Nottinghamshire County Council

Report to Finance & Major Contracts Committee

14 January 2019

Agenda Item: 6

REPORT OF THE SERVICE DIRECTOR, PLACE AND COMMUNITIES

ARC PARTNERSHIP FINANCIAL UPDATE FOR HALF YEAR 2018/19

Purpose of the Report

1. To update the Committee on Arc Partnership's half-year financial performance for the period 1 April 2018 – 30 September 2018.

2. To update the Committee on Arc Partnership's Balance Sheet position as at 30 September 2018.

3. To inform the Committee of LGPS Pension/Dividend considerations relating to Arc Partnership.

4. To allow Committee to consider whether there are any actions required in relation to the detail contained within this report.

Information

Organisational Context

5. Arc Property Services Partnership Limited, trading as Arc Partnership, is a Joint Venture Company formed by Nottinghamshire County Council (NCC) and Scape Group (SG) on 1 June 2016, focused upon the delivery of property design, programme management, planned and reactive maintenance services to the County Council.

Financial Summary – Half Year Position

6. Whilst this report focuses upon financial out turn and forecast, significant progress has been made in establishing a fit for purpose commercial team within Arc Partnership of six posts. (Only one post transferred to the new Joint Venture in June 2016). The focus of the team, aside from general commercial governance/capability across the business, is to ensure every project represents VFM in terms of the build cost, benchmarked accordingly. Strong commercial governance is now in place at feasibility, contract tender, contract delivery and defect liability periods, which is reflected in more robust cost planning and project control to give positive commercial outcomes within agreed budgets.

7. Set out below is the financial result for the half year from 1 April 2018 – 30 September 2018:

	2018/19 Budget £000	18/19 H1 Budget £000	18/19 H1 Actual £000
Total Income	**37,012**	17,804	12,399
Expenditure	**36,141**	17,383	12,094
NET Operating Margin	**871**	**421**	**305**
Operating margin	**2.35%**	2.36%	2.46%
Depreciation	**121**	60	50
Trading Profit	**750**	**361**	**255**

8. In summary, the above table highlights good overall financial performance in H1 impacted by a slow start in April 2018 in terms of commissioned works, which resulted in a £2,455k reduction in forecast revenue for the period and a loss in month of £49k.

9. From February 2018 onwards, major commissions from Nottinghamshire County Council increased significantly with five new schools in design/delivery, Phase 3 of Clayfields, six basic need school expansion projects and £7.7m of design/delivery of third party works. This resulted in circa £200k of external design support being brought in through Arc's supply chain partners.

10. At the end of H1, revenues of £12,399k were £4,405k behind forecast, as a result of the timing of the major County Council commissions, which will see significant carry over of revenue into 2019/2020. However, the relationship between fee income for design and project management fees needs to be recognised, as the revenue / fee income take is not linear. Despite this a net operating margin of £305k and a trading profit of £255k represents a good performance.

11. The forecast impact of this on full year is set out below:

	2018/19 Budget £000	18/19 H1 Budget £000	18/19 H1 Actual £000	2018/19 Full Yr Forecast £000
Total Income	**37,012**	17,804	12,399	32,000
Expenditure	**36,141**	17,383	12,094	31,300
NET Operating Margin	**871**	**421**	**305**	**700**
Operating margin	**2.35%**	2.36%	2.46%	**2.19%**
Depreciation	**121**	60	50	100
Trading Profit	**750**	**361**	**255**	**600**

12. At the end of H1, Arc Partnership's cash position was £1,056k, and all contractor payments are being managed in line with credit terms.

