

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



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FOREWORD

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.

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.

It is hoped and intended that the CIPFA Prudential Code will apply throughout England, Wales and Scotland; and will have statutory backing throughout.

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.

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 listed at the end of the draft Code.

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].

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 and the Institute's Technical Committee].

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</i>
<i>Reference Group</i>	
Ken Barnes	<i>South Norfolk DC, TMP, Society District</i>
<i>Council Treasurers</i>	
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Maureen Wellen	<i>CIPFA, Secretary.</i>

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

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PREFACE

CIPFA has prepared this [draft] Prudential Code in order to underpin a new system of capital finance for local authorities. It provides a framework within which local decision making can operate with respect to the matters covered by the [draft] Code, ensures transparency and accountability for the decisions taken, and provides assurance to Ministers and local taxpayers on the affordability and prudence of the decisions taken. It supports local strategic planning, asset management planning and option appraisal; thereby significantly contributing to the modernisation agenda and best value in service delivery.

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

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

[DRAFT] PRUDENTIAL CODE FOR CAPITAL FINANCE IN LOCAL AUTHORITIES

OBJECTIVES

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

(a) all external borrowings and other long term liabilities are within prudent and 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 [draft] Code should be consistent with and support:

(e) local strategic planning

(f) local asset management planning

(g) proper option appraisal.

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

- external debt
- capital expenditure plans
- treasury management.

PRUDENTIAL INDICATORS

- 3 The local authority shall set and monitor against the specified prudential indicators (paragraphs 8 - 23) in accordance with the matters required to be taken into account (paragraphs 24 - 33), the due processes to be followed (paragraphs 34 - 45) and in accordance with the definitions specified (paragraphs 46 – 59).**
- 4 Prudential indicators for the forthcoming financial year and subsequent two financial years must be set before the beginning of the financial year. They may be revised at any time following the same due process.
- 5 Prudential indicators may take the form of limits, estimates or actual figures. Prudential indicator is the generic term.
- 6 The prudential indicators specified are the minimum required. Local authorities may set further prudential indicators if they wish, and are encouraged to do so where this would assist their own management processes. However, any additional prudential indicators set locally should not, unless required to do so by statute, associate any part of the authority's external borrowing with particular item(s), category (ies) or purpose(s) of expenditure. The authority should have an integrated treasury management strategy within which its borrowings are managed.
- 7 The prudential system is primarily designed to be managed and controlled by local authorities themselves. However, 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. Any centrally determined limit would then replace the authority's own limit for that figure, unless the authority locally sets a lower limit.

External debt

- 8 The local authority will set for the forthcoming financial year and the following two financial years a prudential limit for its total external debt, gross of any investments, separately identifying borrowing from other long term**

liabilities. During the financial year in question this prudential indicator shall be referred to as:

Prudential limit for external debt = prudential limit for borrowing + prudential limit for other long term liabilities

for years 0, 1 and 2.

- 9 The local authority may wish to authorise, in any particular year, a level of external debt that is lower than its prudential limit. The local authority will therefore also set for the forthcoming financial year and the following two years an authorised limit for its total external debt, gross of investments, separately identifying borrowing from other long term liabilities. During the financial year in question this prudential indicator shall be referred to as:**

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

For years 0, 1 and 2.

The authorised limit must be equal to or less than the prudential limit in respect of each separately identified element.

- 10 The local authority will calculate reasonable estimates of the maxima for gross external borrowings and (separately) for other long term liabilities for the forthcoming financial year and the following two financial years. During the financial year in question these prudential indicators shall be referred to as:**

Estimates of maxima for borrowing for years 0, 1 and 2

And

Estimates of maxima for other long term liabilities for years 0, 1 and 2.

- 11 After the year end, the closing balance for actual gross borrowing plus (separately) other long term liabilities will be obtained directly from the local authority's**

balance sheet. This prudential indicator shall be referred to as:

Actual external debt as at xx/xx/xx = actual borrowing as at xx/xx/xx + actual other long term borrowing as at xx/xx/xx.

