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Appendix 1

Scope of work - Financial due diligence (2)

Financial due diligence	
Area	**Scope**
Cost base	Comment on the nature of the cost base (i.e. fixed or variable) and key trends identified. Highlight which of these costs are provided by related parties and the key terms with those suppliers. Comment on the composition of central costs including management recharges and costs shared with any related parties such as property (LCC) and IT costs (BT). Comment on the basis and consistency of the allocation of these costs over the Historical Period.
Staff costs	Comment on staff costs with reference to headcount and the employment terms of key employees, in particular note the difference in terms of Liverpool City Council and BT employees and headcount by department. Comment on the basis of remuneration of key employees including bonuses and pension contributions
Underlying earnings	Summary of the underlying earnings of the business highlighting non-recurring items identified through the course of our work including: • BT management charges • Provision movements Comment on the underlying sales and earnings split by LCC contracts, BT contracts and other third party contracts / trading.
2015 Budget	Comment on the key assumptions used in the preparation of the FY15 budget, in particular sales and gross margin by contract and overhead costs for the Budget Period. In particular comment on the key drivers of budgeted margin growth. Comment on the level of profitability budgeted from existing contracts in the context of historical results.

Scope of work - Financial due diligence (3)

Financial due diligence	
Area	**Scope**
Net assets and potential net debt items	Analyse and comment on the composition of key items on the balance sheet at 31March 2014 and at the latest available date, including : • fixed asset profile, • ageing of debtors and creditors • Prepayments, accruals and indirect tax creditors • Deferred income and restricted cash balances / other creditors • significant one-off items and cash, debt or debt-like items (including dilapidation provisions or related party balances with LCC and BT) Comment specifically on the accounting treatment of contract revenues and costs held on the balance sheet. Analyse and comment on the level of provisions required for bad / doubtful debt. From discussions with management summarise the existence and level of contingent liabilities and capital commitments.
Quality of cash flows	Analyse and comment on monthly working capital trends and comment on potential one off / non trading adjustments during the Historical and Current Trading Periods. Analyse and comment on receivable days and payable days in the historical period. Comment on the underlying working capital requirement based on the monthly working capital profile. If available, summarise and comment on the forecast working capital and cash flows for the Budget period.

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Appendix 1

Scope of work - Corporation tax due diligence

Tax due diligence	
Area	Scope
Corporation tax	Summarise the status of open corporation tax returns Comment on the potential impact of any material outstanding issues in open computations arising from correspondence with HMRC Summarise the tax payment position for FY13 Summarise any material tax attributes carried forward at the end of FY13 and comment on their availability for use in future periods Comment on the corporation tax implications of transactions between the companies and the Director/Shareholder Comment on any elections for tax concessions or similar arrangements which have been accepted by HMRC Comment on the basis of the corporation tax and deferred tax provisions included in the statutory accounts for FY13 Analyse the effective tax rate for FY13 and comment on material variances from the relevant statutory rates Review the reasonableness of the current and deferred tax calculations prepared by the business/ its advisors for the annual FY14 accounting period for each company

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Appendix 1

Scope of work - VAT due diligence

Tax due diligence	
Area	Scope
VAT	Summarise the UK VAT registration status of LDL and comment on whether all registration obligations have been complied with. Enquire whether LDL is or has been a member of any current or previous UK VAT groups Summarise the VAT treatment applied to supplies made by LDL Comment on LDL's VAT recovery status and the application of any partial exemption method, where appropriate Summarise the status of all UK VAT returns due for submission and payments required in the last year Comment on any VAT errors identified and voluntary disclosures notified to HMRC in the last 4 years and comment on whether appropriate controls have been introduced to prevent reoccurrence Comment on LDL's most recent HMRC VAT inspection. Summarise the outcome including whether additional liabilities and/or penalties were imposed and controls introduced to prevent reoccurrence Comment on the VAT treatment adopted by LDL in relation to property interests including any ongoing obligations to carry out VAT Capital Goods Scheme adjustments and whether any options to tax have been made in relation to property interests Comment on any VAT planning arrangements that LDL has been involved in and whether such arrangements have been disclosed to HMRC

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cutting through complexity

This Report is provided in confidence and its circulation and use are limited – see Notice on page 3.

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cutting through complexity

Liverpool Direct Limited

Red flag financial and tax due diligence report

2 July 2014

and use are
on page 3.

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Private and confidential
Liverpool City Council
Municipal Buildings
Dale Street
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L2 2DH

For the attention of Becky Hellard, Peter Casterton and Paul Jones

DRAFT

2 July 2014

Dear Sirs

Project Router

In accordance with our Framework Agreement dated 2 July 2014 ('our Engagement Letter'), we enclose our report on the proposed acquisition of Liverpool Direct Limited dated [ ] July 2014. As stated in our Engagement Letter, you have agreed that this final written report supersedes all previous oral, draft or interim advice, reports and presentations, and that no reliance will be placed by you on any such oral, draft or interim advice, reports or presentations other than at your own risk. The scope of work set out in our Engagement Letter is attached as Appendix 1 to the report. This details the agreed scope of our enquiries, directed at those issues which you determined to be critical to your investment. You should note that our findings do not constitute recommendations to you as to whether or not you should proceed with the proposed transaction. The Important notice on page 3 should be read in conjunction with this letter.

Our report is for the benefit and information of the addressees only and should not be copied, referred to or disclosed, in whole or in part, without our prior written consent, except as specifically permitted in our Engagement Letter. The scope of work for this report included as Appendix 1 has been agreed by the addressees and to the fullest extent permitted by law we will not accept responsibility or liability to any other party (including the addressees' legal and other professional advisers) in respect of our work or the report.

Yours faithfully

KPMG LLP

Registered in England No OC301540
Registered office: 15 Canada Square, London E14 5GL

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Important notice

Our work commenced on 11 June 2014 and our fieldwork was completed on 2 July 2014. We have not undertaken to update our report for events or circumstances arising after that date.

In preparing our report, our primary source has been Liverpool Direct Limited and BT plc internal management information and representations made to us by management of Liverpool Direct Limited and BT plc. We do not accept responsibility for such information which remains the responsibility of management. Details of our principal information sources are set out on page 7 and we have satisfied ourselves, so far as possible, that the information presented in our report is consistent with other information which was made available to us in the course of our work in accordance with the terms of our Engagement Letter. We have not, however, sought to establish the reliability of the sources by reference to other evidence.

This engagement is not an assurance engagement conducted in accordance with any generally accepted assurance standards and consequently no assurance opinion is expressed.

We draw your attention to the significant limitations in the information available to us. Management information available was restricted to specified documents on page 8.

Our report makes reference to 'KPMG Analysis'; this indicates only that we have (where specified) undertaken certain analytical activities on the underlying data to arrive at the information presented; we do not accept responsibility for the underlying data.

The analysis of 'underlying' earnings and working capital is for indicative purposes only. We have sought to illustrate the effect on EBITDA and working capital of adjusting for those items identified in the course of our work that may be considered to be 'non-recurring' or 'exceptional' or otherwise unrepresentative of the trend in EBITDA and working capital using criteria established by the management of Liverpool City Council. However the selection and quantification of such adjustments is necessarily judgmental. Because there is no authoritative literature or common standard with respect to the calculation of 'underlying' earnings and working capital, there is no basis to state whether all appropriate and comparable adjustments have been made. In addition, while the adjustments may indeed relate to items which are 'non-recurring' or 'exceptional' or otherwise unrepresentative of the trend, it is possible that earnings and working capital for future periods may be affected by such items, which may be different from the historical items.

The prospective financial information set out within our report has been prepared by BT plc (Q1 FY15) and Liverpool Direct Limited (FY15 budget); we do not accept responsibility for such information. We must emphasise that the realisation of the prospective financial information is dependent on the continuing validity of the assumptions on which it is based. The assumptions will need to be reviewed and revised to reflect any such changes in trading patterns, cost structures or the direction of the business as they emerge. We accept no responsibility for the realisation of the prospective financial information. Actual results are likely to be different from those shown in the prospective financial information because events and circumstances frequently do not occur as expected, and the differences may be material.

The directors of BT plc or Liverpool Direct Limited have not read our report and have not confirmed the factual accuracy of this report, as they have not yet been requested to do so.

We accept no responsibility or liability for the findings or reports of legal and other professional advisers even though we have referred to their findings and/or reports in our report.