13. There is one significant overdue debtor, which does not represent a risk, and Arc continues to actively target aged debtors, the latest summary of which is set out below:

Customer	Balance	Current	30 Days	60 Days	90 Days	Older
Nottinghamshire County Council	2,129,259	2,009,858	79,015	6,845	25,377	8,163
Inspire	18,383	10,819	2,738	4,825	0	0
Kisimul Group Limited	22,217	22,217	0	0	0	0
Rushcliffe Borough Council	634	0	0	0	0	634
Scape Group Ltd	66,807	66,807	0	0	0	0
Schools	148,295	15,685	106,050	19,498	0	7,062
VIA	18,909	4,500	3,630	6,866	-433	4,345
Grand Total	**2,404,504**	**2,129,886**	**191,434**	**38,034**	**24,945**	**20,205**

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Arc Partnership's Balance Sheet Position as at 30 September 2018

14. The table below shows the Reserves in the balance sheet, the constituent elements that have created them and, in addition, the impact of the requirements to account for the pension fund costs/deficits under IAS 19.

£'000	**2016/17 (10 ms) Actual**	**2017/18 (Actual)**	**2018/19 (Projected)**
Trading profit (Management Accounts)	18	587	700
Setup costs/One-off costs (see Note 1 below)	(242)	(20)	
Depreciation (see Note 2 below)	(136)	(215)	(100)
Profit/(Loss) before tax	**(360)**	**352**	**600**
Taxation	63	(71)	TBC
Profit/(Loss) after tax	**(297)**	**281**	
IAS 19 Pension adj – Profit & Loss a/c	(383)	(779)	TBC
Profit/(Loss) (Statutory Accounts)	**(680)**	**(498)**	
IAS 19 Pension adj – Comprehensive Income	(2,368)	745	TBC
Total for year	**(3,048)**	**247**	
Balance sheet Reserves:			
Reserves Brought forward	0	(3,048)	(2,801)
Total Profit/(Loss) for year	(3,048)	247	
Reserves Carried forward	**(3,048)**	**(2,801)**	
Summary of pensions deficit under IAS 19:			
Brought forward	0	6,528	6,562
Opening deficit valuation adj - Goodwill	3,777		
Profit & Loss a/c adj – as above	383	779	
Comprehensive income adj – as above	2,368	(745)	
Total pensions deficit in statutory accounts	**6,528**	**6,562**	

Note 1 – Arc Partnership was required to account for the setup costs incurred by the JV partners under accounting standards. This is a notional cost, which is not paid as cash and additionally formed the Share Premium attributed at the start of the JV.

Note 2 – Depreciation was excluded from the original commercial model for the JV and so a focus is also made at the Trading Profit level to create a like for like comparison.

15. The above table shows that whilst the business trades successfully, making sustainable profits, the impact of the requirement to account for pensions under IAS19 has resulted in reducing Reserves (which are used for the payment of dividends to shareholders) by £2,785,000 as at March 2018. As stated later in this paper, dividends can only be paid when Reserves are positive and also the amount of any dividend being considered cannot exceed the amount of positive Reserves that may be available. The consequence of having to account for pension costs under IAS 19, therefore, is to prevent the payment of a dividend until such time as the cumulative retained profits (ie profits after tax, and any previous / future IAS adjustments) have exceeded the deficit in reserves of £2,801,000 as at March 2018.

LGPS Pension / Dividend Considerations

16. Over the last 25 years and in the wake of well reported pensions related frauds/problems, accounting standards (embodied by law) have been updated continually to ensure employers hold adequate assets to cover their defined benefit pension liabilities over the short to medium term to afford protection to employees should their employer become insolvent. Actuaries also prepare these valuations for accounts purposes.

17. The accounting standard covering defined benefit pension schemes (known currently as FRS102/IAS19) therefore necessarily has differences in approach compared to the traditional actuarial assessment to pension fund valuation, with the main areas of difference being as follows:

    - FRS102/IAS19 requires an annual, rather than triennial, re-assessment of defined benefit schemes;
    - Organisations are required to account for the full cost of pension provision (and not just up to the actuarily assessed funding level) within the current year profit and loss account;
    - Past service liabilities (i.e. accrued to date) to be paid to employees at retirement are discounted back to 'today's value' using the AA rated Corporate Bond yield rate (currently c2.6%) which is the rate achieved on sterling bonds traded on the money markets, rather than the longer-term asset yield rate (considerably higher) which is used for the traditional actuarial valuation purpose. This has the obvious impact of increasing the current value of future liabilities for accounting purposes compared to actuarial purposes and so results in a higher deficit than is recorded in the traditional actuarial valuation approach. The financial impact of this is the difference in discount rate, which is required by the accounting standard to be taken directly to the distributable reserves in an organisation's balance sheet .

