

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



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1 FOREWORD

- 1.1 CIPFA has prepared this exposure draft of the Prudential Code for consultation with the aim that the finalised Code will underpin a new system of capital finance for local authorities.**
- 1.2 It should be noted that the capital finance systems of local authorities are encompassed within statute and that different statutory regimes apply within England, Wales and Scotland. England and Wales are covered by the same primary legislation but different secondary legislation. Scotland has different primary legislation.**
- 1.3 It is hoped and intended that the CIPFA Prudential Code will apply throughout England, Wales and Scotland; and will have statutory backing throughout.**
- 1.4 The implementation date of the Code is not yet known and, because of the interaction between the Code and statutory framework, may vary between England, Wales and Scotland.**
- 1.5 The Prudential Code will be a key part of a new capital finance system for local authorities and your comments on this exposure draft are important to its development. Your comments on any aspect of the draft Code are requested, and particularly on the questions highlighted in bold in the text. These questions are also summarised at the end of the draft Code.**
- 1.6 Comments on this exposure draft of the Prudential Code should be sent to CIPFA by [date and detailed address contact points to be inserted here].**
- 1.7 This draft Code has been prepared through CIPFA's governance arrangements. The preparation of the draft Code has been overseen by the Prudential Code Steering Group, which reports to the CIPFA Treasury Management Panel. The exposure draft of the Code has been approved for publication for consultation by [insert when approved – the Steering Group, the Treasury Management Panel, the Technical Committee and the Institute Council].**

1.8 The membership of the Prudential Code Steering Group comprises:

Tony Redmond	<i>London Borough of Harrow, Chairman</i>
Paul Bannister	<i>Sandwell MBC, LAAP, Capital Finance Reference Group</i>
Ken Barnes	<i>South Norfolk DC, TMP, Society District Council Treasurers</i>
Ian Brooke	<i>Prebon Financial Consulting, Capital Finance Ref Group</i>
Nick Buxton	<i>HM Treasury</i>
Tim Day	<i>Prebon Financial Consulting, LAAP, Capital Finance Ref Group</i>
Peter Derrick	<i>Corporation of London, Capital Finance Ref Group</i>
Richard Dunlop	<i>Sector, TMP, Capital Finance Ref Group</i>
Martin Easton	<i>Birmingham City Council, LGA, Capital Finance Ref Group</i>
Graham Fletcher	<i>DTLR</i>
Ernie Gamble	<i>Sandwell MBC, Society of Municipal Treasurers</i>
Mike Grealy	<i>Local Government Association</i>
Richard Harbord	<i>LB Hammersmith & Fulham, Capital Finance Ref Group</i>
Ronnie Hinds	<i>Audit Scotland</i>
Frances Houston	<i>HM Treasury</i>
Ian Jackson	<i>Midlothian Council, CIPFA Directors of Finance Scotland</i>
Lisa James	<i>National Assembly for Wales</i>
Lyn James	<i>Bridgend County Borough Council, Society of Welsh Treasurers</i>
Tony Knights	<i>LB Kingston Upon Thames, Society of London Treasurers</i>
John Layton	<i>PricewaterhouseCoopers, LAAP, Capital Finance Ref Group</i>
Ian Miller	<i>Welsh Local Government Association</i>
Peter Morley	<i>Independent Consultant, Capital Finance Reference Group</i>
Paul Mueller	<i>Sector, Capital Finance Reference Group</i>
Mary Munro	<i>Scottish Executive</i>
Ross Proudfoot	<i>Butlers, Capital Finance Ref Group</i>
Iain Richardson	<i>Audit Commission</i>
Stephen Sheen	<i>Ichabod's Industries Ltd, TMP, Capital Finance Ref Group</i>

Peter Swaby *Derbyshire County Council, Society of County
Treasurers*
David Thomas *Butlers, Capital Finance Reference Group*
Mike Weaver *Worcestershire CC, Capital Finance Ref Group*
Pam Williams *DTLR*
Norrie Williamson *COSLA, TMP*
Maureen Wellen *CIPFA, Secretary.*

1.9 [On publication, thanks will be inserted here by CIPFA to members of the Steering Group.]

2 INTRODUCTION

2.1 This introduction to the exposure draft of the Prudential Code first outlines the government's objectives for the new capital finance system which it is intended that the Code will underpin. CIPFA's objectives in preparing the Code are then outlined. Finally, the scope and objectives of the Code are outlined.

The government's objectives for the new capital finance system

2.2 The government has a wide ranging agenda for the modernisation of public services. As part of this, the systems of local government finance are being reviewed.

2.3 The government's view on the aims of a good system for local government finance were expressed in the green paper on modernising local government finance that was published by the (then) DETR in September 2000, as follows:

"Aims of a local government finance system

However, local authorities cannot achieve anything without money. So, getting the local government finance system right is important. In the Government's view, the aims of a good system should be to:

- **fund all authorities adequately.** This means getting the overall balance of resources right. We must then allocate grant fairly, taking due account of authorities' differing needs and capacities to finance expenditure from their own resources;
- promote **continuous improvement** in service quality and efficiency in line with Best Value;
- provide a reasonable degree of **predictability and stability.** Authorities cannot plan ahead with confidence if they are subject to large or unexpected variations in

grant. Taxpayers and other stakeholders would also like greater predictability and stability;

- balance funding for local government's delivery of **national priorities and targets** with real financial **freedom and responsibility** for local authorities. The Government has a clear mandate to raise educational standards, to tackle crime, and to address other pressing national issues for which local government is primarily responsible. But local circumstances and priorities vary. Authorities need to be able to reflect this in their spending and charging plans;
- be **fair** to those who use and pay for local authority services. The system should ensure that they are fully protected;
- clarify **accountability** for financial decisions. If council tax increases are excessive or services are underfunded, people should know who to hold to account;
- be **intelligible and transparent** to all stakeholders. There cannot be true accountability unless people understand the system. At present, many do not;
- make **partnership working** easier. Local authorities need to co-operate with one another and with a wide range of public, private and voluntary sector partners to ensure the richness and diversity of provision which Best Value requires. The local government finance system should help, not hinder;
- encourage **consultation**, particularly with local taxpayers.

Some of these aims reinforce one another. Some are more relevant to some aspects of local government finance than others. Giving local authorities more financial freedom and greater certainty about future funding should help them deliver continuous improvement. Making funding more intelligible and transparent helps clarify accountability. But there are also some tensions between these aims, and balances to be struck. The delivery of national priorities should not be at the expense of local freedom and responsibility. Nor should local freedom be at the expense of fairness to those who use and pay for services.”

Similar wording was included in the consultation paper from the Cabinet of the National Assembly for Wales on local government finance in Wales, “Simplifying the System”, also published in September 2000.

In addition, the Scottish Parliament is undertaking an inquiry into local government finance.

2.4 Specifically in relation to capital finance, the (then) DETR’s green paper stated:

“In the Government’s view, the present capital control system blurs accountability, limits local financial freedom and has become an obstacle to effective capital investment. We need a new regime where local authorities no longer have to get government approval before borrowing, but which protects taxpayers and promotes partnership working. It should enable local authorities to consider revenue and capital solutions on an equal footing, so that Best Value will be what counts.”

The National Assembly for Wales consultation paper concurred with this view.

The local authority capital finance system in England and Wales operates through the Local Government and Housing Act 1989 and regulations made under it. This legislation is highly complex.

2.5 The statutory framework within Scotland is different. Local authority capital expenditure in Scotland is subject to the provisions of section 94 of the Local Government (Scotland) Act 1973. Under section 94, local authorities require the consent of Scottish Ministers before they incur a liability to meet capital expenses. This is conveyed by means of an annual section 94 consent letter.

As part of the modernising agenda, Scottish Ministers have undertaken to review the current system for dealing with local authority capital expenditure.

CIPFA's objectives

2.6 In the Institute's responses to the government's modernising agenda, CIPFA expressed the view that the current systems of capital finance for local authorities could beneficially be changed to a system that places less emphasis on detailed statute and more reliance on the role of the Finance Director and on professional codes of practice.

2.7 As the leading professional accounting body for the public services, CIPFA is uniquely placed to develop a professional code of practice, the Prudential Code, to support the new framework. CIPFA has been asked by the DTLR to develop such a Code and the DTLR is providing funding towards the development of the Code.

2.8 In developing the Prudential Code, CIPFA's objectives are threefold:

- (a) to promote professional best practice, eg by ensuring that the Code fits well with proper option appraisal, sensible treasury management, strategic local planning and the figures required by HM Treasury for macro economic indicators
- (b) to promote UK generally accepted accounting practice (GAAP), not simply for its own sake but because it has a potentially significant and meaningful role to play in capital finance

- (c) to promote better asset management and service delivery as an essential part of the modernising agenda for public services.

