

Essential Reference Paper "D"

# the prudential code

for Capital Finance in Local Authorities  
2017 Edition



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The Chartered Institute of  
Public Finance & Accountancy

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for Capital Finance in Local Authorities  
2017 Edition

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# Foreword

The CIPFA *Prudential Code for Capital Finance in Local Authorities* (the Prudential Code) underpins the system of capital finance. This new edition makes important changes that reflect developments since the Prudential Code was last updated in 2011.

Local authorities determine their own programmes for capital investment in non-current assets that are central to the delivery of quality local public services. The Prudential Code has been developed as a professional code of practice to support them in taking these decisions. Authorities are required by regulation to have regard to the Prudential Code when carrying out their duties in England and Wales under Part 1 of the Local Government Act 2003, in Scotland under Part 7 of the Local Government in Scotland Act 2003 and in Northern Ireland under Part 1 of the Local Government Finance Act (Northern Ireland) 2011.

The Prudential Code is set out in this document and comprises the paragraphs in bold type. The explanatory statements are in standard type and shall be regarded as part of the Prudential Code insofar as they assist in interpreting the Prudential Code.

The *Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes* (CIPFA, 2017) sets out good practice in treasury management and is complementary to this Code.



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# Executive summary

## INTRODUCTION

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- E1** The Prudential Code plays a key role in capital finance in local authorities. Local authorities determine their own programmes for capital investment that are central to the delivery of quality public services. The Prudential Code was developed by CIPFA, the Chartered Institute of Public Finance and Accountancy, as a professional code of practice to support local authorities in taking their decisions. Local authorities are required by regulation to have regard to the Prudential Code when carrying out their duties in England and Wales under Part 1 of the Local Government Act 2003, in Scotland under Part 7 of the Local Government in Scotland Act 2003 and in Northern Ireland under Part 1 of the Local Government Finance Act (Northern Ireland) 2011.
- E2** In financing capital expenditure, local authorities are governed by legislative frameworks including the requirement to have regard to CIPFA's *Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes*, the latest version of which represents good practice in this area.

## OBJECTIVES

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- E3** The framework established by the Prudential Code should support local strategic planning, local asset management planning and proper option appraisal. The objectives of the Prudential Code are to ensure, within a clear framework, that the capital expenditure plans of local authorities are affordable, prudent and sustainable, and that treasury management decisions are taken in accordance with good professional practice and in full understanding of the risks involved and how these risks will be managed to levels that are acceptable to the organisation. In exceptional cases the Prudential Code should provide a framework which will demonstrate that there is a danger of not ensuring this, so that the local authority concerned can take timely remedial action.
- E4** The Prudential Code requires authorities to look at capital expenditure and investment plans in the light of overall organisational strategy and resources and ensure that decisions are being made with sufficient regard to the long run financing implications and potential risks to the authority. Effective financial planning, option appraisal, risk management and governance processes are essential in achieving a prudential approach to capital expenditure, investment and debt.
- E5** To demonstrate that local authorities have fulfilled these objectives, the Prudential Code sets out the indicators that must be used, and the factors that must be taken into account. The Prudential Code does not include suggested indicative limits or ratios. These will be for the local authority to set itself, subject only to any controls under Section 4 of the Local Government Act

2003 (England and Wales), Section 36 of the Local Government in Scotland Act 2003 (Scotland) and Section 14 of the Local Government Finance Act (Northern Ireland) 2011.

- E6** The prudential indicators required by the Prudential Code are designed to support and record local decision-making in a manner that is publicly accountable. They are not designed to be comparative performance indicators. They should be considered in parallel with the treasury management indicators required by the CIPFA *Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes*.

## SCOPE

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- E7** The Prudential Code applies to all local authorities, including combined authorities, police, fire and other authorities.

## PROCESS AND GOVERNANCE ISSUES

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- E8** The Prudential Code sets out a clear governance procedure for the setting and revising of a capital strategy and prudential indicators. This will be done by the same body that takes the decisions for the local authority's budget – ie usually it will be the full council for the authority concerned. The chief finance officer will be responsible for ensuring that all matters required to be taken into account are reported to the decision-making body for consideration, and for establishing procedures to monitor performance. Where budget decisions are made by an elected mayor or a police and crime commissioner, it is expected that the capital strategy and prudential indicators will follow the same procedures as the budget.
- E9** Prudential indicators for previous years will be taken directly from information in local authorities' Statements of Accounts. If any item within a local authority's Statement of Accounts that is relied on for a prudential indicator is the subject of audit qualification, this must be highlighted when the prudential indicators are set or revised.

## MATTERS REQUIRED TO BE TAKEN INTO ACCOUNT

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- E10** In setting or revising its 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 risk, implications for external debt and whole life costing
  - affordability, eg implications for council tax/district rates
  - practicality, eg achievability of the forward plan.
- E11** The Local Government Act 2003 and the Local Government Finance Act (Northern Ireland) 2011 refer to affordability and the requirement that local authorities in England, Wales and Northern Ireland determine and keep under review the amount of money they can afford to borrow for capital investment. The Local Government in Scotland Act 2003 requires Scottish local authorities to keep under review the maximum amount they can afford to

allocate to capital expenditure. In order to carry out their duties under legislation in respect of affordability, local authorities are required to have regard to all those aspects of the Prudential Code that relate to affordability, sustainability and prudence.

