

Briefing Paper

The SORP requirements for Group Accounts in Local Authorities

June 2005

The purpose of this briefing paper is to consider the implications of implementing the new group accounts requirements and the lessons that can be drawn from those authorities that have begun to implement the new requirements in early 2004/2005.

The new requirements arise from the increasing practice by local authorities of using a range of different options to deliver services including companies and joint ventures. Consequently, for some local authorities, single entity accounts do not represent the interests of the local authority in full. In addition, the following developments have resulted in the introduction of modified arrangements for group accounting in the 2004 Code of Practice on Local Authority Accounting in the United Kingdom (the 2004 SORP):

- The issue of the Accounting Standards Board's discussion paper 'Statement of Principles for Financial Reporting – Proposed Interpretation for Public Benefit Entities.
- Whole of Government Accounts

The modified requirements for group accounts were introduced as part of the 2004 SORP. This is included in chapter five of the 2004 SORP and runs to some thirty pages. The modified requirements are substantially different from and much more demanding than the 2003 SORP's requirements. It is also expected that more authorities will need to prepare Group Accounts than under the requirements of the 2003 SORP. Identifying the relationship between the authority and other authorities and similar bodies requires specific attention. The relationship between a statutory body and central government may deem it inappropriate to account for that body as a subsidiary. Where a body is established under statute and the government retains the power of abolition there is a 'rebuttable assumption' that a statutory body of this type is not a subsidiary.

Following consultation during which local authorities protested that time would be required to introduce the new arrangements, it was decided to introduce transitional arrangements. Under these transitional arrangements:

- Local authorities can prepare group accounts under the 2003 SORP in 2004/2005
- Most authorities have used the transitional arrangements
- But all authorities must use the 2004 SORP for 2005/2006

Authorities making use of the transitional arrangements will prepare group accounts for 2004/2005 under the requirements of the 2003 SORP (as set out in appendix G of the 2004 SORP). Comparative figures for 2003/2004 are required.

Authorities that do not take advantage of the transitional arrangements have to prepare group accounts under the 2004 SORP's modified requirements. 2003/2004 comparative figures are not required, but comparative figures can be included at the authority's discretion if:

- Prepared under the modified requirements of the 2004 SORP.

- Or, where originally prepared under the 2003 SORP's requirements, they have been reviewed and found to be the same as, or not significantly different from, comparatives prepared under the modified group accounts requirements of the 2004 SORP.

For 2005/2006 all authorities will have to prepare group accounts under the 2004 SORP's modified requirements. 2004/2005 comparative figures prepared under the 2004 SORP's modified group accounts are required.

In its December 2004 bulletin sixty, the Local Authority Accounting Panel advised that:

"Many local authorities will have already started their preparations; others, particularly those making use of the transitional arrangements may not have done. In the Panel's view, those authorities that have not yet started work should do so as a matter of urgency. In particular, it is important to start the work of identifying the bodies that will need to be included in the Group Accounts."

"For authorities making use of the transitional arrangements, preparation of the 2004/2005 group accounts (as comparative figures for the 2005/2006 group accounts) could be considered a 'dry run' or 'test bed' for preparing the first 'live' 2005/2006 group accounts. The same processes will be involved but there will be much more time available to prepare the 2004/2005 (comparative) group accounts than the short time that will be available to prepare the 2005/2006 group accounts."

"The Panel recommends, to help ensure that the preparation of the 2005/2006 group accounts goes well, that authorities making use of the transitional arrangements should prepare 'dry run' 2004/2005 group accounts well before the start of the main work on the closure of the 2005/2006 accounts."

So, authorities need to prepare group accounts where they have material interests in other entities that meet the criteria for subsidiaries, associates or joint ventures. The key questions are:

- Is there an 'entity'?
- Does the Council have an interest?
- Is the interest material?
- Is the entity a subsidiary, an associate, a joint venture or 'none of these'?

Possible sources of information about interests include:

- Schedule of investments
- Register of interests
- Related parties disclosures
- Discussions with officers from departments
- Comparison of notes with external auditors

The Chartered Institute of Public Finance and Accountancy have prepared guidance for authorities in the form of a workbook ' Group Accounts in Local Authorities Practitioners' Workbook'. This includes:

- A route map for preparation
- Advice on all aspects of preparation
- Case study examples

The Local Authority Accounts Scotland Advisory Committee has also issued a practical checklist on modified group accounts. The checklist does not seek to place a definitive interpretation on the requirements of the SORP. It is intended to be a practical tool in the short term to enable local authority practitioners to plan for the modified group accounts arrangements. It does not represent an exhaustive list of all the steps that may be required but does provide a commencement framework. This advises local authorities to:

- Identify all bodies where the authority has ‘an interest’ and has an access to benefits or exposure to the risk of potential loss. This includes bodies where the authority:
 - Has the power to dissolve the entity and obtain a significant level of the residual economic benefits or bear significant obligations.
 - Has the power to extract distributions of assets from the other entity and/or may be liable for certain obligations of the other entity.
 - Holds direct or indirect title to the net assets/equity of the other entity with an ongoing right to access these
 - Has a right to a significant level of the net assets/equity of the other entity in the event of liquidation or other distribution
 - Is able to direct the other entity to co-operate in achieving the authority’s objectives
 - Is exposed to the residual liabilities of the other entity
- Gather sufficient information about each body to enable determination of whether a group relationship exists and the nature of that relationship. This information should include whether:
 - The body is an ‘entity’ which is a body corporate, statutory body, or delivers a service or carries on a trade or business of its own (separate DSO/commercial trading units will not be entities nor will services delivered under budgets pooled between bodies)
 - The authority holds equity capital in the entity and the amount of the investment
 - The authority is a member of the entity and the level of voting rights
 - The authority has the right to appoint or remove members of the governing body of the entity
 - The authority has the right to exercise dominant influence over the entity through provisions in the governing document of the entity, specific legislation or a control contract or other binding agreement
 - The authority, in practice, exercises influence over the entity and the scale and nature of that influence
 - The authority and entity are managed on a unified basis
 - The entity is a subsidiary of an entity which is itself a subsidiary of the authority
- Compare the accounting policies of subsidiaries, associates and joint ventures to ensure they are aligned with the policies of the authority (as adjusted to comply with UK GAAP). In the event of difference:
 - Identify the consolidation adjustments required to ensure alignment (these adjustments could relate to, for example, FRS17 and valuation of fixed assets)
 - Ensure procedures are in place at an early stage with these entities to ensure that the information required to effect the adjustments is available to allow preparation of the group accounts by the locally set deadline or for 30th June where transitional arrangements are not being utilised
 - Agree a ‘quality control’ mechanism with these entities to ensure that reliable information is supplied and sufficient supporting documentation is obtained

- Identify the financial year-end used by subsidiaries and the planned date of availability of unaudited and audited accounts.
 - If the financial year end is the same, establish arrangements with the subsidiary to ensure that audited accounts are available to allow audit certification of the group accounts by 30th September where transitional arrangements are not being utilised
 - If the financial year of the subsidiary differs, establish arrangements for the subsidiary to prepare interim financial statements to the same date as the authority and agree 'quality control' procedures to ensure that reliable information is supplied and sufficient supporting documentation is obtained
 - If interim financial statements are not practicable, ensure that audited financial statements will be available which are not more than three months before the authority year end. Establish arrangements with the subsidiary to identify changes that materially affect the group accounts in the intervening period
- From the information gathered, use the flowchart (from the 2004 SORP) to assess the nature of the relationship with each entity to determine whether the entity is a subsidiary, associate, joint venture or simple investment.

The flowchart incorporates a series of questions as follows:

1. Does the reporting local authority have an interest in the body? If the answer is 'no' then there is no group relationship.
2. Is the body delivering a service or carrying on a trade or business of its own? If the answer is 'no' the body is not an entity. Examples of such arrangements include local committees with pooled budgets.
3. Does the reporting local authority have access to benefits (future economic benefits or service potential) or exposure to the risk of a potential loss? If the answer is 'no' there is no group relationship. If the answer is 'yes' then the body is considered to be within the local authority group boundary.
4. Does the reporting local authority control the majority of equity capital or equivalent voting rights or appoint the majority of the governing body? If the answer is 'yes' the body should be accounted for as a subsidiary.
5. Does the reporting local authority exercise or have the right to exercise dominant influence? If the answer is 'yes' then the body should be accounted for as a subsidiary. Subsidiaries would include companies where the Council has a majority shareholding or a body such as an Arms Length Management Organisation.
6. Is the reporting local authority able to exercise a significant influence over the entity without support from other participants? If the answer is 'yes' the body should be accounted for as an associate. An example of an associate would be an economic development company in which the Council has a 15% shareholding and one out of five voting Directors on the Board.
7. Do decisions regarding the operating and financial policies of the entity require the consent of all participants? If the answer is 'yes' the body should be accounted for as a joint venture. An example of a joint venture would be a 40% shareholding in a Local Authority Waste Disposal Company. If the 'answer' is no the body should be accounted for as a simple investment.