2.9 Of the above objectives, (c) is the most important. Indeed, if one thinks in terms of ‘means’ and ‘ends’, there is a sense in which (a) and (b) may be thought of as the ‘means’ and (c) as the ‘ends’. Capital finance in local authorities is not just a complex technical matter or an accounting issue. It is both of these, but it is something more. The system of capital finance has a real impact on public services. It can provide a framework for better strategic choices in relation to public service infrastructure and hence make real and significant differences to service delivery at the front line.

Scope of the Prudential Code

2.10 The scope of the Code proposed in this exposure draft for consultation is the same as that proposed in CIPFA’s representations to government. This is that the Code should comprise requirements for locally determined prudential indicators to be set by the local authority, and where appropriate revised, in accordance with definitions and process required by the Code for:

- external debt (all external borrowings and other external long term liabilities)
- capital expenditure/commitments
- treasury management.

2.11 Some commentators have remarked that previous control frameworks have concentrated **either** on external debt **or** on capital expenditure/commitments and that a control framework that includes both would be something of a straightjacket. However, it is stressed that the Code is intended to set the framework for **locally determined** prudential indicators. A system that is determined and managed locally needs to be aware of, manage and be accountable for all of these factors.

2.12 The Code is called a **Prudential** Code. A definition of prudent in the Concise Oxford Dictionary is “(of person or conduct) careful to avoid undesired consequences”. In relation to the Prudential Code, the Code is particularly concerned to avoid the

undesired consequence of the unsustainability of long term liabilities. However, it is intended that the Code will not **only** assist in the avoidance of undesired consequences. In addition to this, the Code should facilitate positive developments by providing a framework that supports the local authority's strategic plans and asset management strategies and hence, in addition to avoiding negative consequences, assists in real improvements to service delivery.

2.13 It is important to stress that the Prudential Code needs to be read in the round. No one prudential indicator can achieve all these ends. Nor should any one prudential indicator be highlighted in isolation from the others. Rather, a range of prudential indicators are proposed, and these need to be seen together.

2.14 Specifically, objectives for the prudential indicators are that, taken together, and with the processes required for their determination, they will 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) all external borrowings and other long term liabilities are within **sustainable levels**
- (b) capital expenditure plans are **affordable**
- (c) treasury management decisions are taken in accordance with **professional good practice**

and that 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 Prudential Code should be consistent with and support:

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

2.15 Comments are invited on any aspect of the Prudential Code and in particular on the questions highlighted in bold in the text. As a final question once the Code has been read, comments are invited on this overview of the Code. Are the scope and objectives appropriate? Will they be met by the recommendations in this draft Code?

2.16 As background information to the preparation of the Code, the DTLR has provided an analysis for all local authorities in England of total debt, investments, net debt, fixed assets and credit ceilings, all as at 3/3/00, plus capital expenditure for 1999/2000 and the budgeted revenue expenditure for 2000/2001. This is in tabular form. In addition, there is a graph showing gross debt plotted up against investment and net debt plotted against credit ceiling. These are reproduced as Appendix A. Individual authorities are not identified. The National Assembly for Wales has provided similar figures for Wales and these are reproduced in Appendix B. The Scottish Executive has provided the equivalent figures for Scotland and these are reproduced as Appendix C.

3 EXTERNAL DEBT

- 3.1 External debt measures the debt of the local authority with respect to its actual external position, which is a good place for a prudential system to start. Furthermore, actual external debt is consistent with the figures required nationally for macro-economic purposes. Also, actual external debt is what has to be serviced and repaid by the local authority.
- 3.2 Actual external debt is an effect not a cause. It results from the actual income and expenditure of the authority combined with its treasury management strategy. The view might be taken, therefore, that if income, expenditure and treasury management are adequately dealt with that there is no need for performance indicators for external debt. However, the Prudential Code takes a different view. The primary outcomes of the authority's income and expenditure are of course the public services provided or facilitated. However, an important secondary outcome is the level of external debt thereby incurred and it is important that the local authority is accountable for its actual external position.
- 3.3 The measurement of external debt will therefore form an important part of the Prudential Code.
- 3.4 This section first considers the definition of external debt that is to be used by local authorities in their consideration of performance indicators. It is vital that the measurement of this key component of the prudential framework is clear and applied consistently. The section then recommends the performance indicators to be used and the matters to be taken into account in setting the performance indicators. Finally, transitional issues from the current to the new system in respect of external borrowing are raised.

Definition of external borrowing

- 3.5 It is CIPFA's view that, throughout, the Prudential Code should be consistent with UK GAAP as applicable to the public services and embodied within the CIPFA/LASAAC *Code of Practice on Local Authority Accounting in the UK* (the SORP for the local authority sector). Certain elements of the SORP currently depart from UK GAAP, particularly in relation to capital finance, because of the

statutory framework for capital finance. These aspects are detailed in the SORP review, which has been completed by the CIPFA/LASAAC Joint Committee and published on the Technical pages of the CIPFA website (www.cipfa.org.uk). CIPFA hopes that it will be possible, as the prudential framework develops, to amend the statutory regimes to enable these divergences from UK GAAP to be removed.

3.6 It is also CIPFA's view that, wherever possible, the items used in the prudential indicators in relation to year-end 'actuals' should be capable of being read from the consolidated balance sheet or the consolidated revenue account of the local authority. This will assist clarity, transparency and ease of audit trail. The Finance Director of the local authority is responsible for signing and dating the Statement of Accounts, stating that it presents fairly the financial position of the authority at the accounting date and its income and expenditure for the year. Further, in England and Wales the authority must approve the Statement of Accounts. This provides a significant level of both assurance and accountability within a public report that is subject to external audit. It is recognised that this will require a procedure for authorities to follow to revise their prudential indicators when appropriate, which may be the case when the requirements within the SORP change as financial reporting develops.

3.7 In relation to external borrowing, the consolidated balance sheet must include on the face of the account:

- Borrowing repayable within a period in excess of 12 months, and
- Borrowing repayable on demand or within 12 month.

A required note to the account shows an analysis of the borrowing repayable within a period in excess of 12 months, by lender category and maturity:

- between one and two years
- between two and five years
- between five and ten years

- in ten years or more.

The maturity of borrowing is determined by reference to the earliest date on which the lender can require payment. All figures are included on an accruals basis.

- 3.8 It is proposed that the aggregation of both borrowing repayable within a period in excess of 12 months, and borrowing repayable on demand or within 12 months should in total form the first step in measuring actual external debt for the prudential indicator.
- 3.9 It is recognised that a counter view can be put that only longer term borrowing should be included, since as a broad rule of thumb this could be considered to reflect borrowing for a capital purpose; whereas short term borrowing is more likely to reflect borrowing for a revenue purpose of a temporary nature. This alternative view is not recommended because:
- there is no necessary congruence between short term borrowing and borrowing related to revenue
 - to exclude short term borrowing from the prudential indicator would introduce perverse incentives to skew treasury management decisions towards short term borrowing
 - both long and short term debt can be applied to capital expenditure
 - it is not possible from the balance sheet to distinguish between temporary revenue borrowing and borrowing for a capital purpose
 - nor is it possible to distinguish these on a day by day basis as cash flows are managed – this is only possible after the event, and then only notionally since individual elements of debt are not matched to individual elements of expenditure
 - both short and long term borrowing involve actual external debt
 - long term borrowing moves into to the ‘borrowing repayable on demand or within 12 month’ category in its final year.

3.10 It is recognised that the recommendation that the prudential indicator includes both short and long term borrowing will extend the prudential system beyond the purposes for which (in England and Wales) basic and supplementary credit approvals are given and (in Scotland) borrowing consents are given. It is considered that it is right that it should do so, for the reasons given above. It will be essential that both the framework for setting local prudential indicators and any limits imposed by central government take this fully into account.

3.11 Comments are requested on the definition of external borrowing proposed.

Gross and/or net of external investments

3.12 A key question is whether the prudential framework should measure external borrowing gross, or net of external investments. It is suggested that the inevitable conclusion to a debate on this is that both are important.

3.13 Views are requested on the proposal that the Prudential Code requires external borrowing to be measured gross, and net of external investments.

Investments

3.14 The SORP requires that, on the face of the balance sheet, the following be disclosed:

- long term investments, and
- (within current assets) investments

where

- a long term investment is an investment that is intended to be held for use on a continuing basis in the activities of the authority. Investments should be so classified only where an intention to hold the investment for the long term can clearly be demonstrated or where there are restrictions as to the investor's ability to dispose of the investment.

- investments which do not meet the above criteria should be classified as current assets and where all figures are included on an accruals basis.

