CIPFA The Chartered Institute of Public Finance & Accountancy

the prudential code

for Capital Finance in Local Authorities
Guidance Notes for Practitioners
2013 edition

CIPFA, the Chartered Institute of Public Finance and Accountancy, is the professional body for people in public finance. Our 14,000 members work throughout the public services, in national audit agencies, in major accountancy firms, and in other bodies where public money needs to be effectively and efficiently managed. As the world's only professional accountancy body to specialise in public services, CIPFA's qualifications are the foundation for a career in public finance. We also champion high performance in public services, translating our experience and insight into clear advice and practical services. Globally, CIPFA shows the way in public finance by standing up for sound public financial management and good governance.

CIPFA values all feedback it receives on any aspects of its publications and publishing programme. Please send your comments to publications@cipfa.org

Our range of high quality advisory, information and consultancy services help public bodies – from small councils to large central government departments – to deal with the issues that matter today. And our monthly magazine, *Public Finance*, is the most influential and widely read periodical in the field.

Here is just a taste of what we provide:

- TISonline – online financial management guidance
- Benchmarking
- Advisory services
- Professional networks
- Property and asset management services
- Recruitment services
- Research and statistical information
- Seminars and conferences
- Education and training
- CIPFA Regions – UK-wide events run by CIPFA members

Call or visit our website to find out more about CIPFA, our products and services – and how we can support you and your organisation in these unparalleled times.

020 7543 5600
enquiries@cipfa.org
www.cipfa.org

MIX
Paper
FSC FSC® C102824

Environmental Information

This CIPFA publication is printed on certified FSC mixed sources coated grade stock containing 50% recovered waste and 50% virgin fibre.

Printed on stock sourced from well-managed forests, ISO 14001.

The Chartered Institute of Public Finance & Accountancy

the prudential code

for Capital Finance in Local Authorities Guidance Notes for Practitioners

2013 edition

Published by:

CIPFA \ THE CHARTERED INSTITUTE OF PUBLIC FINANCE AND ACCOUNTANCY

3 Robert Street, London WC2N 6RL

020 7543 5600 \ publications@cipfa.org \ www.cipfa.org

ISBN 978 1 84508 368 7

Edited by Sarah Williams (sarah@redlane.org.uk)

Designed and typeset by Ministry of Design, Bath
(www.ministryofdesign.co.uk)

Printed by Trident Printing, London

Foreword

The prudential framework for local authority capital investment, introduced through the Local Government Act 2003, the Local Government Finance Act (Northern Ireland) 2011 and the Local Government in Scotland Act 2003, has had a real and beneficial impact on service delivery by supporting strategic planning for capital investment at a local level. It has been used responsibly while at the same time has promoted innovative projects.

CIPFA developed *The Prudential Code for Capital Finance in Local Authorities* (the Code) as a professional code of practice to support local authorities in taking decisions on capital investments. Key objectives of the Code are to ensure, within a clear framework, that local authorities' capital investment plans are affordable, prudent and sustainable; that treasury management decisions are taken in accordance with good professional practice; and that local strategic planning, asset management planning and proper option appraisal are supported.

This guidance is intended to give practitioners a practical interpretation of the Code to enable them to meet its key principles of ensuring that capital programmes are affordable, prudent and sustainable and to explain this effectively to those charged with governance.

This revised guidance updates the 2007 version and includes changes made to the Code and the Treasury Management Code in 2009 and 2011 and the extension of the Prudential Framework to Northern Ireland following the Local Government Finance Act (Northern Ireland) 2011.

CIPFA would also like to thank the members of its Treasury and Capital Management Panel who oversaw the updating of this guidance:

Ken Barnes, *Chair*

Mandy Bretherton, *CIPFA*

Martin Easton, *Birmingham City Council*

Innes Edwards, *Edinburgh Council*

Jonathan Hunt, *Westminster Council*

Kevin Jaquest, *Society of District Council Treasurers*

Gill Kilpartrick, *Society of County Treasurers*

Mark Luntley, *Local Partnerships*

Joy Robson, *Monmouthshire Council*

Janet Senior, *Lewisham Borough Council*

Will Spinney, *Association of Corporate Treasurers*

Thanks also to Matthew Allen, who undertook the original drafting of the guidance notes for CIPFA.

Contents

Introduction

1 This guidance on the practical application of the CIPFA *Prudential Code for Capital Finance in Local Authorities* (the Code) is designed for finance professionals within local authorities, and others seeking a detailed understanding of its technical content. It supersedes the *Guidance Notes for Practitioners* issued in 2007. Where it is necessary to distinguish this latest advice from its predecessor, it will be referred to as the revised, as distinct from the original, guidance.

2 The regulations requiring local authorities to have regard to the Code have been issued under Part 1 of the Local Government Act 2003 in England and Wales, under Part 1 of the Local Government Finance Act (Northern Ireland) 2011 in Northern Ireland and under Part 7 of the Local Government in Scotland Act 2003 in Scotland.[1]

3 This guidance is designed for the application of the Code in England, Wales, Northern Ireland and Scotland. While there are significant differences between the legislative frameworks within which the Code is placed within each country, the practical application of the Code itself may be served by substantially the same guidance:

- In England, Wales and Northern Ireland, the prudential indicator for the authorised limit for external debt for the current year is the legislative limit determined under section 3(1) of the Local Government Act 2003 and section 13 (1) of the Local Government Finance Act (Northern Ireland) 2011: '*A local authority shall determine and keep under review how much money it can afford to borrow.*'
- In Scotland, the prudential indicator for the estimate of capital expenditure for the current year is the legislative limit determined under section 35(1) of the Local Government in Scotland Act 2003: *'It is the duty of a local authority to determine and keep under review the maximum amount which it can afford to allocate to capital expenditure.'*

4 Since this guidance considers the implications of the legislative context in which the Code operates it is necessary to include some guidance that is specific to England, Wales, Northern Ireland or Scotland.

5 This guidance reflects the experience of practitioners since the implementation of the Code and where appropriate these issues are illustrated by worked examples of those elements that introduce new or unfamiliar concepts. Each of these examples has been designed to illustrate the general principles of individual calculations. Although most of these examples are based

1. Statutory Instrument 2003 No. 3146 *The Local Authorities (Capital Finance and Accounting) (England) Regulations 2003,* Regulation 2; Welsh Statutory Instrument 2003 No. 3239 (W.319) *The Local Authorities (Capital Finance and Accounting) (Wales) Regulations 2003,* Regulation 2; Statutory Rules of Northern Ireland 2011 No. 326 *Local Government (Capital Finance and Accounting) Regulations (Northern Ireland) 2011,* Regulation 7; and Scottish Statutory Instrument 2004 No. 29 *The Local Government Capital Expenditure Limits (Scotland) Regulations 2004,* Regulation 2(2).

on data collected from authorities, they may have been simplified and amended to ensure that the principal issues are highlighted. As a consequence, while realistic, they should not be taken to represent the actual prudential indicators of any authority. A particular consequence of the Code is that it highlights the diversity of local authorities, especially in their overall level of borrowing. As a result, practitioners should not necessarily be surprised by any marked divergence between the indicators calculated for their own authority and those of other authorities, nor should they be surprised by divergences from the illustrative examples used in this guidance. The Code itself, of course, states that prudential indicators should not be used for comparative purposes due to the very different starting point for local authorities when the Code was introduced.

6 In 2007 CIPFA published *Capital Success: Good Practice in the Implementation of the Prudential Code* which demonstrated how local authorities had been successful in the use of the prudential system to deliver improvements in the delivery of services.

NB The figures used in this guidance are for illustrative purposes only and do not constitute recommendations for the level at which the figures should be set.

The Prudential Systems of Capital Finance

7 The Code is the key element in the new systems of capital finance that were introduced in England, Wales and Scotland from 1 April 2004 and in Northern Ireland from 1 April 2011. England, Wales and Northern Ireland share broadly similar arrangements that are based on common principles, albeit set out in separate primary legislation – the Local Government Act 2003 for England and Wales and the Local Government Finance Act (Northern Ireland) 2011. The different principles of the Scottish arrangements were established by the Local Government in Scotland Act 2003.

ENGLAND, WALES AND NORTHERN IRELAND

8 Under the prudential system, individual authorities are responsible for deciding the level of their affordable borrowing, having regard to CIPFA's Code, which has been given legislative backing. Prudential limits apply to all borrowing, qualifying credit arrangements and other long-term liabilities – whether supported by government or entirely self-financed. The system is designed to encourage authorities that need and can afford to undertake capital investment to do so.

9 The prudential system is based on principles rather than prescription. This places the responsibility for the success of the system on the professional judgement of practitioners themselves. The basis of this judgement will largely be provided by proper practice, although the Secretary of State, the National Assembly for Wales and the Northern Ireland Government do have powers to define capital expenditure and credit arrangements. In its guidance CIPFA seeks to support practitioners but it cannot and does not wish to be prescriptive.

10 In addition to the Code, the present system of capital finance incorporates arrangements for the treatment of some or all housing capital receipts in England and Wales. Some aspects of these changes are beyond the scope of this guidance, but reference will be made to their links with the Code.

11 While having enough in common to be largely considered together for the purposes of this guidance, there are some differences in the detail of the England, Wales and Northern Ireland regulations. Where the Wales and Northern Ireland systems vary from that in England, the differences are set out in this guidance. Elsewhere it may be assumed that the same guidance on the application of the Code applies in England, Wales and Northern Ireland.

SCOTLAND

12 Before April 2004 the system of capital finance in Scotland was underpinned by fewer statutory regulations than had been the case in England and Wales. The prudential system in Scotland places even greater reliance than elsewhere on proper practices rather than regulation. This has meant that there is less need for specialist guidance on the legislative aspects of the Scottish arrangements.

13 For Scotland, as elsewhere, the introduction of the new arrangements did nevertheless still represent a movement from a system of centralised controls over local authority capital investment to a self-regulatory framework – subject to the retention of reserve powers by the Scottish Executive. In contrast to England, Wales and Northern Ireland, however, this framework addresses local authority capital expenditure rather than local authority borrowing. This guidance will show, however, that this legislative difference has little practical impact on the application of the Code.

Corporate Governance Issues

14 The introduction of the Code reflects a move towards more self-regulation for local authorities and hence effective corporate governance is one of the key elements to successful implementation of the Code. The purpose of this guidance is to assist local authorities to make their own judgements about how the Code may be most effectively implemented to meet their own local circumstances. In order to realise the full potential of the Code, local authorities need to ensure that they have effective governance processes in place and that there is a sense of ownership within the authority. An authority that has a sound medium-term financial planning process will also be able use the Code and associated indicators to help explain to its stakeholders how its finances are managed in the medium term.

15 In its practical application the Code has and will continue to be an iterative process as the authority considers alternative financial strategies before deciding on the one that is suitably affordable, prudent and sustainable. It may be that the first budget iteration and associated indicators are not deemed to be affordable, prudent and sustainable. In this scenario it will be necessary to revise the budget until the criteria are met. This process may take several iterations, but the final budget approved by those charged with governance must meet the criteria. This guidance has not sought to capture the detail of how this process will be managed, which will be determined by the specific circumstances of each local authority.

16 The Code sets out the principles of the corporate governance arrangements that must be followed in relation to the setting of the prudential indicators.

Extract from the Prudential Code

15 Prudential indicators, other than actuals that are taken from information in the local authority's Statement of Accounts, are required to be set and where they are revised, revised through the processes established for the setting and revising of the budget for the local authority. These prudential indicators must be set and where they are revised, revised in accordance with the matters required to be taken into account (paragraphs 11–14).

17 The prudential indicators for the forthcoming and following years must be set before the beginning of the forthcoming year. They may be revised at any time, following due process, and must be reviewed, and revised if appropriate, for the current year when the prudential indicators are set for the following year.

17 These approval requirements arise from the necessity for decisions about affordability to be matters of political judgement, which must be made by those charged with governance, such as elected members. In doing this they are supported by the framework supplied by the Code and by the advice of their chief finance officers (CFOs).

18 There may be some local variations in the manner in which authorities meet the requirements.

19 In setting its treasury management strategy the authority must be clear that security, liquidity and then yield are the prime objectives of its treasury management activities. This is a requirement of CIPFA's *Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes* (2011), which also requires a treasury management strategy, a mid-year review and the annual report on treasury management activities to be considered by the full council or an equivalent body. It follows from this, given the interrelationship of treasury management and capital planning, that the requirements of both codes will best be met by submitting the prudential indicators including the treasury management indicators in tandem with the treasury management strategy to the full council or equivalent decision-making body. Authorities are also required to specify the body to be responsible for scrutiny of the treasury management function, which may be an audit or scrutiny committee, which forms a key element of the governance process.

20 It is therefore important that this decision-making process for setting the authority's prudential indicators is able to identify and evaluate risks, while also including arrangements to reduce such risks to an acceptable level.

21 The integrity of local authority balance sheets is crucial for the successful application of the Prudential Code. A failure to give timely consideration to the balance sheet implications of a major project or other developments with a material impact on the balance sheet could ultimately undermine the credibility of the prudential indicators used to inform capital investment decisions. This is one important reason why local authorities should have regard to CIPFA's *Balance Sheet Management in the Public Services: A Framework for Good Practice* (2006). Good practice would include, for example, the scrutiny of those aspects of the balance sheet that are subject to judgemental assessments and also the application of appropriate levels of management review. The governance arrangements for the appropriate review, scrutiny and approval of decisions with material balance sheet implications should be closely aligned with those for the authority's budget, treasury management strategy and Prudential Code indicators. Balance sheet management should be an integral part of the regular financial management rather than simply a year-end exercise. Only in this way can the authority have continuing confidence in the key financial indicators on which it has based its treasury management and capital investment decisions throughout the year.

22 More generally, corporate governance of the Code must reflect any existing or new guidance. Authorities in England and Wales, for example, must also take account of the guidance from the Secretary of State, the National Assembly for Wales and the Northern Ireland Government, which requires them to produce an investment strategy. It is good practice to establish links between the application of the Code and the investment strategy and this is generally done by combining it with the requirements of the Code in a single document. It remains nonetheless advisable to ensure that authorities make it clear precisely how they are satisfying the requirements of the guidance from the Secretary of State, National Assembly for Wales or Northern Ireland Government.

THE ROLE OF THE CHIEF FINANCE OFFICER

23 The Code explicitly recognises significant responsibilities on finance directors in local government.[2] Through the Code the CFO is responsible for ensuring that all matters that must be taken into account are reported to the budget decision-making body for consideration, and for establishing procedures to monitor performance. This requirement is established in paragraphs 23 and 26 of the Code.

Extract from the Prudential Code

23 The chief finance officer is responsible for ensuring that matters required to be taken into account when setting or revising prudential indicators (paragraphs 11–14) are reported to the decision-making body for consideration.

26 The chief finance officer is required to establish procedures to monitor both performance against all forward-looking prudential indicators and the requirement specified in paragraph 45. The chief finance officer will need to establish a measurement and reporting process that highlights significant deviations from expectations.

24 CFOs need to be particularly aware that the Code sets out the minimum indicators necessary to demonstrate the legislative requirement that the authority's financial plans are affordable. They may wish to set further local indicators in order to demonstrate that the authority's financial plans meet the legislative requirement to be affordable or to assist the authority's management processes. Examples of possible local indicators include the ratio of HRA debt to revenues and the forecast HRA debt per dwelling. Both of these local indicators consider the total level of HRA debt and how its proportion is changing over the three-year period of the indicators. If the proportions are continually increasing year on year, it may give an early indication that the debt is not be sustainable or affordable.

25 The CFO is responsible for ensuring that all the matters that must be taken into account when setting or revising the indicators are reported to the appropriate decision-making body. The CFO will not, however, be able to apply the Code in isolation from other chief officers and professionals since their contribution will be essential if the proposed indicators are compatible with the authority's strategic vision and the stewardship of its assets. Paragraph 11 of the Code sets out the matters to which the local authority should have regard when setting its prudential indicators.

2. *The Role of the Chief Financial Officer in Local Government*, CIPFA, 2010.

Extract from the Prudential Code

11 In setting or revising their prudential indicators, the local authority is required to have regard to the following matters:

- service objectives, eg strategic planning for the authority
- stewardship of assets, eg asset management planning
- value for money, eg option appraisal
- prudence and sustainability, eg implications for external debt and whole life costing
- affordability, eg implications for council tax
- practicality, eg achievability of the forward plan.

26 This guidance on the application of the Code focuses on:

- affordability, eg implications for council tax and council housing rents, and
- prudence and sustainability, eg implications for external borrowing.

27 The Local Government Act 2003, the Local Government Finance Act (Northern Ireland) 2011 and the Local Government in Scotland Act 2003 all refer to affordability. This means that an authority must consider the affordability of its capital investment during **all** the years in which it will have a financial impact on the authority. The scale and timescale of this impact will be a factor that the local authority will take into account when deciding whether its financial planning horizon should be greater than the three-year minimum specified by the Code. The Code refers to affordability, prudence and sustainability, which are related concepts. In order to ensure long-term affordability, decisions have also to be prudent and in the long term sustainable. Therefore, in carrying out their duties under Part 1 of the Local Government Act 2003 (England and Wales), Part 1 of the Local Government Finance Act (Northern Ireland) 2011 (Northern Ireland) and Part 7 of the Local Government in Scotland Act 2003 (Scotland) in respect of affordability, local authorities are required to have regard to all those aspects of the Code that relate to affordability, sustainability and prudence.

28 Prudence is more than simply a narrow financial concept. It requires an authority to ensure that its capital investment decisions can deliver the authority's asset management and community strategy. Prudence is also closely associated with sustainability and it is for that reason its consideration demands medium- to long-term strategic planning. The capital strategy and asset management planning between them set out the requirements for capital investment by the authority. The former should link the authority's capital investment to its service priorities while the latter should identify the cost of maintaining existing assets.

29 A likely starting point is to use these wider corporate planning processes to produce a draft capital programme, revenue forecasts and treasury management strategy. If, in the light of the prudential indicators, the outcomes appear to be unaffordable, imprudent or unsustainable, then a revised capital programme will have to be produced and be subject to the same analysis to demonstrate that it satisfies the requirements of the Code. The alternative is to determine affordable, prudent and sustainable indicators and then work back to determine a capital programme and revenue budget that is consistent with them. In either case, the application of the Code should promote integration of revenue and capital budgeting.

30 The indicators of financing costs and impact on budget, external debt and capital expenditure cannot be set or revised in isolation from each other but should be considered together. It follows from this requirement that the same Code can be applied in Scotland, where the legislation refers to expenditure, as in England, Wales and Northern Ireland, where the legislation refers to borrowing. This process of applying the Code will be the same even though the primary legislation for Scotland isolates a different element of this decision than that for England, Wales and Northern Ireland:

- In England, Wales and Northern Ireland the prudential indicator for the authorised limit for external debt for the current year is the legislative limit determined under section 3(1) of the Local Government Act 2003 and section 13(1) of the Local Government Finance Act (Northern Ireland) 2011: *'A local authority shall determine and keep under review how much money it can afford to borrow.'*
- In Scotland, the prudential indicator for the estimate of capital expenditure for the current year is the legislative limit determined under section 35(1) of the Local Government in Scotland Act 2003: *'It is the duty of a local authority to determine and keep under review the maximum amount which it can afford to allocate to capital expenditure.'*

31 Authorities subject to different legislative regimes need to take into account and monitor the same set of factors in order to demonstrate that their proposals are affordable since both borrowing and expenditure need to be taken into account in identifying an affordable capital investment strategy. This affordability will therefore be demonstrated by the application of the same Code.

32 Each CFO will need to give careful consideration to how the range of possible options is presented to members. The CFO is responsible for determining and presenting possible capital investment options to members and offering them professional advice. However, it is the duty of elected members to balance the constraints of affordability with the demands of services for capital investment, and in all but most exceptional cases it will be for elected members to make the necessary judgement. The advice of the CFO will, however, be important. In England and Wales, the Code has to be considered in conjunction with the specific duties set out for the responsible financial officer by section 114 of the Local Government Finance Act 1988. In Northern Ireland, section 54 of the Local Government Act (Northern Ireland) 1972 identifies the requirements for arrangements for handling receipts and payments. Similarly, in Scotland, section 95 of the Local Government (Scotland) Act 1973 places a responsibility for proper financial administration on the CFO.

33 The CFO will need to determine how the requirements of the Code can be integrated into the financial planning process to ensure that elected members take them into account. The CFO also has specific responsibility for monitoring implementation of the Code. The level and style of monitoring required will vary markedly between the prudential indicators. These are therefore considered within the sections of this guidance devoted to each indicator.

