BUDGET AND PERFORMANCE PANEL

STOREY CREATIVE INDUSTRIES CENTRE
23 October 2012

Report of the Head of Resources

PURPOSE OF REPORT
To provide additional information and allow further consideration of this issue, subsequent to the September meeting of the Panel.
This report is public.

RECOMMENDATIONS

That the Panel considers the report.

1 **Introduction**

1.1 At its meeting on the 25 September 2012, the Panel deferred consideration of answers to two questions relating to the Storey Creative Industries Centre (SCIC) and also asked some additional questions around this topic. Answers are provided below.

1.2 Furthermore the Panel requested information on liabilities of directors and this is set out for completeness.

2 **Questions and Answers**

2.1 Answers to the questions (originally numbered 4 and 5) deferred from the last meeting are set out below .

Q 4: What processes of due diligence took place before the loan was agreed in principle in December 2011, when was the loan paid over to the company, and what due diligence took place between the agreement in principle, and the payment of the loan to the company?

A 4: The loan was agreed in full in December 2011. Delegated authority was given to agree terms and conditions. [The loan agreement was completed on 02 February 2012 and the loan payment to the company processed on 03 February].

Extensive queries and reviews were undertaken with evidence being sought on the company's position, from a cross-service perspective (Finance, Property, Legal, Regeneration, and to a lesser extent Community Engagement). The implications of not granting the loan were also assessed as far as possible, in particular VAT and clawback.

The company's previous year accounts and management accounts were assessed. The company had produced a sustainability plan and that was appraised. A meeting was held in December with representatives from the company, to allow questioning. Various communications took place with the Company's Board and its Finance Committee.

The processes are reflected and summarised in the exempt Urgent Business Report and the Panel is advised to refer to this for more background. Essentially, the due diligence and decision to grant the loan came down to balancing the risks either way, and the following extracts summarise the rationale for granting the loan, but acknowledging the risks involved.

"Option 1 is the preferred option as the potential risk of non-recovery of loan repayments is considered more manageable for the Council when compared to the increased likelihood of far more significant operational and financial implications arising should SCIC Ltd cease trading. That said, it is recommended that further work be done to assess VAT options and to clarify (with the aim of avoiding) clawback liabilities, in order to give the Council greater flexibility in managing its interests in the building.

Conclusion
There is an opportunity for the Council to prevent SCIC Ltd failing in at least the short to medium term by providing it financial assistance by way of a loan on a fully repayable basis over three years. If approved, it is reasonable to assume that provided the SCIC at worst case continues to maintain its current occupancy levels, it can become a self sustainable operation based on its current financial projections. This should in turn protect economic benefits for the district by ongoing support of the development of the creative and cultural industries and visitor economy. There is no guarantee of such an outcome, however."

Once the loan had been agreed, work focused on seeking details and agreement on creditors repayment plans and the terms and conditions attached to the loan. Details of the monitoring and financial management arrangements required under the loan are attached at ***Appendix A.***

Q 5: In what way and at what date did examination of the annual accounts of the company contribute to due diligence?

A 5: The draft annual accounts were reviewed at various points between August and December 2011. In particular, verification and explanation was sought on apparent discrepancies between the Council's accounts and that of the company. In summary, the accounts were used as a comparator for the company's sustainability plan and to inform the views of its overall financial position and outlook, as well as to gain greater understanding of the company's cash flow. Examples of this are highlighted in the exempt Urgent Business Report and extracts from one of the appendices are included below, to help demonstrate the processes adopted:

- *“Although [overall] forecast expenditure for 2011/12 is less than that outturned at 2010/11, this seems ok as the previous year included some one-off grant funded expenditure as verified by SCIC’s draft accounts for this period.*

- *It has been queried whether it is prudent to reduce heat, light and power costs in future years compared to 2010/11 outturn, however SCIC believe they are currently being overcharged for their gas supply and are in dispute with [their provider]....”*

2.2 The additional questions arising from the last meeting are answered below.

Q1: Why was the building's VAT status not changed at that time (as a similar precaution)?

It is assumed that this means at the time the loan was considered and granted.

It was not possible to do so in the time available, recognising too all other work demands at that time. VAT is a very complex area and more time was needed to complete the assessment of the implications for the Council. There are complex linkages between VAT status, lease terms and rent levels, capital works, and any associated services being provided. Changing the VAT status of a building also has cost implications for any tenants that are not VAT registered. Effectively, opting to tax increases the rents and service charges for any such tenants.

VAT has been a complex consideration for the project from the very outset. This is evidenced from much earlier reports, at the time when the Council was deciding whether to progress the project.