## DECISION-MAKING ON CAPITAL INVESTMENT

- E12** A soundly formulated capital investment programme must be driven by the desire to provide high quality, value for money public services. The Prudential Code recognises that in making its capital investment decisions the authority must have explicit regard to option appraisal and risk, asset management planning, strategic planning for the authority and achievability of the forward plan.

## DETERMINING A CAPITAL STRATEGY

- E13** In order to demonstrate that the authority takes capital expenditure and investment decisions in line with service objectives and properly takes account of stewardship, value for money, prudence, sustainability and affordability, authorities should have in place a capital strategy that sets out the long-term context in which capital expenditure and investment decisions are made and gives due consideration to both risk and reward and impact on the achievement of priority outcomes.

## PRUDENCE

- E14** **The local authority shall ensure that all of its capital and investment plans and borrowing are prudent and sustainable. In doing so it will take into account its arrangements for the repayment of debt (including through MRP/repayment of loans fund) and consideration of risk and the impact, and potential impact, on the authority's overall fiscal sustainability. While indicators for sustainability are required to be set over a minimum three year rolling period, indicators should be set in line with a capital strategy and asset management plan that is sustainable over the longer term. Where statutorily ringfenced resources such as the HRA or Police Fund exist, the indicators should be set separately for these areas.**
- E15** Both the authorised limit and the operational boundary for external debt need to be consistent with the authority's plans for capital expenditure and financing, and with its treasury management policy statement and practices. Risk analysis and risk management strategies should also be taken into account. The operational boundary should be based on the authority's estimate of most likely, ie prudent, but not worst case scenario and should equate to the maximum level of external debt projected by this estimate. The authorised limit in addition needs to provide headroom over and above the operational boundary, sufficient for example for unusual cash movements.
- E16** In order to ensure that over the medium term net debt will only be for a capital purpose, the local authority should ensure that gross external debt does not, except in the short term, exceed the total of the capital financing requirement in the preceding year plus the estimates of any additional capital financing requirement for the current and next two financial years. Authorities must not borrow more than or in advance of their needs purely in order to profit

from the investment of the extra sums borrowed. Authorities should also consider carefully whether they can demonstrate value for money in borrowing in advance of need and can ensure the security of such funds.

- E17** Local authorities are reminded that the prime policy objective of their treasury management investment activities is the security of funds, and they should avoid exposing public funds to inappropriate or unquantified risk. Authorities should consider a balance between security, liquidity and yield which reflects their own risk appetite but which prioritises security and liquidity over yield. It is therefore important that authorities adopt an appropriate approach to risk management with regard to their treasury management activities that is proportionate to the overall level of resources available to the organisation.

## AFFORDABILITY

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- E18** The fundamental objective in the consideration of the affordability of the authority's capital plans is to ensure that the total capital investment of the authority remains within sustainable limits. In considering the affordability of its capital plans, the authority is required to consider all of the resources currently available to it and those estimated to be available in the future, together with the totality of its capital plans and income and expenditure forecasts.
- E19** Consideration of affordability should be considered in the light of the authority's medium-term forecast and other fiscal strategies. Capital expenditure plans should be considered alongside the cost of past borrowing, maintenance requirements and planned disposals. The authority's MRP/loans fund policy will have a critical impact on the overall affordability of new borrowing and for this reason it is important to look at affordability not just in the medium term but also over the life of the asset base or underlying debt.
- E20** Where ringfenced resources or separate funds such as the HRA or Police Fund exist, affordability must be considered against those resources available to fund borrowing. Under combined authority arrangements affordability may need to be considered against combined authority resources and the impact on underlying authorities. Where debt or guarantees relating to local enterprise partnerships (LEPs), subsidiaries or other corporate and non-corporate bodies exist, the impact on the authority should be considered. In these cases the development of local indicators may be appropriate.
- E21** When considering affordability, the authority needs to pay due regard to risk and uncertainty. Risk analysis and risk management strategies should be taken into account.

## CONCLUSION

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- E22** The Prudential Code supports the system of capital investment in local authorities. It is integrated within the wider statutory and management processes of local government. Key elements of the system continue to be determined through legislation, in particular the amount required to be charged to taxation by local authorities in respect of capital investment and the amount and method of government support for capital investment. These will be significant considerations when local government takes decisions on capital investment. However, the level of capital investment that can be supported will, subject to affordability and sustainability, be a matter for local decision.

# SECTION TWO

## Objectives

**1 The framework established by the Prudential Code should support:**

- (a) local strategic planning**
- (b) local asset management planning**
- (c) proper option appraisal.**

**The objectives of the Prudential Code are to provide a framework for local authority capital finance that will ensure for individual local authorities that:**

- (d) capital expenditure and investment plans are affordable**
- (e) all external borrowing and other long-term liabilities are within prudent and sustainable levels**
- (f) treasury management and other investment decisions are taken in accordance with professional good practice**

**and that in taking decisions in relation to (d) to (f) above the local authority is:**

- (g) accountable, by providing a clear and transparent framework.**

**In exceptional circumstances the objective of the Prudential Code is to provide a framework that will demonstrate that there is a danger of not ensuring the above, so that the authority can take timely remedial action.**

**2 A framework for the internal control and self-management of capital finance needs to deal with all three of the following elements:**

- capital expenditure and investment plans
- external debt
- treasury management.

