



## REPORT

Committee PRUDENTIAL CODE STEERING GROUP

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Subject Responses to the exposure draft of the Prudential Code

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### PURPOSE

**To discuss and consider the responses received to the exposure draft of the Prudential Code and an initial summary analysis of the responses received.**

### REPORT

- 1 The exposure draft of the Prudential Code was published in December 2001 with requests for responses by 4 March 2002. In the event, responses were being received throughout March and all are included in this analysis. A total of 116 responses were received. A list of the respondees is attached as Appendix A to this report.
- 2 Copies of all responses received have been separately circulated to members of the Prudential Code Steering Group for discussion at the meeting. A summary analysis of the responses is attached as Appendix B to this report.

*Please note – the summary analysis of the responses is being published on the CIPFA website; the copies of the responses received are not.*

### RECOMMENDATION

**The Steering Group is asked to discuss and consider the responses received to the exposure draft of the Prudential Code and the attached initial summary analysis of the responses received.**

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## SUMMARY ANALYSIS OF RESPONSES TO EXPOSURE DRAFT OF PRUDENTIAL CODE

### 1 RESPONSES RECEIVED

1.1 A total of 116 responses were received to the exposure draft of the prudential code that was published by CIPFA in December 2001.

1.2 The total number of responses received comprise:

- 85 from local authorities in England
- 4 from local authorities in Wales
- 10 from local authorities in Scotland
- 9 from local authority treasurers' groups
- 1 joint response from the DTLR and HM Treasury
- 1 from the Local Government Association
- 3 from Audit bodies
- 1 from Sector treasury management services
- 2 from credit rating organisations

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**116**

[NB local authorities include police and fire authorities]

1.3 The remainder of this appendix provides a summary analysis of the responses received from each category of resposdee listed above in paragraph 1.2.

### 2 SUMMARY ANALYSIS OF RESPONSES RECEIVED FROM LOCAL AUTHORITIES IN ENGLAND

#### Responses received

2.1 85 responses were received. These include joint responses from the GLA and its functional bodies, and from East Sussex County Council and East Sussex Fire Authority.

#### Overall response

2.2 The majority of responses received from local authorities in England are generally supportive. For example:

“The Authority welcome the proposals detailed in the consultation paper, which will represent a major move forward in the management of local authority capital finance. It will also help in ensuring that local authorities have the power to determine what capital investment level is required locally.”

**“The Prudential Code Steering Group is to be congratulated on the work that has been undertaken so far as the draft Code forms an excellent basis for the new regime.”**

**“I support the proposed Code, in the hope that it will empower Local Authorities to make real investment decisions, and properly appraise their options for delivering services. Too often, inability to invest has led to excessive maintenance costs, or priorities have been skewed in response to the availability of grant funding.”**

- 2.3 A minority of responses (10 in total) express disappointment. All but one of these are supportive of the principles of the prudential framework but generally feel that the current draft code is unnecessarily complex in a counter-productive manner.**

**“It would be unfortunate if the Code made Treasurers long for the good old days of borrowing approvals.”**

**Many others who are generally supportive of the draft code would like to see some simplification.**

- 2.4 One local authority expressed grave reservations overall.**

**“This Council considers that CIPFA should advise the Government that its current plans for local authority capital finance are radically flawed by the failure to link the issues of Government grant and affordability.”**

- 2.5 The overall tenor of the majority of the responses is characterised by the following.**

**“Most of the proposed Code is acceptable and I have only a few reservations.”**

Comments on matters external to the Code — government support for capital investment

- 2.6 32 responses specifically raise the issue of central government support for capital investment within the prudential framework. The general view that is expressed is that chief finance officers need to have forward information about this in order to be able to sensibly advise on matters of affordability.

Comments on matters external to the Code – the ‘long stop’ control

- 2.7 16 responses express concern about this, either being completely against a long stop provision or highlighting the need for greater clarification.

Responses to question 1 in the exposure draft – Does the [draft] Code achieve the objectives set out in paragraph 1?

- 2.8 Of the 47 responses that directly address this question, 38 consider either that the code achieves the objectives set out or that it generally does so with some reservations. 9 responses do not consider that the code achieves the objectives set out because of its current complexity or because CIPFA ought to set or indicate the maximum limits for local authorities.
- 2.9 Other comments received in answer to this question are that there are currently too many indicators, and that more guidance is needed on looking ahead beyond a 3 year time frame.

Responses to question 2 in the exposure draft – Do you have any comments on the detail of any of the prudential indicators proposed in the draft Code?

