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IFRS and Housing Financial Statements

How will IFRS affect Registered Social Landlords (RSLs)?



Although there is at present no requirement for RSLs to adopt these reporting standards, it is only a matter of time before they become the norm. This straightforward guide for Finance Directors, developed with Great Places Housing Group, explains the key areas in which IFRS will impact on RSLs, and how RSLs can prepare for them.

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IFRS and Housing Financial Statements

The RSL sector is well accustomed to regular changes to its financial reporting requirements through revised Statements of Recommended Practice (SORP) which are issued every couple of years or so. SORP changes tend to be evolutionary rather than revolutionary and typically follow widespread consultation across the sector.

International Financial Reporting Standards promise change of a more fundamental nature and there is a growing feeling of inevitability around adoption of IFRS for RSLs.

In order to help demonstrate some key elements of IFRS, Great Places Housing Group has worked with PKF to help illustrate, with some practical examples, how the adoption of IFRS would change the financial reporting of the Group, and hence signpost the preparatory work RSLs should consider in advance of IFRS implementation.

I would encourage all RSLs to actively consider the recommended preparatory work highlighted within this guide and not to underestimate the costs, both human and financial, which the implementation will place on RSLs.

On a personal note, I would like to thank PKF for their time and effort in preparing this preliminary guide. I have found working with PKF has provided me with an excellent understanding of the critical issues which Great Places must address in adopting IFRS and the extent to which IFRS will impact far beyond our financial statements.



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Great Places Housing Group

What are International Financial Reporting Standards?

International Financial Reporting Standards are now the pre-eminent accounting standards in the world. Over 100 countries now require or permit the use of IFRS in the preparation of company financial statements. In the UK, following the issue of an EU regulation in 2002, companies listed on the full London Stock Exchange have been required to prepare their consolidated financial statements in accordance with IFRS for years commencing on or after 1 January 2005. AIM traded companies are required to do the same for years commencing on or after 1 January 2007.

The International Accounting Standards Committee (IASC) was formed in 1973 with the objective of developing internationally recognised standards of accounting. From 1973 to 2001 it issued 41 International Accounting Standards (IAS).

The International Accounting Standards Board (IASB) replaced the IASC in 2001 and adopted all existing IAS at that time. It has subsequently issued 8 IFRS. IAS and IFRS are of equivalent standing, the change in terminology being similar to the move from SSAP to FRS in the UK. We will use the term IFRS to encompass both IAS and IFRS.

IFRS are principle based standards and are underpinned by very similar concepts as UK standards. However, the devil is in the detail with significant differences arising in the application of those concepts and principles.



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Future of UK financial reporting

Current legislation permits any non-charitable company to voluntarily apply IFRS instead of UK GAAP, although only a very small minority of private companies have chosen to do so. However, UK GAAP will not exist, at least not in its current form, for much longer.

The UK Accounting Standards Board (ASB) is progressing towards the full convergence of UK standards with IFRS in the short to medium term. Whilst various outline proposals for the future of financial reporting in the UK have been discussed in public forums, the ASB have accepted that there is no longer a case for maintaining two sets of GAAP. UK FRS will be withdrawn and one of two multi-tiered approaches are likely to emerge, namely:

- A three-tiered approach with full IFRS applying to listed and, potentially, other large and/or public interest entities, the UK Financial Reporting Standard for Smaller Entities (FRSSE) applying to the smallest entities and the IFRS for Private Entities (IFRS for PEs) applying to those in between; or

- A two-tiered approach with the second and third groups of entities both applying the IFRS for PEs.

In both approaches UK FRS are withdrawn and replaced by IFRS derived standards for all but the smallest of entities.

Public sector adoption of IFRS

Although the timing and precise outcome of the ASB's convergence project remains uncertain, plans are already in place for the adoption of IFRS by public sector bodies. At the time of the 2007 budget, HM Treasury announced that the public sector, including central governmental departments and the NHS would be required to prepare their accounts for the 2008/09 financial year in accordance with IFRS 'as adapted for the public sector'. The 2008 budget postponed this requirement until the 2009/10 financial year due to concerns the sector would not be ready by 2008/9. Local government accounts will also be prepared in accordance with IFRS, starting in the 2010/11 financial year.