Issues to bear in mind when using the flowchart include:

- It is the ability to exercise control which is important, not the actual exercise of control
- Funding is not a primary determinant of control
- Benefits can be economic benefits or service potential
- Substance over form applied throughout

The practical checklist continues:

- Establish criteria (both financial and non-financial) based on the definition of materiality included in the SORP to determine whether group accounts should be prepared. Compare the information collated to the pre-determined criteria to establish if group accounts are required. Criteria will include a consideration of the following:
 - Whether omission could influence judgment on stewardship
 - Whether omission could influence economic decisions
 - Whether omission could influence comparison with other entities
- Identify the adjustments which require to be made to the authority's accounts to comply with UK GAAP in all respects and ensure that systems are in place to make the adjustments. These adjustments are likely to include different treatment of the profit or loss on disposal of assets, charges for fixed assets and amortisation of government grants.
- Identify the adjustments that require to be made to other entities such as statutory bodies to ensure consistency of accounting treatment. In the event that adjustments are required:
 - Ensure procedures are in place with these entities to ensure that the information required to effect the adjustments is available to allow preparation of the group accounts by the deadline of 30th June (for those authorities not intending to make use of transitional arrangements).
 - Agree 'quality control' procedures with these entities to ensure that reliable information is supplied and sufficient supporting documentation is obtained.
- Ensure that procedures in place will enable identification and elimination of all intra-group transactions with subsidiaries. Particular care should be taken with the identification of balances between public sector bodies within subsidiary companies.
- During the process, compile documentary procedural instructions and guidelines which record the responsibility and timescale for each task to prepare the group accounts and relevant disclosure notes. Ensure that external auditors are consulted with regard to the documentation required to support the group accounts.

Materiality is to be considered in the light of the following:

- Does the authority depend significantly on the entity for continued provision of statutory services?
- Is there political concern about the level to which the authority is exposed to commercial risk?
- Has the local authority stepped outside of traditional ways of operating and take on new risks that could impact on its ability to provide services?
- Are the gross value of the investments significant to the authority's balance sheet?
- Are the gross value of subsidiary entities' borrowings/liabilities significant to the authority's balance sheet?
- Would the adjustments to revenue reserves on consolidation be significant?

The Chief Financial Officer has three roles to play:

- Consideration of whether the transitional arrangements will be utilised has been determined.
- All bodies are in the immediate process of being identified, the information on which will enable a group relationship to be identified.
- Accounting policies and year-end harmonisation are being addressed.

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Leeds City Council decided that it would not use the transitional arrangements, and set about identifying the 'new group' in 2004/2005. This included:

- New entities in 2004/2005
- Reviewing original entities under the new rules
- Identifying any possible new entities for 2005/2006
- Confirming the new treatment with partners
- Considering materiality issues
- Confirming treatment with external auditors

There is a need to gather information from bodies that need to be considered. This is best achieved through giving them written notification including:

- The reason for the request
- Clear timescales
- Request copy of draft or unaudited accounts
- Confirm material inter group transactions

It is a good idea to follow up with personal contact to:

- Ensure that they know your timetable
- Discuss any early issues they may have
- Discuss the sensitivity of their data
- Agree and understand their timetable
- Agree materiality – and the effect of different year ends
- Work with them to simplify the process and get them on your side

The main issues in 2003/2004 were:

- Agreeing with auditors any material differences in accounting policies
- Actual consolidation was found to be straightforward
- Contact was maintained with the group throughout the process
- 90% of the information came from the body's accounts
- There was a need to check material inter-group transactions and get the bodies to confirm them
- Draft, unaudited or audited accounts
- Timescales

Emerging issues at Leeds City Council include:

- Entities are not interested
- Early audit agreement is needed to the re-alignment of accounting policies
- The valuer needs to be consulted on valuation of assets and profit or loss on disposals
- Previous years' comparators need to be re-drafted for problem areas

The conclusions that have been drawn at Leeds City Council include:

- Start early
- Consult the auditors
- Consult fellow practitioners
- Consider new entities at the outset
- It is not as bad as it looks!

Good advice to Councils is that they should:

- Think ahead – there is lots to organise and a 30th June deadline for 2005/2006
- Plan to use 2004/2005 as a proper 'dry run' for 2005/2006 – include in closedown plan!
- Attempt to resolve the significant organisational issues
- Treat the preparation of the 2004/2005 comparables as unfinished business for 2004/2005 rather than as a 2005/2006 task.

The completion of Group Accounts for 2005/2006 is becoming a current issue even for those authorities that have used the transitional arrangements.

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