Debt

- 2.10 A common comment is that there is no need for (or that there is a need to explain the need for) 3 different levels in relation to debt – prudential limits, authorised limits and estimates of maxima. This is raised in 27 responses.
- 2.11 Little concern, however, is raised about the proposal within the code to concentrate on total debt.
- 2.12 Little concern is raised about the inclusion of other long term liabilities.
- 2.13 Some third of the responses express a variety of concerns about the proposed ratio of financing costs to net revenue stream, for example:
- more guidance is needed on the proposed HRA split
  - don’t net off investment income in the financing costs
  - not a good indicator of overall affordability

- financing costs should be expressed net of government support for capital
- use gross revenue stream
- definition of net revenue stream requires clarification
- use of reserves clouds the issue that it is intended to measure.

#### Capital expenditure

- 2.14 35 responses raise issues in relation to capital expenditure unfinanced, principally either that the term itself is misleading and/or that more guidance is needed on questions of its definition and/or meaning.
- 2.15 Little concern is raised about the proposal for forward plans for capital expenditure.

#### Treasury management

- 2.16 29 responses comment either that there are far too many prudential indicators within the current draft in relation to treasury management, or that reliance on the TM Code is sufficient in itself without the need for further indicators.
- 2.17 A large number of detailed comments are made on the specifics of the indicators proposed including:
- there are too many divisions for time periods of maturities
  - why is there a need for both upper and lower limits?
  - wide bands for the indicators will be meaningless; narrow will be too constraining
  - some confusion with respect to the 364+ indicator proposed
  - don't net off borrowing and investments (11 responses)
  - use absolute figures not percentages
  - treat amounts managed externally separately.

Response to question 3 in the exposure draft – Are there further matters that should be taken into account when setting or revising prudential indicators, over and above those specified in the draft Code?

- 2.18 Most responses are either silent on this point or specifically express content.
- 2.19 Various detailed points are raised by about a third of responses. Only one point is raised by several authorities (7 responses) – reservation with respect to 3 year forward estimates of Council Tax.

Response to question 4 in the exposure draft – Do you agree with the view taken in the draft Code with respect to the need to ensure that over the medium term net borrowing will only be for a capital purpose?

- 2.20 45 responses specifically agree with this view and only 1 response is specifically against it.
- 2.21 Very few responses argue against the measure proposed. However, several state that daily monitoring for it is unnecessary.

Response to question 5 in the exposure draft – Do you have any comments on the processes proposed for setting and revising prudential indicators and for monitoring against prudential indicators?

- 2.22 22 responses express specific support for the processes proposed in the draft code.
- 2.23 No responses argue with the thrust of the processes proposed. However, several request further guidance on where the Chief Finance Officer should take monitoring reports, several would prefer the indicators to be set by the Executive/Cabinet rather than full Council, and two consider that some of the treasury management indicators could be set by the Chief Finance Officer.
- 2.24 A particular issue is raised in the response from the GLA and its functional bodies. It reports that in accordance with the GLA Act, the Mayor of London approves the budget requirement for the GLA and its functional bodies (the London Assembly can make amendments with a two thirds majority). The question is raised therefore as to whether the GLA should set the prudential indicators for the entire GLA group or whether the GLA and each functional body should set its own indicators.

Response to question 6 in the exposure draft – Do you have any comments on the detail of the definitions proposed (especially capital expenditure unfinanced)?

2.25 A number of definitional issues are raised in individual comments including:

- how to define investment for operational purposes
- the need to establish how to treat local authority companies
- the treatment of long term debtors (eg loans to RSLs) vis-à-vis capital expenditure unfinanced
- the treatment of applied government grants and S106 contributions
- should investments include investment property?
- how to treat government grants deferred
- how to treat deferred purchase schemes
- how to treat PFI schemes
- how to treat premiums
- how to treat deferred capital receipts
- how to treat school balances
- definition of other long term liabilities requires clarification in the new system
- definition of deferred charges requires clarification in the new system.

