

**CIPFA PRUDENTIAL
CODE FOR CAPITAL
FINANCE IN LOCAL
AUTHORITIES –
SECOND EXPOSURE
DRAFT — WORK IN
PROGRESS (2)**



**CIPFA PRUDENTIAL CODE FOR CAPITAL FINANCE IN LOCAL
AUTHORITIES – EXPOSURE DRAFT FOR CONSULTATION**

FOREWORD

Consultation arrangements will be inserted here.

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PREFACE

CIPFA has prepared this [draft] Prudential Code for Capital Finance in Local Authorities (the Prudential Code) in order to underpin and flesh out the new system of capital finance, whereby locally elected authorities [will be able to] determine their own programmes for capital investment in fixed 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 local authorities in taking these decisions. [It is expected that] local authorities [will be] required by Regulation to comply with the Prudential Code when carrying out their duties in England and Wales under Part I of the Local Government [Bill] and in Scotland under Part x of the Local Government in Scotland [Bill].

The [draft] Prudential Code for Capital Finance in Local Authorities (the [draft] Code) is set out in this document. The [draft] Code comprises the paragraphs in bold type. The explanatory statements are in standard type and shall be regarded as part of the [draft] Code insofar as they assist in interpreting the [draft] Code.

The appendices attached to the [draft] Code do not form part of the [draft] Code but will be helpful in explaining the background to the Code and the factors that have influenced its development.

EXECUTIVE SUMMARY

An executive summary, which will form part of the Code, will be inserted here.

[DRAFT] PRUDENTIAL CODE FOR CAPITAL FINANCE IN LOCAL AUTHORITIES

OBJECTIVES

1 The objectives of the [draft] Code are to provide a framework for local authority capital finance that will ensure for individual local authorities (or in exceptional circumstances demonstrate that there is a danger of not ensuring so that the authority can take timely remedial action) that:

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

and that in taking decisions in relation to (a) to (c) above the local authority is

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

Further, the framework established by the [draft] Code should be consistent with and support:

- (e) local strategic planning**
- (f) local asset management planning**
- (g) proper option appraisal.**

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 plans
- external debt
- treasury management.

- 3 The framework in this [draft] Code includes a set of prudential indicators. These will need to be seen together, integrated into a coherent picture, rather than being seen individually in isolation. 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. At all times, the objectives specified in paragraph 1 of this [draft] Code are paramount to the operation of the prudential framework.
- 4 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 [will have] widely different debt positions at the start of the Prudential system and the differences are likely to increase over time as the 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.
- 5 Prudential indicators that are limits are for the determination of the local authority subject only to any long stop controls under [clause] 4 of the Local Government [Bill] (England and Wales) and [clause x] of the Local Government in Scotland [Bill] (Scotland). The government and devolved administrations have indicated that these are long stop powers and will be used only in exceptional circumstances. Any limit imposed centrally under statute will replace any locally determined limit, unless the locally determined limit is lower than the centrally determined limit.
- 6 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 statute, associate any part of the authority's external borrowing with particular item(s), category(ies) or purpose(s) of expenditure. The authority should have an integrated treasury management strategy within which its borrowing and investments are managed.

SCOPE

- 7 The Prudential Code applies to all local authorities in England and Wales that are defined in statute for the purposes of Part I of the Local Government [Bill], from the date that part of the [Bill] comes into effect for the local authority; and to all

local authorities in Scotland that are defined in statute for the purposes of Part [x] of the Local Government in Scotland [Bill], from the date that part of the [Bill] comes into effect for the local authority.

PROCESS AND GOVERNANCE ISSUES

Setting and revising prudential indicators

- 8 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 by the same body that sets 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 23 to 45).**
- 9 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 setting and revising of the prudential indicators should follow the same route as the setting of the budget of the local authority.
- 10 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.**
- 11 Provided that the total authorised limit and total operational boundary for external debt for a year are unchanged, (paragraphs 58 and 59), 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.
- 12 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 [clause] 5 of the Local Government Bill (England and Wales) applies:
- “(1) Subject to subsection (2), any limit for the time being determined by 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.