**3 The Prudential Code requires authorities to look at capital expenditure and investment plans in the light of overall organisational strategy and resources and ensure that decisions are being made with sufficient regard to the long run financing implications and potential risks to the authority. Effective financial planning, option appraisal and governance processes are essential in achieving a prudential approach to capital expenditure, investment and debt.**

**4 The framework in this Prudential Code includes a set of prudential indicators. These need to be taken together, integrated into a coherent entity, rather than individually. The setting of the forward-looking prudential indicators will in practice need to be a circular rather than a linear process. For example, forward estimates for external debt will follow on from the authority's capital plans, revenue forecasts and treasury management strategy. However, if initial estimates would result in outcomes that would not be affordable or prudent, then forward plans for capital and/or revenue will need to be reconsidered before they are finalised. The Prudential Code supports a framework of good financial management, thus facilitating**

the avoidance of situations where urgent remedial action may be needed. At all times, the objectives specified in paragraph 1 of this Prudential Code are paramount to the operation of the prudential framework.

- 5 The prudential indicators are designed to support and record local decision making. They are not designed to be comparative performance indicators and the use of them in this way would be likely to be misleading and counter-productive. In particular, local authorities had widely different debt positions on the introduction of the Prudential Code and the differences are likely to increase over time as a result of the exercise of local choices. The system is specifically designed to support such local decision making in a manner that is publicly accountable.
- 6 Prudential indicators that are limits are for the determination of the local authority subject only to any long-stop controls under Section 4 of the Local Government Act 2003 (England and Wales), Section 36 of the Local Government in Scotland Act 2003 (Scotland) and Section 14 of the Local Government Finance Act (Northern Ireland) 2011.
- 7 Any upper limit imposed centrally under legislation will run parallel to any locally determined limit, in which case the lower of the imposed limit and the locally determined limit will be the effective limit.
- 8 The prudential indicators specified in the Prudential Code are the minimum required. Local authorities may set further prudential indicators if they wish, and are encouraged to do so where this would assist their own management processes. However, any additional prudential indicators set locally should not, unless required to do so by legislation or official guidance, associate any part of the authority's external borrowing with particular item(s), category(ies) or purpose(s) of expenditure other than where it relates to a specific funding source or a subsidiary, associate or joint venture. The authority should have an integrated treasury management strategy within which its borrowing and investments are managed.
- 9 This Prudential Code focuses on capital finance and effective capital planning. The CIPFA *Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes* focuses on effective treasury management and also requires a number of treasury management indicators which are complementary to this Prudential Code and the two should be referred to in parallel.

## SECTION THREE

# Scope

- 10** The Prudential Code applies to all local authorities, including police, fire, combined and other authorities which:
  - in England and Wales are defined in legislation for the purposes of Part 1 of the Local Government Act 2003
  - in Scotland are defined in legislation for the purposes of Part 7 of the Local Government in Scotland Act 2003, and
  - in Northern Ireland are defined in legislation for the purposes of Part 1 of the Local Government Finance Act (Northern Ireland) 2011.
- 11** The Prudential Code covers all capital expenditure and investment decisions and should take account of all potential long-term liabilities relevant to the authority. For authorities that are required to prepare group accounts or those involved in combined authority arrangements, the consideration of investments and liabilities should include all those in which a residual interest remains with the authority.





# Matters required to be taken into account when setting up or revising prudential indicators

- 12** In setting or revising its 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 risks, whole life costing and implications for external debt**
  - **affordability, eg implications for long-term resources and ultimately the council tax**
  - **practicality, eg achievability of the forward plan.**
- 13** The Local Government Act 2003, the Local Government in Scotland Act 2003 and the Local Government Finance Act (Northern Ireland) 2011 refer to affordability and the requirement that authorities determine and keep under review the amount of money they can afford to borrow for capital investment (in England, Wales and Northern Ireland) and (in Scotland) the maximum amount they can afford to allocate to capital expenditure. For England, Wales and Northern Ireland, the legislation requires authorities to consider credit arrangements in this calculation and for Scotland, the affordability calculation encompasses both the borrowing of money and other long-term liabilities arising from capital investment. The Prudential Code refers to both affordability and prudence. The two 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 legislation in respect of affordability, local authorities are required to have regard to all those aspects of the Prudential Code that relate to affordability, sustainability and prudence including risk. The Prudential Code also requires local authorities to have regard to wider management processes (option appraisal, asset management planning, strategic planning and achievability) in accordance with good professional practice.
- 14** The prudential indicators provide a broad framework to be considered alongside robust forecasting procedures embedded into the budget consideration process of the local

authority. Forecasts should be regularly updated as the capital programme develops, and proposals should be considered in terms of their impact on the overall corporate position. Integration of these features into financial processes ensures that prudence and affordability are taken into account.

