Draft HFMA briefing
April 2018

Subsidiary companies – financial considerations

Draft briefing for comment

Background

More and more NHS bodies are establishing subsidiary companies. The HFMA has had a request from several sources for practical guidance in relation to the impact for finance teams of having subsidiaries.

In part, this was addressed in our briefing *Accounting for joint working arrangements*[1] but there seems to be an appetite for a detailed checklist of issues to consider.

This draft briefing has been discussed by both the Accounting and Standards Committee and Provider Technical Issues Group. However, we think that other HFMA members will have experiences which can be included in the briefing. Therefore, this briefing is being issued in draft for comment.

If you have any comments, please send them to Debbie Paterson (debbie.paterson@hfma.org.uk).

We plan to publish the briefing in the week commencing 18 June so please send us your comments by 14 June. Having said that, the briefing will be dynamic, so comments are welcome at any time.

Members are asked to:

- review the draft briefing and provide feedback
- consider whether there are any areas missing from the proposed outline briefing
- provide examples or case studies where appropriate
- respond to drafting notes if possible.

[1] www.hfma.org.uk/publications/details/accounting-for-joint-working-arrangements-2017

Subsidiary companies – financial considerations

Introduction

Most NHS bodies have the power to establish subsidiary companies[2] and more NHS bodies are doing so. This briefing is intended to act as a checklist of issues to consider when establishing a subsidiary or entering into a joint working arrangement.

When determining the appropriate accounting treatment, the key consideration is control. Our previous briefing *Accounting for joint working arrangements*[3] looked at whether the NHS body controls another body or not. Control needs to be reassessed if arrangements/ ownership of the subsidiary or the NHS body change.

While every care had been taken in the preparation of this briefing, the HFMA cannot in any circumstances accept responsibility for errors or omissions and are not responsible for any loss occasioned to any person or organisation acting or refraining from action as a result of any material in it.

The business case for the new entity

Establishing a subsidiary body or entering into a joint arrangement needs to be supported by a robust and detailed business case which demonstrates that it is the most appropriate way of achieving the desired outcome.

Where it is anticipated that the new body will trade with organisations other than its parent the business case will need to include detailed market research.

Companies and partnerships have been set up in the NHS to fulfil many objectives including:

- income generation using the NHS body's spare capacity
- benefiting from intellectual property
- managing estates portfolios
- providing facilities management
- developing healthcare technology
- managing and provide services such as pathology and pharmacy
- providing private healthcare services
- working with partners, for example, clinicians, GPs and private sector entities.

NHS bodies are not allowed to establish companies to avoid tax (the letter from DHSC setting this out is attached in the appendix to this briefing).

The business case supporting the new arrangement should include a robust assessment of how much resource will be required to support it. Whilst the cost of any resource provided by the parent NHS body must be recharged to the subsidiary, the amount of resource needed should not be underestimated and should take into account the increased demands as the company's activities expand to achieve its objectives.

Understanding the structure of the new arrangement

There are many ways that an NHS body can enter into a joint working arrangement – it is important to understand how that arrangement works in order to establish the appropriate accounting treatment.

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[2] Different types of NHS bodies have different statutory powers – when establishing a subsidiary or any other joint working arrangement it is important to establish the statutory basis for that arrangement
[3] HFMA, *Accounting for joint working arrangements*, June 2017

In developing this briefing, we have seen various arrangements in operation in the NHS:

- 100% owned subsidiary companies
- 100% owned subsidiary companies which have their own joint ventures and subsidiaries
- a consolidated charity with a subsidiary company
- joint ventures with other NHS and non-NHS bodies.

Structuring the new arrangement appropriately should result in the most beneficial arrangement for the NHS body whilst minimising the risks.

Formally establishing a new entity

Registration

A company or limited liability partnership can be established with relative ease through Companies House[4].

All companies need to be registered with Companies House. There is guidance on how to do this on their website[5].