Any such increase in the authorised limit should be reported to the next meeting of the body that sets the budget for the local authority.

- 13 Prudential indicators for treasury management should be considered together with the local authority’s treasury management strategy and the annual report on treasury management activities.**
- 14 Prudential indicators for external debt and capital commitments for previous years are to be taken directly from information in the local authority’s statements of accounts.**
- 15 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 or revised.
- 16 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 planning processes. It would be logical for these to be considered when the budget for the local authority is set.
- 17 The Chief Finance Officer is responsible for ensuring that matters required to be taken into account when setting or revising prudential indicators (paragraphs 23-45) are reported to the decision making body for consideration. In relation to the local authority’s statement of accounts, the Chief Finance Officer is responsible for signing and dating the statement, and for stating that it presents fairly the financial position of the authority at the accounting date and its income and expenditure for the year ended.
- 18 This section of the [draft] Code establishes a clear governance procedure for the setting and revising of prudential indicators. This assists transparency and ensures accountability.

Monitoring against prudential indicators

19 The Chief Finance Officer is required to establish procedures to monitor performance against all forward looking prudential indicators plus the requirement specified in paragraph 44. The Chief Finance Officer will need to establish a measurement and reporting process that highlights significant deviations from expectations.

20 With regard 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 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 procedures to ensure that the current limit is not breached. It would be good practice for the Chief Finance Officer to establish an early warning system to notify the executive
- in England and Wales the prudential indicator for the authorised limit for external debt for the current year is the statutory limit determined under [clause] 3(i) of the Local Government [Bill]: “A local authority shall determine and keep under review how much money it can afford to borrow.”
- 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, it should be emphasised that these are estimates. It will probably not be significant if the operational boundary is breached temporarily on occasions due to variations in cashflow. 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, through regular monitoring of 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 over-runs of expenditure on other projects or not achieving projected in-year capital receipts, should trigger management action. This will be particularly important before entering irrevocably into major commitments

- the new framework will put a greater emphasis on the monitoring of the local authority's cashflow. Variations above locally defined limits could trigger investigative action
 - one advantage of using total debt rather than attempting to focus just on long term debt or debt for a capital purpose, is that such a system would provide an early warning signal if 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 on-going basis.
- 21 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. In Scotland, the prudential indicator for the estimate of capital expenditure for the current year is the statutory limit determined under [clause x] (1) of the Local Government in Scotland [Bill]: "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."
- 22 The Chief Finance Officer should make arrangements for monitoring with respect to net borrowing and the capital financing requirement such that any deviation from the requirement in paragraph 44 is reported to him/her, since any such deviation may be significant and should lead to further investigation and action as appropriate.

MATTERS REQUIRED TO BE TAKEN INTO ACCOUNT WHEN SETTING OR REVISING PRUDENTIAL INDICATORS

Overall

- 23 In setting or revising their prudential indicators, the local authority is required to have regard to the following matters:**
- **implications for Council Tax, ie affordability**
 - **implications for external borrowing, ie prudence**
 - **option appraisal for all projects, ie value for money**
 - **asset management planning, ie stewardship of assets**

- **strategic planning for the authority, ie service objectives**
- **achievability of the forward plan, ie its practicality.**

- 24 Further detailed requirements in respect of affordability and prudence are given below since these are primary roles for the [draft] Code. However, all the matters listed above must be taken into account when setting or revising prudential indicators.
- 25 The Local Government [Bill] and Local Government in Scotland [Bill] refer solely to affordability, whereas this Prudential Code refers to both affordability and prudence. The two are related concepts and are distinguished within the Prudential Code in order to separately consider issues of short and medium term affordability and issues of long term sustainability that are essential to the long term affordability of capital investment plans. When making a decision to invest in capital assets, the authority must do more than simply determine whether it can afford the immediate cost. In order to ensure long term affordability, the decisions have also to be prudent and in the long term sustainable. Therefore, in carrying out their duties under Part I of the Local Government [Bill] (England and Wales) and Part xx of the Local Government in Scotland [Bill] (Scotland) in respect of affordability, local authorities are required to have regard to all those aspects of the Prudential Code that relate to affordability and/or prudence. 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.
- 26 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 the financial processes ensures that prudence and affordability is demonstrated.