Notice: About this Report

This Report has been prepared on the basis set out in our engagement contract with Liverpool City Council ("the Client") dated 2 July 2014 (the "Services Contract") and should be read in conjunction with the Services Contract.

Nothing in this report constitutes a valuation or legal advice.

We have not verified the reliability or accuracy of any information obtained in the course of our work, other than in the limited circumstances set out in the Services Contract.

This Report is for the benefit of the Client only to give preliminary considerations to the findings available based on fieldwork carried out up to the date set out in the Report and for no other purpose.

This Report has not been designed to be of benefit to anyone except the Client. In preparing this Report we have not taken into account the interests, needs or circumstances of anyone apart from the Client, even though we may have been aware that others might read this Report. We have prepared this Report for the benefit of the Client alone.

This Report is not suitable to be relied on by any party wishing to acquire rights against KPMG LLP (other than the Client) for any purpose or in any context. Any party other than the Client that obtains access to this Report or a copy (under the Freedom of Information Act 2000, the Freedom of Information (Scotland) Act 2002, through the Client's Publication Scheme or otherwise) and chooses to rely on this Report (or any part of it) does so at its own risk. To the fullest extent permitted by law, KPMG LLP does not assume any responsibility and will not accept any liability in respect of this Report to any party other than the Client.

In particular, and without limiting the general statement above, since we have prepared this Report for the benefit of the Client alone, this Report has not been prepared for the benefit of any other local authority nor for any other person or organisation who might have an interest in the matters discussed in this Report, for example those who work in the development, construction or conference centre operator sector or those who provide goods or services to those who operate in these sectors.

Please note that the Services Contract makes this Report confidential between the Client and us. It has been released to the Client on the basis that it shall not be copied, referred to or disclosed, in whole or in part, without our prior written consent. Any disclosure of this Report beyond what is permitted under the Services Contract will prejudice substantially this firm's commercial interests. A request for our consent to any such wider disclosure may result in our agreement to these disclosure restrictions being lifted in part. If the Client receives a request for disclosure of the product of our work or this Report under the Freedom of Information Act 2000 or the Freedom of Information (Scotland) Act 2002, having regard to these actionable disclosure restrictions the Client should let us know and should not make a disclosure in response to any such request without first consulting KPMG LLP and taking into account any representations that KPMG LLP might make.

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Glossary of terms

ACCL	Arena and Convention Centre Liverpool
FYXX	Financial year ended 31 March 20XX
HMRC	Her Majesty's Revenue and Customs
HR	Human resources
IT	Information technology
LCC	Liverpool City Council
LDL	Liverpool Direct Limited
LGS	Local Government Scheme
Outturn	Two months actual and one month forecast trading ending 30 June 2014
PAYE	Pay as you earn
Q1XX	The three months ending 30 June 20XX
SIA	Security Industry Association
SPA	Sale and purchase agreement
TSA	Transitional services agreement
VAT	Value added tax

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Contents

The contacts at KPMG in connection with this report are:

[redacted]

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Tel: [redacted]

Fax [redacted]

Transaction Services

[redacted]

Manchester, KPMG LLP

Tel: [redacted]

Fax [redacted]

Introduction

Introduction

Confirmation of instructions

KPMG LLP ('KPMG') has been engaged by Liverpool City Council ("LCC") to comment on the proposed acquisition of Liverpool Direct Limited from BT plc.

The report has been prepared in accordance with the terms of reference in our engagement letter dated 2 July 2014 which has been agreed by the members of LCC and is included as Appendix 1 to this report.

Our report is provided solely for the benefit of parties referred to in our engagement letter and must not be quoted, copied or referenced to or distributed, in whole or in part, without prior written consent. We will not accept responsibility to any other party to whom our report may be shown or who may acquire a copy of our report.

Project overview

This report has been produced solely for the purposes of addressing our scope of work set out in Appendix 1 to our Engagement Letter.

The principal focus of our report is as follows:

- Summary of the underlying earnings of the business highlighting non-recurring items identified through the course of our work;
- Analyse and comment on the composition of key items on the balance sheet at 31March 2014 and at the latest available date;
- Comment on the potential impact of any material outstanding issues in open computations arising from correspondence with HMRC.

Sources of information

The sources of information used are noted, wherever possible, in the report. We have not sought to establish the reliability of these sources by reference to evidence independent of management. We have, however, reviewed the information produced and have satisfied ourselves, so far as possible, that the information presented is consistent with other information obtained by us during the course of the work undertaken to prepare this report.

The findings presented in this report are based on certain key sources of information as follows:

- Historical management accounts at corporate and portfolio level (FY13 and FY14);
- Statutory accounts (FY13 and FY14);
- Offset reconciliations (FY13 and FY14);
- Income forecast (FY15);
- LDL workpapers (prepared by LDL management)(FY13 and FY14); and
- Salary figures (FY11 to FY14).

Key discussions

During the course of our work we have had access to the following individuals:

- Becky Hellard, Director of Finance LCC
- Peter Casterton, Head of Corporate Finance LCC
- Paul Jones, Strategic Finance Manager LCC
- Elaine Holmes, Group Finance Manager LCC
- John Roberts, BT Financial Controller LDL
- David McElhinney, Chief Executive Officer LDL
- Richard Keenan, BT project manager

As we have not yet requested, the contents of our report have not been reviewed in detail by the directors of BT and LDL who have not confirmed in writing the factual accuracy of this report.

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Key financials

LDL's key financials have been extracted from management information. The FY13 financial data presented has been reconciled to the audited statutory accounts.

Q1 FY15 is based on two months actual and one month forecast and was prepared by BT plc.

A high level FY15 budget has been received from LDL and is presented in Appendix 3. LDL is forecast to break even in FY15.

P&L

£'000	FY13 Actual	FY14 Actual	Q1 FY15 Outturn
Revenue			
Sales invoices	75,742	81,847	16,175
Movement on deferred revenue	928	469	271
Adjustment - offset	-	(199)	-
Total revenue	76,670	82,118	16,447
Cost of sales - internal (BT)			
Titan transfer	(35,376)	(35,549)	(4,682)
Cost of sales - external			
Invoices (ex VAT)	(39,633)	(46,251)	(12,109)
Prepaid / (accrued) expenses	(1,550)	(367)	15
Movement on prepaid expenses	57	(57)	353
Year end adjustment/ Bank charges	(160)	(84)	(24)
Other period movements	(8)	190	-
Cost of sales - external	(41,293)	(46,569)	(11,765)
Net profit/(loss)	(0)	(0)	0
P&L summary			
Revenue (LCC)	76,670	82,118	16,447
Cost of sales - internal (BT)	(35,376)	(35,549)	(4,682)
Cost of sales - external (LCC)	(41,293)	(46,569)	(11,765)
Net profit/(loss)	(0)	(0)	0

Source: Management accounts at corporate level

Balance sheet

£'000	Mar-13 Actual	Mar-14 Actual	Jun-14 F'cast
Working capital			
Trade debtors - gross	9,615	9,365	6,956
Prepayments/accrued income	2,257	2,400	2,803
Trade creditors	(147)	(61)	(1,904)
Accrued expenses	(2,874)	(3,241)	(3,226)
Deferred income	(6,417)	(6,147)	(5,926)
External VAT creditor	(2,669)	(2,079)	(813)
Net debt			
Cash at bank	6,309	4,366	1,307
Intragroup creditors - BT treasury	(2,056)	-	2,047
Intragroup creditors - Ignite Solutions (BT)	(4,007)	(4,591)	(1,233)
Net assets	10	10	10

Source: Management accounts

Cash flow

£'000	FY13 Actual	FY14 Actual
Cash received from LCC	90,226	98,467
Cash paid to LCC	(48,698)	(54,452)
Cash paid to third party suppliers	(1,096)	(1,136)
Cash pre BT recharges	40,432	42,879
Cash paid to BT - Titan costs (estimate)	(19,874)	(14,622)
Estimated operating cash flow (a)	20,558	28,257
Cash paid to BT - other cash transactions	(16,019)	(30,117)
Bank charges	(160)	(83)
Net cash inflow/(outflow)	4,379	(1,943)

Note: (a) Operating cash flow has been estimated by deducting BT Titan P&L costs excluding margin and overhead recharges, as a proxy for BT operating cash costs.

Source: Management accounts at corporate level

Executive summary

Financial (1)

Initial findings

Headline

Underlying earnings

Based on information and dialogue from both BT and LDL, the underlying profitability of LDL has ranged between £7.8 million in FY13 and £12.1 million in FY14.