Although we have not yet found an example, NHS bodies may wish to establish a Community Interest Company (CIC) which is a company which has social, charitable or community-based objectives. CICs are also established through Companies House, they differ from other companies in that they must have a community interest and an 'asset lock' which means that the company's assets can only be used for its social objectives and limits the amount that can be paid to shareholders.

CICs are regulated by the Office of the Regulator of Community Interest Companies[6].

Practical considerations

It is worth noting that there are some words/ names which cannot be used in company names without permission – NHS is one of these words, as is health centre and some healthcare professions and titles[7].

A company needs a memorandum and articles of association – there are model documents available from Companies House. It is important to ensure that these documents are tailored to include the activities that the company will be undertaking. For example, if the company will own property, the articles should say that.

The memorandum of association cannot be updated once the company has been registered.

Directors

All companies are required to have at least one director who is legally responsible for running the company. The director must be a person – it cannot be the NHS body.

There are legal responsibilities involved in being a company director which individuals need to be aware of.

Limited liability partnerships (LLPs) need to have 2 or more members – these can be individuals or organisations. The NHS body can therefore be a member of an LLP.

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[4] www.gov.uk/government/organisations/companies-house
[5] www.gov.uk/limited-company-formation
[6] www.gov.uk/government/organisations/office-of-the-regulator-of-community-interest-companies
[7] www.gov.uk/government/publications/incorporation-and-names/annex-a-sensitive-words-and-expressions-or-words-that-could-imply-a-connection-with-government#NHS

For NHS bodies, the governance arrangements of the company with the NHS body need to be considered. In the cases we have reviewed, at least one member of the NHS body's governing body is a director of the company. In some cases, all of directors of the company are members of the NHS body's governing body. The decision as to whether to link directorship of the company to a specific senior management role at the NHS body needs to be made at an early stage.

Date of incorporation

The date that the company or LLP is created is its accounting year-end. Consideration should therefore be given to establishing companies so that they align with the NHS body's year end.

It is possible to consolidate bodies which have different year ends. However, where the company's accounts are consolidated into the NHS body's accounts, auditable part-year financial information will have to be prepared by the subsidiary to enable the auditor to complete the audit of the parent NHS body's accounts.

Where the new arrangement is a joint venture, the NHS body will not have control, so the year ends may be different. In this case, part year accounting will be required.

Companies House returns

Annual accounts need to be submitted to Companies House and an annual tax return to HMRC. The deadlines for submission of these returns is more generous than the deadlines for the NHS accounts submissions.

Disclosure to NHS Improvement/ NHS England

For NHS Improvement to prepare consolidated accounts for the provider sector and assist DHSC with its group consolidation, it is important that they know whether an NHS provider has a subsidiary. The summarisation schedules (TAC forms) will be completed on a consolidated basis but there is an additional information tab which must be completed.

Currently, as far as we are aware, no CCGs have subsidiary companies, but it is possible that they might enter into such arrangements. If this does happen then they will need to inform NHS England.

Where several NHS bodies are shareholders in a company, consideration needs to be given to the accounting at a DHSC group level as well as the NHS body level. The company may not be consolidated by any of the NHS bodies because they do not have control but, by the fact that the DHSC has control of the NHS bodies, it may need to be consolidated at the group level.

Accounting by the NHS body

The key consideration in determining the accounting treatment is whether control exists. This briefing assumes that it does, which would mean that the NHS body has a subsidiary body and therefore must prepare consolidated accounts in accordance with IFRS 10 with the necessary disclosures required by IFRS 12.

Paragraphs B86 to B93 of IFRS 10 set out the guidance for the preparation of consolidated financial statements. In summary for wholly owned subsidiaries:

- all like items of assets, liabilities, equity, income, expenses and cash flows are combined
- the carrying amount of the parent's investment in the subsidiary and the parent's portion of equity on the subsidiary should be offset
- intra group assets, liabilities, equity, income, expenses and cash flows are offset
- uniform accounting policies need to be adopted across the group prior to consolidation
- all entities in the group should have the same reporting date.