#### Other comments

2.26 A number of individual responses raise other issues, including:

- the role of the external auditor requires clarification
- more guidance is needed on the issue of affordability
- medium term planning and linkages between capital and revenue are welcome
- the Code needs to be written in a clearer style so that it will be understood by Members
- a plain English guide for members would be helpful and would assist transparency
- the principle of substance over form should be stated explicitly in the Code
- the market will inevitably use PIs to form their own credit assessment of local authorities
- historical levels of debt will impact on these comparisons
- concern from several authorities, especially Police authorities, about the impact of FRS 17 on PIs
- need to have PIs for longer than 3 years
- introduce commercial style retentions practices within the new framework
- CIPFA should revise its guidance on capital accounting to be consistent with the new framework
- how will the PWLB operate in the new system?
- it is important that both the Code and government controls operate on an accruals basis
- opposition to using PIs in league tables
- need to establish what will replace MRP
- need to establish how HRA interfaces with the Code

- will the Code be compulsory on all authorities and does it need to be on those with no long term debt?
- CIPFA should specify some acceptable ratio levels
- investigate whether the Code will be robust in periods of high inflation
- concerns re external debt in the lead up to the new system – paragraph A.50 in the appendix to the Code is important in this respect.

2.27 The response from CIPFA’s primary contact on capital accounting matters with the RICS welcomes the draft prudential code and the importance placed on asset management planning within the draft code. It also comments that a vital part of option appraisal is the valuation of assets.

#### A final illustrative comment

2.28 “The abolition of the current system of statutory capital controls is very much welcomed. Local authorities have for many years sought proper local accountability for decision making involving capital investment and capital controls have largely prevented the flexibility required to deliver this. It is therefore important that local government responds positively to the opportunities brought about by the removal of statutory controls, especially in the light of the major reforms currently proposed through the White Paper. The Prudential Code will need to provide the reassurances required by Central Government that individual authorities should have the relative freedom to act without unnecessary external constraint, but with due regard for accepted levels of financial prudence. Whilst certain aspects of the Code appear fairly onerous (and we do feel some of the proposed indicators could be reduced/re-defined), the underlying expectation is very reasonable – ie that each authority should have in place medium term spending and resourcing plans and a sound Treasury Management Strategy which will both highlight and address potential financial risks. The “reward” for operating the provisions of the Code will in effect be the financial flexibility which authorities will ultimately benefit from, in order to deliver local priorities. We should not lose sight of this.”

### 3 SUMMARY ANALYSIS OF RESPONSES RECEIVED FROM LOCAL AUTHORITIES IN WALES

#### Responses received

3.1 4 responses were received.

Responses to question 1 in the exposure draft – Does the [draft] Code achieve the objectives set out in paragraph 1?

3.2 All of the 3 responses that address this question answer it in the affirmative.

- 3.3 One response adds that treasury management should however be seen as a separate activity, since it has too often in the past been mixed with capital financing to its detriment.

Responses to question 2 in the exposure draft – Do you have any comments on the detail of the prudential indicators proposed in the draft Code?

- 3.4 One response states that there are generally too many indicators.

Debt

- 3.5 One response comments on the need to explain the differences between the 3 levels proposed and the relationship between them. Another suggests using net rather than gross figures.

- 3.6 In relation to the ratio of financing costs net revenue stream one response comments that net revenue stream excludes the HRA, although the HRA debt forms part of debt, which could distort issues of affordability. It also queries the treatment of premiums that have been charged to the PCL.

Capital expenditure

- 3.7 Two responses state that the term capital expenditure unfinanced is confusing and that another name should be found.

Treasury management

- 3.8 As noted above in paragraph 3.3, one response suggests that treasury management should be seen as a separate activity. This response further suggests putting issues relating to treasury management into an appendix to the Code as related controls.

Response to question 3 in the exposure draft – Are there further matters that should be taken into account when setting or revising prudential indicators, over and above those specified in the draft Code?

- 3.9 2 of the 3 responses that address this question do not suggest further matters. The third states that the phrase ‘have regard’ needs to be clarified, and that affordability tests should take into account the running costs of fixed assets as well as financing charges.

Response to question 4 in the exposure draft – Do you agree with the view taken in the draft Code with respect to the need to ensure that over the medium term net borrowing will only be for a capital purpose?

- 3.10 All 3 of the responses that address this question answer in the affirmative.

Response to question 5 in the exposure draft – Do you have any comments on the processes proposed for setting and revising prudential indicators and for monitoring against prudential indicators?

- 3.11 2 responses address this question. One has no comment at this stage. The other states that the responsibility is rightly placed on the Authority, but that it is important to spell out explicitly the role of the Chief Finance Officer.

Response to question 6 in the consultation draft – Do you have any comments on the detail of the definitions proposed (especially capital expenditure unfinanced)?

- 3.12 One response emphasises that more guidance is needed with respect to other long term liabilities.