The accounting policy required by the SORP in relation to investments is:

“Investments in listed and unlisted companies established for the promotion of local authority activities and in marketable securities should be carried at cost less provision, where appropriate, for loss in value. Investments held by pension funds should be carried at market value¹. Long-term investment should be identified separately on the face of the balance sheet. Dividends should be credited to revenue when received or receivable. Where the local authority’s investment in a company is unlikely to be recovered, the loss should be charged against a relevant reserve or written off to the appropriate revenue account.”

- 3.15 One possibility would be that the sum of both long term investments and other (within current assets) investments should in total be used for the prudential indicator. However, for many authorities, the inclusion of all long and short-term investments would include investments held for service purposes in addition to those held as part of the authority’s financing position.
- 3.16 It is therefore recommended that the definition of investments to be used within the Prudential Code is the sum of both long term investments and other (within current assets) investments except that investments that are held clearly and explicitly in the course of the provision of, and for the purpose of, operational services should be excluded.
- 3.17 Comments are invited on the definition of investments proposed.**

Other long term liabilities

¹ NB Investments held by pension funds are not included in the consolidated balance sheet, since 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.

- 3.18 It is recommended that the prudential framework includes other long term liabilities. One advantage of this is that, by doing so, the detailed statutory frameworks in England and Wales for the definition of what constitutes a credit arrangement could then be dismantled. The original purpose of credit arrangements was simple – to ensure that there was no incentive to enter into alternative forms of credit other than borrowing – ie to put all forms of credit onto the same footing vis-à-vis the control framework. However, over time, it has become increasingly apparent that the system is over complex, little understood and well due an overhaul.
- 3.19 CIPFA has recommended that reliance can be placed on UK GAAP, and specifically on the balance sheet of local authorities, to identify long term liabilities. A technical paper detailing the rationale for this view was included within CIPFA's comments to the consultations on local authority finance from the then DETR, National Assembly for Wales, and the Scottish Parliament. It is attached as Appendix D to this exposure draft.
- 3.20 Nationally, separate macro-economic indicators are collected inclusive and exclusive of other long term liabilities. Locally, the information sources for other long term liabilities will be different for borrowing and other long term liabilities. It will therefore be helpful to distinguish between the two within the prudential indicators.
- 3.21 It is recommended that the aggregate total of other long term liabilities identified on the face of the consolidated balance sheet be included within prudential indicators, separately from borrowing. (NB it is not intended to include the Government Grants Deferred Account in the prudential indicators.)
- 3.22 It is recognised that the government may wish to retain the power to specifically over-ride accounting practice and identify other items for inclusion within the prudential indicator. However, CIPFA would recommend that this power is not used as we believe that long term liabilities should be recognised only in accordance with UK GAAP and change only as UK GAAP develops, which in itself is achieved through established due process.
- 3.23 There is one exception to this, and that relates to local authority companies. The CIPFA/LASAAC Joint Committee is re-examining the approach in the SORP to the preparation of group accounts,

with a view to converging on the GAAP treatment. This could result in the preparation of local authority group accounts through full consolidation of subsidiaries. The net indebtedness of local authority regulated companies would thus impact on the picture given by the consolidated accounts. In addition, the gross income of local authority regulated companies would be relevant to measures of the revenue stream of local authorities. If this matter is resolved within the SORP before the prudential framework is introduced then it is recommended that no separate action will be needed or should be taken; however, if not, either the current or an alternative statutory framework for the identification of liabilities associated with local authority companies may be necessary on a temporary basis.

- 3.24 It is important to establish whether other long term contracts such as off balance sheet PFI deals should be included within the prudential indicator. Clearly, such contracts will be an important consideration, along with many others, within the overall finances of the local authority, but it is recommended that the prudential indicator, which relates to external debt, be clearly and explicitly linked to actual external borrowing and other long term liabilities, by associating it with only those items that are identified as such on the face of the consolidated balance sheet. The requirements for accounting in relation to private finance initiative and similar transactions are specified in an amendment to FRS 5, *Reporting the Substance of transactions*, that was published by the Accounting Standards Board in 1998. These have been incorporated as an appendix to the SORP.
- 3.25 Local authorities may have a number of long term revenue commitments, including PFI, that it will be important to take into account when considering the affordability of new capital investment. For some authorities, these will be large and significant elements of their on-going revenue stream. It would however be inappropriate to try to take these into account by attempting to find ways – other than UK GAAP – to add these to other long term liabilities within the Code. Rather, they should be dealt with through a consideration of revenue commitments and affordability – see section 4 paragraphs 4.42 to 4.47.
- 3.26 Views are requested on the proposed approach to other long term liabilities proposed.**

Transferred debt

- 3.27 A complication in using actual external debt within the prudential indicator is that some local authorities are managing debt which was transferred to them on reorganisation and which relates to a number of other local authorities as well as themselves. Whilst such arrangements continue, how should they be handled within a prudential framework?
- 3.28 One alternative is for the lead authority for the debt to reduce its figure for external debt and for each of the other authorities to increase theirs. The relevant figures should be identifiable from the local authorities' balance sheets. This would, however, dilute the principle of using the total of actual external debt for the prudential indicators.
- 3.29 A second alternative would be for each of the local authorities concerned to continue to use their actual figures but to take this into account when setting their prudential indicators. This is the recommended approach. This is on grounds of simplicity, to avoid adjustments and because the lead authority will also receive the income stream for the debt, so this will not affect affordability.
- 3.30 Comments are invited on the proposed treatment of transferred debt.**

Prudential indicator for a limit on gross external borrowing plus other long term liabilities

- 3.31 The Local Government and Housing Act 1989 requires *inter alia* that:
- “45(1) For the purposes of this Part, for each financial year every local authority shall determine-
- (a) an amount of money (in this part referred to as “the overall borrowing limit”) which is for the time being the maximum amount which the authority may have outstanding by way of borrowing;”
- 3.32 It should be noted that the above limit includes both short term and long term borrowing. It includes borrowing whatever its purpose. This is consistent with the approach recommended for the Prudential Code.

- 3.33 The limit has to be determined by the Council itself and not delegated to a Committee or officer. It must be determined before the beginning of the financial year to which the limit is to relate but may, again by the Council itself, be varied either before or after the beginning of that year.
- 3.34 Using this as a starting point, and transposing the requirement into the new prudential framework, it is recommended that the Prudential Code requires that the authority sets, before the start of every year the prudential limit that it will not exceed for gross borrowings; plus separately, the prudential limit that it will not exceed for other long term liabilities. Together, these limits will form the prudential indicator for a limit on external debt (external borrowings plus other external long term liabilities). It is recommended that the limit is set for the medium term (3 years for consistency with the proposals in section 4). It is recommended that the authority be able to determine to change the limit at any time.
- 3.35 Separate figures are recommended for external borrowings and for other long term liabilities both to assist transparency and also to facilitate monitoring in-year against the limits set. Also, some macro-economic indicators include both; other only borrowing.
- 3.36 Views are requested on the inclusion of a prudential indicator for a limit on gross external debt (borrowings plus other long term liabilities) within the Prudential Code.**

Prudential indicators for estimates of gross external borrowings plus other long term liabilities

- 3.37 It is suggested that a limit on gross external borrowings plus other long term liabilities is insufficient on its own. The first additional point to make is that it will be sensible for the local authority to ensure that the limit set can be comfortably lived within. Also, it will be the authority's prudential limit, and this may in many cases be greatly in excess of what the authority actually plans. This means that if all the limits set by all local authorities for a particular year are added together, the total will inevitably exceed (most probably by a significantly large amount) the likely total of gross borrowings and long term liabilities by all local authorities at

any point in the timeframe concerned. It is therefore not a helpful measure for forward planning within the authority, or for consideration vis-à-vis macro-economic indicators. It follows that, in addition to a prudential limit for external debt, estimates of most likely scenarios for actual gross borrowings and long term liabilities at each local authority over the medium term would be useful. The question then arises as to whether these should be estimates of averages, estimates of maxima, and/or estimates of opening and closing balances. It is suggested that they will be most useful locally, and for national macro-economic consideration, if estimates of maxima are required.