Financial Planning and Option Appraisal

34 Before the introduction of the Code, many local authorities' revenue and capital budgeting were managed by distinct processes with, sometimes, little integration of capital decisions and policy priorities into the mainstream financial planning processes. Decisions about capital investment were often made in advance of those on the revenue budget. A fundamental aspect of the prudential system is the ability of each local authority to determine locally the need for capital investment against the option of revenue expenditure. This remains true when considering the best mix of capital and revenue for the achievement of any specific project or service delivery objective, even if the scope for an overall increase in capital investment is limited by central government's limitations on the freedom to raise the council tax or housing rents to increase resources for capital investment. Further information on financial planning can be found in the 2012 CIPFA publication *Thinking Ahead.*

35 One consequence of the previous systems of capital expenditure controls was that in local authorities the starting point for the calculation of capital investment was the government constrained limitations on borrowing or, in Scotland, capital expenditure. In those circumstances, especially when these constraints were tight, the range of options available for the total quantum of capital investment in any one year had been limited. This is no longer necessarily the case under the prudential arrangements, although in practice many authorities have found that the continuing pressures of revenue constraints have limited the level of investment which they would like to make. These constraints would become more direct in the event of the Government or one of the devolved administrations utilising its powers to impose borrowing limits in individual or all local authorities. For England and Wales, these powers are contained in section 4 of the Local Government Act 2003; for Northern Ireland, in section 14 of the Local Government Finance Act (Northern Ireland) 2011; and in Scotland, in section 36 of the Local Government in Scotland Act 2003.

36 The constraints on revenue funding have led many local authorities to re-evaluate their capital programmes to ensure that they link to the latest corporate objectives and that they remain affordable, prudent and sustainable. This is best achieved by an integration of the Prudential Code principles into its broader planning framework within which strategic decisions about the capital programme are made.

37 The requirement in the Code for local authorities to have regard to the practicality of their capital programmes flows from the fact that they will no longer be constrained by financial resources alone. As a consequence they will have to identify their capacity to deliver capital programmes as well as the scale of the programmes that they can afford.

38 The broad scope of the capital and revenue financial planning processes demanded by compliance with the Code is established in paragraph 31 of the Code.

Extract from the Prudential Code

31 In considering the affordability of its capital plans, the authority is required to consider all of the resources currently available to it/estimated for the future, together with the totality of its capital plans, revenue income and revenue expenditure forecasts for the forthcoming year and the following two years. The authority is also required to consider known significant variations beyond this timeframe.

39 Financial planning has to take into account the range of options for revenue funding and capital investment by:

- establishing whether the authority considers it is affordable and prudent to bear the additional future revenue cost associated with additional investment, ie financing and running costs
- establishing whether this use of existing or new revenue resources to finance capital investment should have precedence over other competing needs for revenue expenditure
- establishing the scope for capital investment to generate future revenue savings or income, taking into account the risks associated with such proposals.

40 Within the chosen financial planning horizon, the Code encourages members to determine spending priorities and the affordability criteria so that the best overall solutions can be identified and applied – regardless of whether they are revenue or capital intensive in their use of resources. These may include working in partnerships or permitting local authority controlled companies or trusts to borrow in order to finance capital investment when it is prudent for them to do so.

41 The three-year planning horizon is a minimum requirement, and CFOs must consider whether a longer planning horizon may be appropriate for their authorities. This would be necessary, for example, if significant additional costs (or reductions in income) are anticipated to arise beyond the three-year period. Authorities should also consider the scope to align the time horizon of their financial planning with that used for other corporate plans. Taking an even longer view, 25- to 30-year financial affordability calculations are already a commonplace for private finance initiative (PFI) schemes or Housing Revenue Account (HRA) business planning. Section 35 of the Local Government in Scotland Act 2003 provides for the laying of regulations about the planning horizons to be used by local authorities and about the publication of plans and commentaries upon plans. These powers are currently being held in reserve. The Scottish Executive has sought three-year forecasts and all authorities have found themselves able to meet this minimum planning horizon.

42 Regardless of the planning horizon used for corporate financial planning, it is still necessary to appraise all substantial schemes over their anticipated lifecycle in order to establish, for example, that the revenue consequences of the capital expenditure can be afforded over the whole life of the project. While only a few authorities have reviewed their whole capital investment strategy over such a timescale, such long-term planning may be more widely appropriate for large or complex projects that will have material and long-lasting implications for the financial standing of the authority. The need for authorities to consider the lifelong implications of major asset investment decisions will therefore promote budgetary frameworks that set longer-term horizons.

43 Compliance with the requirement of the Code to have regard to value for money when setting the prudential indicators will also demand that local authorities have effective systems of option appraisal for individual projects. The introduction of a genuine local choice as to whether to adopt revenue- or capital-based options for service delivery has revitalised the use of more sophisticated option appraisal techniques in local government. Such methodologies have become both possible and necessary to appraise the merits of new capital investment. Good practice examples of how this may be achieved are contained in CIPFA's publications *Capital Success* (2007), *Option Appraisal* (2011) and *Whole Life Costing* (2011).

44 A critical element in the application of the appropriate investment appraisal techniques will be the decision on the appropriate interest rate. It is for each local authority to determine according to its local circumstances whether in principle to use its weighted average or the marginal cost of capital. The essence of the question is whether the cost of funds should be taken as the weighted average costs of each type of capital funding or the specific costs of the additional capital being raised to finance a particular project. In practical terms this decision rests on whether the new investment and its funding will remain separately identifiable. In local authorities the integrated or holistic approach taken to borrowing means that the borrowing used to fund a particular project does not have a distinct identity so the weighted average cost of capital is likely to be chosen. It is possible that, for some other methods of financing capital investment, the marginal cost of capital may be the appropriate basis for net present value calculations. A decision will also need to be made as to whether it is appropriate to add a risk adjustment factor in determining the discount rate to be used in project appraisal. Finally, if the capital investment is being made to improve an authority's commercial property portfolio then the starting point for establishing the appropriate rate of return is likely to be a judgement about the minimum acceptable long-term rate or return from the continued ownership of the property. These are matters that must be determined by the professional judgement of the CFO.

45 Where an authority has subsidiary commercial undertakings, the choice of a discount rate can be even more problematic as it should reflect the cost of capital to that organisation rather than to the local authority that owns or controls it. Since the organisation has an identity separate from its owners, which may be the local authority that provides capital, there is scope for considering local discretion in setting a discount rate.

46 In order to avoid extensive debate about the appropriate interest rate, a practical course of action is to use a range of rates to test whether they make any difference to relative priorities. In many cases there may actually be little difference in the pattern of cash flows. Where relative priorities are changed a judgement can be made as to the most 'realistic' discount rate, with other rates being introduced via sensitivity analysis.

47 One important implication of the Code for option appraisal is that the public sector comparator used to evaluate PFIs and public–private partnerships (PPPs) becomes more realistic rather than being simply hypothetical, since the authority would now be able to borrow to undertake its own investment if the business case were sound and the level of borrowing both affordable and prudent. The Government and devolved administrations may, however, still choose to earmark financial support to these types of partnerships, which would impact on decision making by making them financially more attractive.

48 Local authorities must also determine for themselves the extent to which devolved decision making promotes the objectives desired by the application of the Code. It may be possible to develop an approach that permits individual services to do some assessment of whether additional capital investment is affordable. The issue of prudence is, however, one that can only be considered at a corporate level by an aggregation of the capital investment decisions across the council to determine the overall level of proposed borrowing. It will, in all cases, be necessary to have a corporate-wide analysis of overall affordability, prudence and sustainability since the Code requires these factors to be considered together.

49 In an authority with an HRA the affordability of the overall capital investment programme for all services, including housing, will have to be considered on a corporate basis. While the proposed levels of council tax and housing rents may, when considered separately, be affordable, the underlying overall scale of capital investment could still be considered imprudent when measured using the other indicators in the Code. An authority's corporate governance arrangements must therefore permit the assessment of overall affordability and prudence as well as the affordability and prudence of the HRA and GF (or CF) capital programmes.

Calculating the Prudential Indicators

50 Subsequent sections of this guidance give more detailed consideration to each indicator in the Code. There are, however, some important general considerations that need to be addressed at the outset.

ESTIMATES, ACTUALS AND LIMITS

51 In the Code the indicators are set out according to whether they are indicators of affordability or prudence. This is necessary in order to understand the role each indictor plays in the overall decision-making framework. In setting up the practical arrangements to apply the Code, the CFO will find it useful to recognise the different nature of the various prudential indicators. These reflect the different sources from which they are calculated and the moment during the financial planning cycle when they are calculated, assessed and reported.

Estimates: These will be calculated for future years as part of the budget-setting process. Updated estimates of the likely outturn will take place during the year and will feed into the budget process.

Actuals: The source of these will be the latest audited financial statements together with any audit qualifications. Between the end of the financial year and the completion of audit, the latest available figures should be used and their status clarified whenever they are so used.

Limits: Unlike estimates, these are not statements of expected outcomes but are parameters beyond which the associated indicators should not pass without management action. In contrast to estimates, these may need to be monitored constantly rather than simply periodically during the financial year.

52 The estimates and limits specified in the Code are rolling rather than fixed. Those for the forthcoming and following years must be set before the beginning of the forthcoming year. They may be revised at any time during the year, but only following due processes, and must be reviewed, and revised where necessary when the prudential indicators are set for the following year.

53 In setting its prudential indicators, an authority must take into account risk – the threat that an event or action will adversely affect its ability to achieve its objectives and successfully to execute its financial strategy. The Code emphasises that authorities should have effective risk identification and management arrangements in place. The authority should take into consideration the risks that may occur over the lifetime of its capital programme, such as:

- incomplete or inaccurate estimates
- delays in securing capital receipts or capital grants
- partners not meeting commitments to provide finance

- anticipated future savings and revenue funding targets not being achieved
- project management problems
- adverse movements in interest rates
- depreciation and impairments
- other future developments in proper practices
- political changes.

54 An authority should therefore accompany its calculation of the indicators with an analysis of the significant risks that could potentially prevent it from achieving its plans at the desired levels of affordability and prudence. Where possible it should also set out measures being undertaken to mitigate these risks. One of these risks may be significant uncertainty about an element of the process of establishing any of the prudential indicators. Authorities will need to take into account the implications of incomplete or uncertain information when determining the prudent level of capital investment and borrowing. It may be necessary to reconsider the indicators and these risk assessments in the light of new circumstances that may arise during the year.

55 This guidance includes some illustrative exemplifications of the indicators but it must be stressed that these are not intended to be prescriptive. The calculation of the indicators in each authority must be determined by the local requirement to measure the factors that will materially determine whether proposed capital investment is affordable, prudent and sustainable.

56 It is an important underlying principle of the Code that transactions should – unless legislation demands otherwise – be treated, for the purposes of the Code, in accordance with proper accounting practice. These are set out in the *Code of Practice on Local Authority Accounting in the United Kingdom* (the Accounting Code). In England and Wales, the Accounting Code constitutes proper accounting practice under the terms of section 21(2) of the Local Government Act 2003. In Scotland, the Accounting Code constitutes proper accounting practice under section 12 of the Local Government in Scotland Act 2003. In Northern Ireland, the status and authority of the Accounting Code derives from regulation 3(1) of the Local Government (Accounts and Audit) Regulations (Northern Ireland) 2006 and through the relevant accounts direction issued by the Department of the Environment (Northern Ireland).

57 In all cases, however, if practitioners are unsure how to treat a particular transaction that has already occurred for the purposes of calculating a prudential indicator, they should have regard to how that transaction has been treated within the statements of account for their authority. For future planned transactions, they should have regard to how these will be treated within their statements of account. This guidance has not sought to be prescriptive on many issues connected with the calculation of the prudential indicators because they are matters of accounting principle that should be resolved by practitioners using their own judgment in the application of the Accounting Code.

THE DEFINITION OF CAPITAL EXPENDITURE AND LONG-TERM LIABILITIES

58 The definition of capital expenditure to be used in the calculation of the prudential indicators is set out in paragraph 66 of the Code.

> **Extract from the Prudential Code**
>
> **66 Capital expenditure**
>
> The definition of capital expenditure starts with all those items capitalised in accordance with proper accounting practice. To this must be added any items that have/will be capitalised in accordance with legislation that otherwise would not be capitalised. Prudential indicators for actual figures for previous years should be taken from the amounts capitalised as disclosed in the local authority's statutory accounts. Prudential indicators for current and future years should be calculated in a manner consistent with this definition. In Scotland, the definition of capital expenditure for Prudential Code purposes should include any expenditure for which Scottish ministers have provided a 'consent to borrow' under powers contained in the Local Government (Scotland) Act 1975.

59 The reliance placed on the Accounting Code, and on the balance sheet of local authorities, to identify long-term liabilities means that credit arrangements are defined as the result of a transaction, other than borrowing, that creates a liability associated with a fixed asset. This is achieved in England and Wales by regulations issued under section 7(3)(c) of the Local Government Act 2003 and in Northern Ireland under section 17 (3)(c) of the Local Government Finance Act (Northern Ireland) 2011 that specify that any liabilities that do not arise from capital expenditure are excluded from the definition a credit arrangement.[3] These regulations go on to identify the cost of a credit arrangement, or variation of a credit arrangement, as being the amount of the liability that is shown, in accordance with proper practices, in the authority's accounts.[4] In Scotland, the statutory requirement for local authorities to comply with proper accounting practice has the same effect. In addition, in England, securitisation transactions are required to be treated as credit arrangements.

3. Statutory Instrument 2003 No. 3146 *The Local Authorities (Capital Finance and Accounting) (England) Regulations 2003,* Regulation 3; Statutory Instrument 2012 No. 265 *The Local Authorities (Capital Finance and Accounting) (England) Regulations 2012,* Regulation 3; Welsh Statutory Instrument 2003 No. 3239 (W.319) *The Local Authorities (Capital Finance and Accounting) (Wales) Regulations 2003,* Regulation 3, as amended by Welsh Statutory Instrument 2004 No. 1010 (W.107) *The Local Authorities (Capital Finance and Accounting) (Wales) (Amendment) Regulations 2004;* and Statutory Rules of Northern Ireland 2011 No. 326 *Local Government (Capital Finance and Accounting) Regulations (Northern Ireland) 2011,* Regulation 8.
4. Statutory Instrument 2003 No. 3146 *The Local Authorities (Capital Finance and Accounting) (England) Regulations 2003,* Regulation 6; Welsh Statutory Instrument 2003 No. 3239 (W.319) *The Local Authorities (Capital Finance and Accounting) (Wales) Regulations 2003,* Regulation 5; and Statutory Rules of Northern Ireland 2011 No. 326 *Local Government (Capital Finance and Accounting) Regulations (Northern Ireland) 2011,* Regulation 11.

60 An important consequence of this reliance on the Accounting Code is that issues of definition, such as the often difficult one of distinguishing capital expenditure from revenue maintenance, will be a matter for determination by the authority in accordance with the Accounting Code rather than for central legislative prescription. The use of local authority statements of account to provide the basic definition for the prudential indicators should also promote transparency. For this reason if any item within a local authority statement of account relied on for a prudential indicator is the subject of an audit qualification, this must be highlighted when the indicator is set or revised. Any changes to the definition of an indicator owing to changes to the Accounting Code should also be highlighted.

61 Section 16(1) of the Local Government Act 2003 establishes for England and Wales the basic underlying principle that in the prudential system capital expenditure is expenditure which falls to be capitalised in accordance with proper practices. This is, however, subject to the powers that section 16(2) of the same Act gives the Secretary of State and the National Assembly for Wales to specify expenditure which, for the purposes of the Act, shall be treated as being, or as not being, capital expenditure. As a necessary consequence of the legislative split between capital and revenue in local authority accounts and the special nature of some local authority spending, the legislation permits local authorities to finance specified revenue transactions from capital resources. Since this is now a matter for regulation rather than primary legislation, the definition of these transactions is now different in England and Wales.

62 In the English regulations the items of capital expenditure defined in this way are:[5]

- Expenditure incurred on the acquisition or preparation of a computer program, including expenditure on the acquisition of a right to use the program, if the authority acquires or prepares the program for use for a period of at least one year for any purpose relevant to its functions.
- The giving of a loan, grant or other financial assistance to any person, whether for the use of that person or by a third party, towards expenditure which would, if incurred by the authority, be capital expenditure (except for advances made to officers as part of their terms or conditions of employment or in connection with their employment).
- The repayment of any grant or other financial assistance given to the local authority for the purposes of expenditure which is capital expenditure.
- The acquisition of share capital in any body corporate (except for investments in money market funds or an investment in a real estate investment trust or a scheme approved under the Trustee Investment Act 1961 (local authority investment schemes)).

5. Statutory Instrument 2003 No. 3146 *The Local Authorities (Capital Finance and Accounting) (England) Regulations 20*03, Regulation 25, as amended by Statutory Instrument 2004 No. 534 *The Local Authorities (Capital Finance and Accounting) (Amendment) (England) Regulations 2004,* Regulation 5; Statutory Instrument 2007 No. 573 *The Local Authorities (Capital Finance and Accounting) (Amendment) (England) Regulations 2007;* Statutory Instrument 2010 No. 454 *The Local Authorities (Capital Finance and Accounting) (Amendment) (England) Regulations 2010;* and Statutory Instrument 2012 No. 265 *The Local Authorities (Capital Finance and Accounting) (Amendment) (England) Regulations 2012.*

- Expenditure incurred on works to any land or building in which the local authority does not have an interest, which would be capital expenditure if the local authority had an interest in that land or building.
- Expenditure incurred on the acquisition, production or construction of assets for use by a person other than the local authority which would be capital expenditure if those assets were acquired or, as the case may be, produced for use by the local authority.
- The payment of any levy by a local authority under Section 136 of the Leasehold Reform Housing and Development Act 1993 (levy payable on voluntary transfer of housing stock).

63 In the Welsh regulations the items of capital expenditure defined in this way are:[6]

- Expenditure incurred on the acquisition or preparation of a computer program, including expenditure on the acquisition of a right to use the program, if the authority acquires or prepares the program for use for a period of at least one year for any purpose relevant to its functions.
- The making of an advance or the giving of a grant or other financial assistance to any person, whether for use by that person or by a third party, towards expenditure which would, if incurred by the authority, be capital expenditure (except for advances made to officers as part of their terms or conditions of employment or in connection with their employment).
- Payments to the National Assembly of pooled capital receipts relating to notional capital receipts represented by what would have been capital expenditure if paid for by the authority.
- The acquisition of share capital or loan capital in any body corporate where the probability is that these investments are made not for treasury management purposes but to meet the 'service' objectives of local authorities. Investments that might be deemed loan capital, undertaken by local authorities for the prudent management of its financial affairs, are excluded from the definition of capital expenditure. Such investments should be admitted to an official list maintained by a competent authority in member states of the European Economic Area.
- Repayment of any grant or other financial assistance given to the authority for capital purposes. The repayment of a grant or other financial assistance given to the local authority for the purposes of expenditure is capital expenditure. Capital expenditure on assets not owned by the authority. The expenditure incurred on works to any land or building in which the local authority does not have an interest, which would be capital expenditure if the local authority had an interest in that land or building.
- The payment of any levy by a local authority under Section 136 of the Leasehold Reform Housing and Development Act 1993 (levy payable on voluntary transfer of housing stock).

6. Welsh Statutory Instrument 2003 No. 3239 (W.319) *The Local Authorities (Capital Finance and Accounting) (Wales) Regulations 2003,* Regulation 20; Welsh Statutory Instrument 2004 No. 1010 (W.107) *The Local Authorities (Capital Finance and Accounting) (Wales) (Amendment) Regulations 2004;* Welsh Statutory Instrument 2007 No. 1051 (W.108) *The Local Authorities (Capital Finance and Accounting) (Wales) (Amendment) Regulations 2007.*

64 Section 16(2)(b) of the Local Government Act 2003 also gives the Secretary of State or the National Assembly for Wales the power to direct that the expenditure of a particular local authority may, or may not, be treated as capital expenditure. The similar provision in the previous system of capital finance was used, for example, to capitalise the costs of local government reorganisation. Section 19(3) of the Local Government Finance Act (Northern Ireland) 2011 gives similar powers in Northern Ireland.

65 In the Northern Ireland regulations the items of capital expenditure defined in this way are:[7]

- Expenditure incurred on the acquisition or preparation of a computer program, including expenditure on the acquisition of a right to use the program, if the council acquires or prepares the program for use for a period of at least one year for any purpose relevant to its functions.
- The giving of a loan, grant or other financial assistance to any person, whether for use by that person or by a third party, towards expenditure which would, if incurred by the council, be capital expenditure.
- The repayment of any grant or other financial assistance given to the council for the purposes of capital expenditure.
- The acquisition of share capital or loan capital in any body corporate, except where the expenditure is an investment for the purposes of the prudent management of a council's financial affairs and the investment is admitted to an official list maintained by a competent authority in a European Economic Area state.
- Expenditure incurred on works to any land or building in which the council does not have an interest, which would be capital expenditure if the council had an interest in that land or building.

66 In Scotland, as a consequence of section 12 of the Local Government in Scotland Act 2003, capital expenditure is defined according to proper accounting practices. The Act does provide the Scottish Executive with the power to override proper practices in the definition of capital expenditure. One consequence is that the classification of expenditure by local authorities in their accounts differs in some respects from those used by the Scottish Executive for planning purposes. This has been addressed by the authorities being given explicit guidance about what to include as capital for the purposes of the Scottish Executive's planning and monitoring returns. The figures reported for capital to and by the Scottish Executive will now differ slightly from those given for capital in local authority annual accounts, which continue to comply with proper accounting practice.