IFRS and RSLs

The SORP 2008 confirms that there is currently no mandatory requirement for RSLs to apply IFRS and that RSL companies with charitable status are not permitted to voluntarily adopt them. Furthermore, the SORP does not encourage the adoption of IFRS by social landlords and is prepared solely on the basis of UK GAAP. But, when we look to the future, adoption of IFRS by RSLs is inevitable. The drivers of change will be:

- The adoption of IFRS by public sector bodies from 2009/10
- Providers of debt financiers wishing to make comparisons with the private sector
- The wider adoption of IFRS by the UK Accounting Standards Board

Given these drivers it is important that RSLs consider the likely impacts of adopting IFRS in making long term financial and operating decisions, when considering future resource requirements and, more imminently, to shape the sector interpretations and application of the key elements of IFRS.

Accounting for property

It is obvious that the most important line items in the accounts of an RSL relate to property. In addition to its housing stock, it may hold investment property subject to private rentals as well as head office property which may or may not be leased. These properties may be self-constructed or purchased.

Whilst the principles of accounting for property are the same within the SORP as under IFRS, there are significant differences in the details.

Carrying value

Both the SORP and IAS 16 Property, Plant and Equipment permit a choice, by class of asset, between measurement at depreciated historical cost and measurement at a sufficiently recent valuation. However, where a policy of revaluation is applied the amounts recognised can be very different.

The SORP requires that the Existing Use Value for Social Housing (EUV-SH) is used in valuing a RSL's housing stock. EUV-SH reflects the fact that the returns the RSL can make on its property is limited to its use as social housing.

IAS 16 requires that for all non-specialised property the open market value is used, which may be significantly higher than the EUV-SH if more lucrative alternative uses could be found. In such cases, applying IAS 16 in its current form might significantly increase the carrying value of social housing and reduce annual surpluses due to the resulting higher depreciation charge.

IAS 16 is less prescriptive on the frequency of valuations, only requiring that they are performed with sufficient regularity to ensure the carrying value is not materially different to fair value. If prices are relatively stable then revaluations may only be required every 3 to 5 years. However, if prices are relatively volatile then annual revaluations may be necessary.

Where part of an RSL's activities is subject to tax, revaluations may lead to the recognition of a deferred tax liability. This is because IAS 12 Income Taxes requires that deferred tax liabilities are

recognised on 'temporary differences' being differences between the carrying value of an asset and its tax base, normally the future tax deductions available. As the tax base is unlikely to change as a result of a revaluation, the temporary difference will rise, creating a higher deferred tax liability.

Borrowing costs

A recent amendment to IAS 23 Borrowing Costs means that borrowing costs incurred in financing the acquisition, construction or production of an asset that takes a substantial period to get ready for use must be capitalised into the cost of acquisition during the period of development. The alternative treatment available in the SORP of expensing such borrowing costs is no longer available.

The treatment of the amount to be capitalised is also different too. If amounts are specifically borrowed to fund the development but are temporarily invested until payment is required, then the amount to capitalise is net of any investment income received.

Leases

The overall approach in IAS 17 Leases is substantially the same as that set out in the SORP, with the exception of the treatment of leases for land and buildings. IAS 17 normally requires that the land and building elements of the lease are separated and the classification of each element as an operating lease or a finance lease is performed independently. As land has an indefinite useful economic life, leases of land are normally operating leases. Treating the elements separately may also mean that a lease of a building

classified as an operating lease in accordance with the SORP could be classified as a finance lease under IAS 17.

Investment property

During the drafting of the first SORP there was much consultation on whether or not property held for the provision of social housing constitutes investment property. Similar deliberations will be required when the sector adopts International Accounting Standards.

The definition of investment property in IAS 40 Investment Property is 'property held to earn rentals or for capital appreciation or both, rather than for: (a) use in the production or supply of goods or services or for administrative purposes; or (b) sale in the ordinary course of business'. If this definition, as it currently stands, were to be applied in the social housing sector the issue would be whether or not social housing is held to earn rentals, or whether the receipt of rental income was somehow incidental to the provision of some wider service.

Where a property does meet the definition of Investment Property, IAS 40 allows an entity to apply either a cost less depreciation model or to measure the investment property at its fair value. If it is measured at fair value, gains and losses are recognised in the income statement. This differs from SSAP 19 which requires Investment Property to be measured at market value, but any gains and losses are taken straight to equity in a revaluation reserve.