# Process and governance issues

## GOVERNANCE

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- 15** Decisions around capital expenditure, investment and borrowing should align with the processes established for the setting and revising of the budget for the local authority.
- 16** The body that sets the budget for the local authority will usually be the full council of that local authority. Whether or not this is the case, the responsibility for decision-making and ongoing monitoring in respect of capital expenditure, investment and borrowing, including prudential indicators, remains with full council. Although detailed implementation and monitoring may be delegated to a committee, ultimate responsibility lies with full council. In assessing how full council's responsibility is best delivered, authorities may wish to consider where the skills and knowledge to effectively implement and monitor detailed arrangements are placed within governance structures and how the active engagement of full council is best achieved.
- 17** Where budget decisions are made by an elected mayor or a police and crime commissioner, it is expected that the capital strategy and prudential indicators will follow the same procedures as the budget.
- 18** Local authorities may determine the capital strategy, capital programme and prudential indicators ahead of the revenue budget. The requirements of the Prudential Code are met provided that explicit reference to the formal decision is made within the revenue budget report.

## DETERMINING A CAPITAL STRATEGY

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- 19** In order to demonstrate that the authority takes capital expenditure and investment decisions in line with service objectives and properly takes account of stewardship, value for money, prudence, sustainability and affordability, authorities should have in place a capital strategy that sets out the long-term context in which capital expenditure and investment decisions are made and gives due consideration to both risk and reward and impact on the achievement of priority outcomes. The capital strategy should form a part of the authority's integrated revenue, capital and balance sheet planning.
- 20** As local authorities become increasingly complex and diverse it is vital that those charged with governance understand the long-term context in which investment decisions are made and all the financial risks to which the authority is exposed. With local authorities

having increasingly wide powers around commercialisation, more being subject to group arrangements and the increase in combined authority arrangements it is no longer sufficient to consider only the individual local authority but also the residual risks and liabilities to which it is subject.

- 21 The capital strategy is intended to give a high level overview of how capital expenditure, capital financing and treasury management activity contribute to the provision of services along with an overview of how associated risk is managed and the implications for future financial sustainability.** The development of a capital strategy allows flexibility to engage with full council to ensure that the overall strategy, governance procedures and risk appetite are fully understood by all elected members.
- 22 The capital strategy should be tailored to the authority's individual circumstances but should include capital expenditure, investments and liabilities and treasury management. The capital strategy should include sufficient detail to allow all members to understand how stewardship, value for money, prudence, sustainability and affordability will be secured and to meet legislative requirements on reporting.**
- 23** In considering how stewardship, value for money, prudence, sustainability and affordability can be demonstrated local authorities should have regard to the following key areas where material.

#### **Capital expenditure**

- An overview of the governance process for approval and monitoring of capital expenditure, including links to the authority's policies on capitalisation.
- A long-term view of capital expenditure plans, where long term is defined by the financing strategy of and risks faced by the authority with reference to the life of projects/assets.
- An overview of asset management planning including the cost of past borrowing, maintenance requirements and planned disposals.
- Any restrictions around borrowing or funding of ongoing capital finance, for example requirements around the HRA or Police Funds.

#### **Debt and borrowing and treasury management**

- A projection of external debt and use of internal borrowing<sup>1</sup> to support capital expenditure (authorities are encouraged to compare this with the capital financing requirement and establish an appropriate liability benchmark<sup>2</sup>).
- Provision for the repayment of debt over the life of the underlying debt.
- Authorised limit and operational boundary for the following year (see below).
- The authority's approach to treasury management including processes, due diligence and defining the authority's risk appetite.

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1. Internal borrowing refers to the use of internal cash balances to finance capital expenditure in place of borrowing money from external sources.

2. As proposed in the *Treasury Risk Management Toolkit for Local Authorities* (CIPFA, 2012).

**Commercial activity**

- The authority's approach to commercial activities including processes ensuring effective due diligence and defining the authority's risk appetite in respect of these, including proportionality in respect of overall resources. Requirements for independent and expert advice and scrutiny arrangements. While business cases may provide some of this material, these will often reflect historic rather than current circumstances so the information contained in them will need to be periodically re-evaluated when it will inform the authority's overall strategy.

**Other long-term liabilities**

- An overview of the governance process for approval and monitoring and ongoing risk management of any other financial guarantees and other long-term liabilities.

**Knowledge and skills**

- A summary of the knowledge and skills available to the authority and confirmation that these are commensurate with the authority's risk appetite.

- 24 In developing the capital strategy a balance should be struck between the amount of detail included and accessibility to the key audience. Where detailed information is required thought should be given to how this is made available, its format and the training needs of members to encourage active engagement. The role of the formal scrutiny process should not be overlooked in ensuring effective challenge. Links should be made where appropriate to the treasury management strategy. The chief finance officer should report explicitly on the affordability and risk associated with the capital strategy and where appropriate have access to specialised advice to enable them to reach their conclusions.