- 3.38 It is recommended that the Prudential Code requires local authorities to set prudential indicators before the beginning of the financial year which represent their estimates of the maxima for gross external borrowings and (separately) for other long term liabilities for the following three years. NB these indicators should represent totals, not marginal year on year increases/decreases. It is recommended that the authority be able to change these estimates at any time.
- 3.39 It is further recommended that the Prudential Code requires that the forward estimates of maxima for gross external borrowings and other long term liabilities are related to and take into account the authority's plans for forward capital expenditure (see section 4) and treasury management strategy (see *CIPFA Code of Practice for Treasury Management in the Public Services* and section 5 of this Code). In this way, prudential indicators for forward estimates for external debt and other long term liabilities will take into account both affordability considerations and good treasury management practices. Furthermore, the prudential indicators will provide a transparent framework for the authority for the purposes of accountability for the consequences of its actions vis-à-vis external debt (ie gross external borrowings plus other long term liabilities).
- 3.40 The Government has indicated that it may wish to have a power to apply a centrally determined "long stop" in relation to the external debt of local authorities, at least during the initial years of the new system. It will be for discussion and consultation between central and local government to determine how any such long-stop operates. CIPFA would suggest that if such a power is adopted, then the estimates of maxima that have been set locally for gross external borrowing and other long term liabilities are used as the

basis for consideration for any centrally determined limits. The centrally determined limit would then replace the authority's own prudent limit.

3.41 Views are requested on the role of forward estimates of maxima of gross external borrowing and other long term liabilities.

Prudential indicators for actual gross external borrowing plus other long term liabilities

3.42 It is recommended that there is a prudential indicator which identifies, after the year end, the closing balance for actual gross external debt plus (separately) other long term liabilities. This will be obtainable directly from the local authority's balance sheet.

3.43 Views are requested on the proposal for a prudential indicator for actual gross external borrowing plus other long term liabilities.

Ratios comparing external debt to value of fixed assets not appropriate

3.44 Local authorities incur capital expenditure on their own fixed assets. All local authority fixed assets except infrastructure and community assets are valued on the balance sheet at current value. Infrastructure and community assets are valued on the balance sheet at historical cost. Local authorities also incur capital expenditure on deferred charges. These are amortised from the balance sheet at an appropriate rate – in practice most are written off in the year that the expenditure is incurred since they have no on-going value to the authority itself.

3.45 It might be thought, therefore, that it would be appropriate to have a prudential indicator or indicators which involve ratio(s) of debt to the value of fixed assets. However, this is not recommended.

3.46 It should be remembered that local authorities are not permitted by statute to mortgage their assets to raise finance. Rather, all money borrowed by a local authority, together with any interest, is to be charged indifferently on all the revenues of the authority². This is a long standing feature of local government finance which is

² NB This relates only to borrowing

expected will continue in any new regulatory framework. It is therefore considered to be inappropriate to have any prudential indicators that compare the authority's debt with the value of their fixed assets.

3.47 Some commentators have further asked whether the Prudential Code should require that capital expenditure that relates to short lived assets or deferred charges should be required to be financed more quickly than other capital expenditure by requiring debt incurred as a result of such expenditure to be repaid within a certain time frame. However, individual loans are not, and should not be, associated with individual items of expenditure. Rather, the underlying issue raised by these concerns could and should be dealt with through making a charge for depreciation in the service revenue account and **not** reversing this charge out on consolidation of the accounts. A separate paper on the role that depreciation could play in the new system is being prepared.

3.48 Comments are invited on the proposal that there should be no prudential indicators involving ratios of debt to value of fixed assets.

Ratios comparing external debt to the authority's revenues stream

3.49 For reasons of accountability and transparency, and because all money borrowed by a local authority is to be charged indifferently on all the revenues of the authority, it is recommended that there should be prudential indicators based on the ratio of the one to the other.

3.50 Two things should, however, be emphasised. The first is that these will be only one type of indicator in a range of prudential indicators and the indicators should be considered together. The second is that the indicators for debt compare to revenue stream will not be particularly informative in relation to the issue of affordability. The issue of affordability is considered in paragraphs 4.42 to 4.47 of the draft Code.

3.51 A simple indicator based on gross revenues does not identify affordability in the sense of 'head room' for new borrowing. Furthermore, attempting to measure the 'head room' within the measure used for revenue would be self defeating in a prudential

system, in that it would make capital considerations the last element in what should be an overall budget process. It must also be remembered that the starting positions for individual local authorities will be very different.

3.52 It is therefore recommended that a simple measure of revenues is used for the purposes of prudential indicators. It is further recommended that this should be based on the gross revenue stream rather than on the net because a gross measure will:

- include the outcomes of any needs based/resource equalisation undertaken through central government revenue support mechanisms
- include the revenue stream provided by sales, fees and charges
- be consistent with the statutory basis whereby local authority borrowings are secured indifferently on all the revenues of the authority.

3.53 The question then arises as to whether any amounts should be excluded from the gross revenue figure for the purposes of the Prudential Code. A case can be made for excluding what are in effect transfer payments, where these are significant, such as mandatory awards and housing benefit. Many other items could be raised for consideration for exclusion for one reason or another, and in particular exceptional items. It can be argued that the advantages listed in 3.52 for gross figures, plus the virtues of simplicity, outweigh any arguments to the contrary and the gross figure should be used.

3.54 There are significant and relevant items that are excluded in a measure of gross revenue. These are capital receipts and the receipt of capital gains, neither of which go through the revenue accounts of local authorities. Therefore, measures of gross revenue stream exclude significant sources for capital expenditure. CIPFA would recommend that in the longer term the benefits of using a full UK GAAP approach is considered. However, this is unlikely in the short to medium term. It is proposed that on balance and to reflect current practice, capital receipts and capital grants should be considered within the section on capital and expenditure and commitments, as a source of cash for capital investment/debt redemption, rather than here.

3.55 The precise definition proposed for use for gross revenue for the purpose of the prudential indicators is, for the actual figure after the year end, the following amounts from the Consolidated Revenue Account:

- amount to be met from government grants and local taxpayers plus
- income above net cost of services.

Forward estimates would be needed on the same basis.

3.56 It is recommended that prudential indicators are required, comparing external debt to the authority's revenue stream in relation to each of the prudential indicators required above, ie

- limit on gross external borrowing plus other long term liabilities
- estimates of gross external borrowing plus other long term liabilities
- actual gross external borrowing plus other long term liabilities.

In each case this would be expressed as (gross external debt + other long term liabilities) ÷ gross revenue stream, with figures separately identified and totalled

eg $\frac{1,000 + 200}{800}$ or 1.5

3.57 IT HAS BEEN QUERIED WHETHER CIPFA SHOULD RECOMMEND AN UPPER LIMIT FOR THE PRUDENTIAL LIMIT RATIO AND THE PRUDENTIAL CODE STEERING GROUP IS ASKED FOR THEIR VIEWS ON THIS. AN ALTERNATIVE IS THE ENCOURAGEMENT OF BENCHMARKING BETWEEN LOCAL AUTHORITIES HAVING SIMILAR POWERS.

3.58 Comments are invited on the proposals for prudential indicators comparing external debt to the authority's revenue stream.

Prudential indicators and net borrowing

- 3.59 The view was taken in paragraph 3.12 that prudential indicators for borrowing will be required both gross and net of investments. Thus far, all of the prudential indicators recommended have involved gross borrowings. What is the role for net borrowing in a prudential system?
- 3.60 It is suggested that a prudential indicator based on the net position for the authority's borrowing is important. There is a long standing principle adopted by local authorities that borrowing should only be undertaken long term for a capital purpose and such a prudential indicator could be used to demonstrate compliance with this.
- 3.61 The view might be taken that no separate indicator is required for this objective because it is automatically achieved through the balanced budget requirement for local authorities. Certainly the balanced budget requirement is a very important control mechanism. However, it cannot guarantee that long term borrowing is only undertaken for a capital purpose for a number of reasons, including:
- local authorities may borrow for a temporary revenue purpose including, for example, where revenue monies are owed to them. The balanced budget requirement and proper practice means that any bad debts are written off to revenue. However, this does not preclude the situation where the revenue monies owed to a local authority are, over a long period, always greater than the revenue monies that the authority owes to others. This would, unless other cashflow is available, put the authority into the position of borrowing on a long term basis for a temporary revenue purpose, in which case long term borrowing may well occur
 - local authorities can make 'below the line' adjustments which are in accordance with statute but which mean that the balanced budget requirement cannot guarantee that long term borrowing is only undertaken for a capital purpose. For example, under the 1989 Act that applies in England and Wales, the DTLR has indicated that the provision for credit liabilities may be used to meet premiums on the early repayment of PWLB debt and the credit ceiling increased by the equivalent amount.