When is a merger not a merger?

The social housing sector has undergone widespread consolidation over recent years. The pressures to deliver value-for-money through economies of scale, to compete for development funding and to provide the best possible service to tenants, has led many RSLs to the conclusion that combining resources and skills with other RSLs is the best way of meeting their corporate and social objectives. This is unlikely to change in the near future.

Under UK GAAP there are two ways of dealing with the combining of separate businesses; merger accounting and acquisition accounting. Most corporate combinations are treated as acquisitions, because FRS 6 sets out very restrictive criteria for the application of merger accounting. In practice, the SORP relaxes these criteria somewhat, reflecting the fact that the combining of RSLs is not for the sake of generating profits for one or other group of shareholders, but rather for the common good of all tenants from both combining parties. For example, the fact that the combining of RSLs will be for nil consideration, the criteria in FRS 6 relating to the spirit of equity and non-equity consideration are avoided.

This SORP interpretation of the FRS 6 criteria has made the use of merger accounting much more common in the social housing sector than in the wider economy. Such an approach often reflects the true substance of the transaction as the combining RSLs come together as partners to share resources, with shared management and strategic vision, for the mutual benefit of all tenants.

However, under IFRS merger accounting may not be used, wherever the transaction falls within the scope of IFRS 3 Business Combinations irrespective of the true substance of the transaction. Instead, all such transactions will be treated as an acquisition of one RSL by the other. Not only will this have a significant impact on the accounting entries, but may also

cause undue concern to tenants. Where the transaction would have satisfied the criteria in the current SORP for merger accounting, it is likely that the RSLs will have described the prospective transaction as a merger when trying to gain tenant approval for the scheme. It may be politically sensitive for tenants to subsequently find the transaction described as an acquisition.

Accounting for a Business Combination as an acquisition, rather than a merger, results in the net assets acquired being shown at fair value rather than book value and the reserves at acquisition being only those of the acquirer rather than the sum of the two combining entities.

The key steps for accounting for Business Combinations in accordance with IFRS are:

- 1. Identify the acquirer**
- 2. Measure the cost of acquisition**
- 3. Identify the fair value of the assets and liabilities acquired, including intangible assets and contingent liabilities**
- 4. Calculate and account for goodwill**



1. Identify the acquirer

IFRS 3 requires that an acquirer be identified. The acquirer is the entity that obtains control of the other combining entities, i.e. it is the entity with the power to govern the financial and operating policies of the combined group. The nature of many business combinations in the social housing sector is that this power is effectively shared between the pre-existing RSLs. In such cases, we must look to other factors to identify which of the entities to treat as the acquirer. Such factors may include the relative fair values of the combining entities or the ability of one of the RSLs to dominate the selection of the new management team.

On 1 January 2007 the Space New Living Group joined the Great Places Group and was treated as a merger, in accordance with the SORP. At the time of acquisition the book values of their respective net assets (including long-term liabilities) were as follows:

	Great Places £'000	Space New Living £'000	Total £'000
Fixed assets (including Housing Property)	130,927	53,682	184,609
Net current assets	3,516	1,157	4,673
Long-term liabilities	(106,403)	(42,102)	(148,505)
Net assets at book value	28,040	12,737	40,777

As neither party dominates the new board or the selection of management, we must look to their relative sizes and conclude that, for the purposes of accounting in accordance with IFRS 3, the Great Places Group was the acquirer.



2. Measure the cost of acquisition

In common with most such transactions in the social housing sector no consideration was paid to bring about the combination of the Great Places and Space New Living groups. Therefore the cost of acquisition would be zero. Transaction costs associated with the combination have been ignored, because under a revision to IFRS 3 to become effective in 2009 such costs must be excluded from the cost of an acquisition.