Q2: (The VAT status change has now been done) Please tell us more about the purpose of the change and the circumstances in which the change would have significant impact. How long did it take to make this VAT change and for it to become effective?

An extract from the December report is included at ***Appendix B***. This provides information on the purpose of the change and its likely impact in various scenarios.

The change was notified to HMRC on 20 June once it had been fully assessed. It was effective immediately.

Q3: How much of the £90k loan is being claimed against the assets of the company in the liquidation?

All of it, together with interest and other outstanding amounts including charges for trade waste, but less any repayments made. In total the amount being claimed is approximately £129K, which includes interest of approximately £17K, and takes account of the Company having made repayments of approximately £7.5K.

Q4: Why was the £90k support to the company given by way of loan instead of by way of pure grant or some mix of grant and loan?

The company requested support in the form of a loan with provision for interest at 10%. It saw the request as 'a commercial arrangement'. It considered that it would be in a position to repay the loan and therefore there was no reason to consider grant financing. As a loan, there was the opportunity for the support to be repaid, in the interests of council tax payers. As shown earlier the company repaid two instalments totalling just over £7500, including interest. With grant financing, there would have been no opportunity or requirement for any repayment.

Q5: Was it anticipated at the time of the loan being made that it was likely to be recovered in full by means of the agreed scheme of repayments?

Yes, subject to the company managing its business relationships with sub-tenants, recovering amounts owing to it and delivering against its sustainability plan, although there was no guarantee of this and the risks attached were recognised too.

Q6: Was a deadline specified by the company for the granting of a loan, and if so what was it and why?

There was no specific deadline set. The pressure from creditors threatening legal action was the driving force behind timescales.

Cash flow projections provided on 13 December 2011 indicated that the company should have been able to manage payments for the next fortnight or so, with difficulties starting from Christmas week. In January, Officers sought to clarify the urgency surrounding the company's position. A letter of intent was supplied to the company on 24 January 2012, to assist it in avoiding enforcement action.

3 Liabilities of Directors and Former Directors

3.1 At the last meeting the Panel resolved:

> "that information be provided to the panel regarding whether there is any liability of any kind of the directors and former directors of the company in relation to the loan, or other liabilities of the company."

3.2 As a company limited by guarantee, under normal circumstances every director's personal liability is limited to £1 each, should the company be wound up whilst they are still in office, or within one year of them ceasing in that role.

3.3 When a company enters into Creditors Voluntary Liquidation (CVL), it is one of the liquidator's roles to investigate and report upon the conduct of the officers of the company (directors and shadow directors). Should the liquidator conclude that any "wrongful trading" has taken place, directors can be made personally liable for a company's debts. In drawing any conclusions, the liquidator would need to ascertain the point at which the company became insolvent and whether decisions and actions from that point on were made in good faith and in the best interests of the company's creditors.

3.4 In terms of the Council's appointment of a director, as with all other appointments to outside bodies, generally the Council's Official Indemnity insurance provides cover for any personal liability arising. That said, the availability or extent of cover would depend on the specific details and circumstances of any claim.

CONCLUSION OF IMPACT ASSESSMENT
(including Diversity, Human Rights, Community Safety, Sustainability and Rural Proofing)

N/A

LEGAL IMPLICATIONS
None directly arising as a result of this report.

FINANCIAL IMPLICATIONS
None directly arising as a result of this report.

OTHER RESOURCE IMPLICATIONS

Human Resources / Information Services / Property / Open Spaces:
None arising directly as a result of this report.

SECTION 151 OFFICER'S COMMENTS
The s151 Officer (as Head of Resources) has produced this report.

MONITORING OFFICER'S COMMENTS
The Monitoring Officer has been consulted and has no further comments.

BACKGROUND PAPERS Urgent Business Report 20 December 2011 (Exempt status under review).	**Contact Officer:** Nadine Muschamp **Telephone:** 01524 582117 **E-mail:** nmuschamp@lancaster.gov.uk **Ref:**

APPENDIX A

MONITORING AND FINANCIAL MANAGEMENT ARRANGEMENTS (AS REQUIRED UNDER LOAN AGREEMENT)

Immediately following acceptance of the loan agreement, the Borrower takes any actions necessary to ensure its financial management, monitoring and administration arrangements are robust and adequately resourced. This includes (but is not limited to) ensuring the timely setting and full recovery of all relevant rents and service charges, so as to assist the Borrower in discharging its financial liabilities to the Council under this agreement .

On request and at appropriate and timely intervals the Borrower will provide information as reasonably required by the Council's Head of Financial Services or their nominated representative, including but not restricted to:

- Creditor invoices, payment receipts and copies of bank statements to evidence both the need for advance of loan and also the subsequent application of loan and discharge of creditor liabilities
- Monthly management accounts including aged debtor and creditor lists
- Monthly cashflow statements
- Annual Business Plan
- Annual Financial Statements
- Reports produced by the Borrower's Accountants or Auditors.

