COMBINATIONS OF PUBLIC SECTOR BODIES

The following information on Combinations of Public Sector Bodies is taken from CIPFA's *Code of practice on local authority accounting in the United Kingdom Guidance notes for practitioners 2020/21*. It is provided for guidance only and is not intended to be prescriptive in any way. Authorities may wish to seek their own advice when considering such arrangements.

References to 'the Code' means the '*Code of Practice on Local Authority Accounting in the United Kingdom 2020/21*'

Introduction

E1 Paragraph 2.5.1.1 of the Code advises that the combinations of public sector bodies (most commonly seen in the form of local government reorganisation or other transfers of function from one public sector body to another) are business combinations under common control that are outside the scope of IFRS 3 *Business Combinations*.

E2 This means that the combination of two or more local authorities (or other public sector bodies) into one new authority, or the transfer of functions (in full or in relation to a geographic area) from the responsibility of one authority (or other public sector body) to another, will need to be accounted for using the principles that apply to group reconstructions and must be accounted for as either a transfer by absorption or a transfer by merger.

E3 The Code requires that local authorities (or other public sector bodies) account for the transferred functions or the new authorities under both forms of transfer without adjusting the carrying values of the assets and liabilities. The Code includes exceptions to this where there is agreement between the two bodies to revise the amounts as a part of the statutory duties and where "such amounts were agreed after authorities… transferring the services had issued their accounts for the year immediately prior to the transfer date" (see paragraph 2.5.2.6 of the Code). This is also covered in paragraphs E36 and E38 of this module.

E4 Paragraph 2.5.2.1 of the Code defines a transfer of function to or from a local authority as "a transfer of an identifiable service or business operation with an integrated set of activities, staff and recognised assets and/or liabilities that are capable of being conducted and managed to achieve the objectives of that service or business operation."

E5 A transfer of a function may not include all these features or elements but would normally be anticipated to be an identifiable service or business operations with an integrated set of activities. In local government such transfers are often required by statutory prescriptions or relevant orders/instructions from government.

E6 Paragraph 2.5.2.5 of the Code sets out that the underlying objective for accounting for both types of transfer (ie by absorption or by merger) is that they are transfers of function under common control. It indicates that the combination or transfer should be determined by aligning the reporting with the accountability for financial performance. The aim of the process is to ensure the financial reporting supports the accountability for the transferring function, and to do so in a symmetrical way with the other public sector body to ensure there is no transparency and accountability gap.

Transfer by absorption

Gross expenditure, income and net expenditure of acquired functions

E7 The Code requires that income and expenditure directly related to acquired functions are shown separately on the face of the Comprehensive Income and Expenditure Statement. This is so that readers of the accounts can properly appreciate the comparative figures for activities that are continuing, allowing a better understanding of year-on-year trends and future prospects. Accounting policy disclosures for acquired functions will be needed when circumstances arise causing substantial changes to the operation of services.

E8 Acquired functions (operations) are those that the authority has acquired during the accounting period. Examples of acquired functions are:

a) services and/or geographical areas for which responsibility has passed to the authority due to the reorganisation of local government, or

b) services acquired as a consequence of legislation, eg a new statutory responsibility transferred from another entity.

It is suggested that local authorities may wish to refer to the transfers as ‘services transferred from xyz County Council’.

E9 The income and expenditure relating to the acquired function (operation) should be disclosed separately from other continuing operations but before the total continuing operations. Authorities are required to show the results of acquired services separately from the results of continuing services. The results of services acquired in the year should be disclosed below continuing operations but above the line of total continuing operations.

E10 An acquired function (operation) might be, say, the education service in a geographic area transferred to a local authority. It might be the whole of a service not previously carried out. Acquired functions (operations) might embrace a considerable number of services and several services’ costs may need to be apportioned between continuing and acquired operations.

E11 The need for the separation of continuing, transferred and acquired functions (operations) comes from IAS 1 *Presentation of Financial Statements* (IAS 1 paragraphs 85 and 86). This requires that an authority include new line items and amend descriptions when such presentation is relevant to an authority’s performance. The objective is not to require authorities to carry out a technical exercise to separate out these elements of its activity but to make the separation where new functions have been taken on or responsibilities passed to other entities that would have a substantial impact on comparatives across financial years. The authority would need to consider whether the acquisition or transfer causes such a movement in the figures of a service’s total cost that the underlying trends of the authority’s policies are obscured and cannot fairly be understood by users.

