation of the grant.

If properties are held at valuation then, as with current UK GAAP, the grant will not appear on the balance sheet. However, unlike current practice the grant will be shown as income in the year the scheme is completed (the performance model), this could mean that reported surpluses are significantly higher as they reflect the total amount of grant received. Whilst this will not raise an issue with covenant compliance, it will make understanding underlying financial performance more difficult as this may introduce a degree of volatility year on year within the income and expenditure account.

## **Financial instruments**

Some types of embedded and standalone derivatives and finance leases may need to be valued annually and any resulting changes in that value reflected in the income statement. This is a complex area within FRS102 and depends upon whether an instrument is “basic” or “other” (requiring an annual fair value assessment). It is also the one that has been the most heavily trailed and debated. Whilst this does not mean that all providers will be aware of the potential impact it will have on their accounts, it does mean that the issues are well understood by auditors and professional advisors.

Initially the problem for providers will be the amount of work they have to do to establish how their various financial instruments are affected. This is particularly difficult as the definition is drawn very broadly from straightforward loans through to free standing interest rate swaps and currency transactions, but can also include items such as intercompany loans, deposits and on lending to other providers. This is an issue because, under FRS102, there are important decisions that need to be made at the start of reporting that are difficult to reverse later, including whether hedge accounting rules can be used. The risk here is that providers leave these decisions too late and are then forced down a reporting route that is not suitable for their financial structure.

The most significant issue for providers is that, in the on-going reporting of their financial performance, if they have non-basic instruments held at fair value, the annual revaluation will lead to considerable volatility in the reported surplus year on year. This again could have an impact on covenant compliance (discussed below) but also on the ability of users of the accounts to understand the underlying trading performance of a provider.

## Pension issues

Many providers are members of the SHPS. Currently providers recognise only amounts payable at any point in time. Under FRS102, providers will have to recognise any obligations they have with the pension scheme to fund the deficit position on all their multi-employer schemes. For the social housing sector this means that associations will need to reflect the recovery plan for SHPS on their balance sheets. At its last triennial valuation, the SHPS scheme was significantly underfunded and associations have agreements to make significant payments in the future that will need to be recognised.

Whilst this does not change the nature of the liabilities, their presence on the balance sheet may make it more difficult for providers and their stakeholders to ignore them and it will highlight to funders the true nature of the position in a way that has not happened in the past.

## Work to be done by providers

Although the new SORP is yet to be finalised, enough is known of the main areas of change for providers to be working on them already. An analysis of financial instruments and a review of loan documentation are essential to ensure that they are properly defined. Implementation of FRS 102 comes into effect in January 2015 and for the majority of providers the changes will need to be reflected in accounts for the period ending 31 March 2016. However, providers will need comparative figures for the previous year. The opening balance sheet for this transition date will be easier to review at the time rather than some months later.

Some choices on the treatment of intra-group loans and certain options for the treatment of hedge accounting must be made before the transition date (1 April 2014) so providers should discuss these with their auditors as a matter of urgency if they are relevant.

## What do these changes mean for the Regulator?

The Regulator does not have a formal role in agreeing or implementing the new SORP. However, the introduction of FRS102 via the SORP will have a significant impact on the reported position of the social housing sector and as such the SHR has a direct interest in the outcome of the consultation. The Regulator has a particular interest in those elements that could cause problems for providers including the greater volatility in reported surpluses due to the fair value of financial instruments and the as yet unresolved issues around the potential for impairment of social housing assets.

The risks for housing providers fall in to three categories:

- **Agreement of funders to restated covenants:** Where accounting standards change, it is normal for funders to agree to either restate the covenants so that under the new accounting standards providers are in an analogous position as under the previous standards, or for the covenants to be continued to be reported against under the old standards. The change in treatment of grant will affect gearing covenant calculations for some providers. However, not all gearing calculations include grant and the implications will therefore depend on providers' individual circumstances. Whilst there is no definitive view, initial advice is that the changes in standards are so fundamental it would be very difficult to keep effectively two books of accounts that are both audited. It is therefore that providers and lenders will need to negotiate restated covenants

- **Impact of one off changes:** The introduction of the SORP could lead to some significant one off changes in the accounts, which could lead to covenant breaches and require a waiver from lenders.
- **On-going issues of covenant compliance:** As highlighted throughout this section, the overall impact of the SORP will be greater volatility in reported performance therefore making on-going covenant compliance more difficult to manage. This may also have the effect of making providers more conservative to ensure their plans have sufficient capacity to absorb the increased volatility.

It is not in the remit of the Regulator to shield the sector from these risks, which need to be managed by individual providers. However, the Regulator does have a legitimate interest in ensuring the sector manages the risks appropriately.

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The Homes and Communities Agency is committed to providing accessible information where possible and we will consider providing information in alternative formats such as large print, audio and Braille upon request.