However, this includes an add-back of BT's Titan recharge relating to overhead and margin. Additional overheads required in relation to services currently provided by BT (including insurance, legal and HR costs) would need to be considered by LCC and could be significant.

The contracts currently being negotiated with BT (including the TSA, LGS and SIA) could inform this analysis by deducting the annual cost of the TSA from underlying earnings (approximately £2.0 million).

FY15 is forecast by LDL to break even (see Appendix 3).

Issue

Underlying earnings

£'000		FY13 Actual	FY14 Actual	Q1 FY15 O'turn
Profit/(loss)		-	-	-
BT overhead and margin	1	15,503	20,927	2,500
Other adjustments				
Offset reconciliation difference	2	(2,884)	425	[ ]
Non recurring 'Change' income	3	-	(4,449)	-
Desktop refresh	4	-	(2,001)	-
Estimated costs on desktop refresh	4	-	1,800	-
ACCL Arena charges	5	-	200	-
BT funding contribution	6	-	560	-
Discount included in BT charges	7	700	200	-
Reduction in LDL contract value	8	(5,500)	(5,500)	-
Element of BT profit	9	[ ]	[ ]	(511)
Adjusted profit before incremental LCC overheads		7,819	12,163	1,989

Source: Management accounts at corporate level, management representations

We have identified a number of potential underlying earnings adjustments:

1. A breakdown of the Titan charges for FY13 and FY14 provided by BT identifies the element relating to overheads and margin (see Appendix 5). A breakdown of Q1 FY15 charges has been received in a different format, however we note at least £2.5 million of 'management charge' payable to BT in this period. BT are unable to separately identify the element relating to overheads from the margin, and LCC should consider the quantum of incremental overheads required to support LDL.
2. Timing differences on the recognition of offset costs billed by LCC (see Appendix 6). Q1 FY15 includes £1.6 million of invoices relating to FY14. We understand that this drove an underlying loss in May 2015. LDL management have forecast for LCC to fund this loss, however we recommend that some value is sought from BT to fund this invoice.

Recommendation

A number of services are provided at group level by BT, including insurance, legal costs, HR, IT and treasury. LDL should consider the incremental cost of providing these services.

LCC should consider further adjustments to underlying earnings in respect of the incremental cost of new contracts with BT (TSA, LGS and SIA).

Discussions with management indicate that LDL was loss-making on an underlying basis in Q1 FY15. However, we note that Q1 FY15 includes a £1.6 million invoice that relates to FY14. We recommend that value is sought from BT for this invoice, as considered in more detail on the following page.

Financial (2)

Initial findings

Headline	Issue	Recommendation
Underlying earnings	3. FY15 budget revenue is £9.5 million lower than FY14. We understand from management that this is due to a £5.5 million reduction in LCC contract income (see 8, following page), and £4.5 million of non-recurring change requests to the Affordability Contract. LDL management explain that the change requests were fulfilled with existing staff, and as such there is unlikely to be a significant level of incremental costs. 4. £2.0 million of one off income recognised in relation to a desktop refresh programme. BT management estimated profitability of approximately 10% on this contract, i.e. £1.8 million of desktop refresh costs were incurred in FY14. 5. £0.2 million to reflect a one-off additional payment in FY14 relating to the ACCL Arena (£0.4 million in FY14 compared to £0.2 million annually in the forecast). 6. £0.6million relating to a one off capital contribution made to BT in the year in respect of the Notre Dame deployment. 7. £0.2 million (£0.7 million FY13) to reflect an agreed discount on LCC invoices that will not recur post deal and is a non-cash accounting adjustment. 8. LCC has reduced the LDL contract value for FY15 by £5.5 million. This will reduce the underlying profitability of the company in future periods. We understand that the post deal business plan prepared by management of LDL includes some proposed cost saving initiatives (including headcount reduction), so the overall net impact may be lower than this, although we have not had sight of this business plan. 9. Historically, BT services have been provided to LDL at cost. Under any new agreement, BT charges may be higher reflecting an element of built-in overhead and margin recovery for BT. TSA - the annualised cost of the TSA could be £2.0 million; if BT overhead and margin of £2.5 million for Q1 FY15 is added back, a quarter of the TSA (£0.5 million) should be included correspondingly. Our analysis is based on management information for FY13 and FY14. Detailed historical management accounts have not yet been received from LDL / BT. Furthermore, only limited, high level data has been provided for Q1 FY15.	We note that under the proposed 31 March 2014 locked box completion mechanism, there will be limited opportunity for LCC to challenge transactions undertaken by LDL during Q1 FY15. LCC should ensure full disclosure of related party transactions, and transactions outside of the course of normal business is made by BT in Q1 FY15 prior to completion.

Financial (3)

Initial findings

Headline

Net assets

LDL has net debt of £3.4 million at March FY14, based on the analysis and dialogue from BT and LCC.

This includes £2.6 million of provision held on account in a "Mayor's fund" and £0.3 million of revenue share liability owed to LCC..

In addition, LDL had £4.4 million of cash at 31 March 2014 and owed BT £4.6 million in respect of Titan costs.

We note that BT took drawings of £12.0 million on 30 June 2014, increasing net debt to a potential £7.5 million (see Appendix 4).

Issue

Adjusted balance sheet at March 14

£'000		Working capital	Net debt	Total
Trade debtors		9,365	-	9,365
Prepayments / accrued income		2,400	-	2,400
Trade creditors		(61)	-	(61)
Accrued expenses	1	(48)	(3,193)	(3,241)
Deferred income		(6,147)	-	(6,147)
External VAT creditor		(2,079)	-	(2,079)
Working capital		3,429	(3,193)	235
Net debt				
Cash at bank		-	4,366	4,366
Intragroup creditors		-	(4,591)	(4,591)
Net debt	2	-	(225)	(225)
Net assets		**3,429**	**(3,419)**	**10**
Other net debt considerations				
Offset cost difference at Mar 14	3		-	
Adjusted net debt			**(3,419)**	

Source: Management accounts at corporate level, management representations

We have identified a number of potential adjustments to the reported net debt at March FY14:

1. At 31 March 2014 accruals includes two "debt like" items held on account for LCC:
   - A £2.6 million provision held on account for LCC as a 'Mayors Fund', relating to historical billing surpluses which are yet to be offset against LCC costs;
   - A £0.3 million accrual relating to 'revenue share' held on account for LCC; and
   - A £0.2 million accrual for offset invoices.
2. Net debt currently includes £4.6 million of intragroup creditors owed to BT and Ignite Solutions. An element of this balance may be working capital in nature relating to ongoing services provided by BT. Based on FY14 Titan costs excluding margin and overhead (£14.6 million) on 30 day credit terms the working capital element could be £1.5 million each month including VAT. LDL should consider the proposed credit terms with BT in assessing the level of working capital included in this balance.
3. At the year end, an LCC offset reconciling invoice of £1.6 million was only partly accounted for by LDL (an accrual of £0.2 million for offset invoices has been made at March 2014). The remaining £1.4 million should have been recorded at 31 March 2014, however this would result in a reduction in BT profits and a reduction in the BT intragroup creditor by £1.4 million, and as a result there is no net impact on net assets or net debt.

Recommendation

We recommend that LCC seek value from BT for the net debt of £7.5 million at 30 June 2014, which represents the £3.4 million reported March 2014 position and the impact of additional drawings taken by BT in June.

The additional net debt of £4.1 million appears to relate to:

- A reduction in net working capital from March 2014 (£1.4 million) taken in cash by BT.
- An increase in amounts due to LCC (£1.4 million) taken in cash by BT.
- Profit in Q1 above the agreed £2.5 million management fee and BT products/services charge (£1.3 million).
- See Appendix 4.

This excludes any pension considerations.

Financial (4)

Initial findings

Headline	Issue	Recommendation
Working capital LDL has reported working capital of £3.4 million at 31 March 2014. This compares to an average of £3.2 million for FY14, with a maximum working capital swing of £2.8 million.	We note that there is no 'working capital' adjustment proposed on completion. The March 2014 working capital position of £3.4 million compares to an average of £3.2 million for FY14, with a relatively large quarter-end VAT liability offset by increased year-end trade debtors (see Appendix 7). LDL had average working capital of £3.2 million in FY14, and a working capital swing of £2.8 million (£6.4 million in FY13), and appropriate funding should be in place at LCC to fund LDL's working capital profile. Working capital seasonality is driven in part by the payment of VAT liabilities following each quarter ending March, June, September and December. The average VAT balance in FY14 was £1.2 million, with an average quarter end balance of £1.8 million.	