E12 The Code requires that acquired and transferred functions are disclosed separately from continuing services. The authority should disclose gross expenditure, income and net expenditure for each of the continuing services. Where all operations are continuing it will not be necessary to use the heading on the face of the Comprehensive Income and Expenditure Statement, but instead authorities should comply with the normal reporting requirements for the statement set out in Module 3 of these Guidance Notes. Similarly, where all operations are acquired or transferred due to local government reorganisation, for example, disclosure of the situation can be made in a footnote to the Comprehensive Income and Expenditure Statement in the interests of presenting a true and fair view of the new authority or an authority that will cease to exist (see also paragraph E25 for presentational requirements for new authorities).

Transferred functions

E13 In order to apportion expenditure between continuing and transferred functions (operations), approximations may be necessary. Where the information is not readily available, an estimate should be used. It is preferable where both bodies involved are subject to the Code that they agree the estimation process to be used and present the same values for the acquired/transferred activities in their respective accounts.

E14 Care is needed with reporting comparatives. In the year of transfer there should be a comparative for the costs of the services affected, provided it is practicable to split the figures for the prior year. In the year following the transfer there will need to be a comparative of the prior year expenditure on the service, matched to a nil entry in the current year.

E15 Functions (or functions in relation to a geographic area) transferred to another authority are required by the Code to be disclosed separately in the comparative year. Practitioners may wish to use the terminology suggested by the example at paragraph E32. Where the transfer requires reporting in the notes to the accounts, a separate line disclosing the transfer will need to be included after the balance brought forward from the previous year. It is important to note that the Code clearly states that transfers of services do not negate the presumption of going concern (see paragraph 2.1.2.9 of the Code) and that discontinued operations are not those operations transferred from one part of the public sector to another (see paragraph 4.9.2.4 of the Code). Discontinued operations are discussed in Section N of Module 4.

E16 As with continuing and acquired functions (operations), some care is needed with comparatives. In the year of transfer, there should be a comparative for the costs of the services affected, provided it is practicable to split the figures for the prior year. In the year following the transfer, there will need to be a comparative of the prior year expenditure on the service, matched to a nil entry in the current year.

E17 Paragraph 2.5.2.9 of the Code indicates that functions may be transferred from an authority to another body outside the public sector (eg a social enterprise). The Code requires that such transfers be accounted for by derecognising any assets and liabilities transferred to the non-public-sector body. Any income received must be accounted for as proceeds of sale of the asset(s).

Transfer by merger

E18 Paragraph 2.5.2.4 of the Code makes it clear that transfers by merger are rare transactions in local government. They will only occur when management of a local government body considers that the substance of a true and fair presentation of the newly combined entity would be best presented as if it has always existed, ie by restating the financial performance, position and cash flows of the entities involved as if the combined entity or function performed had always taken place in that form.

E19 Thus the financial reporting and presentation requirements would need to represent the combined entity as a result of the transfer. Substantially the combined entity would need to have combined in such a way as the substance of the functions that the combined entity performs remains largely unchanged. Possible indications of this might be, for example:

a) the management structure of the combined entity is (substantially) unchanged (this is also supported by the objectives of reporting a transfer, ie aligning the reporting with the accountability for financial performance – see paragraph 2.5.2.5 of the Code)

b) the functions of the future operation of the combined entity remain (substantially) unchanged, and

c) those charged with governance are reasonably able to approve the accounts of the combined entity, having responsibility for the transactions and sufficient access to information and explanations to perform their duties.

In order to come to the conclusion that the transfer represents a transfer by merger, an authority might need to consider the specific legislation requiring the change including primary and secondary legislation and/or other contractual arrangements that bring about the combined entity.

E20 The Code also specifies that to ensure symmetrical accounting treatment with the rest of the public sector, if a transferring or combining entity's functions originate from outside of the local government sector, this is not a transfer by merger; or if the transfer is from a local government body to another part of the public sector, this again is not transfer by merger.

E21 The results and cash flows of all of the combining entities (or functions) should be brought into the financial statements of the combined entities from the beginning of the financial year in which the combination occurred. As with transfer by absorption, assets and liabilities transfer at carrying value (see paragraph E38 for the detail of this accounting treatment per paragraph 2.5.2.6 of the Code). As noted above in paragraph E18, the combined entity should be accounted for as if it has always existed; therefore, comparative information would be required under this form of transfer, and the combination would require full retrospective restatement. Comparatives should be adjusted as necessary to achieve uniformity of accounting policies and consistency of presentation.

E22 The disclosures in paragraph E24 and E27 will assist with demonstrating the impact of the combination or transfer on the local authority financial statements. It is unlikely that transfer by merger would apply to an individual service. However, even if it did, the requirements to report those services separately in the Comprehensive Income and Expenditure Statement outlined in paragraphs E9, E11 and E12 are unlikely to be appropriate for transfers by merger, ie under a form of presentation which presents the combined entity as if it had always existed.