- 12 After the year end, the ratio of financing costs to net revenue stream will be calculated directly from the local authority's consolidated revenue account. This prudential indicator shall be referred to as:**

Financing costs : net revenue stream.

Capital expenditure and capital commitments

- 13 The local authority will make reasonable estimates of the total of capital expenditure that it plans to incur during the forthcoming financial year and at least the following two financial years. During the financial year in question these prudential indicators shall be referred to as:**

Estimate of total capital expenditure to be incurred in years 0, 1 and 2 (and 3 etc if applicable).

- 14 Forward estimates of capital expenditure will include any capital expenditure that it is estimated might (depending on option appraisals) or will be dealt with as other long term liabilities.

- 15 The local authority will make reasonable estimates of total capital expenditure unfinanced at the end of the forthcoming financial year and the following two years. During the financial year in question these prudential indicators shall be referred to as:**

Estimate of capital expenditure unfinanced as at the end of years 0, 1 and 2.

- 16 The estimates of capital expenditure unfinanced at the end of each year will relate to all capital expenditure – ie they include capital expenditure unfinanced that was incurred in previous years.

- 17 The estimates will not commit the local authority to particular methods of financing. The Chief Finance Officer will determine the actual financing of capital expenditure incurred once a year, after the end of the financial year.

- 18 After the year end, the actual capital expenditure unfinanced will be calculated directly from the local authority's balance sheet. This prudential indicator will be referred to as:**

Actual capital expenditure unfinanced.

Treasury Management

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

20 Before the start of the financial year, the local authority will set, for the forthcoming year and the following two years, both upper and lower limits for its variable and fixed interest rate exposures calculated as follows and expressed as a percentage of borrowing less investments:

Variable rate exposures

(Total borrowing repayable within a period in excess of 12 months that is at variable rates) + (total borrowing repayable on demand or within 12 months)

Less

(Investments that are variable rate investments) + (investments that are fixed rate investments maturing within 12 months).

Fixed rate exposures

(Total borrowing repayable within a period in excess of 12 months that is at fixed rates)

Less

(Investments that are fixed rate investments that mature in a period in excess of 12 months).

During the financial year in question, these prudential indicators shall be referred to as the upper and lower limits for variable interest rate exposures and for fixed interest rate exposures.

21 Before the start of the financial year, the local authority will set for the forthcoming year both upper and lower limits with respect to the maturity structure of its borrowing, calculated as follows

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

**Expressed as a percentage of
Total projected borrowing that is fixed rate at the
start of the period.**

Where the periods in question are

- in excess of 12 months and within 24 months**
- in excess of 24 months and within 36 months
and so on by annual increments until**
- in excess of 10 years.**

**These prudential indicators shall be referred to as
prudential limits for the maturity structure of borrowing.**

- 22 Where a local authority invests, or plans to invest, for
periods longer than 364 days, the local authority will
before the start of the year set an upper limit for each
forward year for which the authority projects the
maturing of such investments, calculated as**

**Total principal sum invested to final maturities
beyond the period end
Less
Projected average cash balances in the period.**

**These prudential indicators shall be referred to as
prudential limits for principal sums invested for periods
longer than 364 days.**

- 23 In all cases, the process of setting prudential indicators for treasury
management should be accompanied by a clear and integrated
forward treasury management strategy, and a recognition of the
pre-existing structure of the authority's borrowing and investment
portfolios.**

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

Overall

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

- **option appraisal for all projects, ie value for money**
- **asset management planning, ie stewardship of assets**
- **strategic planning for the authority, ie service objectives**
- **achievability of the forward plan, ie its practicality**
- **implications for external borrowing, ie prudence**
- **implications for Council Tax, ie affordability.**

25 Further detailed requirements in respect of prudence and affordability are given below since these are primary roles for the [draft] Code. However, all the matters listed above must be taken into account when setting or revising prudential indicators.

