New Financial Reporting Standard and FE/HE Statement of Recommended Practice (SORP)

September 2013

Background

The new Financial Reporting Standard (FRS 102) was approved in March 2013 and replaces all existing UK financial reporting standards, reducing the length from over 3,000 pages to 250 pages. It will apply to all unlisted entities, including not for profit organisations. FRS 102 adopts an international-based accounting framework and is based on the International Financial Reporting Standard (IFRS) for Small and Medium sized entities. Over the last ten years the Financial Reporting Council has endeavoured to align UK Generally Accepted Accounting Standards with International Financial Reporting Standards, and as a result the newer standards are already closely aligned to the IFRS equivalent standard.

A new Further and Higher Education Statement of Recommended Practice (SORP) has been developed to provide guidance and clarification on sector specific issues and to enhance comparability across the sector. The SORP is out for final consultation until 17 November with final publication expected in early 2014. The draft SORP, consultation questions and further information are available on www.fehesorp.ac.uk.

FRS 102 and the new SORP are applicable to Universities for financial years commencing on 1st August 2015. The comparative year's results will also need to be presented under FRS 102 and the new SORP, so in fact conversion is required in less than a year, from 1st August 2014. Thus institutions need to ensure they are fully prepared for the changes and that governing bodies and stakeholders are aware of the implications of the changes.

Potentially Significant Changes

Revenue Recognition

Changes to revenue recognition are likely to result in more volatile surpluses and deficits.

- FRS102 prohibits the accruals method for accounting for government grants. Unless there are specific performance conditions to be met, then the grant income must be recognised immediately in full rather than being deferred and released to the Income and Expenditure account over a period of time. The removal of the deferred grants adjustment from the Financial Statements will result in a one-off step change to balance sheets. *This is to be applied retrospectively and therefore it is necessary to assemble all research and other agreements to assess whether they contain performance conditions. It may be useful to obtain external auditors' agreement.*

- Similarly, endowments will no longer be reflected in the Balance Sheet via the Statement of Recognised Gains and Losses, but will be credited to the Income Statement and then transferred to restricted reserves.

Employee Benefits

FRS 102 requires accruals for holiday and sabbatical pay accruals and provisions for pension liabilities.

- Multi-employer pension deficit recovery plans are to be reflected in the Financial Statements, including recognition of initial liability in the Income Statement and reflecting the liability in the Balance Sheet. These will be unwound as the liability is paid. Each three yearly revaluation is likely to result in amendments to the liability and provision, which could materially impact the surplus and deficit reported.
- The accrual for holiday not taken at the year-end is likely to result in a one-off impact on the Income Statement. This information will need to be readily available.

Fixed Assets & Investment Properties

- During the implementation of FRS 102 and the SORP a decision regarding the value of fixed assets is required. They can be re-valued or continue to be re-valued, or they can be brought forward onto the opening balance at their ‘deemed cost’ and the policy of revaluing assets can be stopped.
- Assets held for the provision of social benefits, i.e. education, shall be deemed as property plant and equipment. Student accommodation falls within the definition.
- Gains and losses on Investment Property will now be reflected on the Income and Expenditure account.

Leases

It is envisaged that future global reporting standards will require all leases to be reflected on the balance sheet. ‘Substance over form’ is still applied when assessing the treatment of leases; however FRS 102 allows more judgement in the assessment, with consideration of the substantial transfer of all risks and rewards, rather than the previous 90% measure.

- Thus it will be necessary to review the treatment of all existing leases to assess which are operating leases (rental expense) or finance leases (recorded as an asset and corresponding liability on the balances sheet).
- Embedded leases may exist within service contracts, for instance a telephone service contract may allow the phones to be retained by the University at the end of the contract.
- Land and buildings leased together may need to be separated if possible to allow the land to be treated as an operating lease, unless it is transferred at the end of the lease term.

Service Concession Arrangements

Currently a University (the grantor) may have contracted with a private sector entity (the operator) to construct / upgrade, and operate and maintain infrastructure assets (such as student accommodation, or research or teaching facilities) for a specified period of time. In return the operator is paid for its services over the period in accordance with a contract which sets out performance standards. These arrangements are currently accounted for as operating leases and hence the assets are "off balance sheet". This reflects the accounting approach which considers risk and reward.

FRS 102 and the new SORP set out a number of tests to instead assess control in the arrangement. If met then they are considered to be service concession arrangements and will be required to be accounted for as a finance lease. As such, this would require the recording of an 'other property plant and equipment' asset and an equivalent liability. Per the SORP, the control tests are as follows:

a. The grantor must control or regulate the infrastructure services the operator must provide with the infrastructure, to whom it must provide them and at what price.

b. The grantor must control any significant residual interest, through beneficial entitlement or otherwise, in the infrastructure at the end of the term of the arrangement. Note that an arrangement that covers the majority of the life of the asset (a whole life arrangement) may be within scope.

The value of the asset and liability is likely to be the present value of the minimum guaranteed payments and the asset will require depreciation. However it should be noted that where arrangements are renewed annually, then these will remain 'off balance sheet' as these are not considered to be long-term guarantees.

What you should be doing

In preparation for FRS 102 higher education institutions should:

- Review relevant Policies and internal Procedures such as those relating to annual and sabbatical leave, and changes to accounting policies such as whether to revalue fixed assets.
- Consider arrangements being entered into to ensure the impact on the Financial Statements prepared under FRS 102 is considered. (E.g. Loans, grants and leases).
- Review bank covenants which may need to be updated to reflect changes, or accounts may need to be prepared under new and old reporting standards to comply with existing covenants.
- Collate relevant contracts and agreements (which may take considerable resource and may be time consuming). Ensure record keeping is effective, for instance, annual leave records and details of grants with performance conditions should be readily available.
- Review the need to update the Financial Strategy, Key Performance Indicators, Budgets and Forecasts to take account of the reporting changes. It is likely that surpluses and deficits will be more volatile for the next few years at least, making the assessment of performance more difficult. It is crucial to provide a clear narrative to explain the underlying financial performance, and to develop revised set of targets and indicators.

How we can help

For more information or for assistance in preparing for FRS 102 and the new SORP, please contact

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