Affordability and prudential indicators for affordability

- 27 **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, and in particular to consider its impact on the local authority's 'bottom line', its impact on the Council Tax. Affordability is ultimately determined by a**

judgement about acceptable Council Tax levels and, in the case of the Housing Revenue Account, acceptable rent levels.

28 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.

29 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 are resources 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 short and long term. This may be any combination of increased revenue expenditure/revenue savings/increased revenue income
- existing expenditure commitments, both capital and revenue. This would by definition include PFI commitments, PPP schemes and operating leases
- contingent liabilities
- the revenue consequences of retirement benefits
- 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
- the extent to which financing costs are supported by government grants or contributions from other bodies
- whatever supersedes or the continuation of the current requirements for minimum revenue provision (England and Wales)/loans fund repayments (Scotland)

- 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.
- 30 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.
- 31 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/entities¹.
- 32 Paragraphs 27 and 28 require the development of three year revenue forecasts and three year forward estimates of Council Tax, as well as three year capital expenditure plans. NB These are rolling scenarios, not fixed for three years.
- 33 The local authority shall set and monitor against the prudential indicators specified in paragraphs 34 - 40 as key indicators of affordability. The prudential indicators specified in paragraphs 47 - 65 are also indicators of affordability. These prudential indicators shall be set and monitored in accordance with this section with the due processes to be followed (paragraphs 8 – 22) and in accordance with the definitions specified (paragraphs 81 – 93).**
- 34 Estimates of ratio of financing costs to net revenue stream**
- The local authority will estimate for the forthcoming financial year and the following two financial years the ratio of financing costs to net revenue stream. This prudential indicator shall be referred to as estimates of the ratio of financing costs to net revenue stream and shall be expressed in the following manner:**
- Estimate of financing costs : estimate of net revenue stream**
- For years 1, 2 and 3**
- and shall be expressed as percentages.**
- 35 In relation to the prudential indicators for estimates of the ratio of financing costs to net revenue stream, a local authority that has a**

¹ Local Authorities with, in aggregate, material interests in subsidiary or associated companies and joint ventures, will also need to have regard to the group accounting requirements of the CIPFA/LASAAC *Code of Practice on Local Authority Accounting*.

Housing Revenue Account (HRA) will identify separately estimates of the ratio of the HRA financing costs to the HRA net revenue stream and estimates of the ratio of the non-HRA financing costs to the non-HRA net revenue stream. The separation between the HRA and non-HRA elements of these prudential indicators will be undertaken as determined under statute. The estimates of HRA and non-HRA capital financing costs will, taken together, sum to the total estimates of the capital financing costs.

36 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 consolidated revenue account. This prudential indicator shall be referred to actual ratio of financing costs to net revenue stream and shall be expressed in the following manner:

Actual financing costs : actual net revenue stream

and shall be expressed as a percentage.

37 In relation to the prudential indicator for actual ratio of financing costs to net revenue stream, a local authority that has a Housing Revenue Account (HRA) will identify separately the actual ratio of the HRA financing costs to the HRA net revenue stream and the actual ratio of the non-HRA financing costs to the non-HRA net revenue stream. The separation between the HRA and non-HRA elements of these prudential indicators will be undertaken as determined under statute. The estimates of HRA and non-HRA capital financing costs will, taken together, sum to the total estimate of the capital financing costs.

38 Estimates of impact of financing costs on the Council Tax

The local authority will estimate for the forthcoming financial year the impact of financing costs on the Council Tax. This impact shall be calculated using the same estimates of financing costs as used in the prudential indicator for the estimates of ratio of financing costs to net revenue stream, and shall be the local authority's best estimates of their impact on the Council Tax. This prudential indicator will be referred to as estimates of impact of financing costs on the Council Tax and shall be expressed in the following manner:

£ xxx.xx p.