Affordability

26 **The fundamental objective in the consideration of the affordability of the authority's capital plans is to ensure that the level of investment in capital assets proposed means that the total capital investment of the authority remains within sustainable limits, and in particular to consider its impact on the local authority's 'bottom line', its impact on the Council Tax.**

27 **In considering the affordability of its capital plans, the authority is required to consider all of the resources currently available to it/ estimated for the future, together with the totality of its expenditure plans, both capital and revenue for the forthcoming year and the following two years.**

28 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 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 and interest receivable. These should be the estimates of the actual amounts of interest that will be expended and received, based on the authority's estimates for actual external debt.
- 29 The requirements in paragraphs 26 and 27 imply the development of three year revenue plans and three year forward estimates of Council Tax, as well as three year capital expenditure plans. NB These are rolling plans, not fixed for three years.

Prudence

- 30 **By virtue of the requirements already listed above, the prudential indicators in respect of external debt must be set and revised taking into account their affordability. It is through this means that the objective of ensuring that external debt is kept within sustainable, prudent limits is addressed.**
- 31 The final two items listed in paragraph 28 of the [draft] Code will be particularly pertinent here.

- 32 Where the full year effect of capital projects will not be felt within a three year time frame, the local authority will need to have regard to the full year effects of the scheme when considering affordability.
- 33 In order to ensure that over the medium term net borrowing will only be for a capital purpose, the local authority should ensure that at no time net external borrowing exceeds the total of capital expenditure unfinanced in the preceding year plus the estimates of capital expenditure unfinanced for the current and next two financial years.**

PROCESS ISSUES

Setting and revising prudential indicators

- 34 Prudential indicators, other than actuals that are taken from information in the local authority's statement of accounts, are required to be set and, where they are revised, revised by the same body that sets the budget for the local authority.**
- 35 The prudential indicators for the forthcoming and following years must be set before the beginning of the forthcoming year. They may be revised at any time, following due process, and should be revised for the current year when the prudential indicators are set for the following year.**
- 36 Prudential indicators for treasury management should be considered together with the local authority's treasury management strategy and the annual report on treasury management activities.**
- 37 Prudential indicators for external debt and capital commitments for previous years are to be taken directly from information in the local authority's statements of accounts.**
- 38 If an item in the authority's statement of accounts that is relied on for a prudential indicator is the subject of audit qualification, this must be highlighted when prudential indicators are set or revised.

- 39 Prudential indicators for external debt and capital expenditure/commitments should not be set or revised in isolation from one another, but considered together. It would be logical for these to be considered when the budget for the local authority is set.
- 40 The Chief Finance Officer is responsible for ensuring that matters to be taken into account are reported to the decision making body for consideration. In relation to the local authority's statement of accounts, the Chief Finance Officer is responsible for signing and dating the statement, and for stating that it presents fairly the financial position of the authority at the accounting date and its income and expenditure for the year ended.
- 41 The [draft] Code establishes a clear governance procedure for the setting and revising of prudential indicators. This assists transparency and ensures accountability.

Monitoring against prudential indicators

- 42 **The Chief Finance Officer is required to establish procedures to monitor performance against all forward looking prudential indicators in paragraphs 8 – 23 plus the requirement specified in paragraph 33.**
- 43 With regard to prudential indicators and external debt:
- in respect of the prudential indicators for the authorised limits on external debt, where the Finance Director forms the view that a limit is likely to be breached a report to the decision making body is required. It will then be for the decision making body to determine if it would be prudent to raise the current limit or, alternatively, to instigate procedures to ensure that the current limit is not breached. It would be good practice for the Chief Finance Officer to establish 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 or regular 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.

44 In respect of prudential indicators and capital expenditure/capital commitments, 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.