The Borrower will continue to provide the Council's Head of Financial Services or her nominated representative an invitation to attend its Finance Sub-Committee meetings for the duration of the loan agreement as an observer.

The Borrower will continue to provide the Council copies of Board papers and the annual report to the Council and an invitation for the Council's contact officer to attend Board meetings as an observer.

In addition, insofar as it relates to this loan agreement or the Borrower's ability to discharge its obligations therein, the Head of Financial Services or their nominated representative may report directly to the Finance Sub-Committee or the SCIC Board.

The Borrower will allow access to the building and keep suitable records including a record of all expenditure and all other invoices, receipts and other relevant documents to support the information required by the Council's Head of Financial Services, or her nominated representative, for the duration of the loan agreement.

APPENDIX B

EXTRACT FROM URGENT BUSINESS REPORT DECEMBER 2012 - VAT CONSIDERATIONS

(Does not contain any commercially sensitive information)

VAT Considerations

4.2.5 A far more immediate and certain issue arising for the Council to consider relates to the complex VAT implications arising from the treatment of the original capital project.

4.2.6 As a reminder, the Storey building was refurbished through external grant funding totalling £3.5M between 2006/07 and 2008/09. This was then let on a peppercorn lease to SCIC, an independent management company (as required by ERDF funders). The arrangement was granted 'non-business supply' status by HMRC and this meant that the Council was able to reclaim all the VAT incurred on the capital phase.

4.2.7 Should SCIC cease trading and if subsequently the Council became directly involved in managing and letting out the building, either temporarily or permanently, it is reasonable to assume that the VAT implications arising would be two-fold:

- *The Council would in all likelihood breach what is known as its 'Partial Exemption' limit. Whilst this is a complex area, the upshot of this occurring would be that the Council would no longer be able to recover VAT on certain supplies, and so would incur additional costs currently estimated at around £170K per year. The Council could avoid this charge only if it were able to empty the building and then sell it on, or if there was some major change in the Council's other activities that significantly improved the VAT position.*

- *Under VAT regulations regarding the 'Capital Goods Scheme (CGS)', building projects are subject to a retrospective, proportionate correction to reclaimed VAT where there is a change of use (for VAT purposes) within approximately 10 years of completion. By becoming involved in direct management of the building, in all likelihood this would change the VAT purpose from 'non-business' to 'business'. This would result in a further £60K VAT charge per year, due up to 2018/19 (the tenth year after completion).*

4.2.8 One way to avoid these implications is to 'opt to tax' the building, although this means that any subsequent business supply (e.g. sale or let) of the building would then be subject to VAT.

4.3 These VAT issues are complex and material but need to be taken into account should option 2 be approved, particularly as this would present further scenarios for the ongoing operation.

Scenarios under Option 2 (refusing the loan request)

4.3.1 Should SCIC ultimately fold then the Council would probably be faced with the following three main scenarios. For all of them, various incidental costs would be incurred but for now, only the key issues are highlighted.

Scenario 1 – transfer to alternative third party management company
Under this scenario, the Council would repossess the building under the terms of the head lease and look to regain the position of granting a peppercorn lease to a third party as a non-business transaction, the main risk being over what would happen in the interim, i.e. the Council may need to 'step in' to manage the building and its tenants if an alternative third party provider could not immediately be put into place. Depending on the timescales involved and the certainty with which the business could be passed over, with reference to the Council's VAT position the best option might be to opt to tax the building.

Scenario 2 – Council takes over operation itself
Under this scenario the Council would repossess the building under the terms of the head lease and take over operational responsibility on similar lines as SCIC, the main financial risk/implication revolves around whether the Council would breach its Partial Exemption limit, as discussed above. Again an option to mitigate this would be to opt to tax the building; the downside is that VAT would have to be added to the rents and service charges. The Council would have to consider the impact of this on tenants; those who are VAT registered should not be impacted on but those who are not would have a real increase in their charges, unless some other compensation adjustment was agreed.

From an operational side, future management of the operation would need further consideration as there is currently no dedicated full time capacity within the Council to take on management of the building. There may also be 'Transfer of Going Concern' issues linked to opting to tax the building and further work would be required by Officers to assess the impact of these.

Scenario 3 – Council closes or sells building
If the Council were to close the building (assuming that this would be possible) there would be no issues from a VAT point of view as there would be no business supplies from the closed building. There may need to be negotiation regarding clawback liabilities, however.

If the Council sought to sell the building on but with tenants still in situ, then there could be VAT implications arising from the sale.