This briefing does not contain comprehensive accounting guidance but identifies some issues that NHS bodies should consider.

Group accounts

A set of consolidated accounts needs to include the group and the parent entity's financial information for all primary statements and notes. Where the difference between the group and parent's information is not material then both sets of information do not necessarily need to be disclosed.

The Companies Act allows the parent entity to exclude its figures from the statement of comprehensive income (SOCI) and disclose only the group position. Some NHS bodies take advantage of this exemption.

Accounting policies

The example accounting policies provided by NHS Improvement and NHS England include accounting policies for accounting for subsidiaries and other joint working arrangements. However, these need to be tailored for the circumstances of the NHS body.

There may be other accounting policies which need to be revised when preparing group accounts – for example, in relation to corporation tax.

Leases

Where there is a lease arrangement between a parent and its subsidiary then the new leases standard will cause complications for consolidation. Under the new standard, the accounting treatment differs for lessees and lessors, so the consolidation will need to eliminate all the lessee accounting entries to leave the only the leased asset in the consolidated accounts.

This will be the case when the subsidiary is the lessor whether it accounts for leases under IFRS or UK GAAP. Where the subsidiary is the lessee then if it is using UK GAAP, the accounting treatments should mirror each other.

Segmental reporting

The financial position of each part of the group is usually reported and managed separately. Consideration should be given as to whether the subsidiary is a separate segment which needs to be disclosed in the segmental reporting note.

Shareholdings

Most NHS bodies disclose their investment in the subsidiary as a long-term investment in the parent body's statement of financial interest. This is consolidated out in the group's statement.

The parent body's investment in the subsidiary body should be valued at cost when the subsidiary is established. A note to the account shows any movement in that investment.

In joint venture or associate arrangements, the investment is valued using the equity method.

Remuneration report

Where members of the governing body are directors of a subsidiary company this needs to be disclosed in the remuneration report. Interests in the subsidiary should be declared in the register of interests.

Where the subsidiary is material, consideration should be given as to whether the directors of the subsidiary are senior managers of the NHS body and should be included in the remuneration report.

Accounting by the subsidiary

Accounting standards

UK companies are not required to apply IFRS unless they are publicly listed. This means subsidiary companies can be accounted for in accordance with UK and Ireland GAAP. UK and Ireland GAAP is made up of five regimes. The choice of regime depends on:

- whether the entity is eligible to use the regime – based usually on its size with thresholds set out in the Companies Act
- the most appropriate regime for the particular circumstances[8].

Going concern

Unlike NHS bodies, companies can go out of business and therefore a full going concern assessment will need to be undertaken each year.

The outcome of the going concern assessment may need to be reflected in the NHS body's risk register and governance statement if material.

Tax

Registration for corporation tax

All companies must be registered for corporation tax within three months of starting to do business.

Accounting for corporation tax can be complicated and is probably outside an NHS accountant's experience. Expert advice may be needed, for example:

- some subsidiaries have to account for deferred tax which can be complex
- some accounting decisions (such as whether a lease is operating or finance) may have tax implications which need to be understood and taken into account as part of the decision making process.

On a practical note, corporation tax files need to be sent to HMRC in iXBRL format which will be new for most NHS finance teams and may require new software.

In the case of joint ventures, understanding where any tax liabilities fall (the parent or the joint venture) is important - this will depend on how the arrangement has been set up. Information from the partnership return will be needed to prepare the tax return. The arrangements for funding the tax liabilities need to be considered before those liabilities become due.

Registration for VAT

Once the company reaches the VAT income threshold[9] it needs to register for VAT.

The VAT regime for companies is different to the regime for NHS bodies. Companies, even those wholly owned by NHS bodies, fall outside of the NHS VAT divisional registration. This means that the trade of taxable goods and services between the subsidiary and the NHS body would be subject to VAT at the appropriate rate.