Financial (4)

Initial findings

Headline	Issue	Recommendation
Business plan (FY15) LDL's post deal business plan shows a breakeven result for FY15.	We have considered the forecast income and expenditure for LDL for FY13 and conclude that, based on currently available information, LDL could achieve a break even result for FY15. We understand that a post deal business plan has been prepared by LDL. This includes: - revenue of £72.3 million, reflecting a £5.5 million reduction in LCC contract value and a lower level of change requests to the Affordability Contract; - planned operational headcount, including potential savings by function and salary; - operational plan to deal with costs currently incurred by LDL and indirectly funded by BT (including ACCL Arena costs and One Stop Shop depreciation recharge); and - a more detailed financial forecast setting out expected changes in LDL's income and cost profile. As noted previously, we would expect LDL's costs to be higher post-deal: - BT have advised that in previous years, BT charges have been derived "at cost" to LDL, as a BT subsidiary, and have included discounts that may not necessarily reflect end customer market prices. It is expected that post deal, any services procured from BT will be at a higher cost than has been seen historically to represent a recovery of BT overheads and an element of profit. A summary of "schedule 2" costs has been prepared by BT, representing BT and Third Party costs which were historically incurred by BT and are expected to novate to LDL. This indicates annual costs of approximately £15.0 million, compared to £13.0 million included in Titan costs in FY14. - Costs associated with the TSA with BT will reduce underlying earnings on a temporary basis during the transitional period until a permanent solution for the back office services is established. The TSA suggests costs of £2.0 million for the 12 months following the transaction. - Incremental overheads to replace services currently performed centrally by BT (e.g. legal, HR and IT) will also need to be considered.	LDL and LCC should closely monitor performance against budget post deal to ensure the underlying results for LDL are maximised.

Corporation tax

Initial findings

Headline	Issue	Recommendation
Corporation tax filing	LDL has filed corporation tax returns for all periods up to and including the year ended 31 March 2013 and hence is up to date with the filing of its corporation tax returns and, per the submitted returns, has no outstanding corporation tax liabilities. As such, tax returns for periods up to and including the year ended 31 March 2012 are outside the enquiry window and are affectively agreed. The tax return for the year ended 31 March 2013 is currently open but to date no HMRC enquiries have been raised. A copy of the tax return for the year ended 31 March 2014 has not been provided and it is understood this is yet to be finalised. It is noted LDL have historically relied upon BT Group resources to undertake the corporation tax housekeeping.	LCC seek a specific indemnity within the relevant legal documentation from BT Group to cover any taxable profits which could potentially arise in LDL as a result of HMRC raising a 'transfer pricing' enquiry in to transactions between LDL and BT Group
Pricing of transaction between LDL and BT Group	A tax sensitive matter has been identified in relation to the pricing of transactions between LDL and BT Group, in particular: ▪ There have been significant transactions between LDL and BT Group companies during the periods in which LDL has been controlled by BT Group. ▪ Documentation has not been provided to support the pricing and arms length nature of these transactions. There is an inherent risk that HMRC could enquire as to whether these transactions have been undertaken on an arms' length basis under the 'transfer pricing' tax provisions. ▪ LDL management have confirmed the transactions are in line with BT Group practice and have been undertaken on the same basis over the last 11 years. It is noted that HMRC have not historically challenged this position ▪ No other corporation tax sensitive matters have been identified.	A general indemnity is sought from BT Group for any other tax liabilities which could arise in relation to a time when LDL was owned b y BT Group. A clause is included within the relevant legal documentation to ensure LCC and LDL have access to books and records held by BT Group should these be required by LDL following the date of completion (e.g. should information be requested by HMRC etc)
Senior Accounting Officer ('SAO') requirements	As LDL is currently part of the BT Group and hence treated as a large company for tax purposes there are specific obligations requiring a 'Senior Accounting Officer' ('SAO') to certify to HMRC that the systems and controls of the company are adequate for tax purposes (including corporation tax, VAT and PAYE). Two notifications are required, one on behalf of the individual confirming they are the SAO and one for the company confirming the systems are adequate. Each notification has a £5,000 penalty for non compliance. BT have confirmed that the relevant SAO certification has been filed on behalf of LDL for all relevant periods up to and including the year ended 31 March 2013. It is understood the SAO certification for the year ended 31 March 2014 is yet to be filed with HMRC. This should be filed on or before 31 December 2014. As the test for SAO is based on the company's prior year position, LDL will continue to be within the SAO regime for at least the year ended 31 March 2015, during which the company was controlled by BT Group for the period 1 April 2014 to [date of completion].	LCC request that BT Group file the SAO certification for the year ended 31 March 2014 on behalf of LDL before 30 June 2014 (or date of completion of the transaction should this be later) and/or BT Group agree to complete the relevant SAO certification within the relevant statutory time limit covering all period for which LDL was part of the BT Group.

Initial findings	
Headline	Issue
VAT compliance	LDL is registered for VAT as a member of the BT VAT Group (registration number 245 7193 48). LDL provides turnover details to BT on a quarterly basis to enable BT to include LDL's VAT information on the BT VAT Group return. LDL subsequently reimburses BT for the net VAT liability attributable to LDL. BT has confirmed that it is not aware of any VAT disclosures or other correspondence with HMRC relating to LDL in the past four years.
Supplies made by LDL	Management has confirmed that LDL supplies services (to LCC and other third parties) that are treated as being subject to VAT at the standard rate and that LDL is entitled to full VAT recovery on business expenditure (subject to normal rules governing input tax recovery). Supplies of goods and services between LDL and other members of the BT VAT Group are disregarded for VAT purposes.
VAT group implications	Following completion of the proposed transaction, LDL will not be "controlled" by BT and will not satisfy the eligibility requirements to remain a member of the BT VAT Group. Therefore LDL will need to be removed from the BT VAT Group with effect from completion of the proposed transaction (and LDL will need to be separately registered for VAT from that date). VAT group members have joint and several liability for the VAT due to HMRC by the representative member of the VAT group. We therefore recommend that the sale and purchase agreement contains appropriate warranty and indemnity protection in respect of historic VAT liabilities. This protection should cover any VAT liabilities for which LDL is primarily liable, as well as any secondary VAT liabilities for which LDL may be jointly and severally liable (in other words VAT liabilities in respect of any entity which has also been a member of the BT VAT group at any time in the past four years). It should be noted that (i) warranties and indemnities may not provide absolute protection against unexpected VAT liabilities, and (ii) this VAT due diligence exercise has only considered LDL (and no other member of the BT VAT group). Any supplies between LDL and BT after completion of the proposed transaction will no longer be disregarded for VAT purposes and may be subject to VAT at the standard rate.

Appendices

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Contents

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Appendix 1

Engagement letter and scope of work

Scope of work - Financial due diligence (1)

Financial due diligence	
Area	**Scope**
Financial overview of LDL	Summarise the reported P&L, BS and CF for the historical and forecast period, including KPIs for each service line / revenue stream for LDL.
Accounting fundamentals	Understand the key accounting policies underlying the financial statements and comment specifically on the revenue recognition policy for contracts. Also comment if these policies have been consistently applied during the Historical and Current trading period. Analyse any relevant reconciliations performed at 30 March 2013 and 30 March 2014 between management accounts and the audited financial statements and comment on the nature of any significant reconciling items. From enquiries of management, provide an overview of the accounting function and describe the key accounting procedures performed on a monthly and annual basis. Comment specifically on transactions relating to third party contracts which may be invoiced via Liverpool City Council.
Contracts	Comment on the key drivers of historical revenue and gross margin development, by reference to major contracts, including LCC, SIA (BT), Amey, Glendale and education customers. Comment on any customer and supplier dependence during the Historical Period. Read the top 10 customer and supplier contracts and summarise the key terms of service, remaining contract period and value where stated.