Mid-year transfers

E23 Local government transfers of functions that take place during the financial year are also relatively rare occurrences. The Code requires that where they do take place, they need to be reported in accordance with the principles of transfers by absorption, ie from the date that the transfer took place; or, in rare cases where management consider that a true and fair presentation requires this to be presented as a transfer by merger, the resultant transfer would be reported as if the newly combined body or functions has always existed.

Presentation and disclosure

E24 Where a local authority either receives a transfer of functions or transfers functions to another authority or public sector entity, paragraph 2.5.4.1 of the Code requires the authority to disclose in its financial statements:

i) that the transfer has taken place (including a brief description of the transferred function)

ii) the date of the transfer

iii) the name of the body that the function is transferred from/to

iv) the effect on the financial statements.

E25 Where new authorities are created under a transfer by absorption at the beginning of the financial year, they are not required to provide corresponding amounts for the previous year in the financial statements. The notes to the financial statements of the new authority must include an opening Balance Sheet presenting transferred assets and liabilities and opening reserve balances. Paragraph 2.5.4.2 of the Code requires that this must be clearly identified as the opening balance on the creation of the new authority, not the previous year's Balance Sheet. The Code comments that for transfers by absorption, authorities should apply judgement as to whether the disclosure of historical financial performance of the function should be provided in addition to the disclosures in E24 above, to enable users to understand the operational performance.

E26 Where transfers by absorption have taken place during the financial year, no comparative information is required for the previous year and the information reported in the complete set of financial statements will be reported from the date the transfer took place. Where applicable, the disclosures set out in paragraphs E24 and E25 above should also be made.

E27 For authorities created under a transfer by merger, restatement of comparatives, including that of the results for all the combining bodies for the previous period, must be provided in accordance with IAS 1 as adopted by the Code. Comparatives must be adjusted as necessary to achieve uniformity of accounting policies and consistency of presentation. In addition to the disclosures in E24 above, the disclosures set out in a) to d) below are required:

a) an explanation that the transfer has been accounted for under the merger accounting provisions of the Code

b) an analysis of the principal components of the surplus or deficit on the provision of services and of other comprehensive income and expenditure pre- and post-merger

c) the carrying amount of the net assets at the merger date

d) a statement of any adjustment to reserves resulting from the merger.

E28 Where transfers by merger have taken place during the financial year, comparative information is required in accordance with IAS 1 as adopted by the Code. The disclosures outlined in paragraphs E24 and E27 above, where they apply to transfers by merger, are also required.

E29 Where a continuing authority acquires a new function (operation) or a function in relation to a geographical area, the comparatives for such continuing or acquired operations need to be treated with care. Transferred operations will normally have no comparatives. In the year following the transfer, the results previously shown as transferred will be in the continuing section of the revenue account and the comparatives for that period should be given some thought. If in Year 1 a city council takes over education in a new area and shows £6m as continuing services and £2m as acquired services, then the comparative in Year 2 for continuing services will be £8m and nil against acquired services.

E30 As indicated above, where the transfer of functions (or functions in relation to a geographic area) requires reporting in the notes to the accounts, a separate line disclosing the transfer is required after the balance brought forward from the previous year. A new sub-total will need to be inserted to disclose the restated opening Balance Sheet figures. These lines will be required in the notes showing the movements in assets, liabilities and reserves, including the Movement in Reserves Statement and the movement on the HRA statement.

E31 Paragraph 2.5.4.7 of the Code requires that the circumstances of any transfer of assets and liabilities to a non-public-sector body arising from the transfer of one or more functions to that body must be disclosed. The disclosure must include details of the assets and liabilities transferred, and their carrying amounts. It may be useful to combine this disclosure with paragraph E24 iv) above.

E32 Below is an example extract from a Comprehensive Income and Expenditure Statement. This is for a county council that under local government reorganisation is transferring services to a new unitary authority. The services are continuing to be provided by the county council in all areas other than the city where the unitary authority is based (net figures only for previous year).

ILLUSTRATION: COMPREHENSIVE INCOME AND EXPENDITURE STATEMENT WITH TRANSFERRED FUNCTIONS[1]

Previous year net expenditure £000s[9]		Gross income £000s	Gross income £000s	Net expenditure £000s
	Continuing operations			
3,762	Business change*	18,594	(15,135)	3,459
73,548	People directorate*	100,272	(25,949)	74,323
17,033	Neighbourhoods*	56,049	(38,688)	17,361
429	Corporate and central services*	526	(65)	461
94,772	Total continuing operations excluding operations transferred to XYZ Council	175,441	(79,837)	95,604
	Services transferred to XYZ Council			
28,744	Service outturn for XYZ area**	37,528	(8,140)	29,388
123,516	**Surplus or deficit on continuing operations**	212,969	(87,977)	124,992

[1] For illustration purposes only; authorities are required to report the gross expenditure, gross income and resultant net expenditure for the comparative year.