**SETTING AND REVISING PRUDENTIAL INDICATORS**

- 25 **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 alongside 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 12–14).**
- 26 The body that sets the budget for the local authority (the decision-making body) will usually be the full council of that local authority. Whether or not this is the case, the setting of the capital expenditure estimates, operational boundary and authorised limit should follow the same route as the setting and revising of the budget of the local authority. Other indicators may be delegated to committees or subcommittees of full council although full council retains overall responsibility. Where other indicators are delegated the impact of these should be taken into account when setting the capital expenditure estimates, operational boundary and authorised limit.
- 27 **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.**

- 28 Provided that the total authorised limit and the total operational boundary<sup>3</sup> for external debt for a year are unchanged, movement may be made between the separately identified figures within these prudential indicators for borrowing and other long-term liabilities by the chief finance officer. Any such changes should be reported to the next meeting of the body that sets the budget for the local authority.
- 29 In order to be able to respond to unforeseen and extraordinary circumstances, the prudential indicator for the authorised limit for the time being in force shall be treated as increased where Section 5 of the Local Government Act 2003 (England and Wales) applies:
- (1) Subject to subsection (2), any limit for the time being determined by or for a local authority under section 3, or applicable to it under section 4, shall be treated for the purposes of this Chapter as increased by the amount of any payment which–*
- (a) is due to the authority in the period to which the limit relates, but*
- (b) has not yet been received by it.*
- (2) In the case of a limit determined under section 3, or set under section 4(2), subsection (1) shall not apply to any payment whose delayed receipt was taken into account in arriving at the limit.*
- 30 In Northern Ireland, the prudential indicator for the authorised limit for the time being in force shall be treated as increased where Section 15 of the Local Government Finance Act (Northern Ireland) 2011 applies:
- (1) Subject to subsection (2), any limit for the time being determined by or for a local authority under section 13, or applicable to it under section 14, shall be treated for the purposes of this Chapter as increased by the amount of any payment which–*
- (a) is due to the authority in the period to which the limit relates, but*
- (b) has not yet been received by it.*
- (2) In the case of a limit determined under section 13, or set under section 14(2), subsection (1) shall not apply to any payment whose delayed receipt was taken into account in arriving at the limit.*
- 31 Any reliance on Section 5 (or Section 15 in Northern Ireland) to borrow above the authorised limit should be reported to the next meeting of the body that sets the budget for the local authority.
- 32 **Prudential indicators for external debt for previous years are to be taken directly from information in the local authority’s Statement of Accounts.**
- 33 If an item in the authority’s Statement of Accounts that is relied on for a prudential indicator is the subject of audit qualification, this must be highlighted when prudential indicators are set, reviewed and/or revised.
- 34 Prudential indicators for financing costs and their impact on the budget, external debt and capital expenditure should not be set or revised in isolation from one another, but considered together and in conjunction with the authority’s strategic service and asset management

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3. See paragraphs 55–56 for an explanation of these terms.

planning processes. It would be logical for these to be considered when the budget for the local authority is set.

**35** The chief finance officer is responsible for ensuring that matters required to be taken into account when setting or revising prudential indicators (paragraphs 12–14) are reported to the decision-making body for consideration.

**36** It should be noted that:

- in England and Wales, the prudential indicator for the authorised limit for external debt for the current year is the statutory limit determined under Section 3(1) of the Local Government Act 2003: *“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 statutory 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”*
- in Northern Ireland, the prudential indicator for the authorised limit for external debt for the current year is the statutory limit determined under Section 13(1) of the Local Government Finance Act (Northern Ireland) 2011: *“A council shall determine and keep under review how much money it can afford to borrow”*.

**37** This section of the Prudential Code establishes a clear governance procedure for the setting and revising of prudential indicators. This assists transparency and ensures accountability.

**38 Local indicators**

Authorities should consider whether additional local indicators are needed to reflect local circumstances, including local indicators showing the impact of residual liabilities arising from group structures where relevant. Where appropriate, to improve understanding and relevance, these may be substituted for the relevant indicator set out within this code with the exception of the authorised limit and operational boundary.

## MONITORING AGAINST PRUDENTIAL INDICATORS

**39** **The chief finance officer is required to establish procedures to monitor performance against all forward-looking indicators. The chief finance officer will need to establish a measurement and reporting process that highlights significant deviations from expectations.**

**40** The chief finance officer should have particular regard to the following with respect to prudential indicators and external debt:

- In respect of the prudential indicators for the authorised limit for external debt, where the chief finance officer forms the view that a limit is likely to be breached<sup>4</sup> a report to the decision-making body is required. It will then be for the decision-making body to determine if it would be prudent to raise the current limit or, alternatively, to instigate

4. Other than where Section 5 of the Local Government Act 2003 applies.

procedures to ensure that the current limit is not breached. It would be good practice for the chief finance officer to establish an appropriate early warning system.

- In respect of the prudential indicators for the operational boundary for external debt and estimate of the ratio of financing costs to net revenue stream, these are estimates. It will probably not be significant if the operational boundary is breached temporarily on occasions due to variations in cash flow. However, a sustained or regular trend above the operational boundary would be significant and should lead to further investigation and action as appropriate.
- Regular monitoring should be undertaken in-year against key measures of affordability and sustainability, by reviewing estimates of financing costs to revenue and the capital financing requirement. Significant variation in the estimates used to calculate these prudential indicators, for example caused by major overruns of expenditure on other projects or by not achieving projected in-year capital receipts, should trigger management action. This will be particularly important before entering irrevocably into major commitments.