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Appendix 1

Scope of work - Financial due diligence (2)

Financial due diligence	
Area	**Scope**
Cost base	Comment on the nature of the cost base (i.e. fixed or variable) and key trends identified. Highlight which of these costs are provided by related parties and the key terms with those suppliers. Comment on the composition of central costs including management recharges and costs shared with any related parties such as property (LCC) and IT costs (BT). Comment on the basis and consistency of the allocation of these costs over the Historical Period.
Staff costs	Comment on staff costs with reference to headcount and the employment terms of key employees, in particular note the difference in terms of Liverpool City Council and BT employees and headcount by department. Comment on the basis of remuneration of key employees including bonuses and pension contributions
Underlying earnings	Summary of the underlying earnings of the business highlighting non-recurring items identified through the course of our work including: • BT management charges • Provision movements Comment on the underlying sales and earnings split by LCC contracts, BT contracts and other third party contracts / trading.
2015 Budget	Comment on the key assumptions used in the preparation of the FY15 budget, in particular sales and gross margin by contract and overhead costs for the Budget Period. In particular comment on the key drivers of budgeted margin growth. Comment on the level of profitability budgeted from existing contracts in the context of historical results.

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Appendix 1

Scope of work - Financial due diligence (3)

Financial due diligence	
Area	**Scope**
Net assets and potential net debt items	Analyse and comment on the composition of key items on the balance sheet at 31March 2014 and at the latest available date, including: • fixed asset profile, • ageing of debtors and creditors • Prepayments, accruals and indirect tax creditors • Deferred income and restricted cash balances / other creditors • significant one-off items and cash, debt or debt-like items (including dilapidation provisions or related party balances with LCC and BT) Comment specifically on the accounting treatment of contract revenues and costs held on the balance sheet. Analyse and comment on the level of provisions required for bad / doubtful debt. From discussions with management summarise the existence and level of contingent liabilities and capital commitments.
Quality of cash flows	Analyse and comment on monthly working capital trends and comment on potential one off / non trading adjustments during the Historical and Current Trading Periods. Analyse and comment on receivable days and payable days in the historical period. Comment on the underlying working capital requirement based on the monthly working capital profile. If available, summarise and comment on the forecast working capital and cash flows for the Budget period.

Appendix 1

Scope of work - Corporation tax due diligence

Tax due diligence	
Area	Scope
Corporation tax	Summarise the status of open corporation tax returns Comment on the potential impact of any material outstanding issues in open computations arising from correspondence with HMRC Summarise the tax payment position for FY13 Summarise any material tax attributes carried forward at the end of FY13 and comment on their availability for use in future periods Comment on the corporation tax implications of transactions between the companies and the Director/Shareholder Comment on any elections for tax concessions or similar arrangements which have been accepted by HMRC Comment on the basis of the corporation tax and deferred tax provisions included in the statutory accounts for FY13 Analyse the effective tax rate for FY13 and comment on material variances from the relevant statutory rates Review the reasonableness of the current and deferred tax calculations prepared by the business/ its advisors for the annual FY14 accounting period for each company

Appendix 1

Scope of work - VAT due diligence

Tax due diligence	
Area	**Scope**
VAT	Summarise the UK VAT registration status of LDL and comment on whether all registration obligations have been complied with. Enquire whether LDL is or has been a member of any current or previous UK VAT groups
	Summarise the VAT treatment applied to supplies made by LDL
	Comment on LDL's VAT recovery status and the application of any partial exemption method, where appropriate
	Summarise the status of all UK VAT returns due for submission and payments required in the last year
	Comment on any VAT errors identified and voluntary disclosures notified to HMRC in the last 4 years and comment on whether appropriate controls have been introduced to prevent reoccurrence
	Comment on LDL's most recent HMRC VAT inspection. Summarise the outcome including whether additional liabilities and/or penalties were imposed and controls introduced to prevent reoccurrence
	Comment on the VAT treatment adopted by LDL in relation to property interests including any ongoing obligations to carry out VAT Capital Goods Scheme adjustments and whether any options to tax have been made in relation to property interests
	Comment on any VAT planning arrangements that LDL has been involved in and whether such arrangements have been disclosed to HMRC

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Appendix 2

Statutory account reconciliations

Mgt accounts to stats rec - FY14 P&L

Item	Per mgt accounts	Per draft stats	Diff
Turnover	82,118	82,118	(0)
Admin expenses			
Internal (interco)	(35,549)	(35,549)	-
External	(46,569)	(46,569)	(0)
Total admin expenses	(82,118)	(82,118)	(0)
Operating Profit	(0)	(0)	(0)

Mgt accounts to stats rec - FY13 P&L

Item	Per mgt accounts	Per draft stats	Diff
Turnover	76,670	76,670	0
Admin expenses			-
Internal (interco)	(35,376)	(35,384)	(8)
External	(41,293)	(41,285)	8
Total admin expenses	(76,670)	(76,670)	0
Operating Profit	(0)	0	0

Source: Statutory accounts, management accounts at corporate level

Mgt accounts to stats rec - March 2014 Balance Sheet

Item	Per mgt accounts	Per draft stats	Diff
Current assets			
Trade debtors	9,365	9,364	1
Prepayments	2,400	2,400	-
Cash	4,366	4,371	(5)
Total current assets	16,130	16,135	(5)
Current liabilities			
Trade creditors	(61)	(62)	1
Accrued expenses	(3,241)	(3,241)	(0)
Deferred income	(6,147)	(6,147)	(0)
External VAT creditor	(2,079)	(2,079)	0
Intercompany	(4,591)	(4,591)	(0)
Other creditors	-	(5)	5
Total current liabilities	(16,120)	(16,125)	5
Net assets	10	10	0

Mgt accounts to stats rec - March 2013 Balance Sheet

Item	Per mgt accounts	Per draft stats	Diff
Current assets			
Trade debtors	9,615	9,615	(0)
Prepayments	2,257	2,257	-
Cash	6,309	6,314	(5)
Total current assets	18,181	18,186	(5)
Current liabilities			
Trade creditors	(147)	(148)	1
Accrued expenses	(2,874)	(2,874)	(0)
Deferred income	(6,417)	(6,417)	0
External VAT creditor	(2,669)	(2,669)	0
Intercompany	(6,063)	(6,063)	(0)
Other creditors		(5)	5
Total current liabilities	(18,171)	(18,176)	5
Net assets	10	10	0

Source: Statutory accounts, management accounts at corporate level

Appendix 3
FY15 budget

P&L	FY13	FY14	FY15
£'000	Actual	Actual	Forecast
LCC revenue	75,289	81,479	72,030
Third party revenue	453	368	220
Movement on deferred revenue	928	469	-
Adjustment	-	(199)	-
Total revenue	**76,670**	**82,118**	**72,250**
Cost of sales - BT			
Third party supplier costs	(12,749)	(9,252)	[ ]
BT products/services	(4,829)	(3,715)	[ ]
BT resource costs	(1,596)	(1,455)	[ ]
Discount	(700)	(200)	[ ]
BT margin and overhead	(15,503)	(20,927)	(2,500)
Cost of sales - external			
LCC employee costs	(38,385)	(39,960)	(43,589)
Other LCC costs	(2,576)	(3,498)	(2,888)
LCC reconciling item	2,864	(425)	-
One stop shop funding	(534)	(534)	-
BT funding contribution	-	(560)	-
ACCL Arena charges	-	(400)	-
Other third party suppliers	(1,021)	(875)	[ ]
Additional costs			
Change costs	-	-	(5,870)
ICT investment	-	-	(4,637)
Telephony	-	-	(3,426)
Software	-	-	(3,400)
Development	-	-	(2,000)
Hardware Maintenance	-	-	(2,000)
Admin	-	-	(1,190)
Staff Training	-	-	(750)
Other costs			
Prepaid / accrued expenses	(1,550)	(367)	-
Movement on prepaid expenses	57	(57)	-
Bank charges	(160)	(84)	-
Other movements	(8)	190	-
Net profit	**(1)**	**0**	**(0)**
FY15 underlying adjustments			
BT management charge			2,500
TSA costs			(2,043)
Underlying profitability			**457**

Source: Management accounts at corporate level; FY15 budget

Revenue is forecast to reduce by £9.5 million between FY14 and FY15, reflecting £5.5 million of reduced LCC contract income, and approximately £4.5 million of one-off "change" income in FY14 which is not expected to recur.

A forecast £3.6 million increase in LCC staff costs partly reflects replacement of BT staff (£1.5 to £1.8 million historically). We understand that LDL management have an operational business plan to reduce employee costs, however it is not clear whether this has been included in the FY15 budget.

The FY15 budget has not been received in a comparable format with FY13 and FY14. Costs for BT products and services and third parties have been included as separate itemised costs ('Additional costs' in the table).