67 Scottish ministers have the power to consent to a local authority borrowing to meet costs that they would not otherwise be able to meet from borrowing. For the purposes of the Prudential Code, these costs should be treated as capital expenditure.

68 This power of the Government and devolved administrations to define accounting treatments differently from that in International Financial Reporting Standards will continue to be reflected in the Accounting Code for local authorities. The introduction of the Movement in Reserves Statement enables the movement in the year on the different reserves held

7. Statutory Rules of Northern Ireland 2011 No. 326 *Local Government (Capital Finance and Accounting) Regulations (Northern Ireland) 2011.*

by the authority to be analysed into ‘usable reserves’ (ie those that can be applied to fund expenditure or reduce local taxation) and other reserves. The Surplus or (Deficit) on the Provision of Services line shows the true economic cost of providing the authority’s services, more details of which are shown in the Comprehensive Income and Expenditure Statement. This is different from the statutory amounts required to be charged to the General Fund balance and the Housing Revenue Account for council tax setting and dwellings rent setting purposes. The Net Increase/Decrease before Transfers to Earmarked Reserves line shows the statutory General Fund balance and Housing Revenue Account balance before any discretionary transfers to or from earmarked reserves undertaken by the council.

69 Since the Code treats borrowing and other long-term liabilities in the same manner, it is not necessary, when setting the indicators of affordability and prudence, to anticipate the outcomes of any option appraisal to determine the best means to finance capital expenditure. The Code did not introduce any perverse incentives to enter into alternative forms of credit other than borrowing, since all form of credit is now on the same footing in relation to the control framework.

THE PRINCIPLES ADOPTED FOR THE HOUSING REVENUE ACCOUNT

70 The Code requires several of the indicators of affordability to be subdivided between the HRA and the GF (CF in Wales). Since the HRA has a legislative definition, it was not a matter for CIPFA to determine the methodology for this. It has instead been taken forward in England and Wales through secondary legislation produced by the Government and the devolved administration, respectively.

71 In England and Wales, the introduction of the prudential system coincided with a wide-ranging change in the system of housing capital finance. While these changes did not have a direct impact on the principles used for calculation of the prudential indicators, they do, however, have an impact on the practical operation of the Code since they will have to be taken into account when authorities with HRAs determine whether a proposed capital programme is affordable, prudent and sustainable.

72 The system in England underwent significant changes in 2012 as a result of the introduction of the self-financing regime. This introduced the concept of a debt cap for English housing authorities which means that even if a proposed capital programme is prudent, affordable and sustainable it will not be permitted to proceed if it exceeds the debt cap. Where relevant this limit should be reported and compared to the HRA CFR. The new self-financing system also requires authorities to consider their debt portfolios in more detail and there are various options including a one, a two or a three pool approach to the future management of existing loans of the authority. Each authority will be faced with its own unique circumstances to consider when deciding on which approach to adopt, although the CIPFA guidance expresses a preference for a two pool approach, where the debt portfolios for the General Fund and the HRA are managed separately.

73 For Wales the allocation of financing costs to the HRA is set out in an annual determination made by the National Assembly for Wales under section 87 of, and item 8 of part I and item 8 of part II of schedule 4 to, the Local Government and Housing Act 1989. The implications of these detailed regulations are considered later in this guidance. Since the move to self-financing the requirements for England have been less prescriptive.

74 In Scotland the legislative requirement to maintain an HRA is contained in the Housing (Scotland) Act 1987, schedule 15 of which sets out the income and expenditure that should be charged to it.

75 The requirement to set aside a proportion of HRA capital receipts has been abolished in England, Wales and Scotland. In England, it has now been replaced by a system of partial pooling of HRA receipts from all authorities. In Wales, there is also no requirement to set aside HRA capital receipts; however, in those authorities with HRA debt it is assumed, for subsidy purposes, that a proportion of capital receipts are used for debt repayment, while for any authorities which are HRA debt free, pooling applies.

GROUP ACCOUNTS

76 The balance sheet used for the preparation of the indicators required by the Code is the authority's own balance sheet. The capital expenditure or borrowing of companies (or other bodies) in which an authority has an interest should not be included within these indicators. Where, for example, an authority controls a major transport company and has prepared group accounts, the authority's balance sheet, rather than these group accounts (or group balance sheet), should continue to be used for the calculation of the prudential indicators. Nonetheless, it remains the case that where an authority has interests in companies or other similar related entities the authority needs to have regard to its financial commitments and obligations to those bodies when deciding whether borrowing is affordable. This may result in the development of specific local indicators based on group accounts, however the authorised limit itself must be set only in relation to borrowing that would appear on the authority's own balance sheet.

77 Section 18(1) of the Local Government Act 2003 empowers the Secretary of State or National Assembly for Wales to make regulations that would require transactions by a passenger transport executive, a local authority company or a local authority trust to be treated as if undertaken by the relevant local authority for the purposes of the capital finance system. No such regulations have been made or are anticipated at the time of the preparation of this guidance.

78 The Accounting Code sets out the steps that a local authority must take to determine whether it should prepare group accounts to ensure that users of its financial statements have a full understanding of the economic implications of its PPPs and other joint ventures. The widening diversity of such service delivery vehicles used by local authorities means that there is an increasing risk that authorities that do not produce consolidated group accounts will not be 'presenting fairly' the activities of the authority. Nonetheless, the requirements for the preparation of group accounts contained in the Accounting Code are not sufficient to require a change in the Code. It remains possible that in the future group accounts may require a change in the Code, but such a change would only take place after a full consultation process.

INTERNATIONAL ACCOUNTING STANDARD 19

79 The Code requires that, when a local authority considers affordability, it takes into account the revenue consequences of retirement benefits. It should be noted, however, that the definition of 'other long-term liabilities' in paragraph 73 of the Code explicitly excludes the pensions reserve.

80 In England and Wales, the treatment of the pension's liability in the Code is given legislative backing through the regulations.[8]

REPORTING THE PRUDENTIAL INDICATORS

81 CFOs need to work with elected members to determine the appropriate style of reporting for their authority. In all cases this must be comprehensive, considering all the indicators in the Code and demonstrating how the proposals address all the factors that the Code requires to be taken into account. It is unlikely that the presentation of the numerical indicators alone, without supporting explanation and analysis, will be sufficient to demonstrate compliance with the Code. Conversely, an authority with well-developed medium-term financial and service planning may wish to integrate the new requirements of the Code into those already successful arrangements.

82 Some of the prudential indicators are forward estimates, and it is important to understand that they are calculated based on the facts known and decisions made at the time. It is possible that these indicators will be changed by the authority's subsequent decisions. Political priorities may change even without the intervention of a local or national election.

83 Authorities should seek to establish forward indicators that are sufficiently robust and credible for the authority to be able to use them to form a judgement as to whether it can afford the proposed capital investment. There is likely to be a balance to be struck between technical sophistication, which may be too complex to command widespread ownership beyond finance specialists, and simpler indicators that have a wider ownership. This is a matter of individual judgement according to the circumstances of each authority, and it is a reason why CIPFA has confined its advice to general principles rather than seeking to be prescriptive.

84 The prudential indicators are designed to support and record local decision making in a manner that is publicly accountable. They are not designed to be used as indicators of comparative performance and using them in this way is likely to be misleading and counterproductive. Local authorities will have, as a result of their local circumstances, widely different debt positions at the start of the prudential system and the differences are likely to change over time as the result exercising local choices.

85 The Code is part of a wider move towards more self-regulation and as a consequence there is an absence of detailed prescription on the calculation of each indicator. This allows

8. Statutory Instrument 2003 No. 3146 *The Local Authorities (Capital Finance and Accounting) (England) Regulations 2003,* Regulation 4; and Welsh Statutory Instrument 2003 No. 3239 (W.319) *The Local Authorities (Capital Finance and Accounting) (Wales) Regulations 2003,* Regulation 4.

each authority to make its own decisions from first principles about the most appropriate method for meeting its own requirements. Since local circumstances vary, practitioners must be prepared to exercise their own professional judgement rather than to expect authoritative guidance that would address all possible scenarios. With the passage of time and the gathering of greater experience, individual local authorities have also refined the calculation of their prudential indicators. Such changes have had to be taken into account when presenting year-on-year comparisons. These acceptable year-to-year variations in the detailed calculations of indicators will further undermine any attempt to use them for crude inter-authority comparisons.

86 Confidence in the integrity of the prudential indicators will be provided by the existing external audit processes because the actual figures reported for each prudential indicator will either be extracted directly from the local authority's balance sheet or calculated from the supporting accounting entries that are already the subject of external audit.

Affordability and the Prudential Indicators of Affordability

87 Local authorities in England, Wales and Northern Ireland are required to keep under review the amount of money they can afford to borrow for capital investment, whereas authorities in Scotland are required to keep under review the maximum amount they can afford to allocate to capital expenditure. This is a consequence of the requirements established under Part 1 of the Local Government Act 2003 (England and Wales), Part 1 of the Local Government Finance Act (Northern Ireland) 2011 and Part 7 of the Local Government in Scotland Act 2003. These requirements are met through the indicators for affordability.

CAPITAL EXPENDITURE

88 The prudential indicators for capital expenditure, based on a capital programme that takes into account the authority's asset management and capital investment strategies, are likely to be the starting point of an authority's calculation of its prudential indicators. These may have to be adjusted in an iterative manner if the initial estimates of capital expenditure prove to be unaffordable, imprudent or unsustainable.

89 The estimates of capital expenditure that the Code requires it to calculate are set out in paragraph 47 of the Code.

Extract from the Prudential Code

47 **Estimates of capital expenditure**
The local authority will make reasonable estimates of the total of capital expenditure that it plans to incur during the forthcoming financial year and at least the following two financial years. These prudential indicators will be referred to as estimates of capital expenditure and shall be expressed in the following manner:

Estimate of total capital expenditure to be incurred in years 1, 2 and 3 (and 4, etc if applicable)

90 Those authorities with an HRA have to calculate separate indicators of capital expenditure in accordance with paragraph 82 of the Code.

> **Extract from the Prudential Code**
>
> **82** Instead of the requirements in paragraph 47, identify separately estimates of HRA capital expenditure and estimates of non-HRA capital expenditure. The separation between the HRA and non-HRA elements of these prudential indicators will be undertaken as determined under legislation or official guidance. The estimates of HRA and non-HRA capital expenditure will, taken together, sum to the total estimates of capital expenditure.

91 In England and Wales, the legislative definition of this HRA capital expenditure is that used for capital purposes on land, houses and other property accounted for within the HRA under section 74(1) of the Local Government and Housing Act 1989.[9] In Scotland the equivalent legislative requirement is contained in section 203(1) of the Housing (Scotland) Act 1987.

92 The Code requires the formal estimate of capital expenditure to be carried out when the prudential indicators are produced for future years and revised for the current year. This will be compared with the actual capital expenditure recorded according to paragraphs 49 and 83 of the Code.

> **Extract from the Prudential Code**
>
> **49** **Actual capital expenditure**
> After the year end, the actual capital expenditure incurred during the financial year will be recorded. This prudential indicator will be referred to as actual capital expenditure and shall be expressed as follows:
>
> Actual capital expenditure for 20xx/20xx.
>
> **83** Instead of the requirements in paragraph 49, identify separately the actual HRA capital expenditure and the actual non-HRA capital expenditure. The separation between the HRA and non-HRA elements of this prudential indicator will be undertaken as determined under legislation or official guidance. The actual HRA and non-HRA capital expenditure will, taken together, sum to the total actual capital expenditure.

93 The estimates of capital expenditure used for the calculation of the prudential indicators will include any capital expenditure that it is estimated might (depending on option appraisals) be dealt with as long-term liabilities. Authorities should note that the requirement in the Code is for *total* capital expenditure to be reported, together with the other prudential indicators. It follows from this that the Code itself will only generate a need for a fresh report to members if the estimate of the total quantum of anticipated capital expenditure has changed, rather than when there has been a change in the portfolio of schemes. The approach to be adopted in reporting these other changes to the capital programme to elected members will be determined by other considerations, such as the appropriate level of delegation, beyond the scope of the Code.

9. As amended by Statutory Instrument 2004 No. 533 *The Local Authorities (Capital Finance) (Consequential, Transitional and Saving Provisions) Order 2004,* Regulation 4.

94 Capital expenditure is a significant source of risk and uncertainty since cost variations, slippage or acceleration of major projects and changing specifications are often a feature of large and complex capital programmes. Capital investment also carries risk in relation to the availability of capital finance from capital receipts, grants and external contributions. For example, planned capital spending may be heavily dependent on achieving in-year capital receipts.

95 In the short term these variations from affordable plans may not initially be picked up by other prudential indicators. These risks associated with capital programming will therefore need to be managed. The CFO should undertake regular monitoring of capital expenditure and income against estimates. Significant variation, for example caused by major over-runs of expenditure on projects or a failure to achieve projected in-year capital receipts, should trigger management action. It will be particularly important for this to be done before the authority enters irrevocably into major commitments.

96 In these circumstances locally developed indicators and management arrangements should prevent specified capital investment from taking place until the anticipated capital receipts have actually been realised or until a decision has been made to increase borrowing to cover the anticipated delay. Locally developed indicators should not of course earmark any element of the authority's general borrowing with particular items, categories or purposes of expenditure. Authorities should of course have an integrated treasury management strategy within which borrowing and investments are managed.

97 The starting point for consideration of the affordability of alternative levels of capital expenditure will be the borrowing and revenue forecasts produced by the financial planning processes already considered. The Code specifies a range of indicators that will have to be calculated to inform the judgement as to whether this borrowing and associated revenue costs is affordable:

- the ratio of financing costs to net revenue stream
- the incremental impact of capital investment decisions on the council tax
- the incremental impact of capital investment decisions on housing rents.

98 These indicators are considered in more detail in the following sections of this guidance.

FINANCING COSTS

99 The definition of financing costs used in the calculation of the prudential indicators is contained in paragraph 69 of the Code.

> **Extract from the Prudential Code**
>
> **69 Financing costs**
>
> Actual figures for financing costs for previous years should be those charges made to the General Fund made by aggregating:
>
> - interest charged to the General Fund with respect to borrowing
> - interest payable under finance leases and any other long-term liabilities
> - gains and losses on the repurchase or early settlement of borrowing credited or charged to the amount to be met from government grants and local taxpayers
> - interest and investment income*
> - amounts payable or receivable in respect of financial derivatives
> - any amounts required for the statutory provision for the repayment of debt, currently minimum revenue provision (England and Wales), loans fund repayments and the repayment of other long term liabilities – PFI and finance leases (Scotland) and general fund charges for loan principal (Northern Ireland), plus any additional voluntary contributions.
> - any amounts for depreciation/impairment that are charged to the amount to be met from government grants and local taxpayers.
>
> Estimates for financing costs for current and future years should be calculated in a manner consistent with this definition.
>
> **NB** See also transferred debt (paragraph 75).
>
> * For consistency, any interest or investment income from investments excluded from prudential indicators in accordance with the definition for investments (see paragraph 70) should be excluded.

100 The Accounting Code requires the balance sheet to include the assets and liabilities of all activities of the authority. This balance sheet excludes all trust funds and similar funds administered for third parties. In Scotland the Common Good is similarly excluded from the balance sheet. It follows from this that all interest or investment income in respect of investments made by these and similar funds should be excluded from the calculation of the prudential indicator for financing costs.

101 When calculating the prudential indicator for financing costs, the financing costs arising from transferred debt should, wherever possible, be excluded from the financing costs of the local authority that is managing the debt for other local authorities. This can be achieved, in line with proper accounting practices, by crediting income from the external organisation that is received in relation to the financing costs of the managed debt.

102 Conversely there will also be local authorities for which another local authority holds and manages debt. Wherever possible the financing costs arising from this transferred debt should be included within the financing costs of the local authority on whose behalf the debt is being managed. This can be achieved by debiting amounts payable, in line with proper accounting practice, to the local authority managing the debt.

103 Pensions interest cost and expected return on pensions assets should be excluded from the calculation of financing costs.

104 Gains and losses on the repurchase or early settlement of borrowing that are credited or charged to the amount to be met from government grants and local taxpayers must be included in financing costs. Such losses that are charged to capital receipts will not, however, be taken into account in the calculation of the financing costs.

105 Any additional voluntary contributions over and above minimum revenue provision (MRP) (England and Wales), the loans fund repayment (LFR) (Scotland) or General Fund charges for loan principal (Northern Ireland) must also be included in financing costs. These will be included in the transfers from the General Fund balance that must be taken into account when determining the movement on the General Fund balance for the year. These contributions may reflect a decision to charge to the movement on the General Fund balance for sums in respect of depreciation or impairment that are not included within the statutory MRP (England and Wales), the LFR (Scotland) or General Fund charges for loan principal (Northern Ireland).

106 In England, the comprehensive income and expenditure statement will include an amount in respect of depreciation in respect of HRA services. Under the transitional arrangements for the implementation of self-financing, housing authorities are able to reduce the charge by the excess of depreciation charged to HRA services over the major repairs allowance for dwelling assets. This excess element is required by statute to be excluded when determining the movement on the General Fund balance for the year. Nevertheless this excess should still be included along with depreciation in the calculation of financing costs for the purposes of the Code.

Exemplification 1

The calculation of financing costs – English metropolitan authority with debt

	£million
Information included in the comprehensive income and expenditure statement	
Interest payable with respect to borrowing	12.6
Interest payable under finance leases and other long-term liabilities	1.9
Interest and investment income	-2.4
Premiums and discounts from debt restructuring	0.2
Statutory amounts included in the determination of the movement in reserves statement for the year	
Minimum revenue provision (England and Wales)/loans fund repayment (Scotland)/general fund charges for loan principal (Northern Ireland)	5.3
Transfers from the general fund balance taken into account when determining the movement on the general fund balance for the year	
Voluntary contribution to financing costs in respect of short-life assets	2.0
Total financing costs	**19.6**

107 It is possible for a local authority to have a negative CFR (see paragraphs 144–155 below for an explanation of CFR). These authorities will, however, still have to comply with the requirements of the Code to calculate and report their financing costs. Capital expenditure by such an authority will still increase the CFR of such an authority before it is reduced by the application of capital receipts or an appropriate capital reserve.

108 The calculation of financing costs for an authority with a negative CFR will still include some interest payments. For these authorities, financing costs will be negative, ie they will be an income source to the consolidated revenue account.

Exemplification 2

The calculation of financing costs – English non-metropolitan authority with a negative capital financing requirement

	£000
Information included in the comprehensive income and expenditure statement	
Interest payable with respect to short-term borrowing	0.8
Interest payable under ‘irredeemable’ long-term liabilities	0.1
Interest and investment income	-4.6
Statutory amounts included in the determination in the movement in reserves statement for the year	
Minimum revenue provision (England and Wales)	0
Transfers from the general fund balance taken into account when determining the movement on the general fund balance for the year	
Voluntary contribution to financing costs in respect of short-life assets	0.5
Total financing costs	**-3.2**

109 Those authorities in England and Wales that maintain an HRA are required by the Code to split their financing costs between the GF and the HRA. This calculation will be driven solely by the legislative requirements of the HRA, which are considered later in this guidance. The financing costs of the GF (or CF in Wales) are not calculated directly but are simply the residual of the authority’s overall financing costs after the debits and credits that legislation requires to be made to the HRA.

110 In Scotland the allocation of financing costs between the HRA and the GF should be based on the operation of the council’s loans fund administered under the powers contained in the Local Government (Scotland) Act 1975.

111 Estimates for the current and future years should be calculated in a manner consistent with the definition contained in paragraph 69 of the Code (see page 28).

NET REVENUE STREAM

112 The Code uses net rather than gross revenue stream because some transfer payments are large enough to distort significantly the ability of the ratio of financing costs to gross revenues streams to act as a useful indicator of affordability. In exceptional circumstances, such as the introduction of the dedicated schools grant (DSG) in England from 2006/07, there can still be significant year-to-year changes in an authority’s net revenue stream. Such changes can be addressed by an explanatory note. They do not require any prescription changes to the application of the principles of the net revenue stream calculation established in the Code. Paragraph 72 of the Code specifies that the net revenue stream is the estimate of the amounts to be met from government grants and local taxpayers.

Extract from the Prudential Code

72 Net revenue stream

Actual figures for net revenue stream should be taken from the amounts in the local authority's comprehensive income and expenditure statement for:

- taxation and non-specific grant income.

Estimates for net revenue stream for current and future years should be the local authority's estimates of the amounts to be met from government grants and local taxpayers, using the equivalent figures from the local authority's original/revised budget where available.

113 In identifying the net revenue stream practitioners should have regard to the changes introduced in the Accounting Code by considering the section in the Accounting Code on the comprehensive income and expenditure statements and the module in the Accounting Code *Guidance Notes for Practitioners* on non-current assets. In order to achieve the desired transparency, an authority's calculation of the net revenue stream should use (or be consistent with) the figure that can be identified in the comprehensive income and expenditure statement for 'taxation and non-specific grant income'. The aim of using net revenue stream is to identify the amounts to be met from government grants and taxpayers and hence should exclude capital grants, contributions and donated assets. This may be supplemented by other local indicators of the net revenue steam that may be necessary to ensure consistency with any figures used in the budget-making process. This approach promotes integration of the Code into the financial planning process.