**41** In respect of prudential indicators and capital expenditure, it should be recognised that it is in the nature of capital expenditure to have variations from short-term time estimates and it is the success of the overall rolling medium-term plan that is important. However, regular monitoring will assist the management of the authority's capital plans.

**42** The chief finance officer should make arrangements for monitoring with respect to gross debt and the capital financing requirement such that any deviation from the requirement in paragraph 62 is reported to him or her, since any such deviation may be significant and should lead to further investigation and action as appropriate.



# Prudence and prudential indicators for prudence

- 43** The local authority shall ensure that all of its capital expenditure, investments and borrowing decisions are prudent and sustainable. In doing so it will take into account its arrangements for the repayment of debt (including through MRP/loans fund repayments) and consideration of risk and the impact, and potential impact, on the authority's overall fiscal sustainability. While indicators for sustainability are required to be set over a minimum three year rolling period, indicators should be set in line with a capital strategy and asset management plan that is sustainable over the longer term. Where statutorily ringfenced resources such as the HRA or Police Fund exist, the indicators of prudence should be set separately for these areas.
- 44** Local authorities are reminded that the prime policy objective of their treasury management investment activities is the security of funds, and they should avoid exposing public funds to unnecessary or unquantified risk. Authorities should consider a balance between security, liquidity and yield which reflects their own risk appetite but which prioritises security and liquidity over yield. It is therefore important that authorities adopt an appropriate approach to risk management with regard to their investment activities.
- 45** Authorities must not borrow more than or in advance of their needs purely in order to profit from the investment of the extra sums borrowed. Authorities should also consider carefully whether they can demonstrate value for money in borrowing in advance of need and can ensure the security of such funds.
- 46** The local authority shall set and monitor against the specified prudential indicators for capital expenditure and external debt (paragraphs 73–74) in accordance with the due processes to be followed (paragraphs 25–38), the matters required to be taken into account (paragraphs 12–14), affordability (paragraphs 63–74), prudence (paragraphs 43–62) and in accordance with the definitions specified (paragraphs 75–87).
- 47** Prudential indicators include indicative figures for years two and three to allow decisions to be made with an appreciation of future trends. It is recognised that these will be subject to change but exist to promote a move away from the focus on annual decision making towards longer-term strategies. Three year figures are also required to evidence that borrowing is for capital purposes.

## CAPITAL EXPENDITURE

### 48 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)**

49 The estimates of capital expenditure will include any capital expenditure that it is estimated might be incurred (depending on option appraisals) and other relevant long-term liabilities.

### 50 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**

### 51 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**

52 The estimate of capital financing requirement at the end of each year will relate to all capital expenditure – ie it includes relevant capital expenditure incurred in previous years. The capital financing requirement will reflect the authority's underlying need to finance capital expenditure by borrowing or other long-term liability arrangements.

53 In order to make these estimates, the authority will need to consider all of the financing options available and estimate their use of these. The estimates will not commit the local authority to particular methods of financing. The chief finance officer will determine the actual financing of capital expenditure incurred once a year, after the end of the financial year.

### 54 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**

## EXTERNAL DEBT

### 55 Authorised limit

The local authority will set for the forthcoming financial year and the following two financial years an authorised limit for its total gross external debt, 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<sup>5</sup>**

**For years 1, 2 and 3**

### 56 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**

57 Both the authorised limit and the operational boundary need to be consistent with the authority's plans for capital expenditure and financing; and with its treasury management policy statement and practices.

58 The operational boundary should be based on the authority's estimate of most likely, ie prudent, but not worst case scenario. Risk analysis and risk management strategies should be taken into account. The operational boundary should equate to the maximum level of external debt projected by this estimate. Thus, the operational boundary links directly to the authority's plans for capital expenditure; its estimates of capital financing requirement; and its estimate of cash flow requirements for the year for all purposes. The operational boundary is a key management tool for in-year monitoring – see in particular paragraph 40 of this Prudential Code, which includes the following:

*It will probably not be significant if the operational boundary is breached temporarily on occasions due to variations in cash flow. However, a sustained or regular trend above the operational boundary would be significant and should lead to further investigation and action as appropriate.*

59 Thus, both the operational boundary and the authorised limit will be based on the authority's plans. The authority will need to assure itself that these plans are affordable and prudent. The authorised limit will in addition need to provide headroom over and above the operational boundary sufficient for example for unusual cash movements.

5. Other long-term liabilities should be expanded to include all liabilities relating to PFI/PPP leases for both the operational limit and the authorised limit.

**60 Actual external debt**

After the year end, the closing balance for actual gross borrowing plus (separately) other long-term liabilities will be obtained directly from the local authority's balance sheet. This prudential indicator will be referred to as actual external debt and shall be expressed in the following manner:

**Actual external debt as at xx/xx/xx = actual borrowing as at xx/xx/xx + actual other long-term liabilities as at xx/xx/xx**

**61** The prudential indicator for actual external debt considers a single point in time and hence is only directly comparable to the authorised limit and operational boundary at that point in time. Actual debt during the year can be compared.