- 3.62 It is therefore recommended that prudential indicators are required for net borrowing in relation to the actual position at the year end and forward estimates for three years. NB other long term liabilities will not form part of these indicators. However, for completeness, cash in hand or overdrawn should be included for these indicators.
- 3.63 It is further recommended that the Prudential Code requires the local authority to ensure that at no time net external borrowing exceeds the total of capital expenditure already incurred but not yet financed in the preceding year plus the total amounts of capital expenditure planned for the current and next two financial years that the Finance Director has estimated will not be financed immediately (see section 4 for the definitions of these latter items). This will ensure that, over the medium term, net borrowings will only be for a capital purpose.
- 3.64 It is suggested that this proposed requirement is flexible enough to enable the local authority to sensibly manage its treasury management activities, including borrowing in advance of need if appropriate.
- 3.65 It is also suggested that it will not require any additional allowance specifically for borrowing for a temporary purpose, as it will be flexible enough to accommodate it.
- 3.66 Comments are invited on the proposed prudential indicators for net borrowing, and on the proposed requirement in paragraph 3.63.**

Transitional issues – exposure to external borrowing

- 3.67 On transition to the new system, local authorities may be concerned that a move to a measure of external debt and talk of a limit on increase in borrowing will curtail their options in the future to minimise their costs through good treasury management and best use of internal resources. This would be most regrettable and negate many of the benefits of the prudential system proposed. Specifically, local authorities may feel that their position is best protected by maximising their exposure to external borrowing within the current framework before the move to the new system, and thereafter continuing to maximise their exposure to – just in

case they need to do so in future and are not able to do so because of future externally determined limits.

- 3.68 It is suggested that this perverse incentive can be avoided if a guarantee is given that no external limit will be applied in the new system to a local authority if its net borrowings do not exceed the total of its actual capital expenditure already incurred / actually committed but not yet financed.

Transitional issues – credit ratings

- 3.69 CIPFA has taken the view that where local authorities borrow money on terms consistent with current statute, then the credit worthiness of all local authorities is exactly the same, and of a very high degree.
- 3.70 This view has come under the spot light on various occasions in the past. It is inevitable that it will do so again as the system changes.
- 3.71 It is expected that any new statutory provisions will retain the current 'safe harbour' provisions with respect to lending to local authorities.
- 3.72 It is the view of the Prudential Code Steering Group that the new system will not make it necessary or appropriate for all local authorities to seek their own credit ratings.

4 CAPITAL EXPENDITURE AND CAPITAL COMMITMENTS

Introduction

4.1 A prudential system for capital finance must consider capital expenditure and capital commitments as well as actual debt. There are a number of reasons for this. Important among them are:

- all capital expenditure, however financed, needs to be considered together as part of the authority's strategic management processes
- for capital expenditure that is not financed immediately (ie not financed from direct revenue contribution, capital receipts or capital grants) the cash flow of the authority and sensible treasury management will mean that external borrowing may not be necessary or appropriate immediately; it will be important for financial probity to have a record of capital expenditure that has been incurred and not yet financed, and to have a method of ensuring that it is financed in an appropriate and timely manner (NB borrowing does not finance the expenditure!)
- the total of capital expenditure incurred that has not yet been financed in a measure of the underlying resource gap within the local authority in relation to capital expenditure that will, over time, need to be financed. This is often thought of as the underlying long term indebtedness in relation to capital finance of the local authority in that, if the authority had no other cash flow available to it, external borrowing would be necessary for the full amount. It will be referred to in the Code as 'capital expenditure unfinanced'
- the total of capital expenditure incurred that has not yet been financed is a vital measure in terms of affordability since, in relation to capital expenditure, it is this that will have to be financed (ie afforded) over time. Its financing therefore needs to be one of the matters taken into account when new capital commitments are considered

- in addition to capital expenditure it will be important for medium and longer term planning to consider other ongoing revenue effects of the capital programme and this will be done as part of a consideration of capital commitments.
- 4.2 This section first considers the definitions in respect of capital expenditure and capital commitments that are to be used by local authorities in their consideration of prudential indicators. It is vital that measures for these key components of the prudential framework are clear and are applied consistently. The section then recommends the prudential indicators to be used and the matters to be taken into account in setting the prudential indicators. Finally, transitional issues from the current to the new system in respect of capital expenditure and capital commitments are raised.
- 4.3 CIPFA recommends that UK GAAP is adopted. The measurement of capital expenditure unfinanced as proposed in this draft has no equivalent within UK GAAP and therefore it may seem odd that it is recommended for use. However, it is clear that there is no current policy to allow gains and losses on the disposal of fixed assets by local authorities to flow through the revenue account. Also, whilst there is a commitment to consider the matter of depreciation, it is not clear whether and when depreciation will be allowed to flow through to the bottom line. It is within this context that a measure of capital expenditure unfinanced is recommended, to offer the necessary level of assurance within a prudential framework. It should be noted, however, that nothing in this draft should be read as implying that specific loans should be associated with specific assets. This is not recommended.

Definition of capital expenditure

- 4.4 It is CIPFA's view that, throughout, the Prudential Code should be consistent with UK GAAP as applicable to the public services and embodied within the CIPFA/LASAAC *Code of Practice on Local Authority Accounting in the UK* (the SORP for the local authority sector). Certain elements of the SORP currently depart from UK GAAP, particularly in relation to capital finance, because of the statutory framework for capital finance. These aspects are detailed in the SORP review, which has been completed by the

CIPFA/LASAAC Joint Committee and published on the Technical pages of the CIPFA website. CIPFA hopes that it will be possible, as the prudential framework develops, to amend the statutory regimes to enable these divergences from UK GAAP to be removed.

- 4.5 It is recommended that the definition for capital expenditure for use within a prudential system should begin with all those items that either should or may be capitalised under the SORP. This may change over time as UK GAAP changes. For example, the requirements of FRS 15, *Tangible fixed assets*, were introduced into the SORP from financial year 2000/2001. In all cases, both the development of the ASB's financial reporting standards and the development of the SORP follow due processes and consultation mechanisms. It will be important that the CIPFA Prudential Code is fully aligned with the SORP. It is recognised that this will require a procedure for authorities to follow to revise their prudential indicators when appropriate, which may be the case when the SORP changes and financial reporting develops.
- 4.6 The SORP requires that capital expenditure, as well as revenue expenditure, is accounted for on an accruals basis. In contrast, the current control frameworks operate on a cash basis for capital. For full alignment with the SORP, it is recommended that the Prudential Code requires that prudential indicators are calculated on an accruals basis.
- 4.7 In the current control frameworks, the government can specifically over-ride accounting practice and identify other items as being capital expenditure for the purposes of financing. It is recognised that the government will wish to retain this power in the new system. Indeed, because of the nature of local authority expenditure, combined with the separation in local authority finance between capital and revenue resources, it is likely that this power will be used for significant items of expenditure. These items are treated as deferred charges rather than fixed assets in the accounts of local authorities. In particular, it is suggested that consideration be given as to whether or not any of the following items that would not be capitalised under UK GAAP should continue to be capitalised for financing purposes, and therefore by the Prudential Code, by statute:

- the making of advances, grants or other financial assistance to any person towards expenditure incurred or to be incurred by him on items of a capital nature, eg improvement grants
- the acquisition of share capital or loan capital in any body corporate
- various items currently defined in regulations in England and Wales as expenditure for capital purposes, eg the carrying out of thermal insulation that would not be capitalised were it not for the regulations
- expenditure capitalised by Secretary of State direction, eg costs of major restructurings
- private finance transactions.

In relation to the last of these items, private finance transactions, the current position is odd in that most private finance transactions are expected to be off balance sheet, therefore expenditure on them revenue expenditure, but in England and Wales the expenditure is then required by statute to be treated as capital expenditure.

4.8 In the current control frameworks, the government can also specifically over-ride accounting practice and identify items as not being capital expenditure for the purposes of financing. It is recognised that the government may wish to retain this power in the new system. However, CIPFA would recommend that this power is not used.

4.9 Comments are invited on the definition of capital expenditure proposed.

4.10 NB Issues related to other long term liabilities – ‘quasi borrowing’ / ‘credit arrangements’ – are covered in section 3.

Capital expenditure unfinanced

4.11 Capital expenditure already made (ie cash basis) but not yet financed (plus in England and Wales credit arrangements) play an important role in the current capital control frameworks. For the reasons outlined in the introduction to this section, it is

recommended that capital expenditure unfinanced (accruals basis) plays an important role in a new prudential framework.