## Other comments

- 3.13 Local authorities in Wales make few comments on matters external to the code. One response comments that financial support from the Welsh Assembly Government for future capital investment needs to be clarified.
- 3.14 One response suggests that there should be some externally set benchmarks for the new system, as it may otherwise be difficult for chief finance officers to argue for restrictions on the capital programme on the basis of assumed risk.
- 3.15 One response states that CIPFA will need to change its guidance on capital accounting in order to match any changes in the code.

## 4 SUMMARY ANALYSIS OF RESPONSES RECEIVED FROM LOCAL AUTHORITIES IN SCOTLAND

### Responses received

- 4.1 10 responses were received.

### Overall response

- 4.2 The great majority of responses are overall supportive of the draft Code.

“Overall the Code is to be welcomed. I believe that it will lead to better and more informed decision making on capital expenditure and will allow authorities to invest according to the needs and wishes of the population of their area rather than the arbitrary decisions of central government. I do hope that the Scottish Executive are similarly persuaded.”

- 4.3 One response states that the Code must not be over prescriptive and must be easy to understand and to operate.

### Comments on matters external to the Code – government support for capital investment

- 4.4 Half of the responses raise this as an issue.

Comments on matters external to the Code – the ‘long stop’ control

- 4.5 4 responses express concern about this, either being completely against a long stop provision or highlighting the need for greater clarification. A further 2 responses accept that such a provision is needed but stress that it must be used only as a long stop and not to replace existing controls.

Response to question 1 in the exposure draft – Does the [draft] Code achieve the objectives set out in paragraph 1?

- 4.6 7 of the 8 responses that address this answer in the affirmative.
- 4.7 One response states that more guidance is needed on how to set the prudential indicators with respect to affordability and prudence. Specifically, concern is expressed that items that are affordable in the short term may not be in the long term interests of the authority.

Responses to question 2 in the exposure draft – Do you have any comments on the detail of the prudential indicators proposed in the draft Code?

Debt

- 4.8 3 responses comment that there is no need for (or there is a need to explain) the 3 different levels in relation to debt.

Capital expenditure

- 4.9 6 responses state that capital expenditure unfinanced is hard to understand. One response supports the treatment and considers it to be clear.

Treasury management

- 4.10 4 responses consider that there are too many indicators in relation to treasury management and/or that they are too prescriptive.

Response to question 3 in the exposure draft – Are there further matters that should be taken into account when setting or revising prudential indicators, over and above those specified in the draft Code?

**4.11 Individual responses make the following suggestions:**

- make a clear link between prudential indicators and the capital programme
- add in a specific reference to best value
- authorities should have their own parameters and guidelines to judge variations by and if appropriate report on variations.

Response to question 4 in the exposure draft – Do you agree with the view taken in the draft Code with respect to the need to ensure that over the medium term net borrowing will only be for a capital purpose?

**4.12 7 of the 8 responses that address this question agree with this view. The other states that if sound debt policies and budgeting are in place, any cash flow differences will be immaterial anyway.**

**4.13 2 responses query the need for daily monitoring.**

Response to question 5 in the exposure draft – Do you have any comments on the processes proposed for setting and revising prudential indicators and for monitoring against prudential indicators?

**4.14 The processes are generally supported. One response suggests not prescribing that the budget setter also sets the prudential indicators. Another comments that while the processes for setting and revising the indicators are well set out, the processes for monitoring are less defined and each authority will need to establish their own if there are no nationally presented processes for this.**

Response to question 6 in the consultation draft – Do you have any comments on the detail of the definitions proposed (especially capital expenditure unfinanced)?

**4.15 A number of definitional issues are raised in individual comments:**

- the treatment of loans fund expenses
- the definition of capital expenditure, especially in relation to deferred charges requires clarification
- the definition of other long term liabilities is not clear
- in respect of capital expenditure unfinanced the position of
  - capital contributions deferred

- premiums
- other long term debtors.

#### Other comments

#### 4.16 A number of individual responses raise other issues including:

- the treatment of premiums
- the treatment of the HRA
- support for 3 year budgeting
- further clarification is needed on the treatment of companies
- the role of external audit should be clarified
- will loans fund accounting be replaced?  
(NB This is specific to Scotland)
- clarification is required with respect to joint boards
- league tables are probably inevitable
- more guidance on risk would be helpful
- link indicators set to changes in Council Tax
- capital accounting should move closer to the new system.