3. Identify and measure the assets and liabilities acquired

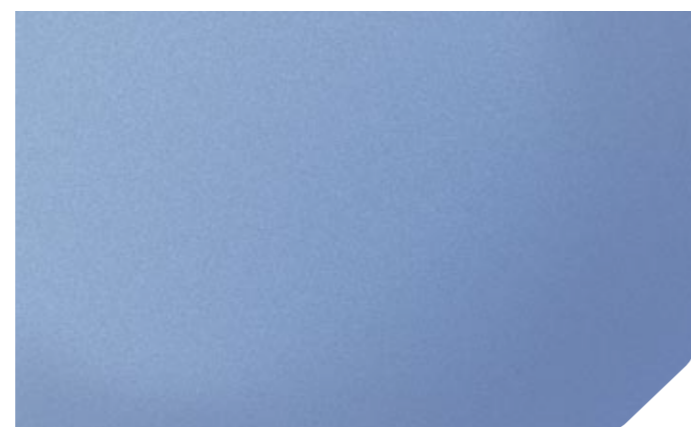
In accordance with the SORP rules for merger accounting the consolidated accounts of Great Places Housing Group Limited shows the net assets of both groups at their pre-existing book values. Under IFRS 3, the assets and liabilities acquired must be measured at their fair value.

Where the book values of property is at historic cost these must be revalued to fair value (see Accounting for property on page 4).

Under IFRS it is generally much more likely that intangible assets acquired in a business combination must be separately identified and recognised. These might include service development costs, software development costs or intangible assets related to any commercial activities such as brand names.

Furthermore any contingent liabilities must be valued at the amount a third party would be willing to charge to take on this liability and recognised. This is true despite the fact that the acquired business would not have recognised any amount for the contingent liability in its own financial statements.

The following table highlights how these requirements might have affected the consolidated accounts of Great Places Housing Group Limited following the acquisition of the Space New Living Group.



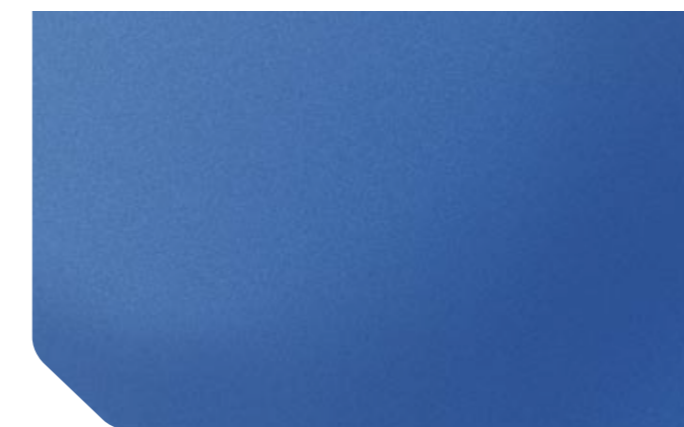
For the sake of argument we shall assume that it is assured that the fair value of housing property is £10m higher than its book value, that there were no intangible assets acquired but the fair value of contingent liabilities acquired was £200,000.

	Book values £'000	Fair value adjustments £'000	Fair values in consolidated financial statements £'000
Fixed assets (including Housing Property)	53,682	10,000	63,682
Net current assets	1,157	(200)	957
Long-term liabilities	(42,102)	-	(42,102)
	12,737	9,800	22,537

4. Goodwill

Goodwill is the difference between the consideration paid and the fair value of the net assets acquired, as determined in step 3. The SORP requires that positive goodwill is amortised over its useful economic life, whilst negative goodwill is recognised as a separate line in capital and reserves and released as the non-monetary assets (mainly housing properties) are recovered either through depreciation or via a sale.

The accounting for goodwill is very different under IFRS. Positive goodwill is not amortised but is reviewed annually for impairment. Negative goodwill is not a recognised term under IFRS. If the fair value of the net assets acquired exceeds the consideration paid, the excess is released immediately to profit or loss.



Continuing our example we see that the fair value of the net assets acquired exceeded the consideration paid (£nil) by £22.537million.

Comparison of SORP and IFRS

Applying the working assumptions in step 3, we can now compare how the consolidated financial statements of Great Places Housing Group Limited would look under IFRS with those actually reported.

	Applying the SORP £'000	Adjustments £'000	Applying IFRS £'000
Fixed assets (including Housing Property)	184,609	10,000	194,609
Net current assets	4,673	(200)	4,473
Long-term liabilities	(148,505)	-	(148,505)
Net assets at book value	40,777	9,800	50,577
Represented by:			
Designated reserve	7,974	(3,025)	4,949*
Revenue reserve	32,803	12,825	45,628*
	40,777	9,800	50,577*

* The consolidated reserves under the SORP are the sum of the pre-combination reserves of both groups, whilst under IFRS 3 they represent the pre-acquisition reserves of the Great Places Group only, plus the 'negative goodwill' released immediately to profit or loss.