- 4.12 In respect of any statutory replacement for the minimum revenue provision (England and Wales) / loans fund debt charges (Scotland), CIPFA would recommend that further consideration is given either instead or at a later date, to making a proper provision for depreciation rather than having such a statutory replacement. A separate paper is being prepared on this subject. However, if a statutory replacement is created, it is recommended that this should use capital expenditure unfinanced (accruals basis), either at the start or the end of the financial year, as its base line for the authority to calculate the amount to be charged to revenue.
- 4.13 It is recommended that other long term liabilities be dealt with separately in a prudential system. It is recommended that these are defined as being other long term liabilities identified on the balance sheet and that these should be charged to the bottom line as they are actually removed from the balance sheet. The current practice in England and Wales whereby repayments in relation to (most) credit arrangements is that these are effectively reversed out from the bottom line and replaced with the amount required for the minimum revenue provision. The logic behind this is understood (to put credit arrangements onto an equal footing with borrowing) but it has led to some very odd results in practice.
- 4.14 Capital expenditure unfinanced cannot on practical grounds be calculated on an ongoing basis but only at a period end. Traditionally in local authorities this is done once a year, after the year end. In particular, financing is only undertaken after the year end and this can have significant advantages in resource optimisation. It can be argued that a more frequent calculation would assist control. However, this would have a substantial cost.
- 4.15 It is recommended that the Prudential Code requires that capital expenditure unfinanced (actually incurred – accruals basis) is required to be calculated once a year, after the year end; and that in addition the Prudential Code requires that the Finance Director establishes arrangements for the in-year monitoring of capital expenditure and income against budget. 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.

4.16 Comments are invited on the proposed recommendation that capital expenditure is required to be calculated once a year, with in-year monitoring of capital expenditure and income against budget.

4.17 It is important to have a clear and consistent method for the calculation of capital expenditure unfinanced. In CIPFA's responses to the green papers in England and Wales we said that:

“The opening balance of unfinanced capital expenditure incurred at the start of the new system is likely to be the closing credit ceiling. However, the individual circumstances of each local authority will need to be examined by that authority and agreed with its external auditor. For example, credit approvals can currently be used to justify credit arrangements as well as borrowing and for those authorities opening adjustments may be necessary to better reflect unfinanced capital expenditure.”

The equivalent in Scotland would be the outstanding balance on the loans fund. A memorandum account would then need to be kept from this opening balance.

4.18 However, further work has now been undertaken on this matter and a method of calculating capital expenditure unfinanced from the balance sheet is possible and is recommended. A balance sheet method is transparent and has a clear audit trail. The alternative of starting with the credit ceiling (England and Wales)/outstanding balance on the loans fund (Scotland) could be problematic, particularly with respect to the credit ceiling and the necessity in some local authorities to make adjustments going back many years.

4.19 The balance sheet method recommended is that capital expenditure unfinanced is calculated by consolidating:

- fixed assets
- deferred charges
- fixed asset restatement reserve
- capital financing reserve

— government grants deferred.

4.20 It is recognised that some of the accounts in the balance sheet calculation are those where concerns have been raised about consistency of treatment. However, these have been concerns such as whether to make a contra entry to the capital financing reserve or to the fixed asset restatement reserve, and any such uncertainties will be cancelled out by totalling all of the accounts listed.

4.21 It is also recognised that it is possible to total the 'cash' elements of the balance sheet rather than the 'capital' elements to reach the same answer. This, by definition, must be true. However, the method proposed is preferred as it relates directly to capital items. Its intention is to identify all the capital related balances in the balance sheet and to bring them together in a capital 'imbalance' sheet, ie it gives a figure for the cash deficit/surplus on capital transactions. The same figure would result by starting with external debt and adding or subtracting revenue balances. Either approach can be used in practice for in-year estimates, but the capital approach is recommended for the formal calculation.

4.22 Comments are invited on the proposed method of calculation for capital expenditure unfinanced.

Capital expenditure committed but not incurred

4.23 It is sometimes necessary for a local authority to have regard to capital expenditure that is already committed but not incurred. For example, a local authority that is experiencing unforeseen expenditure difficulties, or reductions in budgets due to loss of grant or other income may, internally, put a moratorium on capital expenditure that is not already committed.

4.24 However, the definition of capital expenditure committed but not incurred is not as straight forward as it initially sounds. At one extreme, it could be taken to include any individual capital project on which expenditure has already been incurred, eg where work has been commenced on phase 1 of the project but where contracts for phase 2 and phase 3 (which are required to complete the project) have not been let. At the other extreme, it could taken to include only works that have been contractually committed.

4.25 It is recommended that for the purposes of the Prudential Code it is this latter restricted and literal interpretation of committed that is used. No separate prudential indicator is proposed for capital expenditure committed but not incurred, but it may be necessary for the authority to calculate this in certain circumstances.

4.26 Views are requested on the proposed definition of capital expenditure already committed but not incurred.

Looking forward, the level of capital expenditure that the local authority plans in total

4.27 This is where the Prudential Code directly ties in with the strategic planning processes for the local authority, with asset management and with service delivery. For local authorities in England, the DTLR has introduced specific requirements in relation to asset management plans and capital strategies. Whilst the detailed format will vary, all local authorities throughout England, Wales and Scotland will (or should) have their own asset management plan and capital strategy as part of their standard management processes.

4.28 It is of prime importance that the Prudential Code links into the strategic planning, asset management and service delivery of the local authority in a sensible way and without introducing perverse incentives to those activities.

4.29 It is recommended that the Prudential Code requires that local authorities, before the beginning of the financial year, approve a medium term plan for capital expenditure for the year ahead and for, as a minimum, the following two years (ie for a minimum of three years in total). This ties in with the fact that the government publishes the relevant funding figures for three years. The total amounts planned for each year would be prudential indicators required by the Prudential Code. The matters to be taken into account when setting these prudential indicators is considered in paragraphs 3.36 to 3.41 below.

4.30 Comments are requested on whether looking forward a minimum of three years is the right timeframe for the Prudential Code to adopt in relation to the level of capital expenditure that the authority plans.

4.31 It is also proposed that the Prudential Code requires that the Finance Director estimates and reports to Council before the beginning of the financial year, an estimate of how much of the total capital expenditure for each of the three years will be:

- (a) financed from direct revenue contributions
- (b) financed from capital receipts
- (c) financed from capital grants
- (d) not financed immediately and for which therefore, potentially, depending on the authority's cash flow and treasury management strategy, external borrowing may be required.

4.32 The purpose of requiring these estimates is that they are necessary for a consideration of the affordability of the authority's capital plans.

4.33 It is emphasised that these figures will be estimates. They do not commit the Finance Director to the estimates when the actual financing is done. Also, they will be a rolling three year set of estimates, so that they reflect the best available information at the time. It is recommended that the estimates are required background information to the prudential indicators for capital expenditure planned.

4.34 It is further recommended that the Prudential Code requires that, after the end of the financial year, the Finance Director determines how all capital expenditure incurred in the year is to be treated in respect of financing. All capital expenditure will be required to be put into one of the following categories:

- (a) financed from direct revenue contributions
- (b) financed from capital receipts
- (c) financed from capital grants
- (d) not financed immediately and for which therefore, potentially, depending on the authority's cash flow and treasury management strategy, external borrowing may be required.

4.35 Comments are invited on the proposed approach to estimates of capital financing and actual capital financing.

Matters to be taken into account in capital planning

4.36 This exposure draft of the Prudential Code has recommended (see paragraph 4.29) that prudential indicators are set for total capital expenditure planned for a minimum of three years ahead.

4.37 It is recommended that the Prudential Code requires that in setting or revising these prudential indicators, the authority is required to have regard to the following matters:

- option appraisal for all projects, ie value for money
- asset management plan, ie stewardship of assets
- strategic plan for the authority, ie service objectives
- achievability of the forward plan, ie its practicality, eg timescale, construction constraints, skills constraints
Guidance would be needed on how ‘slippage’ of projects should be treated within a prudential framework.
- implications for external borrowing, ie prudence
- the level of financial resources available and expected to become available to the local authority; and the ability of the authority to finance both the capital expenditure (whether immediately or over time) and the revenue consequences of the capital expenditure, ie affordability. NB affordability will need to be considered in the context of all revenue pressures.

4.38 Are there other matters that the Prudential Code should require the local authority to take into consideration when setting its prudential indicators for capital expenditure?

4.39 It is proposed that detailed requirements on how to approach the final two matters listed in paragraph 4.37, prudence and affordability are primary roles for the Prudential Code.

4.40 It is proposed that detailed guidance on the other matters listed in paragraph 4.37 are not included within the Prudential Code.

4.41 Prudence was discussed in Section 3. The question of affordability is addressed here.

Affordability

4.42 The basic 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.

4.43 Matters which are relevant to a consideration of affordability include:

- 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 staffing, PFI commitments, PPP schemes and operating leases
- planned change to revenue, whether growth or savings
- how much flexibility the authority's capital expenditure plans leave for future spending priorities, whether capital or revenue
- whatever supercedes the current requirements for minimum revenue provision (England and Wales)/loans fund repayments (Scotland)
- estimates of total interest costs less 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.