#### 4.17 Half of all responses raise the need to clarify the role of the PWLB in the new system.

### 5 SUMMARY ANALYSIS OF RESPONSES RECEIVED FROM LOCAL AUTHORITY TREASURERS' GROUPS

#### Responses received

#### 5.1 Responses were received from:

- CIPFA Scottish Directors of Finance Section
- Police Authority Treasurers' Society
- Society of County Treasurers
- Society of District Council Treasurers
- Society of London Treasurers
- Society of Municipal Treasurers
- Special Interest Group of Municipal Authorities  
(Outside London) – SIGOMA
- Unitary Treasurers
- CIPFA Scotland Treasury Management Forum.

#### 5.2 The high level of responses from treasurers' groups and the consideration that they have given to their responses is indicative of considerable interest in the development of the prudential framework overall, and of the prudential code in particular.

#### 5.3 Overall the responses from treasurers' groups is welcoming of these developments. There is firm support for the developing prudential framework and prudential code. There is an overall view that the code could be more clearly drafted, and simpler in places. It needs to be understood by non-

finance staff, members and taxpayers or it will be seen as a technical document mainly for finance staff which is not the intention. In relation to the wider prudential framework, there is a high level of concern that the system of future government support for capital investment be established and be consistent with the forward planning demanded by the system.

Comments on matters external to the code – government support for capital investment

- 5.4 All of the responses from treasurers' groups except for one, which does not raise any points extraneous to the code itself, raise this as a vital issue to be resolved for the new system.

Comments on matters external to the code – the 'long stop' control

- 5.5 Two thirds of the responses raise this issue. Most that do so are against this provision, seeing it as running counter to the principles of the prudential system. Two responses accept the need for a long stop provision but stress that it must only be used as a long stop, not to replace existing controls.

Response to question 1 in the exposure draft – Does the [draft] Code achieve the objectives set out in paragraph 1?

- 5.6 The majority of the responses are broadly content that the draft code achieves its objectives.
- 5.7 The Society of Municipal Treasurers and SIGOMA do however raise concerns in this respect. These are broadly: that it will be difficult to assess affordability over the long term because of the lack of knowledge of future funding from the government; that the government will have the power to over-ride local decision making; and that the sheer number of indicators may hinder their achievement and overall transparency.

Responses to question 2 in the exposure draft – Do you have any comments on the detail of the prudential indicators proposed in the draft Code?

Debt

- 5.8 Two thirds of the responses comment that there is no need for (or that it is unclear why there is a need for) 3 different levels in relation to debt.
- 5.9 In relation to the proposed ratio of financing costs to net revenue stream, 3 responses include the need to clarify net revenue stream. One response points out that since the definition of financing costs includes investments this figure will be negative for some authorities. In Scotland, it is the view that financing costs should include debt management expenses.

Capital expenditure

- 5.10 Two thirds of the responses include the view that there is a need for further guidance with respect to capital expenditure unfinanced.
- 5.11 The Police Authority Treasurers suggest separate indicators for capital expenditure funded by grant/third party contributions.

Treasury management

- 5.12 Two thirds of the responses consider that there are too many indicators in respect of treasury management and/or that reliance can be placed on the CIPFA TM Code without the need for further prudential indicators.
- 5.13 A number of the responses make detailed comments on how the indicators for treasury management could be simplified, which broadly mirror those listed in paragraph 2.17 of this appendix. It is also suggested that the 3 separate indicators in paragraph 27 of the draft Code would be usefully combined into one indicator.

Response to question 4 in the exposure draft – Do you agree with the view taken in the draft Code with respect to the need to ensure that over the medium term net borrowing will only be for a capital purpose?

- 5.14 Two thirds of the responses address this point and all that do so agree with this view.
- 5.15 Concern is expressed that local authorities need to be able to meet their cashflow requirements and some short periods of revenue borrowing may be necessary. Also, the system needs to be able to cope with exceptional situations where this becomes longer than short term.

Response to question 5 in the exposure draft – Do you have any comments on the processes proposed for setting and revising prudential indicators and for monitoring against prudential indicators?

- 5.16 The overall tenor of the responses from treasurers' groups is that, as currently drafted, the processes are too prescriptive and that there should be more discretion for authorities to establish their own arrangements.

Response to question 6 in the consultation draft – Do you have any comments on the detail of the definitions proposed (especially capital expenditure unfinanced)?

- 5.17 There is a particular issue in Scotland where loans fund accounting is still a requirement. Its treatment in the new system needs to be clarified.
- 5.18 There is a need to clarify the definition and meaning of capital expenditure unfinanced.
- 5.19 Individual responses also raise:

- the need to clarify what constitutes other long term liability for debt
- how to treat companies
- treatment of PFI.