Accounting for financial instruments

One of the most complex and controversial elements of International Financial Reporting Standards is the required accounting for financial instruments. The rules are contained in 3 standards:

- **IAS 32 Financial Instruments: Presentation**
- **IAS 39 Financial Instruments: Recognition and Measurement**
- **IFRS 7 Financial Instruments: Disclosures**

It would be easy to assume that these standards would have limited impact on many RSLs with relatively straightforward financing arrangements, no apparently complex instruments and no involvement in financial investments. But this would be wrong, not least because the scope of these standards is so broad.

A financial instrument is defined in IAS 32 as 'any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity'. This encompasses, inter alia cash on deposit, rents outstanding, trade creditors, accruals, and bank and other loans. Furthermore, many RSLs will manage their exposure to fluctuations in interest rates on their debt through the use of interest rate swaps and caps, which are examples of financial derivatives within the scope of the definition.



Presentation

FRS 25 was amongst the first wave of convergence standards bringing UK GAAP and subsequently the SORP into line with IAS 32. Central to this standard is the identification of financial instruments as either equity or liabilities. The former are shown within capital and reserves; the latter alongside all other liabilities.

FRS 25 also introduced the requirement to reclassify debt as a current liability where a breach of a covenant has occurred which has resulted in the debt being repayable on demand, unless the bank has waived the breach before the balance sheet date and has provided a period of grace to allow rectification of the breach ending at least 12 months after the balance sheet date. Although this requirement is not repeated within IAS 32, it is contained in full in IAS 1 Presentation of Financial Statements.

Recognition and measurement

IAS 39 is a mixed valuation model. Some financial instruments, including most financial liabilities such as bank loans, are measured at amortised cost, being the initial cost less repayments plus or minus interest charges calculated at an effective rate. This is much the same as the current accounting for loans in accordance with FRS 4.

Other financial instruments must be shown at their fair value, with gains and losses charged to profit or loss, or recognised directly in reserves depending on the nature of the instrument and why it is held. For example, all derivatives being financial instruments with a value that changes in response to changes in some underlying variable must be fair valued through profit or loss, unless hedge accounting permits otherwise. In the context of RSLs the most likely form of derivative is an interest rate swap. These are commonly purchased in the sector to manage the risk of fluctuations in interest rates (the underlying variable) affecting future interest payments. Therefore, an instrument purchased to reduce risk can potentially increase the volatility of earnings as interest rate movements lead to revaluation gains and losses on the swap. This is where hedge accounting can help.

Hedge accounting

At 31 March 2007 Great Places Housing Group Limited had a variable to fixed 4.6875% interest rate swap in place with a nominal value of £20m. At that time there were 3½ years to run on the contract. If we assume that market variable rates at that time were 5.5% we can see that the swap is of value, and thereby is a financial asset, as it saves interest of some 0.8125% per year. This value must be recognised on the balance sheet. The actual calculation of the fair value requires us to consider future expectations of interest rates and to discount savings using the zero coupon curve, but for the sake of argument we shall assume the value at that date was £400,000.

If we further assume that the swap had an initial value of £nil (i.e. it was on the money at inception), under the normal measurement rules in IAS 39 the cumulative gain of £400,000 would have been recognised in the income statement.

Hedge accounting would allow the group, if specific detailed criteria covering the documentation and effectiveness of the hedge are met, to amend the normal rules of accounting and thereby better reflect the actual risk exposure of the business. In this case, this could result in the cumulative gain on the swap to be shown as a separate line in equity until expiry of the swap at which point the fair value will have returned to zero, thereby eliminating the volatility in the income statement.