39 The local authority's best estimates of the impact of financing costs on the Council Tax should be calculated in the same manner as when the local authority calculates the impact of the estimates of the costs of services on the Council Tax for the purposes of the Council Tax Leaflet that is sent out with the notification of Council Tax.

40 In relation to the prudential indicator for the estimates of the impact of financing costs on the Council Tax, a local Authority that has a Housing Revenue Account (HRA) shall use the non-HRA financing costs and shall in addition, in a similar fashion, estimate for the forthcoming financial year the impact of HRA financing costs on rents. This impact shall be calculated using the same estimates of HRA financing costs as used in the prudential indicator for the ratio of HRA financing costs to net HRA revenue stream, and shall be the local authority's best estimates of their impact on rents. This prudential indicator will be referred to as estimates of impact of financing costs on rent and shall be expressed in the following manner:

£xxx.xxp.

Prudence and prudential indicators for prudence

41 By virtue of the requirements already listed above, the prudential indicators in respect of external debt must be set and revised taking into account their affordability. It is through this means that the objective of ensuring that external debt is kept within sustainable, prudent limits is addressed year on year.

42 The final three items listed in paragraph 29 of the [draft] Code will be particularly pertinent here.

43 Where the full year effect of capital projects will not be felt within a three year time frame, the local authority will need to have regard to the full year effects of the scheme when considering affordability and prudence.

44 Net borrowing and the capital financing requirement

In order to ensure that over the medium term net borrowing will only be for a capital purpose, the local authority should ensure that net external borrowing 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. This is a key indicator of prudence. This prudential indicator will be referred to as net borrowing and the capital financing requirement.

- 45 Ensuring that treasury management is carried out in accordance with good professional practice is an essential feature of prudence. The prudential indicators specified in paragraphs 66 – 80 are also indicators of prudence.**

PRUDENTIAL INDICATORS FOR CAPITAL EXPENDITURE,
EXTERNAL DEBT AND TREASURY MANAGEMENT

- 46 The local authority shall set and monitor against the specified prudential indicators for capital expenditure, external debt and treasury management (paragraphs 47 - 80) in accordance with the due processes to be followed (paragraphs 8 - 22), the matters required to be taken into account (paragraphs 23- 45) and in accordance with the definitions specified (paragraphs 81 – 93).**

Capital expenditure

- 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).

- 48 In relation to the prudential indicators for estimates of capital expenditure, a local authority that has a Housing Revenue Account (HRA) will 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 statute. The estimates of HRA and non-HRA capital expenditure will, taken together, sum to the total estimates of capital expenditure.**

- 49 The estimates of capital expenditure will include any capital expenditure that it is estimated might (depending on option appraisals) or will be dealt with as other 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 In relation to the prudential indicator for actual capital expenditure, a local authority that has a Housing Revenue Account (HRA) will 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 statute. The actual HRA and non-HRA capital expenditure will, taken together, sum to the total actual capital expenditure.

52 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.

53 In relation to the prudential indicators for estimates of capital financing requirement, a local authority that has a Housing Revenue Account (HRA) will 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 statute. The estimates of HRA and non-HRA capital financing requirement will, taken together, sum to the total estimates of the capital financing requirement.

54 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 borrow²

- 55 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.

56 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.

- 57 **In relation to the prudential indicator for the actual capital financing requirement, a local authority that has a Housing Revenue Account (HRA) will 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 statute. The actual HRA and non-HRA capital financing requirement will, taken together, sum to the total actual capital financing requirement.**

External debt

58 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, gross of 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**

² NB Cross refer to Appendix D for more information about the capital financing requirement.

For years 1, 2 and 3.

59 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, gross of 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.