Other comments

5.20 Individual responses raise other issues, including:

- the new system will provide an opportunity to simplify capital accounting
- 3 year budgeting linked to the code is welcomed
- clarification is needed with respect to the role of the PWLB in the new system
- add a prudential indicator for the increase in Council Tax from unsupported capital investment
- more work is required with respect to the HRA, as is stated in the introduction to the current draft code
- PFI has a major impact for some authorities
- clarification is needed with respect to FRS 17
- it should be recognised that many examples of good practice already exist with respect to capital strategies, asset management planning and treasury management
- the code should look beyond a 3 year time frame
- there will be a significant role for Chief Finance Officers in the new system – CIPFA should give consideration as to what further guidance and support can be offered
- particular account should be taken of the unique structure of the GLA
- the code and government controls should both operate on an accruals basis
- how to deal with school balances.

6 SUMMARY ANALYSIS OF JOINT RESPONSE RECEIVED FROM DTLR AND HM TREASURY

6.1 The DTLR and HM Treasury welcome the publication of the draft prudential code. When finalised, the code will be of central importance in the new system of capital controls for local government that the Government is committed to introducing. The expertise that has gone into the draft, and the wide range of interested organisations that were drawn into overseeing its preparation, are appreciated.

6.2 The DTLR and HM Treasury express broad agreement with the approach taken in the draft. In particular, they express support for:

- the use of a basket of indicators to capture the factors that should influence authorities' use of borrowing and other forms of credit
- the use of gross external borrowing (plus other long term liabilities) for the key control indicators, and of total capital expenditure unfinanced to assist in the assessments of affordability

- the implicit requirement to prepare capital plans and revenue forecasts for three years ahead
  - the proposal to prepare a second draft expanded to deal with the treatment of the Housing Revenue Account, other ring fenced accounts and local authority companies
  - the inclusion of the supporting material in Appendix A to assist in understanding the Code.
- 6.3 The DTLR and HM Treasury have specific concerns about the current draft in relation to:
- clarity and user-friendliness
  - allowance for uncertainty and contingencies
  - developments beyond the three year horizon
  - response to in-year monitoring.
- 6.4 The full text of the joint response from the DTLR and HM Treasury is attached as Appendix C to this report.
- 7 SUMMARY ANALYSIS OF RESPONSE RECEIVED FROM THE LOCAL GOVERNMENT ASSOCIATION
- 7.1 Overall, the Local Government Association welcomes the draft prudential code.
- 7.2 The Local Government Association stresses that the code and the prudential indicators need to be focused on the key issue of affordability.
- 7.3 In order to achieve the objective of accountability, the code needs to be clearer and more accessible.
- 7.4 With respect to the prudential indicators, the Local Government Association makes the following comments:
- there should be one level of indicator for debt not three
  - the proposed ratio of financing costs to net revenue expenditure says little about affordability
  - the prudential indicators for treasury management should be reconsidered.
- 7.5 The Local Government Association is content with the matters required to be taken into account in setting and revising prudential indicators.
- 7.6 The response agrees with the view that over the medium term borrowing should only be for capital purposes but believes that the balanced budget requirement suffices to achieve this. If a new requirement is, however, introduced then the code needs to recognise the unpredictability of cash flow, the absolute requirement for local authorities to be able to obtain the cash they need even if this limit is breached, and that daily monitoring is unnecessary except when an authority is in danger of breaching its limit.

- 7.7 The response agrees with the processes required by the draft code.
- 7.8 Capital expenditure unfinanced requires further clarification and should be linked to capital financing statements in order to assist understanding and forward estimates.
- 7.9 The legal status of the code needs to be absolutely clear within the new system.

## 8 SUMMARY ANALYSIS OF RESPONSES RECEIVED FROM AUDIT BODIES

### Responses received

#### 8.1 Responses have been received from

- the Audit Commission
- Audit Scotland – the Accounts Commission
- Ernst & Young.

### Overall response

- 8.2 The responses from audit bodies welcome the prudential framework and the prudential code as positive contributions for the improvement of the stewardship of public assets.
- 8.3 There are a number of issues that will require further consideration before the code is finalised.

Response to question 1 in the exposure draft – Does the [draft] Code achieve the objectives set out in paragraph 1?

- 8.4 The responses welcome the objectives within the draft code. One response states that accountability will be assisted if the framework for this is more explicit, and that the code could augment planning and appraisal processes to ensure that they play central roles in forming the assessments required by the code.