Disclosure

The disclosure requirements of IFRS 7 would, if applied, have an impact on all RSLs. The standard requires extensive detailed disclosures on the significance of financial instruments to the business and both quantitative and qualitative disclosures on the nature and extent of the risks attached to such instruments. Example disclosures would include:

- Carrying amounts by category and class of financial instrument
- A comparison of carrying amounts by class to fair values, including the fair value of fixed rate loans
- The amount of financial assets pledged as collateral for loans and other liabilities
- Details of defaults on and breaches of terms of loan agreements during the period
- Aged analysis of any financial assets past due, such as overdue rents receivable
- Extensive disclosures regarding the RSLs' exposure to credit risk (the risk another party will fail to discharge its obligations to the RSL, such as rent receivable), liquidity risk (including an analysis of the maturity of bank loans) and market risk (the risk of changes in future cash flows and fair values due to changes in market prices such as interest rates).



Moving to IFRS

There are numerous other differences to be found in the detail of IFRS. Some of these differences will have limited impact on the financial statements of RSLs, while others may need greater consideration.

Areas of note include:

1. Different terminology, such as 'non-current assets' instead of 'fixed assets', 'property, plant and equipment' instead of 'tangible fixed assets', 'inventories' instead of 'stock' and 'receivables' and 'payables' instead of 'debtors' and 'creditors'. Stakeholders may need training or guidance to understand the new terminology.
2. Where an RSL has taxable activities, the calculation of deferred tax is based on very different principles. Where UK GAAP adopts an income statement approach to calculate deferred tax, comparing accounting profits with taxable profits, IAS 12 requires a comparison of the balance sheet carrying amounts of assets and liabilities with their 'tax bases'. The tax base of an asset will usually be the future tax deductions available. Where an asset is revalued, the carrying amount changes but the tax base does not, creating an IAS 12 'temporary difference' on which deferred tax must be calculated.
3. Differences in the scope of related party disclosures.
4. Treatment and presentation of non-current assets held for resale and discontinuing activities is different to that required by IFRS 3.
5. Differences in the presentation and disclosure of joint ventures and associates.

On transition to IFRS each RSL will have to consider the detail in every standard to ensure that the impacts on its own financial statements can be assessed.

First time adoption of IFRS

Given the global growth in the application of IFRS, the IASB's first major new standard, IFRS 1, was written to provide a framework to be applied with additional disclosure requirements on first time application of international standards.

IFRS 1 is only applicable to an entity's first IFRS financial statements and has three distinct effects:

1. It requires the retrospective application of those IFRS in effect at the reporting date, with limited specific exemptions.
2. It sets out the specific exemptions from retrospective application.
3. It sets out additional disclosures to be provided as a one-off exercise on first time adoption.

Retrospective application

Any adjustments from UK GAAP, as interpreted by the SORP, to IFRS will be made through opening reserves at the date of transition, being the beginning of the comparative period. Therefore an RSL preparing its first IFRS financial statements for the year ended 31 March 2010 will need to prepare a balance sheet with IFRS retrospectively applied as at 1 April 2008, subject to the exemptions discussed below.

Exemptions from retrospective application

IFRS 1 does allow some relaxation in the general requirement to retrospectively apply IFRS, but only in very specific instances. Each exemption is optional – on first time adoption, an RSL will have the right to take some, all or none of the

exemptions as it sees fit. The choices made may impact on the measurement of net assets presented and future reported performance.

Optional exemptions of particular reference to RSLs would include:

- Not applying IFRS 3 to business combinations which arose before the date of transition – e.g. if an RSL has previously applied merger accounting to a business combination it does not need to apply acquisition accounting to it.
- Using a previous GAAP revaluation or fair value as deemed cost.

Additional disclosures

In its first IFRS financial statement an RSL will need to provide, along with narrative explanations, reconciliations from UK GAAP, as interpreted by the SORP, to IFRS of:

- Equity at the date of transition and at the end of the comparative period.
- Profit or loss for the comparative period.

What RSLs need to do now

RSLs need to start thinking about the impact of IFRS now. Although compliance is unlikely to be required until 2009/10 at the earliest, comparatives would have to be restated. Therefore, RSLs need to consider as soon as possible a number of issues:

- **whether the systems they have in place are able to meet the demands of IFRS disclosure.**
- **RSLs are also unlikely at present to have the in-house skills to meet the demands of IFRS disclosure.**
- **The costs in terms of time and training of staff need to be considered in terms of RSLs budgeting processes.**



The adoption project

Experience gained in supporting UK fully listed and AIM traded companies in their transition to IFRS shows that the adoption of the new standards represents a change management project to be planned and controlled like any other. The impact of IFRS reaches much wider than the financial reporting team, and can have significant commercial, investment and resource implications.