A summary of "schedule 2" costs has been prepared by BT, representing BT and Third Party costs which were historically incurred by BT and will novate to LDL. This indicates annual costs of approximately £15.0 million, compared to £13.0 million included in Titan costs in FY14. We cannot conclude whether the "schedule 2" costs of £15.0 million as per the BT summary have been included in the FY15 budget.

We note that total additional costs of £23.3 million compares to BT and third party costs of £18.6 million in FY13 and £13.8 million in FY14. The additional costs in FY15 include ICT investment (£4.6 million) and change costs (£5.9 million) which have not been incurred historically.

It is not clear whether "Additional costs" includes temporary annual costs of approximately £2.0 million per the TSA.

FY15 includes £2.5 million of management charge for BT, representing one quarter of the total £10.0 million per annum management charge.

We have illustrated the potential underlying earnings for FY15 but stripping out the non-recurring BT management charge and the temporary TSA costs which will not recur longer than 12 months following the proposed transaction (although we note that is is not clear if these have been included in "Additional costs" above.

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Appendix 4

Net debt update – July 2014

Net debt update		
£'000		Reported debt
Net debt at March 2013		
Cash		4,366
Debt		
Mayor's Fund		(2,646)
LCC profit share		(348)
FY14 LCC reconciling item		(199)
Intercompany creditor		(4,591)
Net debt at March 2013		**(3,419)**
July update		
BT drawings	(11,950)	
Less:		
Repayment of intercompany creditor	4,591	
Adjustment for unaccrued invoice	(1,392)	
Q1 management charge	2,500	
Q1 costs	2,182	
Net BT drawings		(4,069)
Adjusted net debt		**(7,488)**

Source: Management accounts at corporate level.

[PM TO INCLUDE BANK A/C TABLE]

The intercompany creditor of £4.6 million does not take into account the £1.4 million of unaccrued LCC invoices at year end.

Had this invoice been accrued correctly, the intercompany creditor would be £1.4 million lower, at £3.2 million.

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Appendix 5
Titan charge

Breakdown of Titan charges

£'000	FY13	FY14
Third party supplier costs	12,749	9,252
BT products/services	4,829	3,715
BT resource costs	1,596	1,455
Discount	700	200
BT overhead and margin	15,503	20,927
BT Charges	35,377	35,549

Source: BT intercompany charge response

We have not been provided with a breakdown of the BT overhead and margin figures.

Historical charge

Historically, specific BT services have been provided to LDL at cost with any remaining profit being extracted by BT in the form of an additional 'BT overhead and margin' charge.

We have added back the overhead and margin charge as part of our underlying earnings analysis presented earlier in this report.

Future arrangements

Contracts negotiated with BT relating to the post-deal period (LGS, SIA and TSA), may be at a greater cost to LDL to represent contribution towards BT overheads and an element of profit. This will be reflected in a reduction in underlying earnings in future periods.

In addition, you should consider the potential need to replace key BT staff or include temporary resource requirement in the TSA.

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Appendix 6
LCC Offset calculation

LCC offset calculation		
£'000	FY13	FY14
Costs as recorded by LCC		
Employees	38,106	39,960
Premises	533	496
Transport	156	149
Supplies	718	1,485
Services	988	1,210
Agency & Transfer	278	-
Recharges	182	157
Total other expenditure	2,856	3,498
Total offset	40,962	43,458
Costs as recorded by LDL		
Per management information	38,078	43,882
Difference	2,884	(425)

Source: Management accounts at corporate level, LDL offset reconciliation

The £0.4 million FY14 is due to timing differences on the recognition of offset costs billed by LCC (see appendix 4). An FY13 bill of £2.0 million was recognised in early FY14, whilst an FY14 charge of £1.6 million was recognised in Q1 FY15.

The £2.8 million difference in FY13 is due to the £2.0 million invoice recognised in FY14, together with further FY12 reconciling items that were recognised in FY13 of £0.9 million.

Basis of preparation

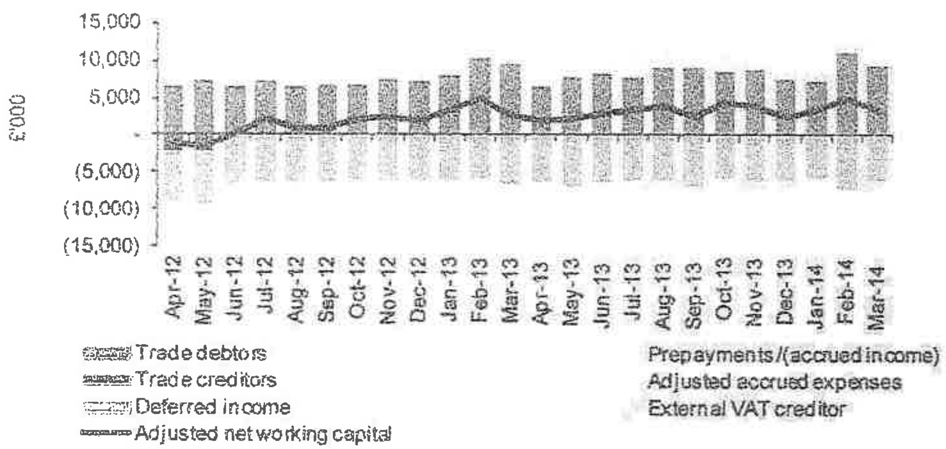
We have compared LDL costs as recorded internally, to costs recognised by LCC.

There is a discrepancy between LCC offset costs as recorded by LCC and LDL relating to timing differences on the recognition of offset costs billed by LCC.

We have reclassified costs into current period in our underlying earnings analysis presented earlier in the report. LDL management agree in principal to this reclassification.

Adjusted net working capital

Net working capital



Source: Management accounts

Basis of preparation

Following a review of items included on the LDL balance sheet, we have identified a number of balances within reported working capital that are debt like or non-recurring in nature (as discussed earlier on page 13 of this report). We have therefore adjusted the reported working capital figure to exclude these items.

VAT

£'000	FY13	FY14	Q1 FY15
Minimum	(2,669)	(2,104)	(813)
Maximum	(389)	(420)	(346)
Average	(1,222)	(1,181)	(504)
At period end	(2,669)	(2,079)	(813)
Period end variance to average	(1,447)	(897)	(309)

Source: Management accounts at corporate level

Adjusted net working capital

£'000	FY13	FY14
Minimum	(1,547)	1,989
Maximum	4,865	4,832
Average	1,516	3,228
At 31 March	2,630	3,429
Period end variance to average	1,114	200

Source: Management accounts at corporate level

Adjusted net working capital is £0.2 million higher than the average for FY14 driven by relatively large trade debtor balance in March 2014. This profile is consistent with the phasing of trade debtors in FY13.

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Appendix 8

Balance sheet detail

Prepays (accrued income)		
£'000	Mar 13	Mar 14
Revenue accrued to offset discount	(10,800)	(12,600)
Discount applied in invoice	15,000	16,000
Revenue deferred	(9,000)	(13,500)
Contract refresh discount applied in invoice	7,000	12,500
Total	2,200	2,400

Source: Management accounts at corporate level

Accrued expenses		
£'000	Mar 13	Mar 14
Accomodation/mayor fund	(2,646)	(2,646)
Estimated profit share	(220)	(348)
Offset reconciliation	-	(199)
Ext supplier charges BSF	-	(40)
PWC invoice	(8)	(9)
Total	(2,874)	(3,241)

Source: Management accounts at corporate level

At 31 March 2014 accruals includes three "debt like" items held on account for LCC:

- A £2.6 million provision held on account for LCC as a 'Mayors' Fund', relating to historical billing surpluses which are yet to be offset against LCC costs;
- A £0.3 million accrual relating to 'revenue share' held on account for LCC; and
- A £0.2 million accrual for offset invoices.

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Appendix 9
Staff costs

Staff costs	FY13	FY14
£'000	**Actual**	**Actual**
Total salary costs	n/a	30,907
Total employee costs	38,105	39,960
Approximate no of employees	1,170	1,175
Cost per employee		
Salary (£'000)	n/a	26.3
Total cost (£'000)	32.6	34.0

Note: This is an approximate cost per employee as employee numbers have only been provided at March 2013 and April 2014.