On 1 April 20XX, the county transferred its responsibilities for providing services in the area of XYZ City to the newly created XYZ Council. The county spent the following amounts on these services in 20WW/XX:

Previous year net expenditure £000s		Gross expenditure £000s	Gross income £000s	Net expenditure £000s
1,473	Business change*	3,535	(1,990)	1,545
22,379	People directorate *	27,467	(4,703)	22,764
4,892	Neighbourhoods*	6,526	(1,447)	5,079
28,744	**Total continuing operations**	37,528	(8,140)	29,388

** These are illustrative descriptions of service segments. A local authority will use its own description of its service segments.*

***Note: services transferred to XYZ Council*

E33 If a local authority has acquired or transferred any functions (operations) with material effect, then a note is required explaining what has taken place. This should be a straightforward explanation of events.

E34 If transferred functions (operations) are disclosed, practitioners should set out details of outstanding liabilities that remain from those services. It is suggested that the disclosure provides details of continuing expenditure, such as repayment of principal and interest, where assets are no longer usable or significant contractual obligations remain despite the transfer or closure of the authority.

Detailed accounting requirements for combinations of public sector bodies[2]

E35 The Code contains provisions that apply the 'machinery of government' principle to reorganisations that have been imposed by central government on local authorities. The importance of this is that, using the principles that apply to group reorganisations or reconstructions, merger accounting (per FRS 6 *Acquisitions and Mergers*) can then be applied to reorganisations, with assets and liabilities being transferred at their carrying amounts between two authorities. The alternative, acquisition accounting, would require assets and liabilities to be brought into the Balance Sheet at their fair values, with any difference between the net fair value and the consideration given being accounted for as goodwill or the gain from a bargain purchase under IFRS 3.

E36 The following treatments should be applied:

a) Reorganisations should normally be accounted for as taking place on 1 April, ie at the start of the new financial year. Authorities affected by a reorganisation will

[2] Note this section (paragraphs E35–E41 of Module 2) largely covers the accounting requirements under transfers by absorption with the exception of paragraphs E35, E38 and E39 which apply to both transfers by absorption and transfers by merger.

bring forward the closing Balance Sheet for the preceding year then put through adjustments for assets and liabilities that have transferred, together with any reserve movements, as transactions for the new financial year.

b) Transfers of assets and liabilities will usually be negotiated on a breakeven basis, where the net amount of assets/liabilities is compensated for by a cash settlement and an arrangement to contribute to the outstanding capital finance on property, plant and equipment. Where this is the case, there will be no gain or loss to be recognised, but the increase/decrease in net worth of the transferring authorities will need to be included exceptionally and be separately disclosed in the Movement in Reserves Statement.

c) The notes to the accounts will need to separately identify transfers of assets and liabilities and any consequential changes to reserves.

E37 If there is a gain or loss on the transaction (ie there is an imbalance in the carrying amount of the assets and liabilities that have transferred), the difference will need to be written off. Paragraph 2.5.2.7 of the Code protects the surplus or deficit on the provision of services from debits and credits arising from reorganisation, so the gain/loss will be treated as a movement in reserves and reported in the Movement in Reserves Statement. Exceptions to this treatment will be:

a) an authority relinquishes property, plant or equipment without receiving full compensation – the loss will be reversed out of the General Fund balance and posted to the capital adjustment account, to be financed as originally intended under the Prudential Framework

b) an authority acquires property, plant or equipment assets without paying full compensation (either in the form of cash or a deemed debt arrangement) – the income will need to be posted as a credit to the Comprehensive Income and Expenditure Statement in accordance with the required treatment for government grants (see paragraphs C16 to C20).

E38 Assets and liabilities will normally be transferred at the amount at which they are being carried in the 31 March Balance Sheet of the relinquishing authority. However, paragraph 2.5.2.6 of the Code allows revised amounts to be used where these have been negotiated in accordance with statutory duties and agreed after the statement of accounts for the preceding year had been issued. Where carrying amounts are used that are different from revised amounts, reconciling entries will be needed once the transfer has been accounted for. These reconciling entries again will not impact on the surplus or deficit on the provision of services but will be recorded in the Movement in Reserves Statement. Once a transfer has taken place, the carrying amounts may need to be adjusted to comply with the receiving authority’s accounting policies – this will especially be the case with non-current assets, which might require a revaluation.