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[8] The Financial Reporting Council's *Overview of the financial reporting framework* sets out the options available and the eligibility criteria

[9] This is currently £85,000, see www.gov.uk/vat-registration-thresholds and www.gov.uk/government/publications/vat-maintain-thresholds-for-2-years-from-1-april-2018/vat-maintain-thresholds-for-2-years-from-1-april-2018

The same applies to all organisations trading with the subsidiary. It is important that it is clear to all other organisations (including NHS bodies) which entity they are trading with (the NHS body or the subsidiary) so that they can make the appropriate decisions in relation to VAT treatment.

The subsidiary body's VAT regime falls outside of the contracted out services regime. This may be something that NHS finance staff are not familiar with so expert advice or additional training may be required.

Where staff are employed and paid by the NHS body and seconded/ recharged to the subsidiary this is a supply of staff which would be subject to VAT.

Where the subsidiary company is undertaking estates management, VAT on capital works may be reclaimable. This is not the case for capital expenditure incurred by NHS bodies. This may be grounds to revalue the NHS estate net of VAT – the accounting treatment and revaluation approach should be discussed with valuers and auditors at an early stage.

Registration for PAYE

If the subsidiary company is going to employ staff it will also need to register for PAYE. It will have to comply with pension auto-enrolment requirements and may (if it is large enough) have to pay the apprenticeship levy.

Practical issues

Governance framework

A new subsidiary company will need to have appropriate governance arrangements. It may be that the NHS body's own standing financial instructions (SFIs) can be used but they may be inappropriate for an entity much smaller than its parent.

The standing orders of an NHS body will take into account the statutory framework that NHS bodies work within – this will be different for a company so new standing orders may be needed. For example, there is no requirement for companies to hold their board meetings in public whereas this is a requirement for NHS bodies.

As part of establishing the governance arrangements for the new entity, consideration should be given to how the subsidiary supports the overall aims and objectives of the NHS body and how senior management direction feeds into the subsidiary.

Banking and cash management

The company will have to have its own bank account. Experience is that this may take a considerable amount of time to set up.

As the company is new it will not have a credit limit until it has been trading so a while. This may mean that suppliers require payments on account which the company should include when estimating its cash requirements. A parental guarantee may also be required from the NHS body.

The new subsidiary will not have cash reserves. If there are transactions between the NHS body and the subsidiary, same day payment terms for the NHS body to make immediate payment to the subsidiary may need to be considered to ensure that the subsidiary maintains its cash position.

A subsidiary may require a loan to cover initial expenditure as there are no cash reserves. This can be done in the form of a loan by the NHS body to its subsidiary or in the form of a capital investment (additional shares).

If a loan is made then consideration needs to be given to the terms of that loan – length, repayment terms and interest rate. These should all be set out in a loan agreement signed by both parties. Legal advice may be required when drafting the agreement.

Alternatively, the NHS body could make a capital contribution to the subsidiary – this will be reflected in the reserves of the subsidiary body.

General ledger and other software

A decision will need to be made as to whether to use a single financial system for the parent NHS body and its subsidiaries or whether to use separate systems.

In either case, consideration should be given to how the consolidation will be undertaken and how intra-company transactions will be eliminated. It may be tempting to use a spreadsheet when the subsidiary is small, but plans should be made for when this is not the case.

Where NHS bodes use NHS organisations, such as Shared Business Services (SBS), they will need to discuss with the supplier what services can be provided for a non-NHS subsidiary body. For example, we are aware that NHS bodies have had to employ a different payroll provider for their subsidiary body as SBS is unable to contract with a non-NHS body.

Where a different payroll is being set up then it is important to allow time to set up the new arrangement and transfer staff to the new system.

DN: if there are any case studies these would be helpful

Auditor

Subsidiary companies may be exempt from audit where particular circumstances apply[10]. Where an audit is required, the qualifications needed for an auditor of a company may be different to those for an NHS body. Auditors will be able to ensure that they can provide appropriate staff to undertake the work.