4.44 Much of the detail in relation to affordability will depend on the outcomes of the current reviews into local authority finance and in particular:

- whether support for capital expenditure is in future given through capital grant or ‘supported borrowing’ and the extent, if any, of the hypothecation of such support
- whether the resourcing of depreciation is introduced or alternatively the nature of the statutory replacement for minimum revenue provision/loans fund repayments.

4.45 It is recommended that the Prudential Code requires that, in considering the affordability of its capital plans, the authority considers all of the resources currently available to it/estimated for the future, together with the totality of its expenditure plans, both capital and revenue.

4.46 It is further recommended that detailed guidance on this is a matter for guidance notes rather than the Code.

4.47 Comments are invited on the approach with respect to affordability proposed.

Transitional issues

- 4.48 The SORP requires that capital expenditure, as well as revenue expenditure, is accounted for on an accruals basis. However, the current capital control frameworks operate on a cash basis. It is proposed (see above, paragraph 4.6) that the prudential framework for capital expenditure and financing operates on an accruals basis. In order to bring this about, in the first year only of the new system, the financing system will need to deal with two sets of accruals: items that were accrued in the previous year for accounting purposes but excluded from the control framework (for BCAs etc) on a cash basis, and items that are accrued at the year end. Prudential controls set locally and any long-stop central controls will all need to take this into consideration in the first year of operation of the new system.
- 4.49 It is proposed that where there are differences between the definition of capital expenditure under the current control framework as compared with the Prudential Code, any expenditure incurred (ie accruals basis) in the financial years before the introduction of the new framework that was capitalised under the old control frameworks should continue to be treated as capital expenditure in the new framework in respect of being able to be financed from capital resources. Conversely, any expenditure incurred (ie accruals basis) in the financial years before the introduction of the new framework that was not able to be capitalised under the old control frameworks should continue to be treated as revenue expenditure in the new framework in respect of not being able to be financed from capital resources.
- 4.50 Views on the proposed treatment with respect to accruals at the point of transition are requested.**

5 TREASURY MANAGEMENT

Introduction

- 5.1 One of the key objectives for the Prudential Code is that the Code should provide a framework within which treasury management decisions can be taken in accordance with best treasury management practice and without introducing perverse incentives that skew decision making away from best practice. The treasury management activity of a local authority is what links the authority's capital expenditure / commitments (see section 4) and external debt (see section 3). Therefore, the manner in which these sections of the Code operate will be instrumental in achieving this objective. In addition, any prudential indicators for treasury management need to be consistent with this objective. It is vital not to place too much emphasis on numerical treasury management prudential indicators in isolation from good practice processes.

CIPFA Treasury Management Code

- 5.2 CIPFA has published a *Code of Practice for Treasury Management*. This provides a framework for good practice for treasury management. The CIPFA *Code of Practice for Treasury Management in Local Authorities* was originally published in 1992 and revised in 1996. CIPFA also published codes and guides for other public services. Recently, CIPFA has been preparing, through the work of the CIPFA Treasury Management Panel, a *Code of Practice for Treasury Management in the Public Services*, which will replace the existing sector specific codes. The new Code has now been approved by the Institute Council with a recommended start date of 1 April 2002.
- 5.3 The *Code of Practice for Treasury Management in the Public Services* (the TM Code) is a high level document that sets out the key recommendations and practices to be followed by an organisation in its treasury management activities. The TM Code defines treasury management activities as:

“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.”

5.4 The TM Code makes four key recommendations:

“Key Recommendation 1

Public service organisations should put in place formal and comprehensive objectives, policies and practices, strategies and reporting arrangements for the effective management and control of their treasury management activities.

Key Recommendation 2

Their policies and practices should make clear that the effective management and control of risk are prime objectives of their treasury management activities.

Key Recommendation 3

They should acknowledge that the pursuit of best value in treasury management, and the use of suitable performance measures, are valid and important tools for responsible organisations to employ in support of their business and service objectives; and that within the context of effective risk management, their treasury management policies and practices should reflect this.

Key Recommendation 4

In order to achieve the above, organisations should:

- (1) adopt the 4 clauses in Section 5 [of the TM Code]**
- (2) adopt a Treasury Management Policy Statement, as recommended in Section 6 [of the TM Code]**
- (3) follow the recommendations in Section 7 [of the TM Code] concerning the creation of Treasury Management Practices (TMPs).”**

- 5.5 The TM Code requires that the organisation (ie for local authorities full Council) will receive reports on its treasury management policies, practices and activities including, as a minimum, an annual strategy and plan in advance of the year, and an annual report after its close.
- 5.6 It is recommended that the first prudential indicator for treasury management in local authorities should be that the local authority has adopted the CIPFA TM Code for use within its own authority. The adoption of the TM Code will set the context for treasury management activity within the authority. Making this the first prudential indicator for treasury management will obviate the need to reproduce the requirements of the TM Code within the Prudential Code.
- 5.7 It is further recommended that within the framework established by the TM Code, the Prudential Code should specify other prudential indicators which each local authority would be required to set for its treasury management activities.
- 5.8 Should the first prudential indicator for treasury management be that the local authority has adopted the CIPFA Code of Practice for Treasury Management in the Public Services (the TM Code)?**
- 5.9 Should the Prudential Code specify, within the framework established by the TM Code, other prudential indicators which each local authority would be required to set for its treasury management activities?**

Objectives for treasury management activities

- 5.10 The TM Code stresses the overriding importance of effective risk management as the foundation for treasury management in all public service bodies.
- 5.11 The TM Code also encourages the pursuit of best value in treasury management, and promotes the reasoned use, development and appreciation of appropriate and practical measures of performance.

5.12 It is the Institute's view, expressed within the TM Code, that throughout the public services the priority is to protect capital rather than to maximise return. The avoidance of all risk is neither appropriate nor possible. However, a balance must be struck with a keen responsibility for public money.

5.13 The TM Code states:

“... the successful identification, monitoring and control of risk [are] the prime criteria by which the effectiveness of [an organisation's] treasury management activities will be measured”

and

“... effective treasury management will provide support towards the achievement of (an organisation's) business and service objectives.”

Source: Recommended forms of words for a Treasury Management Policy Statement.

5.14 By implication, therefore, undesired consequences of treasury management in the public services would be:

- (a) failure to identify, monitor and control risk properly, and
- (b) lack of support for business/service objectives.

It is recommended that the Prudential Code should seek to create a framework for these to be avoided. The first of these is of prime importance – the other is secondary to this but is nevertheless important.

5.15 By way of example to illustrate the TM Code states that an “... organisation will manage its exposure to fluctuations in interest rates with a view to containing its interest costs, or securing its interest revenues, in accordance with its budgetary arrangements.”

The TM Code also states that it will do so “... primarily to create stability and certainty of costs and revenues, but at the same time

retaining a sufficient degree of feasibility to take advantage of unexpected, potentially advantageous changes in the level and structure of interest rates”

The former is the authority’s prime objective, the latter is secondary. Prudential indicators should seek to measure both, but should reflect the TM Code’s clear priorities.

It will, of course, be for each local authority, in setting its own prudential indicators, to determine how precisely the balance should be struck.

5.16 Should the Prudential Code seek to create a framework for the undesired consequences identified in paragraph 5.14 to be avoided? Does it achieve this?

5.17 Joint working between the Treasury Borrowing Committee and the Capital Programmes Working Party [insert when done – has led] to the publication of a report on a review of local authority investments. [Insert here what the report says about the general principles and aims that should govern local authority investments.]

5.18 Insert here conclusions re 5.17.

5.19 Insert here question re 5.17.

Short-list of prudential Indicators for treasury management

5.20 The following five short listed indicators follow the TM Code’s proposed Treasury Management Practices (TMPs).

5.21 The short listed indicators are:

- (a) the adequacy of an authority’s liquidity (TMP 1(1))
- (b) the structure of its interest rate exposures (TMP 1(2))
- (c) the structure of its maturities for its borrowings (TMP 1(6))
- (d) the security of its principal (TMP 1(9))
- (e) the control over its future interest liabilities (TMP 7).

5.22 Comments are invited on which of the short listed indicators for treasury management should be adopted

within the Prudential Code; and on the detail of the indicators.

Indicator (a) – the adequacy of an authority’s liquidity

5.23 TMP 1(1) suggests the following form of words for liquidity risk management:

“This organisation will ensure it has adequate, though not excessive, cash resources, borrowing arrangements, overdraft or standby facilities to enable it at all times to have the level of funds available to it which are necessary for the achievement of its business/service objectives.”

Local authorities, of course, do not borrow (except for temporary cashflow reasons) for revenue purposes, and traditionally have had little or no need for standby facilities.

5.24 Local authorities in England and Wales are required under S45 of the 1989 Act to set annually a short-term borrowing limit.