114 The approach to the calculation of the net revenue stream used within the Code means that it is net of contributions from (or to) reserves and balances. A demonstration, for the purposes of the Code, that the authority's financial strategy is sustainable will need to consider the overall levels of these reserves and balances. In doing this the authority must have regard to CIPFA's *Local Authority Reserves and Balances* (LAAP bulletin 77, 2008) and to *Balance Sheet Management in the Public Services: A Framework for Good Practice* (2006). It is possible that the authority may set local indicators to measure the extent to which the use of reserves and balances is prudent and sustainable.

115 In both England and Wales, the net revenue stream of the HRA, for the purposes of the Code, should be the total HRA income that will be shown in the authority's accounts: ie rent, other income and, in Wales, subsidy (where positive). For this purpose the payment of an amount of 'negative subsidy' in Wales should be treated as an expenditure item.

116 In Scotland the Housing (Scotland) Act 1987 does not require benefits to be debited (nor subsidy credited) to the HRA. The debits that together represent the net revenue expenditure of the Scottish authorities' HRAs are therefore those set out under part II of schedule 15 to the Housing (Scotland) Act 1987.

THE RATIO OF FINANCING COSTS TO NET REVENUE STREAM

117 Once the financing costs and net revenue stream have been identified it is straightforward to calculate the ratio of financing costs to net revenue stream.

Exemplification 3

A calculation of the ratio of financing costs to net revenue stream: Scottish authority

	£million
Financing costs	38.1
Net revenue stream	630.3
Ratio of financing costs to net revenue stream	6.0%

118 Those authorities with an HRA will have to calculate a separate ratio of financing costs to net revenue stream for this account. This will be determined by the legislative requirements considered in this guidance.

119 Where there is a marked change in the authority's net revenue stream, as with the introduction of the DSG in England from 2006/07, additional indicators may be used to aid comparison with earlier years. An additional indicator calculated by adding back to net revenue stream the receipt of the new grant may in some circumstances have provided a useful supplement to the one required by the Code.

120 In a typical authority with significant borrowing and other long-term liabilities, an important factor determining the existing and future levels of debt is the level of financial support from government. Variations in the level of financial support from government is one factor that will account for differences in the ratios of financing costs to net revenue stream between local authorities. This is thus a reason why crude comparisons of this ratio across different local authorities are unlikely to be a meaningful measure of the relative prudence of their borrowing. It may therefore be helpful for authorities to ensure that they provide a narrative in relation to this indicator.

121 At present the Government is only continuing to give support to existing debt commitments pre-2011/12 and since 2011/12 support for new capital has been in the form of capital grant for English authorities. Welsh authorities are however still able use for this purpose the debt financing standard spending assessment (SSA). In Scotland a similar comparison can be made with the level of loan charge support. Local authorities may however wish to devise other methods of taking into account the anticipated levels of government support for their capital investment. In Wales, those authorities that have an HRA will need to consider how to take the level of housing subsidy into account when making decisions about their capital strategy.

122 In an authority with a negative CFR it is possible that interest costs may be confined to short-term borrowing for cash flow purposes. In these circumstances, these interest costs will normally be greatly exceeded by interest and investment income. As a consequence the ratio of financing costs to net revenue stream will, for such an authority, be negative (Exemplification 4). This reflects the fact that for these authorities, the negative financing costs are making a contribution to the comprehensive income and expenditure statement.

Exemplification 4

A calculation of the ratio of financing costs to net revenue stream: English non-metropolitan authority with no long-term debt

	£million
Financing costs	-4.6
Net revenue stream	11.9
Ratio of financing costs to net revenue stream	-38.7%

123 It is important to note that capital receipts and capital grants, which are key determinants of whether a proposed level of capital financing costs is affordable, are excluded from the net revenue stream. All these determinants of affordability are, however, reflected directly in the impact on future council taxes and, where appropriate, housing rents. They are reflected indirectly in the ratio of financing costs to net revenue stream because without, for example, the use of capital receipts, the financing costs will be greater. Another factor that will impact on the affordability of capital investment is the amount that such investment will generate in the way of revenue income or how much it will impact on other revenue income or expenditure. It should be noted that this will affect the impact that the capital investment will have on the council tax or housing rents but it will not affect, either directly or indirectly, the capital financing costs. So, for example, a capital-intensive energy-saving scheme that is financed by borrowing would increase the capital financing costs (say by £500), although there will be an improvement in the budgetary position because of the reduction in heating costs (say by £1,000), making the impact a net £500.

124 In addition to these forward estimates, a revised estimate should also be calculated for the ratio of financing costs to net revenue stream for the current financial year – one which again reflects the requirements of the Accounting Code. This will give an indication of the robustness of these estimates and of the impact of changing financing costs or net revenue stream on the overall financial strategy of the authority. In this respect the Code remains rooted in the financial reporting that legislation requires an authority to undertake. For this purpose, as well as the provision of year-on-year comparisons, the following indicator set out in paragraph 38 of the Code should also be considered with these forward estimates. This information will again be extracted from the comprehensive income and expenditure statement and the movement in reserves statement.

Extract from the Prudential Code

38 **Actual ratio of financing costs to net revenue stream**
After the year end, the ratio of financing costs to net revenue stream will be calculated directly from the local authority's comprehensive income and expenditure statement. This prudential indicator shall be referred to as actual ratio of financing costs to net revenue stream and shall be expressed in the following manner:

Actual financing costs ÷ actual net revenue stream x 100%

INCREMENTAL IMPACT ON COUNCIL TAX AND HOUSING RENTS

125 A fundamental indicator of affordability for a council to consider in setting its forward plans is the impact on the council tax, district rates in Northern Ireland, and in the case of the HRA, housing rents that will result. While the local authorities to which the Code applies under the legislation include police, fire and other levying or precepting authorities, for simplicity of exposition this guidance refers only to the council tax.

126 The purpose of these indicators of the incremental impact of capital investment decisions is to allow the effect of the totality of the council's plans to be considered at budget-setting time. They should also allow different options for the capital investment programme to be considered by comparing the different impact on council tax (and housing rents) that would result, holding all other things constant other than varying the capital programme. In doing this these indicators take into consideration the effects of self-financing from revenue and capital receipts and, to the extent that it can be done, the effects of government support. These indicators should reflect the revenue impact of capital schemes other than financing costs, thus facilitating the consideration of revenue-intensive compared to capital-intensive options. In satisfying these requirements local authorities have scope to develop their own methods that are most appropriate for sound financial planning and budgeting.

127 The indicators that measure the incremental impact of the capital programme are specified in paragraphs 39 and 80 of the Code.

Extract from the Prudential Code

39 **Estimates of the incremental impact of capital investment decisions on the Council Tax**

The local authority will forecast the total budgetary requirements for the authority arising from the proposed changes to the capital programme and calculate the addition or reduction to council tax that would result.

This calculation shall be undertaken for the forthcoming year and the following two financial years or longer timeframe if required to capture the full-year effect of capital investment decisions. This prudential indicator will be referred to as estimates of the incremental impact of the new capital investment decisions on the council tax and shall be expressed in the following manner:

£xx.xx

NB Financial forecasts should be made on the basis of best information available at the time and making reasonable assumptions where there is a significant element of uncertainty.

80 Instead of the requirements in paragraph 39:

(i) forecast the total non-HRA budgetary requirements for the authority arising from the proposed capital programme and calculate the addition or reduction to council tax that would result

(ii) forecast the total HRA budgetary requirements for the authority arising from the proposed capital programme and calculate the addition or reduction to average weekly housing rents that would result.

These calculations shall be undertaken for the forthcoming year and the following two financial years or longer timeframe if required to capture the full-year effect of capital investment decisions on the council tax/housing rents. These prudential indicators will be referred to as estimates of the incremental impact of the new capital investment decisions on the council tax/average weekly housing rents, and shall be expressed in the following manner:

£xx.xx

128 Exemplification 5 gives an example of such calculation and is followed by some more detailed explanations of the more important underlying principles of this indicator.

Exemplification 5

Incremental effect of the capital programme on council tax and housing rents: Welsh county council

	20x7/x8	20x8/x9	20x9/x0
	£000	£000	£000
Loss of general fund interest due to use of capital receipts/reserves	84.6	183.1	283.3
Annual cost of borrowing	54.5	122.0	118.1
General fund revenue implications of capital schemes (net savings)	-20.0	-45.1	-70.2
Total	119.1	260.0	331.2
Council tax base (000s)	50.6	51.0	51.4
Council tax implication	£2.35	£5.10	£6.44
HRA loss of interest due to use of capital receipts/reserves	9.363	25.155	38.055
Housing stock (units)	5571	5438	5316
Housing rent implications per week	£0.03	£0.09	£0.14

Assumption

The loss of interest is calculated on the assumption that the reduction in reserves would reduce the scope for the authority to borrow internally and therefore increase its short-term borrowing.

129 The first step in producing these indicators is to identify the incremental impact of capital investment decisions. This is done by first forecasting total budget requirements based on no changes to the existing capital programme (forecast (i)), then forecasting total budget requirements with the changes proposed to the capital programme included within the calculation (forecast (ii)), then taking the difference between the two amounts in order to identify the incremental impact of capital investment decisions:

- Forecast (ii) is what local authorities have always had to do during budget setting for the forthcoming year.
- What is new within the Code is forecast (i). In this context, what is meant by the budget requirement based on 'no changes to the existing capital programme'? It means the authority's best estimate of the impact of its current capital programme.

130 It is extremely unlikely that forecast (i) will be the same as the estimate the authority made when it set its budget the previous year. This can be illustrated by two examples:

(a) When it set its budget the previous year, the authority may have forecast the following expenditure for a particular capital scheme:

20x7/20x8	20x8/20x9
£18,000	£25,000

If the current estimates for expenditure on this scheme are now:

20x7/20x8	20x8/20x9	20x9/20x0
£10,000	£30,000	£3,000

then forecast (i) should incorporate this revised schedule. The scheme is included within the existing capital programme. Best estimates about it should be included in forecast (i).

(b) When it set its budget the previous year, the authority may have forecast the receipt of £5million capital receipts during the year, but is currently forecasting the receipt of £7million capital receipts. Similarly, the authority may have changed its estimates of interest rates since the previous year. The implications of such revised estimates should be included in forecast (i).

131 The authority is required to make two separate calculations – one for the budget requirements based on its best estimates of the implications of making no changes to its existing capital programme, and one for the budget requirements based on its best estimates including any changes proposed to the capital programme. In this way, one can see how the revenue budget is growing (or reducing) as a result of capital investment decisions being taken during the current budget-making cycle.

132 To isolate the impact of the decisions the authority is being asked to make, the existing capital programme should be interpreted to mean that which would exist if the authority did not make any further decisions. This represents the programme of capital investment for which officers already have explicit approval and which could continue without any further meetings of the full council or equivalent body. Particular care is needed in the treatment of annual programmes of, for example, lift improvements or window replacements, which are rolled forward each year. Since these are often expensive, the decision on whether they are included in the existing capital programme will significantly affect the calculation of the programme's incremental impact. The appropriate treatment can only be determined according to each local authority's corporate governance arrangements. Similarly, if schemes are withdrawn from the capital programme, this may lead to reduced revenue cost and hence reduces the impact on council tax or housing rents.

133 There will be other estimates that are included within the budget requirements which are not affected by the capital programme. These should be held constant as between forecasts (i) and (ii). However, if any estimate will vary depending on the decisions made for changes to the capital programme, then that estimate should be varied as between forecasts (i) and (ii).

134 It is possible that the overall impact of the capital programme could have a negative impact on the council tax or housing rents. For example, an authority may decide to include a new capital scheme for capital expenditure on energy saving works that will reduce the requirement within the revenue budget for heating costs. The estimates for forecast (i) should include the estimates for heating costs without the new energy-saving measures; the estimates for forecast (ii) should include the impact (phased over time if appropriate) that the proposed energy-saving measures will have on the heating budget.

135 It is possible that the requirement to calculate the incremental impact of changes in the total capital programme represents a marked change to the previous practices of the authority. In some authorities the practice may have been to report the financial impact of schemes only when they are started or committed. In contrast, the Code requires the impact of changes to the total of the programme to be reported even though it will include schemes that are not yet started or to which the authority does not yet have a contractual commitment. The requirements of the Code that relate to the overall scale of the capital programme are distinct from the requirements for effective arrangements for the approval and management of individual projects.

136 The requirement of the Code for the incremental impact of the capital programme to be calculated for three or more years will identify its phased impact on the authority's revenue budget. Where the programme contains a number of large and complex projects, expenditure may at first be relatively low until the planning and procurement process reaches a stage when the main phase of the project can proceed. As a consequence, the financing costs associated with paying for the capital expenditure may accelerate once the project is fully implemented and will in later years be supplemented by any running costs and savings flowing from the new facilities. For all these reasons, those authorities whose financial planning processes previously focused only on the impact of the capital programme in the subsequent year will find that the adoption of the Code will reveal a striking increase in the reported impact of the capital programme.

137 Where there are changes in indicators between years as a result of external factors, for example the possible reduction in taxbase as a result of the implementation of a local council tax support scheme, such changes should be clearly communicated to members.

138 The broader approach adopted in the Code reflects its emphasis on the capital programme as a means of delivering the authority's service plans and not as a conglomeration of individual projects. Within this framework it remains possible for a local authority to adopt an incremental approach to the preparation of its capital programme by adding new projects at the time each one has passed through the system of option appraisal. Regardless of the approach taken, one estimate should be undertaken based on the existing capital programme, the other with the changes proposed – ie for the entire capital programme with the changes included. Different options for the capital programme may be considered by producing estimates based on different options in a similar manner, if required.

139 It should be noted that the Code states that financial forecasts should be made on the basis of best information available at the time and making reasonable assumptions where there is a significant element of uncertainty. This will apply, for example, to future capital receipts as well as capital expenditure plans. There may also be uncertainties in the operation of service-based funding and grant regimes, therefore the development of these forecasts, and the making explicit of the assumptions on which they are based, may require specialist service expertise. Clearly, however, the aggregate of changes to the capital programme for a year for which the council tax and housing rents have already been set will have a net zero impact on these indicators of incremental impact. In these circumstances the impact of changes in the capital programme for that year will be to alter the level of balances.

140 In calculating the incremental impact on the council tax the Code refers to the 'budget requirements' for the authority. This phrase should be read as having the same meaning as that which the authority is required to follow by legislation when setting its budget requirement for the year.[10]

141 Billing authorities should note that the budget requirement of other authorities that precept separately on the face of the calculation for the council tax is not included within their own budget requirements. For example an English district council should not include the budget requirements of a county council; a London borough should not include the budget requirements of the Greater London Authority.

142 In contrast, however, where an authority is required to include as a levy (or other payment) all or part of the budget of another body within its own budget requirement, then the implications of that levy would be included within the forecasts of the authority's own budget requirement. Where variations to the budget requirements of such bodies over time are expected to impact on the authority's three-year forecasts for the incremental impact of capital investment decisions, then the authority should request specific information from the other body, but where this is not the case then existing information should suffice. For local authorities whose calculation of budget requirements includes the budget requirements of parishes (or communities in Wales), then, except in unusual circumstances, no additional information will be required. The same approach should be taken for information from other bodies required for the calculation of the net revenue stream.

143 Financial support for capital expenditure by way of either revenue or capital grants in England, Wales and Scotland continues to contribute to both capital investments in steady-state maintenance and in new and enhanced assets. Under the prudential regime, authorities are also free to undertake self-financed investment. The methodologies used by the Government and devolved administrations to support capital expenditure are issues that are

10. The relevant legislation in England and Wales is, for billing authorities, section 32 of the *Local Government Finance Act 1992*; for major precepting authorities, section 43 of the *Local Government Finance Act 1992*. In Scotland, the requirement to set a balanced budget is established in section 108(2) of the *Local Government (Scotland) Act 1973* and section 93(3) of the *Local Government Finance Act 1992*.

beyond the scope of the Code itself, but they are important determinants of the incremental impact of the capital programme. It is for this reason that assumptions about the level of such financial support plays an important role in the calculation of the incremental impact of the capital programme. Some authorities have based their calculations on broadly based but still prudent judgements while others have used more sophisticated council tax projection methodologies. Such decisions are a matter for local choice about the degree of sophistication that is necessary, or even possible, to manage the risk represented by long-term borrowing. It all cases the implications of the assumptions made should be made explicit and be consistent with those used for budget setting and medium-term financial planning.

THE CAPITAL FINANCING REQUIREMENT

144 The CFR is defined in paragraph 67 of the Code. Since the latest revision of the Code, heritage assets have been included in local authority balance sheets and therefore should form part of the CFR.

Extract from the Prudential Code

67 **Capital financing requirement**

Actual figures for capital financing requirement for previous years should be taken from the local authority's balance sheets for those years, by consolidating:

- tangible fixed assets (ie property, plant and equipment, investment properties and non-current assets held for sale)
- intangible assets
- long-term debtors relating to capital transactions (where applicable)
- any amounts carried as investments that were treated as capital expenditure (where applicable)
- Revaluation Reserve
- Capital Adjustment Account
- Donated Assets Reserve.

In addition, any other items on the local authority's balance sheet that relate to capital expenditure incurred should be included, but excluding the underlying liability – ie the underlying need for the equivalent to borrowing – for finance leases, deferred purchases and similar arrangements in respect of long-term credit. (See in particular the definition of other long-term liabilities in paragraph 73.) Any items on the balance sheet that relate to prepayments for revenue items should not be included. Useable capital receipts that have not been applied to finance capital expenditure should not be included. Grants unapplied should also not be included.

NB The capital financing requirement can be a negative figure.

Estimates for capital financing requirement for current and future years should be calculated in a manner consistent with the definition given above.

145 The CFR measures a vital component of an authority's capital strategy; the amount of capital spending that has not yet been financed by capital receipts, capital grants or contributions from revenue income. It measures the underlying need to borrow for a capital purpose, although this borrowing may not necessarily take place externally. The authority may judge it prudent to make use of cash that it has already invested for long-term purposes, such as insurance funds. In doing this the authority does not, of course, reduce the magnitude of the funds it is holding for these long-term purposes, but is simply adopting an efficient and effective treasury management strategy. This practice, often known as 'internal borrowing', is common in local authorities and means there is no immediate link between the need to borrow to pay for capital spending and the level of external borrowing.

146 The CFR was a new concept when it was introduced by the Code. However, it is very similar in concept to the earlier credit ceiling (England and Wales, Local Government and Housing Act 1989), the balance on the loans fund (Scotland) and the pre-1990 measure of capital undischarged (England, Wales and Scotland pre-1994). Significantly, the CFR is driven by the balance sheet and therefore the Accounting Code, while the credit ceiling was defined by legislation. As a consequence, in England and Wales, differences arise as a consequence of transactions required or allowed by the 1989 Local Government and Housing Act that did not lead to items in local authorities' balance sheet or revenue accounts. In Scotland, the opening CFR could be expected to have the same value as the outstanding balance on the LF, but if there is a difference, the Code took precedence. The appendix to this guidance gives a comprehensive explanation to the rationale behind the CFR.

147 Where an authority maintains an HRA it will be necessary to calculate a separate HRA and GF CFR according to the requirements of paragraphs 50 and 84 of the Code.

Extract from the Prudential Code

50 **Estimates of capital financing requirement**

The local authority will make reasonable estimates of the total capital financing requirement at the end of the forthcoming financial year and the following two years. These prudential indicators will be referred to as the estimates of capital financing requirement and shall be expressed as follows:

Estimate of capital financing requirement as at the end of years 1, 2 and 3

84 Instead of the requirements in paragraph 50, identify separately estimates of the HRA capital financing requirement and estimates of the non-HRA capital financing requirement. The separation between the HRA and non-HRA elements of these prudential indicators will be undertaken as determined under legislation or official guidance. The estimates of HRA and non-HRA capital financing requirement will, taken together, sum to the total estimates of the capital financing requirement.

148 It is also necessary to calculate the actual CFR for previous years according to the principles set out in paragraphs 53 and 85 of the Code.

Extract from the Prudential Code

53 **Actual capital financing requirement**
After the year end, the actual capital financing requirement will be calculated directly from the local authority's balance sheet. This prudential indicator will be referred to as the actual capital financing requirement and shall be expressed as follows:

Actual capital financing requirement as at xx/xx/xx

85 Instead of the requirements in paragraph 53, identify separately the actual HRA capital financing requirement and the actual non-HRA capital financing requirement. The separation between the HRA and non-HRA elements of this prudential indicator will be undertaken as determined under legislation or official guidance. The actual HRA and non-HRA capital financing requirement will, taken together, sum to the total actual capital financing requirement.

149 There is an important distinction between the overall CFR for an authority and that for the HRA. The former is derived from the application of accounting principles in the balance sheet, the latter from the application of legislation which is considered later in this guidance.