60 The prudential indicators for the authorised limit and operational boundary need to be set in accordance with the other provisions of this Prudential Code, in particular the requirements with respect to:

- **process and governance issues for setting and revising prudential indicators (paragraphs 8-22)**
- **the matters required to be taken into account when setting or revising prudential indicators (paragraphs 23 - 45)**
- **definitions used (paragraphs 81-93).**

61 Both the authorised limit and 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.

62 The operational boundary should be based on the authority's estimate of most likely, 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; their estimates of capital financing requirement; and their estimate of cashflow requirements for the year for all purposes. The operational boundary is a key management tool for in-year monitoring – see in particular paragraph 20 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 cashflow. However, a sustained or regular trend above the operational boundary would be significant and should lead to further investigation and action as appropriate”

- 63 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 operational boundary will be based on the most likely, prudent but not worst case scenario. The authorised limit will in addition need to provide sufficient headroom over and above the operational boundary for unusual cash movements.

64 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.

- 65 The prudential indicator for actual external debt will not be directly comparable to the authorised limit and operational boundary, since the actual external debt will reflect the actual position at one point in time.

Treasury Management

- 66 **The first prudential indicator in respect of treasury management is that the local authority has adopted the CIPFA Code of Practice for Treasury Management in the Public Services.**

67 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 prudential 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.

68 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.

69 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.

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

71 In cases where the terms of the borrowing or investment raise questions as to whether it should be treated as fixed or variable, it should be treated as being variable for the purposes of these prudential indicators.

72 The effect of setting these upper limits is to provide ranges within which the authority will manage its exposures to fixed and variable rates of interest.

73 It is expected that for most authorities the calculations under paragraphs 69 and 70 will result in a positive figure. However for local authorities that do not have borrowings, and for some other authorities with substantial cash investments, these calculations will result in a negative figure.

74 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 at the start of the period.**

Where the periods in question are

- **under 12 months**
- **12 months and within 24 months**
- **24 months and within 5 years**
- **5 years and within 10 years**
- **10 years and above.**

75 The maturity of borrowing should be determined by reference to the earliest date on which the lender can require payment.

76 Revisions to limits on interest rate exposures and maturity structure of borrowing

Where prudential indicators for interest rate exposures and/or the maturity structure of borrowing are revised during the financial year, the time periods under 12 months/12 months and within 24 months, etc shall refer to the time periods within 12 months of the start of the financial year/from 12 months and within 24 months, etc respectively.

77 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.**

- 78 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.
- 79 In all cases, the process of setting prudential indicators for treasury management should be 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.
- 80 Local authorities should bear in mind that prime policy objectives of their investment activities are to encourage safety and liquidity, and to avoid exposing public funds to unnecessary or unquantified risk. The pursuit of optimum performance from the investment of legitimate surplus funds, as a secondary policy objective, is a best practice approach to treasury management and is to be encouraged. But 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 – a practice referred to as 'roundtripping'. Freedoms afforded to local authorities to invest longer-term or in investment instruments should therefore be used always with these principles in mind.

DEFINITIONS

- 81 These definitions shall be used for all purposes connected with the [draft] Code, and in particular shall be used by the local authority in setting, revising and monitoring against their prudential indicators.**
- 82 It is intended that, throughout, the definitions used in respect of the [draft] Code will be consistent with UK generally accepted accounting practice (UK GAAP) as applicable to the public services and embodied within the CIPFA/LASAAC Code of Practice on Local Authority Accounting (the SORP), except where statute requires otherwise. The SORP changes over time, particularly as UK GAAP and/or the statutory framework for local authority finance changes. In all cases, the development of the SORP follows due process and consultation. It is important that the [draft] Code is aligned with the SORP. 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 the SORP. In relation to previous years, this means the version(s) of the SORP applicable to the

year(s) involved. In relation to the current year or estimates for future year, this means the current SORP. Where changes to the SORP 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.

83 Borrowing

In the [draft] Code, borrowing refers to external borrowing. Prudential indicators for actual figures for previous years should be taken from the local authority's consolidated 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

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

NB See also transferred debt (paragraph 93 below).

84 Capital expenditure

The definition of capital expenditure starts with all those items capitalised under the SORP. To this must be added any items that have/will be capitalised in accordance with statute that otherwise would not be capitalised. Prudential indicators for actual figures for previous years should be taken from the amounts capitalised and included on the local authority's balance sheet. Prudential indicators for current and future years should be calculated in a manner consistent with this definition.