The adoption project should consider, amongst other things, the following issues:

Resource needs

- HR – project management, IFRS training, internal communication of impacts
- IT and similar systems – new data collection and control requirements
- Internal management reporting – the form and content of internal management information should reflect external reporting needs

Stakeholder relations

- The impact of the changes in the reported financial position and performance of the RSL should be communicated to key stakeholders such as providers of finance, tenants and regulators

Commercial impacts

- Where debt covenants, regulatory targets and staff performance measurements are based on externally reported financial information the impact of IFRS must be considered and, if necessary, these targets renegotiated.

The adoption project will require the continual input of those charged with governance. The board of trustees, senior management and other sources of oversight such as the audit committee should be involved as much as possible in the important decision making involved in the adoption of IFRS such as key accounting policy options, the nature and scope of the transition project and the use of external advisers.

To assist in this process, PKF has developed a one-day introductory IFRS training course for RSL staff. This focusses on areas highlighted in this paper and other elements of IFRS which will impact on RSLs. Ask your regional contact (see page 15) for more details.

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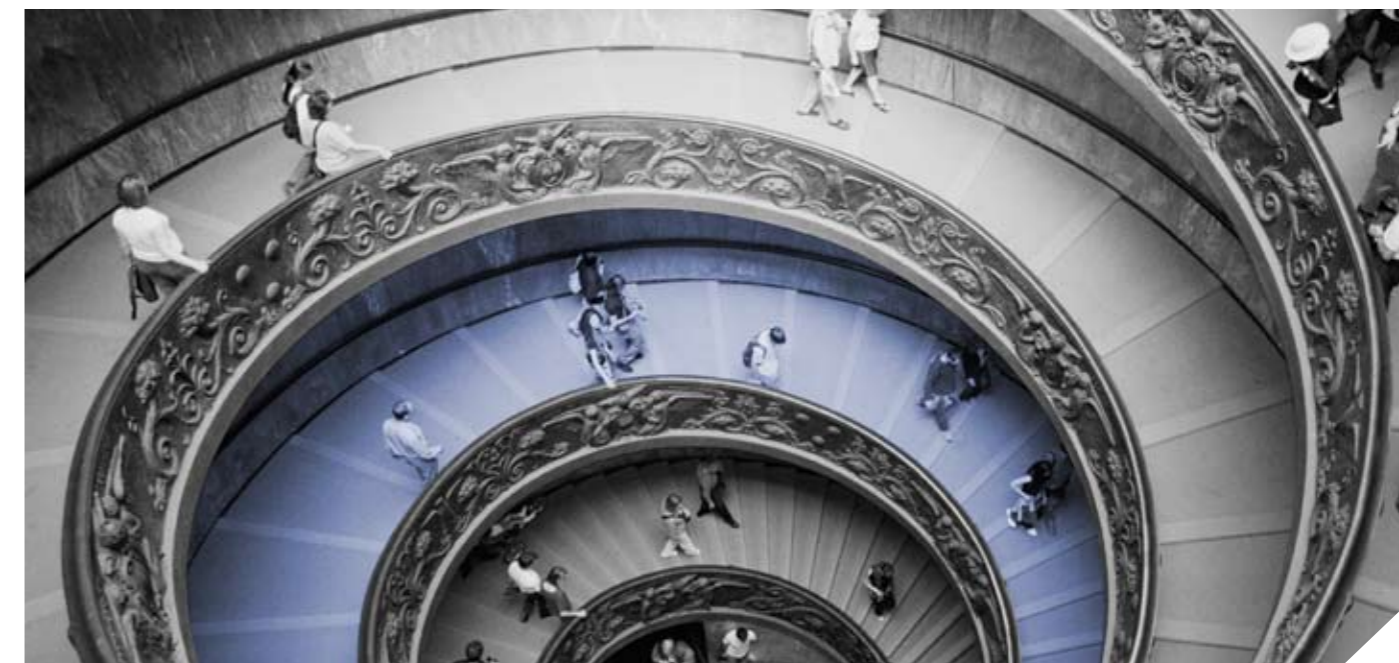
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