Source: Management accounts at corporate level

Suppliers

Key third party supplier analysis

Supplier name	FY14 P&L charge (£'000)	Service provided	Payment terms	Contract terms
Computacenter	441	Hardware/ service	42 days	Contract expires 31.3.14 (to be extended for 9 months for reduced service and ACCL)
BNP Paribas	399	MFD Hardware and Services.	30 days	13 months from 31.3.14

Source: Management accounts at corporate level

Key suppliers

Computacenter and BNP Paribas are the only third party suppliers with a significant charge to the P&L through the LCC offset cost line in FY14.

The Titan charge in FY14 included a value of £9.2 million (£12.7 million in FY13) in relation to third party suppliers. This line represents all third party supplier invoices associated with the services and goods supplied to Liverpool contract procured through BT, including Customer Premises equipment (CPE), IT equipment hardware, software, licences, support/maintenance, postage, courier costs, stationery, mobile and blackberry rentals and usage charges, training courses, accreditations, audit and professional fees, contractor fees, consultancy.

These services are expected to novate to LDL post deal and the timing and practicality of this novation should be considered as part of the TSA.

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Appendix 11

Accounting policies

Key accounting policies

- LDL's key accounting policies are set out in the statutory accounts:
- Turnover from long term contractual arrangements is recognised based on the percentage of completion method. For long term contracts, as the performance pattern is not straight line, turnover is recognised as services are provided, usually on an output or consumption basis. In the case of time and materials contracts, turnover is recognised as the service is rendered.
- Costs related to delivering services under long term contractual arrangements are expensed as incurred.
- Profit is not recognised unless the financial outcome of a contract can be estimated with reasonable certainty.
- Deferred income comprises services that have been invoiced in advance of the service or goods being fully delivered as ordered.
- Trade debtors are stated in the balance sheet at estimated net realisable value. Net realisable value is the invoiced amount less provision for doubtful debt. Provisions are made specifically where there is objective evidence of a dispute or an inability to pay. An additional provision is made based on an analysis of balances by age, previous losses experienced and general economic conditions.

Accounting practices

- LDL produce monthly management accounts, whilst BT are responsible for the production of both statutory accounts and forecast information.
- BT Treasury is responsible for settling all outstanding invoices in relation to services performed and goods provided by BT Global Solutions (Ignite). A creditor balance relating to Ignite is allowed to build up, alongside a corresponding positive cash balance in LDL, which is then cleared on a periodic basis.

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cutting through complexity

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cutting through complexity

Liverpool Direct Limited

Issues update document

27 August 2014

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Headlines
Context of our involvement

This is an issues update further to our draft red flag report dated 2 July 2014.

This document should be read in conjunction with that report. Furthermore we draw your attention to the draft transmittal letter and important notice within the report dated 2 July 2014.

We have been engaged by Liverpool City Council to assist in understanding the financial position of Liverpool Direct limited, as part of the proposed acquisition.

Our work has focussed on the balance sheet as at 31 March 2014. As you are aware, this has identified a lack of consistent accounting and record keeping. Furthermore, there are a range of queries from our work, your own queries and the Chief Executive of LDL which remains unresolved.

Despite being provided with a restated balance sheet as at 31 March 2014, there remains uncertainty around whether the net asset position is accurate. This is supported by further information we have received on the 30 June 2014 position, which highlighted balances that should have been accounted for as at 31 March 2014. We note, that detailed work has not been carried out on the 30 June or 31 July 2014 balance sheets.

We would strongly recommend that a complete set of accounts are prepared, with supporting evidence and reconciliations, for both LCC and BT to review and consider.

Headlines
Balance sheet reconciliation

The March 2014 balance sheet has been restated with a net impact of a reduction in the BT Ignite Solutions creditor of £0.4 million.

Balance sheet - 31 March 2014

£'000		Mar-14 Reported	Accrue for LCC offset rec invoice	Remove pre-existing LDL offset year end accrual	Sales credit - JE impact for 2012/13 and 13/14 change control	Vodafone rebate (other receivable)	Revenue share calcs rebased from 1.9% service to 1.25% cash	P&L adjust ment	Total adjust ments	Mar-14 Restated
Working capital										
Trade debtors - gross	1	9,365	-	-	(310)	-	-	-	(310)	9,055
Prepayments/accrued income		2,400	-	-	-	-	-	-	-	2,400
Prepaid expenses	2	-	-	-	-	887	-	-	887	887
Trade creditors		(61)	-	-	-	-	-	-	-	(61)
Accrued expenses	3	(3,241)	(1,904)	199	-	-	385	-	(1,321)	(4,563)
Deferred income		(6,147)	-	-	-	-	-	-	-	(6,147)
External VAT creditor		(2,079)	317	-	52	-	-	-	369	(1,710)
Net debt									-	
Cash at bank		4,366	-	-	-	-	-	-	-	4,366
Intragroup creditor (BT treasury)		-	-	-	-	-	-	-	-	-
Intragroup creditor (Ignite)	4	(4,591)	-	-	-	-	-	375	375	(4,216)
Net assets		10	(1,587)	199	(258)	887	385	375	-	10

The following adjustments have been made to the 31 March balance sheet:

1. An amount of £0.3 million (gross of £0.1 million VAT) decrease in trade debtors to reflect the previously disputed job evaluation invoice (see Appendix 1). **We are unaware as to whether this adjustment now removes the dispute in full.**

2. An additional £0.9 million prepayment to reflect an expected Vodafone rebate as referenced in LDL's notes (see Appendix 2). This effectively reduces the impact of disputed items on the Ignite creditor. As you have already noted, the rationale for why this rebate benefits BT only, is unclear. Furthermore, there is no support for the actual value of this rebate. **We suggest LCC includes this in their disputed items.**

3a. The accounts previously showed an accrual of £0.2 million in relation to the LCC offset reconciliation which was disputed. The accounts now show an amount of £1.9 million relating to the LCC offset reconciliation invoice (gross of £0.3 million VAT) and the reversal of the existing LCC offset accrual of £0.2 million. **This amount is no longer disputed and should be included in net debt.**

3b. The restated balance sheet now shows a further £0.4 million reduction to accrued expenses, which relates to the Mayor's Fund and revenue share accruals. There is no support for the rebasing of this calculation. **As this reduces net debt, we recommend that you query this adjustment** (and note you have already sent some queries to BT).

4. A £0.4 million reduction in the Ignite intragroup creditor, to reflect the net impact of the above items.

Net debt

The restated net debt position now reflects the adjusted 31 March 2014 balance sheet together with our previous findings on the 30 June 2014 accounts that have been communicated to you via email.

We have not undertaken work on the 31 July 2014 accounts and our work on the 30 June 2014 balance sheet is not exhaustive.

Net debt update		
£'000		
Net debt at March 2014		
Cash		4,366
Debt		
Mayor's Fund		(2,381)
LCC profit share		(229)
FY14 LCC offset reconciling item		(1,904)
Deferred income of LDL relating to commitments of LDL to LCC		(800)
Historical provision for apprenticeship scheme		(800)
Intercompany creditor		(4,216)
Net debt at March 2014		(5,964)
June update		
BT drawings	(11,950)	
Less:		
Repayment of intercompany creditor	4,216	
Q1 management charge	2,500	
Q1 costs	3,315	
Net BT drawings		(1,919)
BT charges paid twice (June 2014)		(200)
Historical amounts owed by LCC to LDL (eg JE as agreed)		400
Adjusted net debt		(7,684)

The following definition of net debt includes items that we have come across in the course of our analysis and should be used as a guide for negotiations with BT. There may be other issues (including those that were identified by the Chief Exec of LDL) that you may wish to discuss.

1) A £2.4 million provision held on account for LCC as a 'Mayors Fund', relating to historical billing surpluses which are yet to be offset against LCC costs;

2) A £0.2 million accrual relating to 'revenue share' held on account for LCC;

3) A £1.9 million accrual for offset invoices.

4) Deferred income of £0.8 million relating to commitments made by LDL to LCC.

5) A £0.8 million provision for historical obligations to LCC for the apprenticeship scheme, adult services training and children's services training.

6) Amounts owed to BT Ignite Solutions at March 2014. Net debt includes £4.2 million of intragroup creditors owed to BT and Ignite Solutions. An element of this balance may be working capital in nature relating to ongoing services provided by BT. Based on FY14 Titan costs excluding margin and overhead (£14.6 million) on 30 day credit terms the working capital element could be £1.5 million each month including VAT. LDL should consider the proposed credit terms with BT in assessing the level of working capital included in this balance.