85 Capital financing requirement

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

- fixed assets
- deferred charges
- fixed asset restatement reserve
- capital financing reserve
- government grants deferred.

In addition, any other items on the local authority's consolidated balance sheet that relate to capital expenditure incurred should be included, for example deferred purchase schemes. 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 also not be included.

NB1. In Scotland the capital financing requirement will be equal to the balance outstanding on the loans fund as determined under Schedule 3 to the Local Government (Scotland) Act 1975.

NB2. 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.

86 Debt

For the purposes of the [draft] Code, debt refers to the sum of borrowing (see above paragraph 83) and other long term liabilities (see below paragraph 91). It should be noted that the term borrowing used within the Local Government [Bill] includes both borrowing as defined for the balance sheet and other long term liabilities defined as credit arrangements under statute. This means that the definition of 'debt' for the purposes of the [draft] Prudential Code is the same as the definition of 'borrowing' under the Local Government [Bill]. Within the [draft] Prudential Code borrowing is distinguished from other long term liabilities in order to relate the prudential indicators directly to the balance sheet.

87 Financing costs

Actual figures for financing costs for previous years should be taken from the local authority's consolidated revenue account by aggregating

- interest payable with respect to borrowing³
- interest payable under finance leases and any other long term liabilities³
- 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

³ These items are required by the SORP to be charged to the asset management revenue account. The notes to the consolidated revenue account require information on the nature and amount of all material transactions to the asset management revenue account if not disclosed on the face of the account.

- interest and investment income⁴
- any amounts required in respect of the continuation of or whatever supersedes the current requirements for minimum revenue provision (England and Wales)/loans fund repayments (Scotland) plus any additional voluntary contributions plus any other amounts for depreciation/impairment that is 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 93 below).

88 Investments

Actual figures for investments for previous years should start with the sum of the amounts on the local authority's consolidated balance sheets⁵ for

- long term investments
- (within current assets) investments
- (within current assets) cash and bank
- bank overdraft.

From this should be subtracted any investments that are held clearly and explicitly in the course of the provision of, and for the purposes of, operational services. Estimates for investments for current and future years should be calculated in a manner consistent with this definition.

89 Net borrowing

For the purposes of the [draft] Code, net borrowing refers to borrowing (see above paragraph 83) net of investments (see above paragraph 88).

NB See also transferred debt (paragraph 93 below).

90 Net revenue stream

⁴ For consistency, any interest or investment income from investments excluded from prudential indicators in accordance with the definition for investments (see paragraph 88) should be excluded here.

⁵ NB The SORP requires that the consolidated balance sheet should include 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.

Actual figures for net revenue stream for previous years should be taken from the amounts in the local authority's consolidated revenue account for

— amount to be met from government grants and local taxpayers.

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.

91 Other long term liabilities

The definition of other long term liabilities starts with the sum of the amounts on the local authority's balance sheet that are classified as long term liabilities other than borrowing repayable within a period in excess of 12 months. Amounts that relate to the fixed asset restatement reserve, capital financing reserve and pensions reserve are not included within the definition of other long term liabilities for the purposes of the [draft] Prudential Code. To the resultant figure must be added any amounts that are determined by statute to be other long term liabilities⁶ that would otherwise not be so classified and from which must be subtracted any amounts that are determined by statute not to be other long term liabilities that would otherwise be so classified (referred to below as statutory adjustments). 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.

92 Treasury management

Treasury management has the same definition as in CIPFA's Code of Practice for Treasury Management in the Public Services

“The management of the organisation's 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.”

93 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

⁶ Credit arrangements under Part I of the Local Government [Bill].

themselves. While such arrangements continue, such local authorities (ie those managing the transferred debt) should include these amounts in their prudential indicators, except only that

- (a) these amounts should be netted off when calculating net borrowing for the purposes of paragraph 44 of this [draft] Code
- (b) when considering financing costs for paragraphs 34-40 of this [draft] 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 their prudential indicators, except only that

- (c) when considering financing costs for paragraphs 34 – 49 of this [draft] 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.

APPENDICES

Appendices, which will not be part of the Code itself, will be inserted here.