150 Exemplification 6 illustrates the relationship between the CFR and the contents of a typical local authority balance sheet. The exemplification shows how the CFR is calculated by consolidating entries that are already present in local authority balance sheets as a consequence of the existing requirements in the Accounting Code. This process brings together all the items on the balance sheet that relate to capital transactions in order to reveal the deficit or surplus on capital transactions. In doing this it is necessary to exclude the underlying liability – ie the underlying need for the equivalent to borrowing – for finance leases, deferred purchases and similar arrangements in respect of long-term credit. This exemplification is designed to enable practitioners to understand the concepts behind the calculation of the CFR and does not seek to illustrate all the possible transactions that may have to be included in its calculation.

151 The CFR is designed to be a measure of the surplus or deficit on capital transactions plus long-term liabilities related to fixed assets. Local authorities should not simply treat the exemplification and the guidance in the Code as a template. They need to satisfy themselves that they have correctly identified all the items in their balance sheet that should be included in the calculation. Care should be taken over, for example, the treatment of grants and loans to third parties. Furthermore, in the calculation of the CFR it is important to ensure that proper account is taken of the position of each item in the balance sheet. The calculation is not simply a summation of the figures shown for each entry, but a consolidation that must deduct entries that represent liabilities from those representing assets.

Exemplification 6

The capital financing requirement

				31 March 200z
		£000	£000	£000
Long-term assets				
Intangible assets			37,173	
Property, plant and equipment			1,120,284	
Investment properties			51,262	
Long-term investments			16,633	
Total long-term assets				**1,225,352**
Current assets				
	Cash	15,217		
	Other	97,540		
			112,757	
Current liabilities – creditors			-58,339	
Net current assets				**54,418**
Net assets less current liabilities				**1,279,770**
Long-term liabilities				
Borrowing due >12 months				-285,804
Net assets				**993,966**
Usable and unusable reserves				
Usable reserves				
Capital receipts unapplied		27,385		
Capital grants unapplied		8,523		
Schools balances		7,000		
Earmarked reserves		45,964		
General fund balance		24,458		
Usable reserves			**113,330**	
Unusable reserves				
Revaluation reserve		27,324		
Capital adjustment account		853,312		
Unusable reserves			**880,636**	
				993,966

		31 March 200z	
	£000	£000	£000
Capital financing requirement 31 March 200z			
Property, plant and equipment		1,120,284	
Investment properties		51,262	
Intangible assets		37,173	
Revaluation reserve		-27,324	
Capital adjustment account		-853,312	
Capital financing requirement 31 March 200z		**328,083**	

152 Recognition of the reliance of the calculation of the CFR on the local authority's balance sheet is essential for a proper understanding of the treatment off PFI and other private sector partnerships in the prudential framework. The essential issue is to determine whether the contract results in the authority having an asset on its balance sheet, with a consequent liability to pay the operator for its use of it, or whether it has a contract only for service. This is a matter of the accounting treatment which is to be determined by authorities according to the Accounting Code and other authoritative guidance to accounting principles. If the partnership does result in an asset on the local authority's balance then it will have the same implications for the CFR as any other capital expenditure financed by a credit arrangement. Practitioners must always base their application of the Code to private sector partnerships on the requirements of the same proper accounting practice that they have used in the preparation of their balance sheet.

153 Expenditure on revenue expenditure funded from capital under statute (REFCUS), ie expenditure that would not be capitalised in accordance with accounting standards but is capitalised in accordance with legislation, increases the CFR. The CFR is subsequently reduced when REFCUS is financed by capital receipt, application of capital grant or contribution, or revenue. The CFR is not reduced if the REFCUS is effectively being financed over the period by the repayment of loans. In this case it will be reduced over time by the MRP (England and Wales), general fund charges for loan principal (Northern Ireland) or LFR (Scotland). A similar situation will arise with any asset that has been depreciated in the accounts but has not yet been fully financed.

154 For authorities in England, Wales and Northern Ireland, a complication may arise in the calculation of the CFR as a consequence of the acquisition of some share capital (and loan capital in Wales and Northern Ireland) in a body corporate and also for certain loans made to other parties being defined by regulation as capital expenditure.[11] While this investment

11. Statutory Instrument 2003 No. 3146 *The Local Authorities (Capital Finance and Accounting) (England) Regulations 2003,* Regulation 25(1)(d), as amended by Statutory Instrument 2004 No. 534 *The Local Authorities (Capital Finance and Accounting) (Amendment) (England) Regulations 2004,* Regulation 5; and Statutory Instrument 2004 No. 1010 (W.107) *The Local Authorities (Capital Finance and Accounting) (Wales) (Amendment) Regulations 2004,* Regulation 2(11).

remains in existence, to the extent that capital resources have been applied to finance it, its impact on the local authority's balance sheet will be to increase the capital adjustment account by an equivalent amount. Following the strict logic of the calculation of the CFR, which brings together all the items on the balance sheet that relate to capital transactions, this will in turn have the effect of reducing the CFR. This outcome would permit an authority to increase its capital expenditure while remaining within its existing authorised borrowing limit, a result which is inconsistent with the purpose of defining these investments as capital expenditure in the regulations.

155 In order to address this inconsistency, authorities should treat these investments as capital expenditure for the purposes of the calculation of the CFR. In this way they will be treated for the purposes of this calculation as if they were held on the balance sheet as an intangible asset rather than an investment. This approach should be adopted for the calculation of the CFR and not, of course, for the preparation of the balance sheet itself. The different measurements of such investments may impact on the CFR calculation. Where they are classified as 'Available for Sale', the relevant portion of the Available for Sale Reserve should also be included in the CFR calculation to offset the change in the balance sheet value. Where they are classified as 'Fair Value through Profit and Loss', the revenue impact of gains or losses arising from changes in value are normally transferred to the Capital Adjustment Account in the Movement in Reserves Statement resulting in no change to the CFR.

EXTERNAL DEBT

156 For a given CFR, the level of external debt is a consequence of a treasury management decision about how much external borrowing to undertake. Within the prudential framework there is a greater emphasis on the monitoring of the local authority's cash flow than there was under previous systems of capital finance. The prudential indicator for the authorised level of external debt is the focus of corporate decision making and managerial control as it is the immediate means by which, in England, Wales and Northern Ireland, the authority will comply with the legislative requirement to keep under review the amount it can afford to borrow for capital expenditure. In Scotland, it will be of equal importance to an authority's demonstration that it is complying with the corresponding legislative requirement to keep under review the amount it can afford to spend on capital expenditure.

157 It is important to recognise, however, that taken alone the quantum of external borrowing does not itself measure whether an authority has adopted a prudent borrowing strategy. As a consequence, while it has a prominent position in the Code, it is not the only indicator of whether the authority has applied the Code to its borrowing strategy. The Code also includes a carefully selected set of treasury management indicators, together with a broad overarching requirement specified as the net borrowing and capital financing requirement, which are considered in detail later in this guidance.

158 The starting point of the definition of external borrowing in the new arrangements is the debt shown in an authority's balance sheet according to the Accounting Code. The relationship between this debt and borrowing according to the Local Government Act 2003 and borrowing within the Code is explained in paragraph 86 of the Code.

Extract from the Prudential Code

68 Debt

For the purposes of the Prudential Code, debt refers to the sum of borrowing (see paragraph 65) and other long-term liabilities (see paragraph 73). It should be noted for authorities in England, Wales and Northern Ireland that the Local Government Act 2003 and the Local Government Finance (Northern Ireland) Act 2011 require credit arrangements to be treated as the borrowing of money for the purposes of determining the affordable borrowing limit and the imposition of borrowing limits. In Scotland credit arrangements are not treated as the borrowing of money but are recognised as an outstanding liability on the balance sheet and are considered to be a debt associated with capital financing. Within the Prudential Code borrowing is distinguished from other long-term liabilities in order to relate the prudential indicators directly to the balance sheet.

Net debt is debt which is net of investments (see paragraph 70).

159 In England and Wales these 'other long-term liabilities' were in the previous system of capital finance defined by legislation. In the prudential system reliance is largely placed on proper accounting practice and therefore judgement by local authorities and their auditors. The bedrock of the arrangements will therefore be the local authority's balance sheet, which will be of significance to the financial management of the authority.

160 It has already been shown that in both England and Wales the regulations explicitly define the credit arrangements taken into account for the purposes of monitoring and controlling borrowing limits to include only those long-term liabilities that result in capital expenditure (plus securitisation transactions for England). While the aim is that in the majority of cases proper practice should identify those long-term liabilities which are qualifying credit arrangements, this clarification seeks to ensure the exclusion of such items that accounting practice might identify as long-term liabilities but which do not result in capital expenditure. Examples include liabilities to return performance bonds to contractors and contingent liabilities dependent on the outcome of legal cases.

161 Section 7(2)(b) of the Local Government Act 2003 gives the Secretary of State and the National Assembly for Wales the power to specify through legislation that certain items will be treated as long-term liabilities that would otherwise not be, according to proper practices. Similar powers exist in Northern Ireland via Section 17 2(b) of the Local Government Finance Act (Northern Ireland) 2011. The regulations issued at the onset of the prudential system do not make use of these powers, although for England subsequent regulations require securitisation transactions to be treated as credit arrangements.

162 A complication of using actual external debt within the prudential indicator is that some local authorities are managing debt that was transferred to them on reorganisation and which relates to a number of other local authorities as well as themselves. It follows from the logic of using actual gross external debt as the prudential indicator that the local authorities concerned should use their actual figures, including transferred debt, but take into account the income from the other local authorities when setting their prudential indicators.

163 A similar situation would arise in the case of local authority partnerships since one of its members would have to act as the lead authority for purpose of its borrowing. The power to borrow provided under the Local Government Act 2003 has to reside with an individual local authority and the lending of the Public Works Loan Board (PWLB) would be secured by statute on the revenues of that authority. A partnership established as a limited company would be regulated by the Companies Act and be outside the terms of the prudential system so long as the local authority did not have sufficient effective economic control for the assets and liabilities of the company to appear on its own balance sheet.

164 The inclusion of total external debt in the Code means it encompasses all borrowing whether for capital or revenue purposes. This is mainly a consequence of the fact that in day-to-day cash management no distinction is made between revenue and capital cash, while substantial changes can occur on a daily basis. External borrowing arises as a consequence of all a local authority's financial transactions, not simply those arising from capital spending. The concept of borrowing for a financial purpose is explored in more detail in the section on prudence and prudential indicators for prudence starting on page 53.

165 The prudential indicators for external debt have been designed to ensure that, if properly applied, the presence of short-term variations will not prevent a local authority receiving an early warning that it may be in danger of acting imprudently. One advantage of using total debt, rather than attempting to focus just on long-term debt or debt for a capital purpose, is that the system provides an early warning signal if in exceptional circumstances an authority is getting into major difficulties through budgetary overspends which its other control mechanisms are not yet flagging up – since such authorities will have unplanned demands for cash on an ongoing basis. Such a fundamental breakdown of financial control would be exceptional but, experience has shown, not impossible.

166 The treatment of off-balance-sheet PFI schemes should be noted and taken into account in determining whether the proposed level of capital investment is affordable. Local authorities need to comply with the Accounting Code when determining whether PFI schemes, or other forms of partnership with the private sector, are on or off balance sheet.

THE AUTHORISED LIMIT

167 The prudential indicators for debt relate to the scale of the authority's borrowing rather than simply its net indebtedness. The authority will need to set an authorised limit that separately identifies borrowing and other long-term liabilities according to the principles set out in paragraph 54 of the Code and illustrated in Exemplification 7.

Extract from the Prudential Code

54 **Authorised limit**

The local authority will set for the forthcoming financial year and the following two financial years an authorised limit for its total external debt, excluding investments, separately identifying borrowing from other long-term liabilities. This prudential indicator will be referred to as the authorised limit and shall be expressed in the following manner:

Authorised limit for external debt = authorised limit for borrowing + authorised limit for other long-term liabilities

For years 1, 2 and 3

Exemplification 7

The authorised limit: English police authority

	20x7/8
	£million
Borrowing	13.1
Other long-term liabilities	0.5
Authorised limit	13.6

168 In practice, as Exemplification 8 shows, the components of the authorised limit may be diverse and may need to be managed by a range of local indicators and management arrangements without blurring the fundamental importance of the overall authorised limit.

Exemplification 8

The authorised limit: English non-metropolitan district council – with transferred debt

		20x7/8
	£million	£million
X Authority borrowing	150	
Debt for A County Council (abolished) transferred to X Authority	9	
Long-term borrowing		159
Deferred liabilities (deferred purchase scheme)	1	
Finance leases	0.5	
On balance sheet PFI scheme	2.5	
Other long-term liabilities		4
Comparison for authorised limit		163

169 In England, Wales and Northern Ireland, the authorised limit represents the legislative limit specified in section 3 of the Local Government Act 2003 and section 13 of the Local Government Finance Act (Northern Ireland) 2011.

170 The authorised limit, like all the other prudential indicators, has to be approved and revised by full council or the equivalent decision-making body. It should not be set so high that it would never in any possible circumstances be breached. It should reflect a level of borrowing which, while not desired, could be afforded but may not be sustainable. In this way it may include provision for additional borrowing that may be required for a short period in order to deliver the agreed treasury management strategy.

171 An unanticipated revision to the council's authorised limit would be a most exceptional event that would trigger a review of all the prudential indicators having regard to their affordability and the other factors that need to be taken into account. The authorised limit must therefore be set to establish the outer boundary of the local authority's borrowing based on a realistic assessment of the risks. It is not a limit designed to be brought into consideration during the routine financial management of the authority – this is the purpose of the operational boundary. The authorised limit is certainly not a limit up to which an authority will expect to borrow on a regular basis. It is crucial that it is not treated as an upper limit for borrowing for capital expenditure alone since it must also encompass borrowing for temporary purposes. However, it does effectively represent a limit, beyond which a local authority must not borrow until prudential indicators are reviewed or amended.

172 Thus authorities may wish to include prudent headroom between the outer boundary of the results of cash flow forecasting based on a range of plausible scenarios, but this headroom should not be so great as to nullify the effectiveness of the control represented by the authorised limit. In particular, there is sufficient flexibility in the statutory requirement to make it unnecessary to include excessive headroom in order to avoid any possibility of the authority breaching its authorised limit in the event of unforeseen circumstances. Section 5 of the Local Government Act 2003, which applies to both England and Wales, and section 15 of the Local Government Finance Act (Northern Ireland) 2011 for Northern Ireland both allow the authorised limit to be treated as increased in relation to any payment which:

(i) is due to the authority which has not yet been received by it, and

(ii) was not a delayed receipt of a payment which was taken into account when the limit was first arrived at.

173 In England, Wales and Northern Ireland, reliance on this section to borrow above the authorised limit should be reported to the next meeting of the body that sets the budget for the local authority. In Scotland, the authorised limit is not the legislative limit so there is no requirement for such a clause to address the possibility of a legislative borrowing limit being breached.

174 The distinctive legislative bases of the Scottish arrangements have also been taken into account by the PWLB in formulating its lending policy from April 2004.[12] This avoids explicit reference to the authorised borrowing limit in order to allow a consistent policy to be applied to all authorities in England, Wales and Scotland.

12. Public Works Loans Board Circular 154 *Lending Arrangements.*

175 The PWLB will expect any authority undertaking financial transactions with the Board to act prudently and comply with all relevant legislation. In dealing with applications the Board's officers will wish to ask the local authority for certain information to assure the Board that the authority is acting properly and within the legislative framework by adopting the following procedure detailed in the Lending Arrangements Circular:

When an authority seeks a loan, the authority's dealer will be asked … the following two questions:

- *Is your authority complying with the appropriate requirements of the Board's current circulars?*
- *Is this application within the relevant legislation and your council's borrowing powers?*
- *By when does the Director of Finance expect the loan to be entirely applied to expenditure? (The answer should be expressed in terms of the number of months from the point of application. The response to this question should be agreed in advance with the responsible finance officer.)*
- *Is your authority on the published list of local authorities qualifying for the Certainty Rate discount?*

The authorised dealer will be asked the figure for the authority's legal borrowing limit and the 'headroom', ie the amount of borrowing capacity available within the limit at the date of the proposed advance, which is calculated by deducting the authority's existing debt from the legal borrowing limit.

THE OPERATIONAL BOUNDARY

176 This indicator is, as its name suggests, the focus of day-to-day treasury management activity within the authority. It is a means by which the authority manages its external debt to ensure that it remains within the self-imposed authorised limit. It is defined by paragraph 55 of the Code.

Extract from the Prudential Code

55 Operational boundary

The local authority will also set for the forthcoming financial year and the following two financial years an operational boundary for its total external debt, excluding investments, separately identifying borrowing from other long-term liabilities. This prudential indicator will be referred to as the operational boundary and shall be expressed in the following manner:

Operational boundary for external debt = operational boundary for borrowing + operational boundary for other long-term liabilities

For years 1, 2 and 3

177 The operational boundary differs from the authorised limit in that it is based on expectations of the maximum external debt of the authority according to probable – not simply possible – events and is consistent with the maximum level of external debt projected by the estimates.

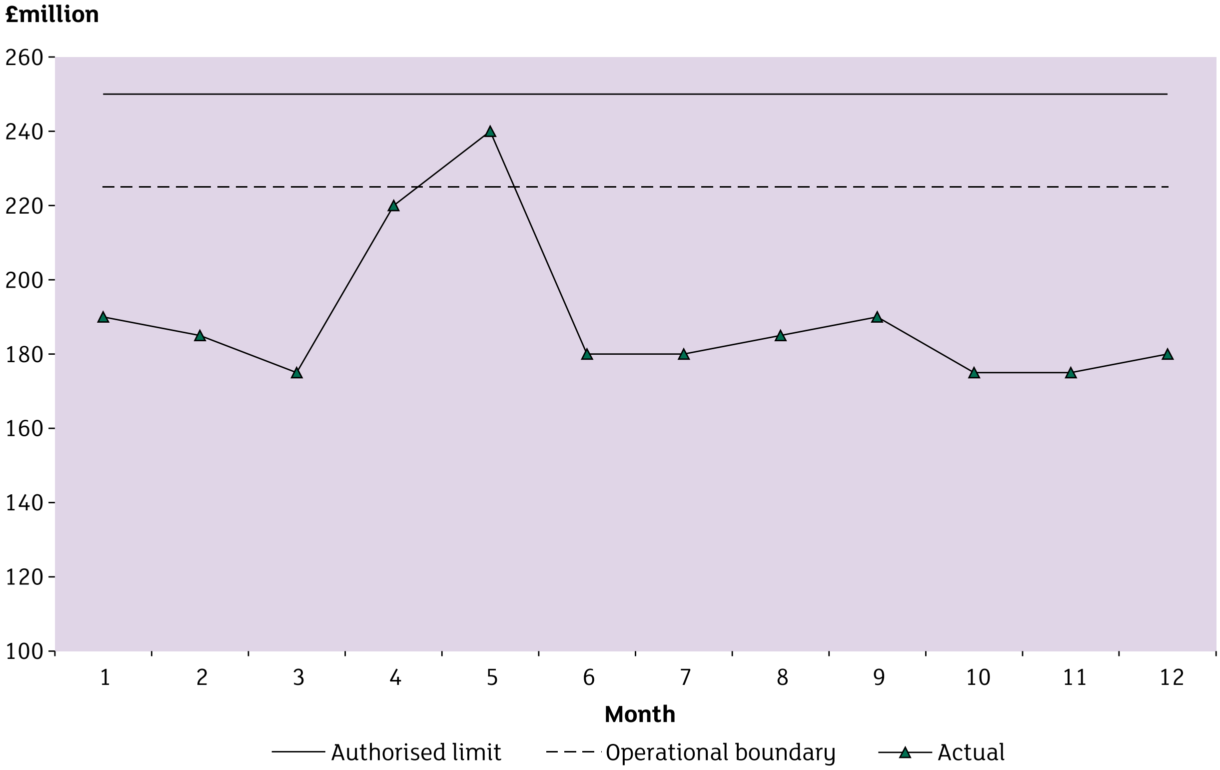
178 This limit will be lower than the authorised limit because cash flow variations may lead to the occasional (but not sustained) breaches of operational boundary illustrated in Exemplification 9. Sustained breaches of the operational boundary would give an indication that the authority may be in danger of stepping beyond the prudential boundaries it has set itself. It would be inadvisable to set an operational boundary at the level of the authorised limit since in those circumstances the operational boundary would be unable to alert the authority to the possibility of an imminent breach of the authorised limit.

179 The setting of this operational boundary will be a matter of careful judgement. If it is set too high then it may be too near the authorised limit for there to be a margin sufficient to allow time to take corrective action before the authorised limit is breached. Alternatively, if it is set too low it will be breached so frequently that it will cease to act as a credible warning indicator.

180 The establishment of the operational boundary and the authorised limit, and consequently the margin between them, will therefore be based on each authority's assessment of the risks that it faces. It is possible, for example, that the margin may be greater in an authority that has few or no investments since in those circumstances total gross debt may be more variable. Alternatively, an authority that anticipates making some large capital receipts or payments will need to take into account the inherent uncertainty of predicting the timing of this type of transaction and their possible coincidence with other significant transactions such as the payroll. Whatever the circumstances, the authority has a responsibility not only to identify its operational and financial risks but also to develop and implement proper arrangements to manage them, including adequate and effective internal control.