5.25 The practices of local authorities concerning the levels of cash held vary considerably from authority to authority, influenced often by the results of past asset sales, especially in respect of housing.

5.26 The high level of cash held by some authorities has often been the result of past peculiarities in the capital controls system, which have created the conditions for authorities to retain, rather than utilise, surplus cash. The skills of investment managers have supported this phenomena.

5.27 It is assumed that revisions to the capital controls system will in future create a basis on which decisions on appropriate levels of cash holdings will be capable of being made by local authorities on wholly objective and rational grounds.

5.28 A prudential indicator of liquidity (ie cash plus short-term investments) would identify not only the minimum level of cash necessary to meet potential liquidity shortages resulting from cash flow troughs, but also the maximum level needed to satisfy wider business and service objectives. The two figures may be

the same; but the latter may be considerably higher than the former. It will be for each authority to determine the appropriate level or levels of liquidity, influenced *inter alia* by its budgeted requirement for investment and interest income, its perception of the likely future structure and course of interest rates, and the confidence it has in its cash and cash flow monitoring/forecasting systems.

- 5.29 Prudential indicators might reasonably be set not only as a statement of intended minimum or maximum accounts at any one point in the year, but also as an average throughout the year.

Indicator (b) – the structure of an authority's interest rate exposure

- 5.30 It is a statutory requirement in England and Wales under S.45 of the 1989 Act that local authorities determine, before the beginning of the financial year to which it relates, a limit on the proportion of interest which is to be subject to variable rates of interest. Whilst there is no equivalent legislation in Scotland, it is recommended as good practice.
- 5.31 Although local authorities apply these limits in practice to loans outstanding, statute requires it to be stated as a proportion of the total amount of interest payable.
- 5.32 These statutory arrangements represent an important element of a prudential system for managing and controlling interest rate exposures.
- 5.33 However, it is suggested that they do not successfully address the question of whether an authority has denied itself an opportunity to provide support towards its business/service objectives. The 1989 Act provisions were designed to encourage authorities to consider carefully whether caution should dictate their placing a limitation on their exposure to variable interest rates, especially when rates were volatile and/or fixed rates were high.
- 5.34 The 1989 Act provisions, moreover, relate only to borrowings. In reality, many local authorities already manage their exposures to interest rates by integrated strategies which cover both their borrowings and cash investment activities, a practice which it is recommended should become universally adopted.

5.35 It is suggested that prudential indicators for managing interest rate exposures might need not only to cover the 1989 Act provision, but might need also to establish a framework for

- (a) identifying undue caution by a local authority, and
- (b) recognising the value of an integrated approach to local authorities' interest rate management strategies.

5.36 There is a question surrounding the period which prudential indicators for managing interest rates should cover – a rolling (say) 3 year strategy could lead to a more reasoned assessment by an authority of the effects of likely interest rate scenarios, and take better account of the authority's medium-term business and service issues.

Indicator (c) – the structure of an authority's maturities for its borrowings

5.37 TMP 1 (6) of the TM Code reports the need for maturity profiling in order to obtain offer terms of loan renewals which are competitive and favourable.

5.38 Local authorities must include on the face of the consolidated balance sheet details of borrowings repayable with a period in excess of 12 months, and those repayable on demand or within 12 months.

5.39 A required note shows an analysis into 4 categories of the borrowing repayable within a period in excess of 12 months, by lender category and maturity, viz:

1 – 2 years

2 – 5 years

6 – 10 years, and

10+ years,

5.40 It is suggested that this provides a basis for a prudential indicator on maturities for borrowings, subject to an authority setting maximum percentages of maturities by amount within any one

period. Different percentages are likely to be appropriate for different periods of maturity. Minimum as well as maximum percentages may be appropriate.

- 5.41 It is already not unusual for authorities to state as a matter of policy that in no one year will maturities exceed (say) 20% of total borrowings. Actual practices in this respect will inevitably vary from authority to authority, and will be a function, inter alia, of their particular view of such matters as forthcoming political and economic events, both domestically and internationally.

Indicator (d) – the security of an authority’s principal

- 5.42 TMP 1 (9) states the need for a policy to provide protection against “adverse market fluctuations in the value of the principal sums (an organisation) invests” compromising its “stated treasury management policies and objectives”.
- 5.43 It is not uncommon for local authorities to seek to enhance their cash investment returns by using the gilt markets – and a few are said to have invested in securities issued by other highly credit-rated issues and institutions.
- 5.44 There is an issue as to whether there needs to be a prudential indicator which, for example, might put an upper limit on the proportion an authority can invest in investments which are the subject of fluctuations in market value. A lower limit may also be appropriate.
- 5.45 There would seem to be some merit in such an indicator. It would be for the local authority to determine the limit(s) in the light of the anticipated improvement in investment returns and on professional competence and market skills of those undertaking its investment management activities. It is already common practice for local authorities to set upper limits, particularly where they are using firms of investment managers.

Indicator (e) – the control over an authority’s future interest liabilities

- 5.46 The suggested prudential system for external debt includes a measure related to a local authority’s revenue stream.

- 5.47 There is similarly a case to be made for an indicator to measure an authority's future liabilities for interest payments, related to total revenue streams.
- 5.48 A suggested basis is that the authority determines an upper limit on the projected interest payments, including on commitments, as a percentage of the authority's revenue stream over, say, a 3 year period.
- 5.49 The limit could be set as an absolute figure and/or a limit on the change from a previous period. Depending on the previous period levels, the limit could be either positive or negative. The acknowledgment of the possibility of a negative limit would reinforce the principle that a prudential indicator should reflect the authority's business/service objectives, as well as its prime intention to manage and control risk.

6 PROCESS ISSUES

Process issues for setting and revising prudential indicators

- 6.1 The Prudential Code should establish a clear governance procedure for the setting and revising of the recommended prudential indicators. This will assist transparency and, crucially, will ensure accountability.
- 6.2 It is recommended that the Prudential Code requires that all the prudential indicators required by the Code are set, and where they are revised, revised, by the Council and that this cannot be delegated to any committee/group of or individual elected member/officer of the Council.
- 6.3 It is recommended that the prudential indicators in relation to external debt and capital expenditure/commitments for future years are required to be set when the Council's budget is set; and that prudential indicators for the previous year are included within the Council's published statements of account. NB The latter would require inclusion within the local authority accounting SORP which has a due process separate from the Prudential Code – therefore if this approach is supported CIPFA will need to make recommendation to the CIPFA/LASAAC Joint Committee for its inclusion within the SORP.
- 6.4 It is recommended that the Prudential Code requires that the prudential indicators in relation to treasury management for future years are required to be set when the Council agrees its treasury management strategy; and that the Prudential Code requires that those for the previous year are included within the annual report to Council on treasury management activities.
- 6.5 The Council would be able to revise the current and future year's prudential indicators at any time.
- 6.6 It is recommended that the Prudential Code requires that the prudential indicators for the current year are reviewed and, if necessary, revised when the Council sets its budget (for external debt and capital expenditure / commitments indicators) and when it agrees its treasury management strategy (for treasury management indicators).

- 6.7 These recommendations give clear accountability for the prudential indicators to the Council.
- 6.8 They also give a clear role in the preparation of the prudential indicators to the Finance Director of the Council.
- 6.9 **Comments are invited on the process recommended with respect to the setting and revising of prudential indicators.**

Process issues for monitoring

- 6.10 It is recommended that the Prudential Code requires that the Finance Director establishes procedures to monitor performance against all of the prudential indicators.
- 6.11 Within this general principle, the following should be noted in respect of prudential indicators and external debt:
- in respect of the prudential indicator for a limit on gross external debt (borrowings plus other long term liabilities), it is recommended that where the Finance Director forms the view that the limit is likely to be breached that a report to Council is required. It will then be for the Council to determine if it would be prudent to raise the current prudential limit or, alternatively, to instigate procedures to ensure that the current limit is not breached. It is suggested that it would be good practice for the Finance Director to establish a warning system to the executive of a 'yellow card' nature, ie warning of problems before they become severe
 - in respect of the prudential indicators for estimates of maxima it should be emphasised that these are estimates. It will probably not be significant if these estimates are breached temporarily on occasions due to variations in cashflow. However, a sustained trend above the estimated maxima would be significant and should lead to further investigation and action as appropriate
 - 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.

6.12 Comments are invited on the process recommended with respect to the process for monitoring.

7 SUMMARY OF CONSULTATION

7.1 Comments are invited on any aspect of the draft Code and particularly on the questions highlighted in bold in the text. For ease of reference, these questions are reproduced here:

[Final list to be inserted here on publication]

7.2 Comments on this exposure draft of the Prudential Code should be sent to CIPFA by **[date and detailed address contact points to be inserted here]**.