18. The discount rate used to value future liabilities, therefore, is a money-market driven rate (which can and does vary day to day) and it is neither controllable nor predictable by any employer (or advisor) and, as such, the accounting valuation of a defined benefit pension scheme is (to a substantial degree) a direct function of market sentiment on any given day (e.g. each year end). Obviously, there are other factors that affect the annual change to pension scheme deficits (e.g. returns on assets/numbers of members/experience gains &

losses which arise on differences between actuarial assumptions and reality - none of which are considered in detail here), but the greater volatility risk relates to the valuation of future obligations.

19. It is important to understand that whilst the above adjustments are accounting entries only (i.e. they are not paid as cash contributions), ultimately they can affect the level of distributable reserves held in organisations and from which dividends may be paid. The purpose behind this treatment is to require organisations to maintain sufficient assets to provide for employees past pension rights as a primary concern and permit dividends to be paid to shareholders only when this obligation is first satisfied.

20. The accounting entries for Arc Partnership are significant, and will impact the ability of the company to pay dividends to shareholders in the short to medium term, as this accounting deficit must be covered by accumulated profits after tax before the Company can legally (under the Companies Act) consider making a dividend payment to Shareholders. This is because Company Law requires that any dividend payment cannot be allowed to turn distributable reserves into deficit . As at March 2018 the deficit on distributable reserves was £2,801,000 which represented trading performance since the start of Arc Partnership, less the part of the accounting pensions deficit that we have been required to charge to the Balance Sheet.

21. The total pension scheme deficit, for accounting purposes, shown in the statutory accounts of Arc as at March 2018 is £6,562,000, of which £3,777,000 was treated as goodwill (and so did not affect distributable reserves) on setting up the Arc Partnership business and represents the revaluation of the opening liabilities using the lower AA rated Corporate Bond yield rate. This represents a significant contrast to the formal triennial Actuarial Valuation that was carried out at commencement which matched assets with liabilities and hence gave a neutral position. It is the formal triennial actuarial valuation which determines employer pension contributions and also will form the real basis of pension fund deficit/surplus evaluation at the very end of the term contract. The effect of this is to supress distributable reserves during the length of the contract until such time as accumulated profits after tax may exceed the pension deficit and, in any event, at the very end of the contract when the final actuarial position is established. The next actuarial valuation is due as of March 2019.

Other Options Considered

22. None

Reason for Recommendation

23. To enable Committee to comment upon and assess the financial performance matters set out in this report.

Statutory and Policy Implications

24. This report has been compiled after consideration of implications in respect of crime and disorder, data protection and information governance, finance, human resources, human rights, the NHS Constitution (public health services), the public sector equality duty, safeguarding of children and adults at risk, service users, smarter working, sustainability and the environment and where such implications are material they are described below. Appropriate consultation has been undertaken and advice sought on these issues as

required.

Crime and Disorder Implications

25. There are no direct crime and disorder implications within the report.

Financial Implications

26. Arc Partnership continue to perform strongly, as does Scape Group. Other financial impacts are set out in the body of this report.

RECOMMENDATION/S

It is recommended that:

1) Members consider whether there are any actions required in relation to the detail contained within this report.

Derek Higton
Service Director, Place and Communities

For any enquiries about this report please contact: Mick Allen, Group Manager, Place Commissioning, Tel: 0115 9774684

Constitutional Comments [CEH 19/12/2018]

27. The recommendation falls within the remit of Finance and Major Contracts Management Committee under its terms of reference.

Financial Comments [KP 18/12/2018]

28. The financial implications are set out in paragraph 26 of the report.

Background Papers and Published Documents

Except for previously published documents, which will be available elsewhere, the documents listed here will be available for inspection in accordance with Section 100D of the Local Government Act 1972.

- None

Electoral Division(s) and Member(s) Affected

- All