45 The Chief Finance Officer should make arrangements for daily monitoring with respect to the requirement re net borrowing in paragraph 33. Any deviation from the requirement may be significant and should lead to further investigation and action as appropriate.

DEFINITIONS

46 These definitions shall be used for all purposes connected with the [draft] Code, and in particular shall be used by the local authority in setting, revising and monitoring against their prudential indicators.

47 It is intended that, throughout, the definitions used in respect of the [draft] Code will be consistent with UK generally accepted accounting practice (UK GAAP) as applicable to the public services and embodied within the CIPFA/LASAAC *Code of Practice on Local Authority Accounting* (the SORP), except where statute requires otherwise. The SORP changes over time, particularly as UK GAAP and/or the statutory framework for local authority finance changes. In all cases, the development of the SORP follows

due process and consultation. It is important that the [draft] Code is aligned with the SORP. Therefore, many of the definitions that follow cross refer to amounts that are required to be included within a local authority's statement of accounts in accordance with the SORP. In relation to previous years, this means the version(s) of the SORP applicable to the year(s) involved. In relation to the current year or estimates for future year, this means the current SORP. Where changes to the SORP significantly affect the prudential indicators this fact should be highlighted by the local authority when setting or revising the indicators. If any figures in the authority's statement of accounts that are used in prudential indicators are subject to audit qualification this fact should be highlighted when any prudential indicators are set or revised.

48 Borrowing

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

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

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

NB See also transferred debt (paragraph 59 below).

49 Capital expenditure

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

50 Capital expenditure committed but not incurred

For the purposes of the [draft] Code, capital expenditure committed but not incurred refers only to capital expenditure that has been contractually committed and that has not been incurred.

51 Capital expenditure unfinanced

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

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

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

52 Debt

For the purposes of the [draft] Code, debt refers to the sum of borrowing (see above paragraph 48) and other long term liabilities (see below paragraph 57).

53 Financing costs

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

- interest payable with respect to borrowing¹
- interest payable under finance leases and any other long term liabilities¹
- gains and loses on the repurchase or early settlement of borrowing
- interest and investment income²

¹ These items are required by the SORP to be charged to the asset management revenue account. The notes to the consolidated revenue account require information on the nature and amount of all material transactions to the asset management revenue account if not disclosed on the face of the account.

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

54 Investments

Actual figures for investments for previous years should start with the sum of the amounts on the local authority's consolidated balance sheets³ for

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

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

55 Net borrowing

For the purposes of the [draft] Code, net borrowing refers to borrowing (see above paragraph 48) net of investments (see above paragraph 54).

NB See also transferred debt (paragraph 59 below).

56 Net revenue stream

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

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

² For consistency, any interest or investment income from investments excluded from prudential indicators in accordance with the definition for investments below (see paragraph 54) should be excluded here.

³ NB The SORP requires that the consolidated balance sheet should include the assets and liabilities of all activities of the authority, excluding the pension, trust, common good (in Scotland) and similar funds administered for third parties, therefore investments held by these funds will not be included.

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

57 Other long term liabilities

The definition of other long term liabilities starts with items classified as long term liabilities on the local authority's balance sheet (ie other than borrowing repayable within a period in excess of 12 months). To this must be added any amounts that are determined by statute to be other long term liabilities that would otherwise not be so classified and from which must be subtracted any amounts that are determined by statute not to be other long term liabilities that would otherwise be so classified (referred to below as statutory adjustments). Prudential indicators for previous years should be taken from the local authority's balance sheets as amended for any statutory adjustments. Prudential indicators for current and future years should be calculated in a manner consistent with this definition.

58 Treasury management

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

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

59 Transferred debt

Some local authorities are managing debt that was transferred to them on reorganisation and which relates to a number of other local authorities as well as themselves. While such arrangements continue, such local authorities (ie those managing the transferred debt) should include these amounts in their prudential indicators, except that these amounts should be netted off only when calculating net borrowing for the purposes of paragraph 33 of this [draft] Code.