E39 It should be noted that merger accounting will require uniform accounting policies in the new authorities and in any authorities with newly acquired services or functions (in full or in relation to a geographic area).

E40 Where the transfer requires reporting in the notes to the accounts, a separate line disclosing the transfer is required to be included after the balance brought forward from the previous year. A new sub-total will need to be inserted to disclose the restated opening Balance Sheet figures. These lines will be required in the notes showing the movements in assets, liabilities and reserves, including the Movement in Reserves Statement and the movement on the HRA statement.

ILLUSTRATION: TRANSFER OF BALANCES ON REORGANISATION

Ellebeau County Council is transferring services to Heartichman Keys Borough Council upon the latter's establishment as a unitary authority. The relevant balances for transfer have been extracted from the county's Balance Sheet as published in the preceding year's accounts, with certain exceptions:

The county had a bad debt provision of £100,000 for the debtors to be transferred to the borough, but it has been agreed that the transfer should reflect a £120,000 provision.

The borough will recognise a long-term liability to the county of £20m for the unfinanced part of the non-current assets to be transferred.

The county will transfer £1m cash to the borough – this ensures that the total amount of assets and liabilities transferred to the borough (including the cash) net to zero.

The transfer will be accounted for based on carrying amounts. Consequently, the bad debt provision will be derecognised by the county and recognised by the borough at the £100,000 amount. Based on the cash settlement, the transfer will result in a £20,000 discrepancy – a loss for the county and a gain for the borough. The loss and gain will then be corrected by a credit to the county's General Fund balance in the Movement in Reserves Statement and a debit for the borough to uplift the loss allowance

With regard to the deemed debt arrangement, this will be treated by the borough as the historical cost of the non-current assets acquired. The non-current asset balance will then largely be balanced by the long-term debtor, and shares of the revaluation reserve and the capital adjustment account.

E41 The overall implications for the various types of authority involved in a reorganisation are set out below.

1. Local authority ceases to exist

Although not a discontinued operation (see paragraph E15 above) in the interests of ensuring a true and fair presentation, a footnote to the Comprehensive Income and Expenditure Statement should be provided explaining circumstances to the users of the financial statements. The account will not look any different to the accounts prepared had the authority not been subject to reorganisation.

2. Local authority loses some of its services to another authority but continues to exist

In the last year of operation, the authority should disclose those operations that are being transferred. Where the geographical provision of the service is changing so that the authority is losing part of a service but continuing to provide that service, the costs will have to be split between those relating to the transferred service(s) and those relating to the continuing services of the authority.

This means that in the year of reorganisation, the prior year comparatives relating to the transferred service will be separately identified and appropriate conclusions can be drawn about the costs of the continuing service (see paragraph E14).

Data should exist from the preparations for reorganisation for authorities to provide suitable year comparatives. Approximations can be used where detailed information is not available.

Where an authority has some of its area and services transferred to another local authority, it may wish to show a single line on the face of the Comprehensive Income and Expenditure Statement ‘services transferring to ABC Unitary Authority’, and then provide a breakdown to services in a note to the accounts so that the comprehensive income and expenditure account does not show the same services listed twice.

In the Movement in Reserves Statement and wherever the transfer has an effect on the amounts disclosed in notes to the accounts (eg movements in non-current assets), the transfer should be presented as an adjusting line to the opening figure, with a sub-total to show the restated position post-transfer.

3. A new local authority is brought into existence

In its first year of operation, all of the services/operations will be classified as acquired functions (operations) and there will be no prior-year comparatives available. In practice, a footnote will be required to record that this is the first year of a new authority and that all operations are acquired. The Code requires the opening Balance Sheet to be disclosed in a note to the accounts, clearly identifying it as the opening position on the creation of the new authority rather than the closing position for a preceding year.

4. A local authority acquires some new services

In the first year of operation of the new services, they will be shown as acquired services or functions – even if the authority already provides that service. To avoid showing a list of services twice on the face of the Comprehensive Income and Expenditure Statement, the authority may wish to show a single line ‘services transferred from XYZ Council’ and provide a breakdown in the notes to the accounts. Then, in the following year, the comparative for each service will be the amount shown under continuing operations plus that shown in the note as acquired in the current year’s accounts.

In the Movement in Reserves Statement(s) and wherever the transfer has an effect on the amounts disclosed in notes to the accounts (eg movements in property, plant and equipment), the transfer should be presented as an adjusting line to the opening figure, with a sub-total to show the restated position post-transfer.