7) Drawings in the period to 30 June included a cash sum of £12.0 million extracted by BT to cover the following items:

- BTGS management charge of £2.5 million;
- Other Titan 'third party pass through costs' of £2.8 million (leaving an outstanding balance of £0.5 million at this date);
- Charges under the TCA of £4.6 million (to reflect the original creditor balance at 31 March 2014, before adjustments); and,
- A BT treasury VAT settlement of £2.1 million.

8) A £0.2 million provision in relation to BT charges in June 2014 that are repeat charges of costs paid by LDL in 2013/14.

9) A £0.4 million debtor in relation to amounts owed by LCC to LDL.

Updated findings (1)

Initial findings		
Headline	**Issue**	**Status**
Outstanding issues A £0.8 million provision in relation to a historical obligation of LDL is yet to be reflected in the accounts at 31 March 2014.	Per email, the following items still remained unresolved as of 14 August 2014: 1) BT ignite solutions creditor of £4.6 million is overstated by [£] million due to accounting errors (understated accrual to LCC for the year end offset reconciliation, understated provisions overstated invoicing to LCC) 2) The accrual for amounts owed to LCC of £0.2 million for the year offset reconciliation is understated by £1.4 million. 3) Provisions for historical obligations to LCC for the apprenticeship scheme, adult services training and children's services training (currently nil) are understated by £0.8 million. 4) Amounts invoiced to LCC at 31 March 2014 in respect of historical items (e.g. job evaluation) of £1.5 million are disputed and the debtor is overstated by £[ ] million.	■ Partially resolved ■ Resolved ■ Unresolved ■ Partially resolved
Various further outstanding items raised by LDL's chief executive are also yet to be reflected in the accounts.	Additional issues were raised by the LDL chief executive per your email of 20 August 2014 . These items are addressed below: 1) No SIA, LMH, L&Q or Knowsley MBC provisions (total value £0.03 million) 2) Vodafone - £0.5 million cash bonus (subsidy payment due) plus unconfirmed value for the revenue rebate have not been provided to LDL. – [figure of £0.9 million has now been added to prepaid expenses] **A figure of £0.9 million has now been added to prepaid expenses, however we have not had confirmation that this outstanding balance is now fully accounted for.** 3) Cisco overcharging – Overcharge of £0.2 million to be returned plus support cost overcharge of [£0.04 million]. 4) David McElhinney salary – BT have not paid £0.1 million salary (April-August 14). 5) LCC believe that an intercompany recharge will be raised for (4) LDL Directors paid in OCL March 2012 which should be against LDL. Estimated at £0.05 Million.	■ Unresolved ■ Partially resolved ■ Unresolved ■ Unresolved ■ Unresolved

Updated findings (2)

Initial findings		
Headline	Issue	Status
Outstanding issues Various further outstanding items raised by LDL's chief executive are also yet to be reflected in the accounts.	6) 2013/2014 provisions	
	▪ £2.6 million Mayoral Fund provision as at 31.03.14. **This figure has been adjusted down to £2.4 million.**	▪ Partially resolved
	▪ £0.4 million Profit share provision as at 31.03.14. **This figure has been adjusted down to £0.2 million.**	▪ Partially resolved
	▪ £0.2 million Offset reconciliation provision as at 31.03.14 understated by £1.4 million - relates to non-payment of invoice LCC X1901296490 £1.6 million (£1.9 million gross). **This figure has now been adjusted to £1.9 million.**	▪ Resolved
	▪ £0.04 million third party accrual- BSF Computacenter as at 31.03.14 – This has since been paid in June 14.	▪ Immaterial?
	▪ £9,000 third party accrual – PwC invoice – note in accounts- "Hscavelli e-mail19/2/14 at 14.15"	▪ Immaterial?
	▪ £1.3 million 2013/14 ICT Investments with no provision. **This potentially looks to be an "off-balance sheet" item and could impact upon net debt.**	▪ Unresolved
	▪ £0.64 million Apprenticeship under spend with no provision	▪ Unresolved
	▪ £0.19 million Adult Services training under spend with no provision	▪ Unresolved
	▪ £0.03 million Children's services training under spend with no provision	▪ Unresolved
	7) 2013/14 LCC debtors	
	▪ £15,000 Parking Services discount – 2013/14 Invoice 352732 included the disputed £0.24 million against BRC24128. There was an agreement for a £15,000 discount to settle the issue. The £15,000 has not been set aside within provisions.	▪ Unresolved
	▪ £0.35 million overstated Job Evaluation impact – (now adjusted for) – Invoice 352732 included a £0.77 million charge for the impact of the Job Evaluation (JE) between Oct 12-Mar I4. This has been disputed as LCC believe it has been overstated by approximately £0.35 million. No JE adjustment should be paid as LDL made a 25% GM in 2013/2014 also the staffing affordability budget is well under spent. **We are unaware as to whether this adjustment now removes the dispute in full.**	▪ Partially resolved
	▪ £0.19 million Director's Buyout – Invoice 352753 was disputed on the grounds that it had to go via the offsets and that £0.19 million was based on 6 directors when it should have only been 5. A request has been made to BT to issue via the offsets (for 2013/2014) and withdraw the invoice. No response to date.	▪ Unresolved

Updated findings (3)

Initial findings

Headline	Issue	Status
Outstanding issues Various further outstanding items raised by LDL's chief executive are also yet to be reflected in the accounts.	8) TITAN Intercompany recharges 2013/14	
	▪ £2.74 million Closing third Party Accrual - Require detail of what 3rd party invoices are covered by this £2.74 million accrual.	▪ Unresolved
	▪ £0.06 million Closing iBuy Feed Accrual- This accrual is system generated and is due to the over receipting of purchase orders in iBuy. The accrual is invalid as it simply required the closing of the relating purchase orders in the system.	▪ Unresolved
	▪ Confirmation is required that 2013/14 SIA winning business charges are correct - In Nov13 and Mar14 in particular revenue stream appears unusually low (£39,000 and £1,000 respectively).	▪ Unresolved
	▪ Confirmation is required that 2012/13, 2013/14 and 2014/15 OCL charges are correct. It appears no print or postage has been charged.	▪ Unresolved
	9) TITAN Intercompany recharges 2014/15	
	▪ £2.5 million Management Fee – LCC agreed fee for Q1 2014/15 but LCC has no evidence of BT being engaged with LDL for this period. No contact by BT with any member of LDL BT accountants moved off site and provided no service or support.	▪ Unresolved
	▪ £0.57 million prepayments reclaimed in April'14 – Evidence that the relating invoices were previously paid in full 2013/14 via TITAN, however no evidence that they were then credited back and treated as a prepayment on the balance sheet. Without supporting evidence it would appear the invoices in question have been paid twice.	▪ Unresolved
	▪ £0.08 million charged in P2 but no supporting data provided – Related to May TITAN charges, Gavin Hooker advised supporting data would follow but not received.	▪ Unresolved
	▪ £1.53 million Unidentified pass through third party costs in P3. No data provided by BT	▪ Unresolved
	▪ £0.08 million External Billing for Q1 with no evidence (Knowsley MBC/LIVIH/L&Q)	▪ Unresolved
	▪ Q1 OCL revenue recharge – £30,000 was credited back for April & May, no evidence of June recharge (£30,000 outstanding) or print/postage.	▪ Unresolved
	▪ Q1 SIA revenue recharge – Only £26,000 recharged back to LDL for April 14.There is no validation of these costs.- No evidence of SIA recharge for May/June/ July.	▪ Unresolved

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Supporting analysis

Restated balance sheet

Balance Sheet

£'000	Mar-14 Restated	Previously reported movements	Adjusted movements	Jun-14 Restated
Working capital				
Trade debtors - gross	9,054.5	(1,453.7)	-	7,600.8
Prepayments/accrued income	2,400.0	50.0	-	2,450.0
Prepaid expenses	886.8	1,851.5	(296.1)	2,442.2
Trade creditors	(61.5)	(1,948.3)	-	(2,009.8)
Accrued expenses	(4,562.7)	215.4	613.5	(3,733.8)
Deferred income	(6,147.4)	221.4	-	(5,926.0)
External VAT creditor	(1,709.7)	1,376.7	(317.4)	(650.4)
Net debt				
Cash at bank	4,365.7	(4,365.7)	-	0.0
Intragroup creditors - BT treasury	-	2,645.9	-	2,645.9
Intragroup creditors - Ignite Solutions (BT)	(4,215.9)	1,406.9	-	(2,808.9)
Net assets	**10.0**	**(0.0)**	**0.0**	**10.0**

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cutting through complexity

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