Exemplification 9

Illustration of the relationship between the authorised limit and operational boundary



181 During the year actual external debt will be monitored on a basis that reflects the circumstances and management arrangements of the authority. At the end of the year, actual external debt on the balance sheet will be reported with the other prudential indicators. There is no requirement in the Code to report the trend of actual debt against the operational boundary during the year but CFOs may consider it useful to report this to elected members in a graphical form.

182 Like the authorised limit, the operational boundary should distinguish between borrowing and other long-term liabilities. In many authorities this will reflect the reality of the management arrangements in which the two are monitored separately. Adjustments between the indicators set for borrowing and other long-term liabilities will be at the discretion of the CFO. Provided that the total authorised limit and total operational boundary for a year is unchanged, the CFO can make changes within the separately identifiable totals within them for borrowing and other long-term liabilities, but these must be reported to the next meeting of the body that sets the budget for the local authority.

Prudence and Prudential Indicators for Prudence

183 The Code addresses prudence by means of a carefully selected set of treasury management indicators together with a broad over-arching requirement specified as the gross debt and capital financing requirement, as well as requiring that the objective of ensuring that external debt is kept within sustainable, prudent limits is addressed year on year.

GROSS DEBT AND CAPITAL FINANCING REQUIREMENT

184 It is possible that, while an authority's financial strategy may be affordable in the short term, it is imprudent and unsustainable because in the medium term it would, if pursued, be dependent on the use of borrowing to fund revenue expenditure. For this reason the Code makes it necessary, if a financial strategy is to be prudent, that it is one in which in the medium term debt is only to be used for capital purposes. This indicator originally compared net borrowing to the CFR, however this excluded other long-term liabilities such as PFI liabilities and finance leases liabilities from the comparison. The 2011 version of the Code was therefore amended to compare net debt, ie borrowing plus long-term liabilities to the CFR. There was still concern, however, that comparing the net position was masked by netting off investments. Following consultation in 2012, the prudential indicator was therefore changed to compare gross debt to CFR.

185 In the Code this requirement is to be met through a comparison of gross debt with the CFR. Paragraph 44 (which was subject to an amendment after publication) of the Code requires the following:

Extract from the Prudential Code

44 **Gross debt and the capital financing requirement**
In order to ensure that over the medium term debt will only be for a capital purpose, the local authority should ensure that debt does not, except in the short term, exceed the total of capital financing requirement in the preceding year plus the estimates of any additional capital financing requirement for the current and next two financial years. If in any of these years there is a reduction in the capital financing requirement, this reduction is ignored in estimating the cumulative increase in the capital financing requirement which is used for comparison with gross external debt. This is a key indicator of prudence. This prudential indicator will be referred to as net debt and the capital financing requirement. Where the gross debt is greater than the capital financing requirement the reasons for this should be clearly stated in the annual treasury management strategy.

186 Except in the short term, external debt (ie borrowing for any purpose, plus other long-term liabilities) should not exceed the CFR in the previous year plus the estimates of any increase in the CFR at the end of the current and next two financial years. If in any of these years there is a reduction in the CFR, this reduction is ignored in estimating the cumulative increase in the CFR which is used for this comparison with external debt. If a local authority's gross debt does exceed its CFR, the reasons for this should be clearly stated in its treasury management strategy.

Exemplification 10

Gross debt and capital financing requirement: English metropolitan authority

	£million	£million
Capital financial requirement opening balance		323.2
20x7/x8 estimated change in capital financial requirement		
Capital expenditure	101.1	
Application of capital receipts	-14.9	
Application of capital grants/contributions	-54.4	
Minimum revenue provision	-5.9	
Additional voluntary contributions	-1	24.9
20x8/x9 estimated change in capital financial requirement		
Capital expenditure	141.1	
Application of capital receipts	-12.8	
Application of capital grants/contributions	-54.7	
Minimum revenue provision	-6.9	
Additional voluntary contributions	-1.5	65.2
20x9/x0 estimated change in capital financial requirement		
Capital expenditure	169.6	
Application of capital receipts	-9.9	
Application of capital grants/contributions	-46.7	
Minimum revenue provision	-8.3	
Additional voluntary contributions	-1.5	103.2
Capital financial requirement:		
Estimated opening balance 20x7/x8		323.2
Estimated closing balance 20x8/x9		516.5
Estimates of additional capital financing requirements for the three years		193.3

	£million	£million
Therefore the capital financing requirement in the previous year (ie the opening balance for the current year – 20x7/x8) plus the estimates of any additional capital financing requirements for the current and the next two financial years is:	323.2 193.3	516.5

187 When calculating gross debt for the purpose of this prudential indicator, authorities should exclude transferred debt, ie debt that has been transferred to them on reorganisation and which they are managing on behalf of a number of other organisations.

188 The CFO will need to report formally that the authority is complying with this aspect of the Code. The Code leaves the definition of the medium term to the judgement of individual CFOs, but it does indicate that a three-year financial planning horizon (or a longer period selected by the authority) will be appropriate.

189 This requirement in the Code needs to be carefully contrasted with the more familiar legislative requirement that a local authority does not budget for a deficit. While setting a balanced budget is an annual requirement, the prudential indicator of the gross debt and the capital financing requirement should be monitored on a more regular basis. In the short term a mismatch between the local authority's actual revenue income and actual expenditure, which manifests itself in rising levels of borrowing for revenue purposes, may not be a cause for alarm. Since, however, this position cannot be sustained in the longer term, the circumstances giving rise to it should be investigated to ensure that the demands of the Code continue to be satisfied.

190 A technical problem in the satisfaction of this requirement may be caused by the deferred write-off of loan premiums. When a premium is paid but not charged in full to council tax payers in the year but financed from borrowing, gross debt will increase without any corresponding increase in the CFR. Technical breaches of the CFR requirement due to loan modifications or deferred loan write-offs in accordance with the regulations should not therefore be viewed as substantive breaches.

191 The application of these accounting policies for discounts and premiums could have had material implications for local tax levels. On the one hand it would allow authorities to treat their revenue resources in any year to have been increased by the full amount of any discount received, while on the other the full cost of premiums would have to be borne by the taxpayer for the year in which they were incurred. To address this problem regulations were issued for England and Wales, and incorporated into the Accounting Code, that allow local authorities to continue to spread the cost and benefits of premiums and discounts over more than one financial year without them appearing on the balance sheet even if they do not satisfy the criteria established by accounting standards.[13]

13. Statutory Instrument No. 573 *The Local Authorities (Capital Finance and Accounting) (Amendment) (England) Regulations 2007,* Regulation 6; and Welsh Statutory Instrument 2007 No. 1051 (W.108) *The Local Authorities (Capital Finance and Accounting) (Wales) (Amendment) Regulations 2007*, Regulation 4.

192 The Scottish Executive has issued guidance on proper accounting practices to address this issue.[14] This permits Scottish local authorities to forgo a review of the premium and discounts on their 2006/07 closing balance sheets and treat them all as not capable of being positively identifiable to individual loan debts carried on the balance sheet. The regulations also permit Scottish local authorities to continue to spread the revenue charge or credits for such transactions in accordance with existing practice, but nothing prevents the authorities writing down the premiums more quickly. From 1 April 2007, Scottish authorities have also been able to use capital receipts to meet the cost of premiums.

REVENUE EXPENDITURE FUNDED FROM CAPITAL UNDER STATUTE

193 A technical breach of the Code will also be deemed *not* to have arisen in respect of those items that were defined as capital expenditure in the previous arrangements but are excluded from the current definition. This is a consequence of the transitional arrangements that permitted expenditure capitalised under the old control frameworks to continue to be treated as capital expenditure in the new framework in the sense that it could be financed from capital resources.

TREASURY MANAGEMENT INDICATORS OF PRUDENCE

194 Treasury management creates the link between an authority's CFR and the structure of its external debt. Like the operational boundary, these are of direct relevance to day-to-day financial management. However, it is still essential that decisions about the acceptable limits of treasury management indicators are made transparently by the same decision processes as the budget and the other prudential indicators.

195 For most authorities the requirements of the Code closely reflect previous practices for controlling interest rate exposure, the maturity structure of borrowing and the risks associated with investment. For many, the greater transparency of activities has increased elected member, scrutiny and chief officer involvement, thus raising the profile of the treasury function. It may also have demanded new skills and affected the internal organisation of treasury in some authorities since the activities will need to be brought together in a more integrated manner than before.

THE RELATIONSHIP WITH THE TREASURY MANAGEMENT CODE

196 CIPFA's *Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes* (the CIPFA TM Code) recognises that in the public services the priority is to manage and control risk effectively. It also acknowledges, however, that a balance has to be struck because the avoidance of all risk is neither appropriate nor possible. The pursuit of value in the form of higher returns is a best practice approach to treasury management that should be encouraged, but only within the context of effective risk management.

14. Scottish Executive Finance Circular No 4/2007.

197 The CIPFA TM Code is a strategic document that ensures that authorities do not place too much emphasis on numerical indicators with respect to treasury management in isolation from good practice processes. If the CIPFA TM Code did not exist much of its contents would have had to be incorporated into the Code. Instead, the same result has been achieved by the prudential indicator for treasury management contained in paragraph 61 of the Code.

Extract from the Prudential Code

61 The prudential indicator in respect of treasury management is that the local authority has adopted the CIPFA *Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes*. The aim is to ensure that treasury management is led by a clear and integrated forward treasury management strategy, and a recognition of the pre-existing structure of the authority's borrowing and investment portfolios.

198 In England, Wales, Northern Ireland and Scotland, the regulations also explicitly require local authorities to comply with the CIPFA TM Code.[15] This represents explicit legislative backing to the CIPFA TM Code beyond that indirectly given by its inclusion in the Code to which authorities must have regard in determining their affordable level of borrowing.

199 By requiring the adoption of the CIPFA TM Code, the Code can in turn assume that local authorities:

- have in place formally adopted, codified treasury objectives, policies and practices
- have established a clear separation of responsibilities between treasury management policy formulation and treasury management execution
- have established an appropriate scrutiny mechanism for those charged with governance
- have established proper reporting arrangements
- have given top priority to identifying, monitoring and controlling risk
- have established procedures to ensure that officers involved in treasury management and those charged with governance receive appropriate training.

200 The CIPFA TM Code recommends that organisations put a treasury management reporting system in place which should include, at a minimum, an annual strategy and plan in advance of the year, a mid-year review and an annual report after its close. Prudential indicators for treasury management should be considered as part of a local authority's treasury management strategy and the annual report on treasury management activities.

201 Decisions on treasury management should also have regard to other relevant codes of professional and proper practice as appropriate, such as:

- The Non Investment Products Code from the Bank of England
- The Financial Services Authority's Code of Market Conduct.

15. Statutory Instrument 2003 No. 3146 *The Local Authorities (Capital Finance and Accounting) (England) Regulations 2003,* Regulation 24; and Welsh Statutory Instrument 2003 No. 3239 (W.319) *The Local Authorities (Capital Finance and Accounting) (Wales) Regulations 2003,* Regulation 19; Statutory Rules of Northern Ireland 2011 No. 326 *Local Government (Capital Finance and Accounting) Regulations (Northern Ireland) 2011*; and Finance Circular 5/2010 *The Investment of Money by Scottish Local Authorities*.

202 Since the implementation and monitoring of both the CIPFA TM Code and the Code are the explicit responsibility of the CFO, that officer will also be responsible for deciding on the appropriate means of meeting each Code's reporting requirements. This will be achieved by the treasury management strategy incorporating a statement by the CFO of the authority's proposed treasury management indicators of prudence and by the annual report after the year-end incorporating a statement concerning the actual indicator for the year.

THE STATUTORY FRAMEWORK FOR INVESTMENTS

203 For authorities in England and Wales, the 2003 Act removed the doubts that persisted under the 1989 Act regime and gives a local authority power to invest for *'any purpose relevant to its functions under any enactment or for the purposes of the prudent management of its financial affairs'*. The reference to *'the prudent management of its financial affairs'* is included to cover investments that are not directly linked to identifiable legislative functions but which are simply made in the course of treasury management. This would also allow the temporary investment of funds borrowed for the purpose of expenditure in the reasonably near future; however, the speculative procedure of borrowing solely in order to invest and make a return remains unlawful.

204 England, Wales and Northern Ireland have all published guidance on local authority investments which does not aim to duplicate the material covered in the Code but builds upon it and supplements it as necessary to implement the Government's policy. This general policy objective is that local authorities should invest prudently the temporarily surplus funds held on behalf of their communities. The guidance emphasises that priority is to be given to security and liquidity, rather than to yield. However, that does not mean that authorities should ignore yield. It would be reasonable to seek the highest rate of interest consistent with the proper levels of security and liquidity.

205 In all three sets of guidance this policy objective is achieved by distinguishing between specified and non-specified investments. The former are those that offer high security and high liquidity in sterling, for no more than one year. They include investments with central or local government or in a body with a 'high credit quality'; it is for authorities to determine how the latter term is to be defined. Non-specified investments are those with a higher potential risk and authorities considering them will need to be able to say how that risk is to be managed and monitored. The authority must identify the general types of investment that it may use during the course of the year and must set a limit to the overall amount that may be held in each type of investment at any time in the year. The limit may be a sum of money or a percentage of total investments.

206 These decisions about the specified and non-specified investments that the authority will use have to be recorded in the investment strategy required by the guidance, which should be approved by the full council or at an equivalent level in authorities without a council and published. This investment strategy must also lay down the principles to be used during the year in determining the amount of funds that can prudently be committed for more than a year. Relevant considerations would include the relationship between overall funds and foreseeable spending needs, together with the need to make provision for contingencies and maintain adequate reserves.

207 Typically the investment strategy will form part of a local authority's treasury management strategy. The investment strategy should also indicate the extent to which the local authority's assessment of risk depends on the use of credit ratings, the use of treasury management advisers, procedures for reviewing and addressing training needs and investment and any policies relating to the investment of monies borrowed in advance of need.

208 Section 40 of the Local Government in Scotland Act 2003 provides that local authorities may invest money in accordance with regulations made by the Scottish ministers. Finance circular 5/2010 provides the consent of Scottish ministers and sets out the requirements for local authorities making investments. Local authorities are required to manage their investments in a way that minimises the risk to the capital sum and optimises the return on the funds consistent with those risks. Scottish local authorities are required to prepare an annual investment strategy which should be approved by full council before the start of the financial year and an annual investment report presented after the end of the financial year. There is no concept of specified and non-specified, with local authorities required to identify in their strategies the types of investment they permit, which are known as permitted investments. Policies in relation to borrowing in advance of need should be detailed and the concept of a rolling 12-month period is used for this.

SPECIFIC TREASURY MANAGEMENT INDICATORS OF PRUDENCE

209 The CIPFA TM Code is generic guidance designed to be applicable across the whole of the public services, while the Prudential Code (the Code) is specific to local authorities. Both the TM Code and the Code refer to the requirement to report the specific treasury management indicators which are detailed in CIPFA's *Treasury Management in the Public Services: Guidance Notes for Local Authorities including Police Authorities and Fire Authorities* (2011) (the TM Code Guidance Notes).

210 The setting of prudential indicators for treasury management requires authorities to recognise key implications of their borrowing and investment strategies. This has broadly three aspects: the exposure to the risk of interest rate changes; the exposure inherent in the maturity structure of borrowing; and the risks associated with longer-term investment. These indicators should combine both borrowing and investments to form part of an integrated treasury management strategy that seeks to minimise risk. Within an overall framework, it is left to individual local authorities to decide on the most appropriate detailed form of the indicators for their circumstances.

211 The treasury management indicators are not targets to be aimed at but are instead limits within which the treasury management policies of the authority are deemed to be prudent. They are not intended to create fixed absolute limits for the investment and borrowing activities of the authority but should be reviewed and revised as appropriate. The use of numerical indicators should not be allowed to obscure the basic demands of good practice. Authorities must not borrow more than or unreasonably in advance of their needs, purely in order to profit from the investment of the extra sums borrowed – a practice known as 'round tripping'. Freedoms afforded to local authorities to invest longer term or in new investment instruments should therefore be used always with the principles of good practice in mind.

212 The 2011 TM Code Guidance Notes introduced a new treasury management indicator which compared gross and net debt. With the change in the prudential indicator to compare gross debt to the Capital Financing Requirement, this treasury management indicator has been withdrawn.

INTEREST RATE EXPOSURES

213 Interest rate risk management should be a top priority for CFOs. While fixed-rate borrowing and investment can contribute significantly to reducing the uncertainty surrounding future interest rate scenarios, the pursuit of optimum performance may justify, or even demand, retaining a degree of flexibility through the use of variable interest rates on at least part of a treasury management portfolio. This is a best practice approach to treasury management and is to be encouraged to the extent that it is compatible with the effective management and control of risk.

214 There are a number of treasury management indicators which used to be contained within the Prudential Code but are now within the TM Code Guidance Notes. These are complementary to the Prudential Code. The prudential indictors and treasury management indicators should be referred to in parallel. Page 13 of the TM Code Guidance Notes establishes and elaborates on the two indicators that will provide the operational boundaries to an authority's exposure to interest rate risks.

Extract from the TM Code Guidance Notes (page 13)

Interest rate exposures

The local authority will set for the forthcoming financial year and the following two financial years upper limits to its exposures to the effects of changes in interest rates. These indicators will relate to both fixed interest rates and variable interest rates and will be referred to respectively as the upper limits on fixed interest rate and variable interest rate exposures.

The upper limits on fixed interest rate and variable interest rate exposures may be expressed either as absolute amounts or as percentages. They may be related either to the authority's net interest on or to its net principal sum outstanding on its borrowing/ investments.

The upper limit on fixed interest rate exposures shall be calculated as follows:

Either

Interest payable on borrowing at fixed rates

Less

Interest receivable on investments that are fixed rate investments

For years 1, 2 and 3

Or

Principal sums outstanding in respect of borrowing at fixed rates

Less

Principal sums outstanding in respect of investments that are fixed rate investments

For years 1, 2 and 3

The upper limit on variable interest rate exposures shall be calculated as for fixed interest rate exposures, but substituting 'variable rates' for 'fixed rates'.

215 The setting of upper limits has the effect of creating ranges within which an authority will limit its exposure to both fixed and variable interest rate movements. It will be observed that the Code gives authorities the freedom to set their limits for interest rate exposures as either absolute amounts or as percentages of totals on either the net principal outstanding or the net sums payable as a result of their interest obligations. The requirement to control at the net level encourages authorities to manage interest rates in an integrated way, so as to achieve prudent interest rate management. It provides a single point of control over the overall interest obligations on a net basis. Operationally, there may still be a split between those managing investment and those managing debt – but it encourages a single point of control on the net positions.

216 The exemplifications below show the use of these alternative methods. It is for each authority to decide which alternative provides the more meaningful set of indicators to articulate the rationale behind its local treasury management decisions.

Exemplification 11a

Limits in interest rate exposure calculated with reference to net interest

			20x7/x8	20x8/x9	20x9/x0
Total projected interest payable on borrowing			1.0m	1.2m	1.4m
Total projected interest receivable on investments			-0.1m	-0.1m	-0.2m
Net interest			**0.9m**	**1.1m**	**1.2m**
Upper limit – fixed rates	=	either 90% or	0.81m	0.99m	1.08m
Upper limit – variable rates	=	either 30% or	0.27m	0.33m	0.36m

Effective ranges within which interest exposures will be managed:

Fixed rates – either 70% to 90% or

20x7/x8: 0.63m to 0.81m

20x8/x9: 0.77m to 0.99m

20x9/x0: 0.84m to 1.08m

Variable rates – either 10% to 30% or

20x7/x8: 0.09m to 0.27m

20x8/x9: 0.11m to 0.33m

20x/x0: 0.12m to 0.36m

Exemplification 11b

Limits in interest rate exposure calculated with reference to net outstanding principal sums

			20x7/x8	20x8/x9	20x9/x0
Total projected principal outstanding on borrowing			10.0m	12.0m	14.0m
Total projected principal outstanding on investments			-1.0m	-1.1m	-1.2m
Net principal outstanding			**9.0m**	**10.9m**	**12.8m**
Upper limit – fixed rates	=	either 90% or	8.1m	9.81m	11.52m
Upper limit – variable rates	=	either 30% or	2.7m	3.27m	3.84m

	20x7/x8	20x8/x9	20x9/x0
Effective ranges within which interest exposures will be managed:			
Fixed rates – either 70% to 90% or			
20x7/x8: 6.3m to 8.1m			
20x8/x9: 7.63m to 9.81m			
20x9/x0: 8.96m to 11.52m			
Variable rates – either 10% to 30% or			
20x7/x8: 0.9m to 2.7m			
20x8/x9: 1.09m to 3.27m			
20x0/x0: 1.28m to 3.84m			

Exemplification 11c

Limits in interest rate exposure calculated with reference to net interest for an authority with a negative capital financing requirement

			20x7/x8	20x8/x9	20x9/x0
Total projected interest receivable on investments			-1.2m	-1.4m	-1.5m
Upper limit – fixed rates	=	either 80% or	-0.96m	-1.12m	-1.2m
Upper limit – variable rates	=	either 40% or	-0.48m	-0.56m	-0.60m
Effective ranges within which interest exposures will be managed:					
Fixed rates – either 60% to 80% or					
20x7/x8: -0.72m to -0.96m					
20x8/x9: -0.84m to -1.12m					
20x9/x0: -0.90m to -1.20m					
Variable rates – either 20% to 40% or					
20x7/x8: -0.24m to -0.48m					
20x8/x9: -28m to 0.-56m					
20x9/x0: -0.30m to -0.60m					

217 The exemplifications show that only upper limits are explicitly set on interest rate exposures, but since they are set for both fixed and variable rates of interest an implied lower limit is established. The introduction of a limit on fixed as well as variable rate exposure reflects the fact that too much or too little fixed-rate investment or borrowing could also be a source of risk. For that reason both fixed and variable rate borrowing are explicitly included within the Code's treasury management indicators.