The auditor of the subsidiary body does not need to be the same as the auditor of the NHS body. Where different auditors are involved the auditor of the NHS body will need to issue group instructions to the auditors of the subsidiary body in accordance with auditing standards.

Staff

DN: some practical experiences would be useful in relation to staff issues

Subsidiary bodies can employ staff. Some NHS bodies second their staff to the subsidiary, others transfer staff. If staff are transferred, then the Transfer of Undertakings (Protection of Employment) regulations (known as TUPE) apply. Staff are transferred on the same terms and conditions that they were previously employed on.

The use of secondments where businesses are transferred is complicated so legal advice may be required[11].

Subsidiary bodies do not need to employ new staff on the NHS terms and conditions. Some recruits may see this as a positive, others may not. There may be objections to the transfer of staff to the subsidiary, so they and their representatives should be engaged with the new process as early as possible.

In particular, the subsidiary body may not be able, or want, to offer the NHS pension scheme to its employees. Where this is the case then alternative pensions may need to be considered.

The appropriate auto-enrolment arrangements need to be made for the subsidiary's staff.

[10] www.gov.uk/audit-exemptions-for-private-limited-companies

[11] See the House of Lords decision in the case of Celtec Ltd vs Astley https://publications.parliament.uk/pa/ld200506/ldjudgmt/jd060621/nwales-1.htm

Reference material

https://www.gov.uk/topic/company-registration-filing/running-company
https://www.gov.uk/government/publications/life-of-a-company-annual-requirements/life-of-a-company-part-1-accounts
https://www.gov.uk/topic/business-tax/vat
https://www.gov.uk/topic/business-tax/corporation-tax
http://nhsproviders.org/wholly-owned-subsidiaries-in-the-nhs
https://www.grantthornton.co.uk/insights/why-set-up-an-nhs-company/
https://www.grantthornton.co.uk/insights/nhs-companies-an-enterprising-approach-to-health/

DN: this section needs to be expanded – any suggestions?

Appendix: text from the letter from the letter from the finance director of the Department of Health

28 September 2017

NHS Provider Finance Director

Dear Colleagues

Tax Avoidance Issues in the NHS

Whilst the challenge facing NHS organisations in delivering efficiency savings remains a clear priority; within that context this letter seeks to clarify the Departmental of Health (and Government) view on the use of tax advisors, with particular reference to tax avoidance.

You will be aware that an element of VAT incurred on the supply of any applicable services "contracted-out" of the public sector is genuinely 'reclaimable' and this is accepted practice worth in the region of E2 billion per annum across the NHS.

However, The Department has been made aware of a number of tax advisors offering tax solutions to health bodies which, although legal, avoid the payment of tax for which that body has been funded. The fees chargeable to the tax advisors represent a direct leakage out of the health system and while at a local level there may be an immediate financial benefit, there is an overall net loss to the exchequer as a result.

The only tax advice the Department deems acceptable is that necessary for the fulfilment of statutory functions or to assist in compliance with tax rules beyond in-house expertise. Tax avoidance schemes should not be entered into under any circumstances: for the avoidance of doubt, HMRC's definition of tax avoidance is:

"...bending the rules of the tax system to gain a tax advantage that parliament never intended. ...it often involves contrived, artificial transactions that serve little or no purpose other than to produce this advantage. It involves operating within the letter, but not the spirit, of the law."

HMRC are actively investigating the health sector in relation to tax avoidance schemes and the level of scrutiny is likely to increase in the future. Any findings indicating systemic issues will likely have significant implications, both locally for those organisations directly involved and nationally for the future use of the contracting out regime by the NHS.

I ask that careful consideration be given by NHS organisations when looking into contractual arrangements which give rise to a tax advantage. If there are genuine commercial reasons for entering into contracts which, as a by-product, have a tax benefit this Is considered acceptable. However, arrangements considered solely to gain a tax advantage is clearly tax-avoidance and should not be entered into for the reasons set out above.

For further information and any advice on this matter, please do not hesitate to get in touch.

Yours sincerely

Chris Young

Finance Director