Responses to question 2 in the exposure draft – Do you have any comments on the detail of the prudential indicators proposed in the draft Code?

#### 8.5 Individual responses include the following points:

- add a requirement for the Chief Finance Officer to comment on/confirm that the proposed limits are prudent and affordable
- guidance on how to determine the various indicators would be useful
- it is difficult to set limits without long term business plans
- there should be more references from the indicators to their description and purpose

- all indicators should reflect approved capital plans, revenue forecasts and a treasury management strategy
- variances with respect to capital expenditure unfinanced will be a key part of the controls and should feed through into forward estimates of affordability.

Response to question 3 in the exposure draft – Are there further matters that should be taken into account when setting or revising prudential indicators, over and above those specified in the draft Code?

- 8.6** The responses from audit bodies emphasise that the need to take risk into account should be specifically recognised; also that more guidance should be given in respect of risk.

Response to question 4 in the exposure draft – Do you agree with the view taken in the draft Code with respect to the need to ensure that over the medium term net borrowing will only be for a capital purpose?

- 8.7** One response stresses that the purpose of borrowing must be related to statutory powers and that this aspect of the code should be reviewed when this is known, particularly as the gross position may exceed the net.

Response to question 5 in the exposure draft – Do you have any comments on the processes proposed for setting and revising prudential indicators and for monitoring against prudential indicators?

- 8.8** One response gives detailed comments on this and supports the overall process. It should be recognised that if performance is not meeting expectations, then it is not just the prudential indicators that need revising but also the forecasts and plans in all likelihood. Reference should be made to the Chief Finance Officer's responsibilities in relation to financial forecasts, cash flow projections, capital strategies and asset management plans.

Response to question 6 in the consultation draft – Do you have any comments on the detail of the definitions proposed (especially capital expenditure unfinanced)?

- 8.9** The explicit use of figures taken from audited accounts is welcome, as is the linking of definitions, wherever possible, with UK GAAP and the SORP.

- 8.10** One response stresses the need to examine the implications of FRS 17, particularly in relation to the discretionary element of pensions liabilities.

Other comments

- 8.11** One response states that while many elements of the code lend themselves to objective scrutiny some, for example the actual level of borrowing limits, are

more judgemental, and any auditor comment will need to be carefully phrased.

9 SUMMARY ANALYSIS OF RESPONSE RECEIVED FROM SECTOR

9.1 Overall, Sector welcomes the draft prudential code, generally agrees that the code will achieve its objectives and with its content.

9.2 Future funding mechanisms from central government and devolved administrations remain to be finalised, and this is a concern.

9.3 Detailed points on the code:

- the prudential indicators will be further examined through road testing
- the fundamental principle that over the medium term borrowing should only be for a capital purpose is agreed
- when the replacement for the MRP is known better links should be developed between it and capital accounting
- CIPFA should revise its guidance on capital accounting for any changes introduced by either the code or legislation
- guidance is needed on the definition of other long term liabilities
- contingent liabilities may arise from PFI schemes
- capital expenditure unfinanced is a key figure – there may have been inconsistencies in the past and the opening balance should be agreed and audited, following which all authorities can move forward in a uniform manner under the new system.

10 SUMMARY ANALYSIS OF RESPONSES RECEIVED FROM CREDIT RATING ORGANISATIONS

10.1 Responses have been received from:

- Fitch
- Sovereign & International Public Finance Ratings.

10.2 Fitch have submitted a copy of a report that they have prepared on the proposed reforms. Fitch welcomes the proposals and takes the view that the reforms will be more effective if UK local authorities also obtain credit ratings as part of a broader programme of increasing transparency and performance measurement.

10.3 The Fitch report contains some additional measures:

- debt to operating balance
- debt servicing including maturing capital
- total public sector risk to revenue
- debt per capita.

10.4 Sovereign & International Public Finance Ratings takes issue with the content of paragraphs A.51 – A.54 of the current appendices to the code and interalia

**views it as contrary to the stated aims of transparency and accountability. It is suggested that the final draft omits any reference to credit ratings.**

## **CIPFA PRUDENTIAL CODE      December 2001 Exposure Draft**

### **Response by DTLR and HM Treasury to the consultation**

#### *General*

- 1      The DTLR and HMT welcome the publication of the draft Prudential Code. When finalised the Code will be of central importance in the new system of capital controls for local government that the Government is committed to introducing. The White Paper "Strong Local Leadership - Quality Public Services" (Cm 5237) set out the role that the Government sees the Code playing in the new system. We appreciate the expertise that has gone into the draft, and the wide range of interested organisations that were drawn into overseeing its preparation.
  