218 These limits have to be set for a minimum of three years forward, though in practice that may be too short for some authorities if their interest rate exposures are to be under full control.

Where necessary, authorities should therefore establish a longer planning horizon if it is appropriate.

219 There are circumstances in which an authority's actual or projected interest rate exposures, when subjected to the calculations set out in the Code, will deliver extreme values of less than zero or more than 100%. Where this happens officers should not dismiss this as an aberration, but must evaluate the underlying meaning of the figures produced and establish a coherent explanation that can be given to elected members and other interested parties. This approach may be illustrated by considering in some depth the example of an authority with an unusual interest rate position. Many authorities use the absolute version of the indicator in order to overcome potential issues with negative percentages.

220 This example authority has the following actual treasury profile at the start of the prudential system:

	Fixed rate	Variable rate	Total
	£million	£million	£million
Borrowing	30	0	30
Less investments	0	15	15
Net position	**30**	**-15**	**15**

221 Using the Code calculations, the authority's actual interest rate exposures are:

	£million	
Fixed rate	30	200%
	15	
Variable rate	-15	minus 100%
	15	

222 These extreme values are explained by the treasury position in which the authority finds itself. A likely explanation is that it has been formulated on the belief that interest rates are likely to rise. The authority has therefore adopted a position which should allow it to lock into higher rates on its investments if and when rates do rise, yet at the same time have certainty over its borrowing costs. This strategy carries with it the risk that interest rates, contrary to the expectation of the authority, may in reality fall. The extreme values may not automatically be interpreted to mean that the authority's treasury positions or interest rate strategy are flawed – but they do highlight its exposure if interest rates fall. It is possible that they may lead to a re-evaluation of treasury management policies which, for this purely illustrative example, will be that over a three-year period the authority pursues a strategy of locking into higher fixed rates on its investments – £10million in year 1 and a further £5million in year 2. It is also assumed that £5million of its debt matures in each year. As a consequence of this approach the following position emerges:

	Opening balance Year 1		Opening balance Year 2		Opening balance Year 3		Opening balance Year 4	
£million	Fixed	Variable	Fixed	Variable	Fixed	Variable	Fixed	Variable
Borrowing	30	0	25	0	20	0	15	0
Investments	0	15	10	5	15	0	15	0
Net position	**30**	**-15**	**15**	**-5**	**5**	**0**	**0**	**0**

223 These opening treasury management positions result in the following prudential indicators for interest exposure over successive years:

	Year 1		Year 2		Year 3		Year 4	
£million								
Fixed rate	30	= 200%	15	= 150%	5	= 100%	0	= 0%
	15		10		5		0	
Variable rate	-15	= -100%	-5	= -50%	0	= 0%	0	= 0%
	15		10		0		0	

224 The figures show that the chosen course of treasury management leads to a move away from the extreme values calculated at the opening of the prudential system. In such situations, an authority might decide that it is more helpful, and more easily explained to elected members and other interested parties, if the upper limits under the Code are set as absolute amounts and, perhaps, also ranges rather than percentages.

225 If, however, the authority were to decide on upper limits based on percentages, the above start-year figures would be used. In the above example, therefore, the upper limit to its variable interest rate exposure in year 1 would be set at minus 100%. To express this policy in another way, the authority would be seeking to reduce its variable interest rate exposure in the year, aiming for its exposure to fall from minus 100% to minus 50% by the year-end. As a consequence its target range for the year becomes minus 100% to minus 50%.

226 CIPFA believes that authorities should be seeking to minimise the risks to which they are exposed in their treasury management activities. Accordingly, if an authority has actual interest rate positions, or plans to set interest rate upper limits that produce extreme values, then it would be expected to highlight and explain fully the reasons for this and the risks associated with them when it considers its prudential indicators.

MATURITY STRUCTURE OF BORROWING

227 Local authorities are exposed to the risk of having to refinance debt at a time in the future when interest rates may be volatile or uncertain. The Code is therefore designed to assist authorities to avoid large concentrations of fixed rate debt that has the same maturity structure and would therefore need to be replaced at the same time. The relevant indicator, established on page 14 of the TM Code Guidance Notes, is therefore in effect a limit on longer-term interest rate exposure:

Extract from the TM Code Guidance Notes (page 14)

Maturity structure of borrowing

The local authority will set for the forthcoming financial year both upper and lower limits with respect to the maturity structure of its borrowing. These prudential indicators will be referred to as the upper and lower limits respectively for the maturity structure of borrowing and shall be calculated as follows:

Amount of projected borrowing that is fixed rate maturing in each period

Expressed as a percentage of:

Total projected borrowing that is fixed rate

Where the periods in question are:

- under 12 months
- 12 months and within 24 months
- 24 months and within five years
- five years and within 10 years
- 10 years and above.

228 It is not thought necessary to include variable rate debt in the derivation of this indicator because local authorities do not face substantial refinancing risks.

229 Authorities can if they wish also establish controls over total debt maturities (ie including variable rate debt), but as the purpose of the indicator in the Code is to reduce exposure to refinancing at times of volatile or high interest rates, the requirement in the Code is confined to fixed rates. For many local authorities their debt is typically long term and so may appear in the '10 years and above' category. If this is the case, authorities should break down the period in excess of 10 years into several ranges if significant debt is held in those periods, eg 10 to 20 years, 20 to 30 years. The maturity of borrowing should be determined by reference to the earliest date on which the lender can require payment. If the lender has the right to increase the interest rate payable with limit, such as in a LOBO loan, this should be treated as a right to require re-payment. That said, a prediction should be made of the likelihood that the lender might give the authority an opportunity to repay at any option date and, if so, whether the authority would take up that option or whether the actual maturity date should be used.

230 At any point the actual percentages of debt projected to mature in each year will add up to 100%, but the proposed indicator is for a range of approved percentages. This gives discretion within an approved range to the treasury manager. It does mean that (unless no discretion is given) each 'set' of figures will sum to more than 100%. This is shown in Exemplification 12.

Exemplification 12

The maturity structure of borrowing

Amount of projected borrowing that is fixed rate maturing in each period as a percentage of total projected borrowing that is fixed rate:		
	Upper limit	Lower limit
Under 12 months	20%	0%
12 months and within 24 months	20%	0%
24 months and within 5 years	50%	0%
5 years and within 10 years	75%	0%
10 years and above	90%	25%

231 This requirement to set prudential indicators for the maturity structure of borrowing will not unreasonably fetter the discretion of an authority to take advantage of a favourable debt restructuring opportunity. It will however make the decision to embark on such a course more transparent and open to greater scrutiny by stakeholders.

TOTAL PRINCIPAL SUMS INVESTED

232 The risk inherent in the maturity structure of an authority's investment portfolio if it is forced to realise an investment before it reaches its final maturity, and thus at a time when its value may be dependent on market conditions that cannot be known in advance, is that it may lose some of its principal.

233 To address these risks, page 15 of the TM Code Guidance Notes requires local authorities to establish limits on long-term investments:

Extract from the TM Code Guidance Notes (page 15)

Total principal sums invested for periods longer than 364 days
Where a local authority invests, or plans to invest, for periods longer than 364 days, the local authority will set an upper limit for each forward financial year period for the maturing of such investments. These prudential indicators will be referred to as prudential limits for principal sums invested for periods longer than 364 days and shall be calculated as follows:

Total principal sum invested to final maturities beyond the period end

For years 1, 2, 3, etc

The purpose of the prudential limits for principal sums invested for periods longer than 364 days is for the local authority to contain its exposure to the possibility of loss that might arise as a result of its having to seek early repayment or redemption of principal sums invested.

234 Exemplification 13 gives a practical example of how the indicator for total principal sums invested may be calculated. In determining the correct treatment of the maturities of marketable securities (eg certificates of deposit and gilts), authorities should use their final maturity dates. If authorities anticipate that they may dispose of such investments before those dates, this should be reflected in their investment strategy and the justification in terms of risks and likely rewards should be explained. These are not rolling targets and should only be changed as a consequence of a review of the authority's treasury management strategy with the continuing objective of encouraging safety and liquidity, and to avoid the exposure of public funds to unnecessary or unquantified risk.

Exemplification 13

Total principal sums invested

		At 31/3/20x7
Longer-term investments	5m	
Less held for operational purposes	1m	4m
Current assets		
■ investments		5m
■ cash and at bank		1m
Total available for investment longer term		10m
Limits to be placed on investments to final maturities beyond year-end: 31/3/20x8 = 3m 31/3/20x9 = 2m 31/3/20x0 = 1m		

235 In setting this indicator it would be prudent for local authorities to take into account their projected resources available for investment. This is to minimise the possibility that longer-term investments will need to be realised early, which might have disadvantageous results. The justification should include explicit references to liquidity and consistency with financial plans.

236 This indicator will also be pertinent to demonstrating that the authority is not borrowing more money than it needs, or in advance of its needs, purely in order to profit through investment from the extra borrowed.

237 The Code emphasises the importance of considering the authority's treasury activities in their totality. However, for many authorities, the inclusion of all long- and short-term investments would include investments held for service purposes in addition to those held as part of the authority's financing position. The former could include, for example, any activities pursued for economic regeneration purposes (ie operational purposes) that are classified on the balance sheet as investments. Clearly the authority's approach to treasury management would be likely to be more transparent if any such investments held for this purpose were not included in this prudential indicator.

238 For consistency the Code therefore requires each authority to determine which investments it holds for operational service purposes and to deduct them from the opening balance identified from the authority's balance sheet. Any investments so classified would then be excluded from the treasury management indicators and capital financing costs. Evidence that an investment is not held for a treasury management purpose would include, for example, the decision to make the investment being taken as part of a service plan rather than as part of the treasury management strategy. The original making of such investments and any actual or expected gains, losses, income or expenditure from such investments would need to be taken into account when considering affordability and the prudential indicators for affordability.

Financing Costs – Legislative Requirements (England)

239 The legislative framework within which the Code operates has a direct impact on the calculation of a key indicator of affordability – financing costs – as well as setting the overall context within which elected members must make their decisions about capital investment.

240 The present systems of capital finance in England, Wales and Northern Ireland, based on the same primary legislation, are broadly similar. There are, however, some important differences arising through the different policy intentions underlying the separate regulations and HRA determinations that have been issued by the Secretary of State and the National Assembly for Wales. These differences have increased since the time of the original guidance. For the convenience of practitioners the legislative requirements for the calculation of financing costs in England, Wales and Northern Ireland are therefore considered separately in this guidance.

THE GENERAL FUND MINIMUM REVENUE PROVISION (ENGLAND)

241 For England, the Government has established a longer-term objective of moving to full depreciation accounting in local government. Such an approach should eliminate the need for any legislative requirement for English local authorities to make a minimum revenue contribution each year to meet the liabilities of borrowing/credit arrangements. Until such a development, the Government has sought to achieve stability by introducing regulations to require local authorities to make a prudent provision each year.[16] This is supplemented by Department for Communities and Local Government statutory guidance on minimum revenue provision from the Secretary of State.

242 The guidance provides four ready-made options for calculating the minimum revenue provision. These are likely to fulfil most scenarios, however the guidance does allow the use of an alternative approach if an authority can demonstrate that it is consistent with the statutory duty to make a minimum provision. There are restrictions on the use of options one and two (they can only be used for supported borrowing) and option three, based on asset life, has proved the most popular method in practice. Local authorities are required to have their MRP policies approved by members prior to the start of the financial year.

THE HOUSING REVENUE ACCOUNT CAPITAL FINANCING REQUIREMENT AND FINANCING COSTS (ENGLAND)

243 For reasons of practicality, and to achieve sound treasury management, those councils with an HRA do not manage cash flows separately from those of the rest of the GF. It follows that

16. Statutory Instrument 2008 No. 414 *The Local Authorities (Capital Finance and Accounting) (England) (Amendment) Regulations 2008.*

it is therefore impossible for practical purposes to identify the financing costs of the HRA, which is a legislative account, from first principles. Historically it was necessary to define by an annual determination issued by the Secretary of State the share of an authority's financing costs that are attributable to the HRA. It follows from this approach that the GF financing costs are, in turn, simply derived by deducting these legislatively determined HRA financing costs from those for the whole authority (derived from an analysis of its balance sheet).

244 The abolition of the housing subsidy system in April 2012 meant that some housing authorities would need to take on additional borrowing to buy themselves out of the subsidy system while other authorities received a lump sum. In addition, local authorities needed to allocate existing and future borrowing costs between housing and the General Fund as the statutory method of apportioning debt charges between the General Fund and the HRA ceased. CIPFA's preferred solution was a two-pool approach where existing loans were split between the GF and the HRA and new loans allocated to either the GF or the HRA. While there was a requirement for a methodology for attributing loans to the HRA for accounting purposes, it should be remembered that the loans themselves remain a debt of the overall authority and the Government did not require the PWLB to separate existing loans at source.

245 In contrast to the situation for the GF, the introduction of resource accounting means that local authorities in England are now required to make a depreciation rather than an MRP charge to the HRA. This depreciation has to be calculated in accordance with proper accounting practices so it is the responsibility of each CFO to decide on the most appropriate method of estimating depreciation in respect of their authority's assets. In practice, however, there is widespread acceptance that in most circumstances the major repairs allowance (MRA) which was used for HRA subsidy purpose is a reasonable estimated measure of depreciation for council housing. However, where this is used it still has to be supplemented by an estimate of the depreciation charge for other HRA assets, such as garages and shops accounted for within the HRA, that are not included in the calculation of the MRA. There is a five-year transitional period where housing authorities can reverse the depreciation charge for dwellings and replace it with the MRA.

246 The HRA resource accounting arrangements are driven by the need to charge this depreciation, which is often measured by the MRA, together with a charge reflecting the cost of capital, to the revenue account. A significant change from the previous system of capital finance is therefore that, for English authorities, there is now no longer any requirement to make an MRP in respect of housing revenue capital expenditure. Depreciation should be included as a financing cost.

247 Although there is no legislative MRP in the HRA it is still necessary to identify its CFR – which seeks to measure the underlying need for borrowing that is a consequence of HRA capital expenditure – for three reasons:

- in order to measure the underlying need to borrow for a capital purpose within the HRA
- in order to divide the financing costs in the form of interest on borrowing for capital purposes (or on capital investments) as well as a share of interest from revenue balances between the HRA and the GF
- in order to ensure compliance with the HRA limit on indebtedness (for English authorities).

248 The methodology used to calculate the HRA CFR is described in the Housing Revenue Account Self-financing Determinations, published in February 2012. The closing CFR as at 31 March 2013 is calculated as follows:

The opening HRA CFR 31 March 2012

Add:

- capital expenditure of the local authority financed by borrowing or credit arrangements which was incurred during the 2012/13 financial year on any interest in housing land

and

- the certified value of any interest in a dwelling or housing land which commenced or recommenced to be accounted for in the Housing Revenue Account during the 2012/13 financial year for a reason other than acquisition by the local authority

Deduct:

- any part of capital receipt from the disposal of an interest in housing land, which was used during 2012/13 to repay the borrowing by the local authority or to meet any liability in respect of credit arrangements
- the amount of any payment made by the Secretary of State to the Public Works Loan Board in 2012/13 as a result of the disposal of housing land less the part used to pay premiums on the early redemption of loans
- the certified value of any interest in a dwelling or housing land that ceased to be accounted for in the Housing Revenue Account in the 2012/13 financial year other than by virtue of disposal by the local authority
- the amount of the provision for the repayment of the principal of any amount borrowed by the local authority or the meeting of any liability in respect of credit arrangements which the local authority determined during the 2012/13 financial year to make from the Housing Revenue Account

and

- the amount of the provision for the repayment of the principal of any amount borrowed by the local authority or the meeting of any liability in respect of credit arrangements which the local authority determined during the 2012/13 financial year to make from the Major Repairs Reserve

Equals:

- the closing HRA CFR for 31 March 2013.

249 While there is no legislative requirement to set aside capital receipts for the repayment of debt, English local authorities may use capital receipts from the disposal of HRA assets to reduce HRA debt. This will result in a reduction in an authority's HRA CFR by a corresponding amount – which would also equal the reduction in the authority's overall CFR. The consequence of this optional reduction would be a decrease in the financing costs charged to the HRA. This adjustment is made on the same basis as that made when an authority chooses to make use of its Major Repairs Reserve to repay debt.

250 Appropriations of assets between the GF and the HRA do not, of course, have any impact on the overall CFR of the authority. It is, however, still necessary to increase HRA CFR by the total value of land, houses or other property which commenced or recommenced to be accounted for in the HRA for a reason other than acquisition, eg by appropriation. Where HRA land or property ceases to be accounted for in that account for reasons other than disposal, the directions require that the HRA CFR is reduced by the value of the appropriation.

251 The closing HRA CFR for subsequent years will be calculated as follows:

The opening HRA CFR on 1 April of that financial year

Add:

- capital expenditure of the local authority financed by borrowing or credit arrangements which was incurred during the current financial year on any interest in housing land

and

- the certified value of any interest in a dwelling or housing land which commenced or recommenced to be accounted for in the Housing Revenue Account during the current financial year for a reason other than acquisition by the local authority

Less:

- such part of any capital receipt from the disposal of an interest in housing land which was used during the current financial year to repay the principal of any amount borrowed by the local authority or to meet any liability in respect of credit arrangements
- the amount of any payment made by the Secretary of State to the Public Works Loan Board as a result of the disposal of housing land less the part used to pay premiums on the early redemption of loans
- the certified value of any interest in a dwelling or housing land that ceased to be accounted for in the Housing Revenue Account during the current financial year other than by virtue of disposal by the local authority
- the amount of the provision for the repayment of the principal of any amount borrowed by the local authority or the meeting of any liability in respect of credit arrangements which the local authority determined during the current financial year to make from the Housing Revenue Account

and

- the amount of the provision for the repayment of the principal of any amount borrowed by the local authority or the meeting of any liability in respect of credit arrangements which the local authority determined during the current financial year to make from the Major Repairs Reserve.

252 The HRA CFR and financing costs are prudential indicators that must be taken into account when authorities determine whether their capital investment plans are affordable.

Financing Costs – Legislative Requirements (Wales)

253 It is the long-term aim of the Welsh Assembly Government that local authorities in Wales should eventually be able to move to charging depreciation amount to their revenue accounts in recognition of the cost of consumption of capital assets in the provision of local authority services. This could be coupled with a change in the form of Assembly support for capital investment to reflect the fact that delivering local authority services results in assets being used up. Such an approach would eliminate the need for any legislative requirement for Welsh local authorities to make a minimum revenue contribution each year to meet the liabilities of borrowing/credit arrangements. Until such a development, the Welsh Assembly Government has sought to achieve stability by producing regulations which require local authorities to make a prudent provision each year.[17]

CALCULATION OF THE MINIMUM REVENUE PROVISION CHARGE TO THE COUNCIL FUND (WALES)

254 These regulations are very similar to the English regulations and provide four ready-made options for calculating the provision, which have specific limitations on their usage. These are likely to fulfil most scenarios, however the guidance does allow the use of an alternative approach if an authority can demonstrate that it is consistent with the statutory duty to make a minimum provision. There are restrictions on the use of options one and two (they can only be used for supported borrowing) and option three, based on asset life, has proved the most popular method in practice. Local authorities are required to have their MRP policies approved by members prior to the start of the financial year.

THE HOUSING REVENUE ACCOUNT CFR AND FINANCING COSTS (WALES)

255 While some of the basic principles of calculating the HRA CFR and financing costs are similar in England and Wales, there are distinctive features to the Welsh arrangements. The arrangements in Wales are outlined in this section of the guidance.

256 In the application of the Code the most significant difference between the English and Welsh legislative requirements is that Welsh authorities still have to make an MRP in the HRA. The MRA used in Wales is a simplified version of the English model. It is treated as a capital grant rather than being regarded as a measure of depreciation, as it is in England. (NB: depreciation

17. Welsh Statutory Instrument 2003 No. 3239 (W.319) *The Local Authorities (Capital Finance and Accounting) (Wales) Regulations 2003,* Regulation 22; as amended by Welsh Statutory Instrument 2008 No. 588 (W.59) *The Local Authorities (Capital Finance and Accounting) (Wales) (Amendment) Regulations 2008*.

is still required to be charged to the HRA but is effectively reversed out 'below the line' and replaced with MRP plus any additional voluntary contributions.)