**62 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 gross 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.

# Affordability and prudential indicators for affordability

- 63** The fundamental objective in the consideration of the affordability of the authority's capital plans is to ensure that the level of investment in capital assets proposed means that the total capital investment of the authority remains within sustainable limits.
- 64** 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, income and expenditure forecasts.
- 65** Affordability should be considered in the light of the authority's medium-term forecast and other fiscal strategies. Capital expenditure plans should be considered alongside the cost of past borrowing, maintenance requirements and planned disposals. The authority's MRP/loans fund repayment policy will have a critical impact on the overall affordability of new borrowing and for this reason it is important to look at affordability not just in the medium term but also over the life of the asset base or underlying debt.
- 66** Where ringfenced resources or separate funds such as the HRA or Police Fund exist, affordability must be considered against those resources available to fund borrowing.
- 67** Under combined authority arrangements affordability may need to be considered against combined authority resources and the impact on underlying authorities. Where debt or guarantees relating to LEPs, subsidiaries or other corporate and non-corporate bodies exist, the impact on the authority should be considered. In these cases the development of local indicators may be appropriate.
- 68** Several significant matters that are relevant to a consideration of affordability are listed below (NB: This is not intended to be an exhaustive list):
- To what extent resources are likely to be available to finance proposed capital expenditure immediately (capital receipts, grants and direct revenue contributions).
  - The revenue consequences of proposed capital expenditure in both the medium and the long term. This may be any combination of increased revenue expenditure/revenue savings/increased revenue income.
  - Estimates of total interest costs and interest receivable. These should be the estimates of the actual amounts of interest that will be expended and received, based on the authority's estimates for actual external debt.
  - Existing expenditure commitments, both capital and revenue. This would by definition include PFI commitments, PPP schemes, financial guarantees, operating leases and all long-term revenue commitments including the level of reserves.
  - Planned change to revenue income or expenditure, whether through growth or savings.

- How much flexibility the authority's capital expenditure plans leave for future spending priorities, whether capital or revenue.
  - Contingent liabilities.
  - The revenue consequences of retirement benefit obligations.
  - The extent to which financing costs are supported by government grants or contributions from other bodies.
  - The current requirements for minimum revenue provision (England and Wales)/loans fund repayments (Scotland), or whatever may supersede these arrangements in the future.
- 69 Where the authority has interests in companies or other similar related entities, the authority needs to have regard to its financial commitments and obligations to those companies/entities.<sup>6</sup>
- 70 In considering affordability, the authority needs to pay due regard to risk and uncertainty in relation to all the above matters. Risk analysis and risk management strategies should be taken into account.
- 71 **The authority shall ensure that the revenue implications of capital finance, including financing costs, are properly taken into account within option appraisal processes, the capital programme and the medium-term forecast. In assessing affordability the authority shall consider the council tax implications of its capital programme, borrowing and investment decisions. The local authority shall set and monitor prudential indicators as key indicators of affordability.**
- 72 It is recognised that indicators of affordability are best determined in the light of local constraints around precepts and ringfenced and statutory funds such as the HRA and Police Fund. Authorities are encouraged to use local indicators that reflect how capital finance is permitted to be financed locally. For example for those authorities with a HRA, the ratio of financing costs to revenue budget should be calculated within the HRA ringfence and an impact on rents calculated. In setting indicators, it should be recognised however that ultimately all debts of a local authority fall on the taxpayer.
- 73 **Estimates of financing costs to net revenue stream**
- As a minimum, the local authority will estimate for the forthcoming financial year and the following two financial years the proportion of financing costs to net revenue stream. This prudential indicator shall be referred to as estimates of the proportion of financing costs to net revenue stream and shall be expressed in the following manner:**
- Estimate of financing costs ÷ estimate of net revenue stream x 100%**
- For years 1, 2 and 3**
- 74 **Actual financing costs to net revenue stream**
- After the year end, the proportion of financing costs to net revenue stream will be calculated directly from the local authority's comprehensive income and expenditure**

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6. Local authorities with interests in subsidiary or associated companies and joint ventures will also need to have regard to the group accounting requirements of proper accounting practice.

**statement. This prudential indicator shall be referred to as actual proportion of financing costs to net revenue stream and shall be expressed in the following manner:**

$$\text{Actual financing costs} \div \text{actual net revenue stream} \times 100\%$$





# SECTION EIGHT

## Definitions

**75** These definitions shall be used for all purposes connected with the Prudential Code, and in particular shall be used by the local authority in setting, revising and monitoring against its prudential indicators.

**76** It is intended that, throughout, the definitions used in respect of the Prudential Code will be consistent with proper accounting practices for local authorities. The development of proper accounting practices follows due process and consultation. It is important that the Prudential Code is aligned with these practices. Therefore, many of the definitions that follow cross-refer to amounts that are required to be included within a local authority's Statement of Accounts in accordance with proper accounting practices. Where changes to proper accounting practices significantly affect the prudential indicators this fact should be highlighted by the local authority when setting or revising the indicators. If any figures in the authority's Statement of Accounts that are used in prudential indicators are subject to audit qualification, this fact should be highlighted when any prudential indicators are set or revised.