- 2      We are broadly in agreement with the approach taken in the draft. In particular we support:
  - the use of a basket of indicators to capture the factors that should influence authorities' use of borrowing and other forms of credit
  - the use of gross external borrowing (plus other long term liabilities) for the key control indicators, and of total capital expenditure unfinanced to assist in the assessments of affordability
  - the implicit requirement to prepare capital plans and revenue forecasts for three years ahead
  - the proposal to prepare a second draft expanded to deal with the treatment of the Housing Revenue Account, other ring fenced accounts and local authority companies
  - the inclusion of the supporting material in Appendix A to assist in understanding the Code.
  
- 3      The specific concerns that we have about the current draft are set out in the remainder of this response, and fall under the following headings:
  - clarity and user-friendliness
  - allowance for uncertainty and contingencies
  - developments beyond the three year horizon
  - response to in-year monitoring.

#### *Clarity and user-friendliness*

- 4      The new system of controls should result in a change in the way authorities think about their options for meeting policy aims. They will have much greater freedom to choose between capital and revenue based solutions. The Government is anxious that all those involved in making these decisions, and those that will be

affected by them, understand both the new freedoms and the constraints within which they must be exercised. This is particularly vital in the run up to the introduction of the new system, so that the nature of the change is understood from the outset.

- 5 The Code must therefore aim for maximum clarity. The supporting information in Appendix A assists in understanding it, and we would expect summaries to be prepared and training provided in due course for those, such as members and local organisations, who need a more high level understanding. But in our view the Code itself must be modified so that it conveys its requirements more clearly.
- 6 We suggest, first, that the relationship between "prudent and sustainable levels" and "affordable" in paragraph 1 should be enlarged upon to make it clear that the fundamental criterion is affordability, and that prudence and sustainability are measured by reference to affordability.
- 7 Second, the various indicators should be designated by different terms to distinguish: those that are indicators used to assess spending requirements and affordability, those that function as limits, those that signal the need for in-year reviews and those used for monitoring outturn.
- 8 Third, the relationship between the indicators should be clarified within the Code itself. The main elements are already there, but are difficult to pick out without a close reading of the Code. Some form of table or diagram to support the text might be a part of the solution.

### *Allowance for uncertainties and contingencies*

- 9 The draft sets out a three tier structure of limits on borrowing and other long term liabilities (paragraphs 9 - 14) and includes risk and uncertainty among the matters to be considered when assessing affordability (paragraph 37). But in our view more explicit provision needs to be made in the Code on an issue of this importance. The appropriate way to do this would be to require separate allowances to be calculated for:

- the uncertainty inherent in the budgeting and forecasting process
- contingencies that might arise.

These allowances should then be incorporated in the limits on borrowing either by deduction before arriving at the prudential limit or by requiring that they set the minimum difference between two of the limits. We suggest the Code should stipulate that the allowance for uncertainty should be deducted before arriving at the prudential limit, and that the difference between the prudential limit and the authorised limit must be no less than the allowance for contingencies.

### *Developments beyond the three year horizon*

- 10 The draft (paragraph 41) already directs authorities to consider the full year effects of capital projects where they will not be felt within the three planning

horizon. But in our view a more comprehensive provision is needed, requiring authorities in making their assessments of both resources and demands on them (revenue and capital) to consider developments beyond the third year. They would not be required to seek out remote possibilities or insignificant events. But they should take account of major financial developments which they are aware are certain or likely to occur. Because of the significance of these events for the assessments of affordability, we believe that the relevant provision of the Code should be in bold type.

***Response to in-year monitoring***

- 11 The White Paper (paragraph 4.13 of Part II) makes the point that there should be continuous review of the ability to take on new borrowing or other long-term liabilities. The draft (paragraph 51) requires the Chief Finance Officer to establish procedures to monitor performance against forward-looking indicators, and (paragraph 52, 2<sup>nd</sup> bullet) requires investigation and action where a sustained or regular trend of divergence from the financing cost / revenue stream ratio is detected. This is a valuable safeguard, but in our view it needs to be strengthened. The financing cost / revenue stream should be recognised as the key in-year indicator of changes in affordability. We would wish to see its role brought out more explicitly within the Code, along with requirements for regular in-year monitoring of it and a specific review before major commitments were irrevocably entered into.

March 2002