257 The requirement for Welsh local authorities to make an HRA MRP has not been established by regulations but by the annual determination issued by the National Assembly for Wales under section 87 and item 8 of part I and item 8 of part II of schedule 4 to the Local Government and Housing Act 1989 to determine the share of an authority's financing costs attributable to the HRA. These require an MRP of 2% of the opening HRA CFR where that is positive after a series of technical adjustments specified in the determination.

258 The opening HRA CFR is also calculated in order to:

- measure the underlying need to borrow for a capital purpose within the HRA
- derive the CF CFR, which is required to calculate the continuing CF MRP
- apportion the financing costs in the form of interest on borrowing for capital purposes (or on capital investments) as well as a share of interest from revenue balances between the HRA and the CF.

259 There is no legislative requirement to set aside capital receipts for the repayment of debt. It is worth noting that, for subsidy purposes, the HRA Subsidy Determination (which specifies the HRA subsidy CFR) continues to assume that 75% of HRA capital receipts have been set aside to repay debt, so as to minimise potential distributional impacts. However, authorities should refer to the HRA determination for the relevant financial year, as the assumptions in terms of the amount of capital receipts assumed for debt redemption may differ for categories of HRA asset and may differ over time.

260 While there is no longer any legislative requirement to set aside capital receipts for debt redemption, authorities may still use capital receipts from the disposal of HRA assets to reduce HRA debt. Authorities should note, however, that the 2003 Regulations require that HRA capital receipts are applied only for the purposes of the redemption of HRA debt or for the other uses set out in Regulation 18 (as amended).[18] This will result in a reduction in an authority's HRA CFR by a corresponding amount – which would also equal the reduction in its overall CFR. The consequence of this reduction would be a decrease in the financing costs charged to the HRA. Authorities should also note that because of the assumed 'set-aside' of 75% of capital receipts as part of the calculation of the HRA subsidy entitlement, there may be a difference between the Item 8 HRA CFR, used to calculate the MRP, and the HRA subsidy CFR.

261 In Wales, authorities cannot use their MRA for the repayment of debt or to finance new borrowing. As a consequence, no adjustment for such transactions is necessary in the calculation of the HRA CFRs in Welsh authorities.

18. Welsh Statutory Instrument 2003 No. 3239 (W.319) *The Local Authorities (Capital Finance and Accounting) (Wales) Regulations 2003,* Regulation 20; and Welsh Statutory Instrument 2004 No. 1010 (W.107) *The Local Authorities (Capital Finance and Accounting) (Wales) (Amendment) Regulations 2004.*

262 In Wales, the pooling of HRA capital receipts applies only to those authorities that have a debt-free HRA. For this purpose 'HRA debt free' is defined as being where the calculation of the HRA CFR as set out in the 2003 regulations in respect of HRA MRP is nil or negative. Furthermore, in Wales, HRA capital receipts that are not subject to pooling (ie where the authority is not HRA debt free) are required by regulation 18 of the 2003 regulations to remain within the HRA and cannot be used for CF purposes. They can only be used for HRA capital expenditure, debt repayment to meet liabilities arising under credit arrangements that are not required by proper practices to be charged to a revenue account or to pay a premium charged in relation to any amount borrowed.

263 The differences between the English and Welsh arrangements for the pooling of HRA capital receipts is reflected in differences made to the HRA CFR in respect of the removal of assets other than by disposal. The appropriation of assets between the CF and the HRA does not, of course, have any impact on the overall CFR of the authority. It is, however, still necessary to increase the HRA CFR by the total value of assets appropriated for housing purposes and to reduce it by the total value of housing property taken out of the HRA other than by disposal.

264 In Wales, it is also necessary to include in the calculation of the HRA CFR a deduction with respect to the annual HRA MRP. A similar deduction will all be made as a consequence of voluntary contributions to capital financing above the minimum legislative provision.

265 In summary, the adjustments needed to roll forward the HRA between years are:

Add:

- The capital expenditure financed by borrowing or credit arrangements that is incurred during the year on land, houses or other property in the HRA – either new or existing.
- The value of land, houses or other property that commenced or recommenced to be accounted for in the HRA during the year for a reason other than acquisition (eg by appropriation).

Deduct:

- HRA MRP for the year.
- Voluntary set-aside.
- any other capital receipt from the disposal of HRA assets used to meet capital expenditure on both HRA and non-HRA assets during the year.
- The amount the authority determined during the year to set aside from the HRA for the repayment of debt.
- The value of other HRA land or property that ceased to be accounted for in the HRA during the year (other than by disposal).

266 It should, however, be noted that the exact changes needed to calculate each year's HRA CFR will depend on the content of the Item 8 determination, or equivalent, for the year. Once the opening HRA CFR has been calculated, it follows that the CF CFR is the remaining balance of the authority's overall CFR. This CF CFR is, as has already been explained, an essential component of the calculation of the legislative MRP in the CF.

267 In addition to the MRP and voluntary contributions that have been explained in the previous paragraphs, the HRA financing costs also include an allocation of interest and investment income, including the costs of premiums and benefits of discounts. An allocation of treasury management costs to the HRA also has to be carried out according to proper practices. All these allocations should be made in accordance with the relevant determination or equivalent for the relevant financial year.

268 The HRA CFR and financing costs are prudential indicators that must be taken into account when authorities determine whether their capital investment plans are affordable. As previously explained, in making decisions as to the affordability of HRA capital expenditure, Welsh local authorities will need to take into account their HRA subsidy. The system of calculating the notional financing elements in the HRA subsidy calculation reflect the same broad principles as the calculation of the actual housing financing costs set out in this section of the guidance, with the key exception that, for subsidy purposes, it is assumed that for the majority of HRA capital receipts 75% of the receipt is used to repay debt.

Financing Costs (Northern Ireland)

269 In Northern Ireland, as part of the introduction of the prudential capital finance system in April 2012, the Department of the Environment introduced guidance on minimum revenue provision (MRP) for district councils in Northern Ireland. Under section 25 of the Local Government Finance Act (Northern Ireland) 2011, councils have a statutory duty to have regard to the guidance.

CALCULATION OF THE MINIMUM REVENUE PROVISION CHARGE TO THE GENERAL FUND (NORTHERN IRELAND)

270 The guidance sets out two options for calculating a prudent provision:

- **Option 1** – asset life method: amortising expenditure over an estimated useful life for the relevant assets created.
- **Option 2** – depreciation method: making charges to revenue based on proper practices for depreciation as they apply to the relevant assets.

Financing Costs (Scotland)

271 In Scotland councils administer loan funds (LFs) under powers contained in the Local Government (Scotland) Act 1975, and all loans raised are paid into the fund. Advances are made to services from the fund in order to finance capital expenditure. It follows that in Scotland the division of the CFR between the HRA and GF should be based on the operation of the LF.

272 Annual repayments of principal, based on either equal annual instalments or annuity over the maximum permitted redemption periods in accordance with Scottish Office Circular 29/1975, are charged to the consolidated revenue account as a contribution to the capital financing account.

‘Safety’ Mechanisms and Government Reserve Powers

273 Key objectives of the Code are to ensure that the capital investment plans of local authorities are affordable, prudent and sustainable. In exceptional cases, however, there will be a need to demonstrate that there is a danger that an authority’s plans do not meet these criteria and there is therefore a need for the local authority concerned to take timely remedial action. In these circumstances the Code will be of assistance to CFOs when exercising their fiduciary responsibilities.

274 In addition to setting up monitoring procedures to ensure that the authority stays within its authorised limit for borrowing, the CFO will therefore also need to establish procedures to invoke if the limit is about to be exceeded. When the CFO forms the view that a limit is likely to be breached, then a report to the decision-making body that originally set the limit is required. It will then be for the decision-making body, taking into account the advice of the CFO, to determine if it would be prudent to raise the current limit or, alternatively, to instigate procedures to ensure that the current limit is not breached. Authorities need to have arrangements in place to ensure that an adjustment to the limit can be made expeditiously. In order to be able to respond to unforeseen and extraordinary events, authorities in England and Wales may make use of the provision in section 5 of the Local Government Act, which permits temporary borrowing in certain circumstances, such as when a capital receipt is anticipated in a period but is delayed. Reliance on this section to borrow above the authorised limit should be reported to the next meeting of the body that set the budget for the authority.

275 The proper application of the Code should ensure that it is rare for a local authority to be faced with the prospect of exceeding its affordable and prudent authorised limit, and it should be most exceptional that an authority has to undertake an unanticipated adjustment to the limit in order to remain within in it. The legislation does, however, give the Government and devolved administrations powers to intervene where they considered that an authority was breaking the Code by undertaking borrowing or incurring expenditure that was unaffordable, imprudent and unsustainable. Section 4(2) of the Local Government Act 2003 permits the Secretary of State or National Assembly for Wales to issue a direction which sets a borrowing limit for an individual authority in order to prevent it borrowing more that it could afford. This would happen, for example, if the authority were ignoring or breaching the Code. Section 14 (2) of the Local Government Finance Act (Northern Ireland) 2011 gives the Department of Finance and Personnel similar powers. Similarly, section 36(1)(b) of the Local Government in Scotland Act 2003 gives Scottish ministers powers to set by direction the maximum amount that a particular authority may allocate to capital expenditure.

276 The legislation also recognises that the Government may, in certain circumstances, have macro-economic reasons for limiting the overall level of borrowing and capital expenditure by local authorities. In Scotland, in these circumstances Scottish ministers would, under

section 36(1)(a) of the Local Government in Scotland Act, set by order the maximum amounts that local authorities may allocate to capital expenditure. In England and Wales, this power is contained in section 4(1) of the Local Government Act 2003 and in Northern Ireland, in section 14 (1) of the Local Government Finance Act (Northern Ireland) 2011. It is envisaged that if these national limits were to be applied, limits would be set for each local authority but that it would be possible for these to be transferred between authorities.

The Operation of the Prudential System

277 The prudential system provides a flexible framework approach within which capital assets can be procured, managed, maintained and developed. At a strategic level it allows authorities to make their own decisions about the balance to be struck between revenue intensive or capital intensive methods of procuring services. It also allows capital investment to proceed where the authority can fund it within prudent and affordable limits. As a consequence these arrangements permit, for example, 'spend to save' schemes to proceed where they are not only affordable but also prudent and sustainable.

278 The Code does not itself remove all distortions from capital investment decisions. Since the cost of borrowing falls on the revenue account, and much of this is funded by government grant, it is inevitable that government financial support has a significant impact on overall levels of investment. In periods of austerity where revenue budgets are under increased pressure this inevitably impacts upon the ability to finance capital expenditure.

279 There are a number of key benefits of the Code, as follows:

- **Integration into the corporate planning process** – the Code integrates revenue and capital budgeting, which were previously driven by separate processes, with the capital elements mainly driven by the government-constrained limits on borrowing.
- **More effective asset management** – the enhanced links to the corporate planning process are designed to ensure that a local authority's assets are managed in accordance with their strategic objectives. The Code also allows flexibility in capital financing, for example a local authority may initially finance its capital expenditure from internal resources rather than taking out external borrowing, as demonstrated by external borrowings being less than the underlying need to borrow. This enables resources to be used effectively in line with local circumstances.
- **Prudent medium-term financial planning** – the Code promotes effective financial planning which considers the range of options for revenue funding and capital investment by:
  - establishing whether the local authority considers it affordable and prudent to bear additional future revenue costs associated with additional investment, ie financing and running costs
  - establishing whether the use of existing or new revenue resources to finance capital investment should have precedent over other competing needs for revenue expenditure
  - establishing the scope for capital investment to generate future revenue savings or income, taking into account the risks associated with such proposals.

- **More rigorous option appraisal** – given the pressures on revenue resources many local authorities appraise schemes on an 'invest to save' basis which allows individual schemes to be appraised.

APPENDIX

Capital Financing Requirement

INTRODUCTION

A1 Local authorities have available to them a number of ways of financing traditionally procured capital investment. In all cases, cash will be paid over. The term 'financing' does not refer to the payment of cash but the resources that are applied to ensure that any underlying amount arising from capital payments is dealt with absolutely, whether at the point of spend or over the longer term.

A2 A number of financing options that are available to local authorities involve resourcing the investment at the time it is incurred. These are:

- the application of capital receipts
- a direct charge to revenue for the capital expenditure
- the application of a capital grant
- securing an up-front contribution from another party towards the cost of a project.

A3 Capital expenditure that is not financed up front by one of the above methods will increase the CFR or underlying requirement to borrow of the authority. It has often been referred to as 'capital expenditure financed by borrowing'. However, there are two difficulties with this term. Firstly, borrowing does not finance capital expenditure; it provides the cash but it does not provide the resource, since the borrowing has to be repaid. Secondly, the use of the term 'borrowing' in this context does not necessarily imply external debt since, in accordance with best practice, the local authority should have an integrated treasury management strategy. The local authority will not, and should not, associate borrowing with particular items of expenditure (unless required to do so under statute). The local authority will, at any point, have a number of cash flows, both positive and negative, and will be managing its position in terms of its borrowings and investments in accordance with its treasury management strategy and practices.

A4 In measuring external debt, the Code encompasses all borrowing whether for capital or revenue purposes. In day-to-day cash management no distinction can be made between revenue cash and capital cash. External borrowing arises as a consequence of all the financial transactions of the local authority and not simply those arising from capital spending. It includes other long-term liabilities associated with credit arrangements, such as PFI or finance leases.

A5 The CFR will reflect the local authority's underlying need to finance capital expenditure by borrowing or other long-term liabilities.

A6 In summary:

- The CFR of a local authority will increase whenever capital expenditure is incurred.
- Where capital expenditure is resourced immediately (from capital receipts, direct charge to revenue or capital grant/contributions), the CFR will reduce at the same time that the capital expenditure is incurred, resulting in no net increase to the CFR.
- Where capital expenditure is not resourced immediately, this will result in a net increase to the CFR that represents an increase in the underlying need to borrow for a capital purpose. This will be the case whether or not external borrowing actually occurs.
- The CFR may be reduced over time by future applications of capital receipts or capital grants/contributions, or by future charges to revenue.
- The CFR is reduced when minimum revenue provision or loans fund repayments are made to revenue.
- The CFR will increase when a new other long-term liability is entered into.

CALCULATION OF THE CAPITAL FINANCING REQUIREMENT

A7 The Code requires the calculation of the CFR from the balance sheet as follows:

Extract from the Prudential Code

67 Capital financing requirement

Actual figures for capital financing requirement for previous years should be taken from the local authority's balance sheets for those years, by consolidating:

- tangible fixed assets (ie property, plant and equipment, investment properties and non-current assets held for sale)
- intangible assets
- long-term debtors relating to capital transactions (where applicable)
- any amounts carried as investments that were treated as capital expenditure (where applicable)
- Revaluation Reserve
- Capital Adjustment Account
- Donated Assets Reserve.

In addition, any other items on the local authority's balance sheet that relate to capital expenditure incurred should be included, but excluding the underlying liability – ie the underlying need for the equivalent to borrowing – for finance leases, deferred purchases and similar arrangements in respect of long-term credit. (See in particular the definition of other long-term liabilities in paragraph 73.) Any items on the balance sheet that relate to prepayments for revenue items should not be included. Useable capital receipts that have not been applied to finance capital expenditure should not be included. Grants unapplied should also not be included.

NB The capital financing requirement can be a negative figure.

Estimates for capital financing requirement for current and future years should be calculated in a manner consistent with the definition given above.

A8 The following sample journal entries demonstrate how capital transactions will impact on the CFR:

(a) *To capitalise accrued capital expenditure for the year*

		£000	£000
Dr	Fixed assets	25,000	
Cr	Cash		24,500
Cr	Creditors		500

Result – CFR is increased by £25,000,000.

(b) *To write out the net book value of fixed assets sold during the year*

Dr	Capital adjustment account	10,000	
Cr	Fixed assets		10,000

Result – CFR is unchanged.

(c) *To account for income from the disposal of fixed assets during the year*

Dr	Cash	11,000	
Cr	Useable capital receipts		11,000

Result – CFR is unchanged.

For items (b) and (c) only balance sheet items are shown.

(d) *To reflect the revaluation of fixed assets*

Dr	Fixed assets	40,000	
Cr	Revaluation reserve		40,000

Result – CFR is unchanged.

(e) *To finance capital expenditure from useable capital receipts*

Dr	Useable capital receipts	17,000	
Cr	Capital adjustment account		17,000

Result – CFR reduced by £17,000,000.

(f) *To finance capital expenditure directly from revenue*

Dr	General fund	1,000	
Cr	Capital adjustment account		1,000

Result – CFR is reduced by £1,000,000.

(g) *To charge amount required under statute and any additional voluntary contributions to the revenue account in respect of past capital expenditure*

Dr	General fund	8,000	
Cr	Capital adjustment account		8,000

Result – CFR is reduced by £8,000,000.

ESTIMATING THE FUTURE CAPITAL FINANCING REQUIREMENT

A9 The Prudential Code requires that:

Estimates for capital financing requirement for current and future years should be calculated in a manner consistent with the definition given above.

A10 The following sample calculation shows how the required calculations could be made at budget-setting time in 20x7.

(a) Actual CFR at 31 March 20x5

Calculated from the council's balance sheet = £500,000,000.

(b) *Estimate of capital financing requirement at 31 March 20x0, ie for the current year*

	£000
Actual capital financing requirement at 31 March 20x9	500,000
Estimate of capital expenditure for 20y0	38,000
Estimate of application of capital receipts in 20y0	(10,000)
Estimate of capital expenditure funded directly from revenue in 20y0	(5,000)
Estimate of application of capital grants/contributions in 20y0	(5,000)
Statutory charge to revenue in 20y0 for past capital expenditure	(20,000)
Additional voluntary contribution in 20y0 (ie additional charge to revenue for past capital expenditure)[19]	(1,000)
Estimate of capital financing requirement at 31 March 20y0	**497,000**

19. The local authority has decided to buy computer equipment and to charge it to revenue over a three-year period. It then plans to replace the equipment.

(c) *Estimate of capital financing requirement at 31 March 20y1, ie for the forthcoming year*

Estimate of capital financing requirement at 31 March 20y0	497,000
Estimate of capital expenditure in 20y1	42,000
Estimate of application of capital receipts in 20y1	(10,000)
Estimate of capital expenditure funded directly from revenue in 20y1	(2,000)
Estimate of application of capital grants/contributions in 20y1	(7,000)
Statutory charge to revenue in 20y1 for past capital expenditure	(19,880)
Additional voluntary contribution in 20y1	(1,000)
Estimate of capital financing requirement at 31 March 20y1	**499,120**

(d) *Estimate of capital financing requirement at 31 March 20y2*

Estimate of CFR at 31 March 20y1	499,120
Estimate of capital expenditure in 20y2	50,000
Estimate of application of capital receipts in 20y2	(8,000)
Estimate of capital expenditure funded directly from revenue in 20y2	(2,000)
Estimate of application of capital grants/contributions in 20x7/x8	(7,000)
Statutory charge to revenue in 20y2 for past capital expenditure	(19,965)
Additional voluntary contributions in 20y2	(1,000)
Estimate of capital financing requirement at 31 March 20y2	**511,155**

(e) *Estimate of capital financing requirement at 31 March 20y3*

Estimate of CFR at 31 March 20y2	511,155
Estimate of capital expenditure in 20y3	45,000
Estimate of application of capital receipts in 20y3	(7,000)
Estimate of capital expenditure funded directly from revenue in 20y3	(7,000)
Estimate of application of capital grants/contributions in 20y3	(3,000)
Statutory charge to revenue in 20y3 for past capital expenditure	(20,446)
Additional voluntary contributions in 20y3[20]	(1,100)
Estimate of capital financing requirement at 31 March 20x7	**517,609**

20. The authority plans to buy new computer equipment in 20x5/20x6 and to charge it to revenue over a three-year period.

QUESTIONS AND ANSWERS ABOUT THE CAPITAL FINANCING REQUIREMENT

Q.1 The local authority has an old deferred purchase scheme. It has items for this separately identified on its balance sheet. Should these be included in the calculation for the capital financing requirement?

A.1 Yes, except for the underlying liability.

Q.2 The local authority has an old covenant scheme (Scotland). It has items for this separately identified on its balance sheet. Should these be included in the calculation for the capital financing requirement?

A.2 Yes, except for the underlying liability.

Q.3 The local authority has received a donated asset for which certain conditions have yet to be met. This means that, until those conditions are met, there is a donated assets account in the liabilities section of the balance sheet. Should this be included in the calculation for the capital financing requirement?

A.3 Yes.

Q.4 The local authority has received capital grants and contributions that have not yet been applied to meeting capital investment. Some of these grants have conditions which have yet to be met, and are shown as creditors in the liabilities section of the balance sheet. The remaining grants and contributions do not have any outstanding conditions, and are shown in the reserves section of the balance sheet. Which if any of these balances should be included in the calculation for the capital financing requirement?

A.4 None of the capital grants and contributions unapplied should be included in the calculation for the capital financing requirement.

Q.5 In Scotland, will the capital financing requirement be the same value as the outstanding balance on the loans fund?

A.5 Yes, unless part of the capital financing requirement is met through a finance lease when the balance on the loans fund would be expected to be lower than the capital financing requirement.

NB The figures used in this appendix are for illustrative purposes only and do not constitute recommendations for the level at which the figures should be set.