### **77** Borrowing

In the Prudential Code, borrowing refers to actual external borrowing. Prudential indicators for actual figures for previous years should be taken from the local authority's balance sheets for those years, by aggregating the amounts for:

- borrowing repayable with a period in excess of 12 months
- borrowing repayable on demand or within 12 months.

This value should then be adjusted to exclude any accounting adjustments made including premiums and discounts, transactions costs, accrued interest and effective interest rate adjustments. The resulting value for borrowing should then be equal to the actual outstanding external borrowing at the end of the financial year.

Prudential indicators for current and future years should be calculated in a manner consistent with this definition.

NB: See also transferred debt (paragraph 87).

### **78** 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 the Local Authority (Capital Finance and Accounting) (Scotland) Regulations 2016 and relevant finance circulars.

## 79 **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 under proper practice or applicable regulations
- Revaluation Reserve
- Capital Adjustment Account
- Donated Assets Account.

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 lease obligations, deferred purchases and similar arrangements in respect of long-term credit. (See in particular the definition of other long-term liabilities in paragraph 85.) 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.

## 80 **Debt**

For the purposes of the Prudential Code, debt or gross 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 82).

**81 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 87).

**82 Investments**

Actual figures for investments for previous years should start with the sum of the amounts on the local authority's balance sheets<sup>7</sup> for:

- long-term investments
- short-term investments
- cash and cash equivalents.

This value should then be adjusted to exclude accrued interest, so that the resulting value is equal to the value of external investments including impairments.

Estimates for investments for current and future years should be calculated in a manner consistent with this definition.

**83 Net borrowing**

For the purposes of the Prudential Code, net borrowing refers to borrowing (see paragraph 77) net of treasury management investments (see paragraph 82).

NB: See also transferred debt (paragraph 87).

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7. The balance sheet includes the assets and liabilities of all activities of the authority, excluding the pension, trust, common good (in Scotland) and similar funds administered for third parties; therefore investments held by these funds will not be included.

**84 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.

**85 Other long-term liabilities**

'Other long-term liabilities' in this Code relate to the liabilities which are outstanding under credit arrangements (as defined by statute for authorities in England, Wales and Northern Ireland). The objective is to identify liabilities outstanding (other than borrowing) in relation to the financing of capital expenditure.

The definition of other long-term liabilities starts with the sum of the amounts on the face of the local authority's balance sheet that are classified as liabilities that are for periods in excess of 12 months, other than borrowing repayable within a period in excess of 12 months or liabilities that are for less than 12 months, for example during the last year of a PFI contract or finance lease. For clarification, amounts that relate to the Capital Adjustment Account, Financial Instruments Adjustment Account, Capital Grants Unapplied, Unequal Pay Back Pay Account, Revaluation Reserve, Pensions Reserve, Capital Receipts Reserve, Available-for-Sale Financial Instruments Reserve and Major Repairs Reserve (England and Wales – authorities with an HRA) are not included within the definition of other long-term liabilities for the purposes of the Prudential Code.

To the resultant figure must be added any amounts that are determined by legislation to be other long-term liabilities<sup>8</sup> that would otherwise not be so classified and from which must be subtracted any amounts that are determined by legislation not to be other long-term liabilities that would otherwise be so classified (referred to below as statutory adjustments). Deferred liabilities in respect of transferred debt should be treated in accordance with paragraph 87. Prudential indicators for previous years should be taken from the local authority's balance sheets as amended for any statutory adjustments. Prudential indicators for current and future years should be calculated in a manner consistent with this definition.

**86 Treasury management**

Treasury management has the same definition as in the CIPFA *Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes*:

*The management of the organisation's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks.*

**87 Transferred debt**

Some local authorities are managing debt that was transferred to them on reorganisation and which relates to a number of other organisations as well as themselves. While such

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8. Credit arrangements under Part 1 of the Local Government Act 2003.

arrangements continue, such local authorities (ie those managing the transferred debt/ borrowing to on-lend) should include these amounts in their prudential indicators, except only that:

- (a) These amounts should be netted off when calculating debt for the purposes of paragraph 62 of this Prudential Code.
- (b) When considering financing costs for paragraphs 73–74 of this Prudential Code, wherever possible financing costs arising from transferred debt should be excluded from the financing costs of the local authority that is managing the debt for other local authorities. This can be achieved by crediting income from the external organisation received in relation to the financing costs of the managed debt, in line with proper practices.

A local authority that is in the reverse of this position, ie for which another local authority holds debt managed in this way, should exclude these amounts from its prudential indicators, except only that:

- (c) When considering financing costs for paragraphs 73–74 of this Prudential Code, wherever possible financing costs arising from transferred debt should be included within the financing costs of the local authority for which another local authority is managing its debt. This can be achieved by debiting amounts payable to the local authority managing the debt, in line with proper practice.

Borrowing undertaken in Scotland under Regulation 10 of the Local Authority (Capital Finance and Accounting) (Scotland) Regulations 2016 should be treated in the same way as transferred debt.

