

CAPITAL ACCOUNTING REVIEW: INTERIM POSITION

DECEMBER 2002



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1. INTRODUCTION

- 1.1 The CIPFA/LASAAC Joint Committee launched a review of the current capital accounting regime earlier in 2002. A summary of the capital accounting review and the individual project briefs are available on the technical pages of the CIPFA website <http://www.cipfa.org.uk/pt/capitalreview.ihtml>.
- 1.2 This is a brief summary of progress, which highlights some interim conclusions and discusses the way forward. It gives the preliminary views of the CIPFA Secretariat and does not represent the views of the CIPFA/LASAAC Joint Committee or any other CIPFA panel. The Joint Committee will formally consider the views in the first quarter of 2003. Any proposed changes to the local authority SORP will be subject to a future consultation process which will seek views of practitioners and interested bodies.
- 1.3 If you wish to comment on any of the issues raised in this interim report please use the contact details on the capital accounting review website or use the CIPFA Members Helpdesk at helpdeskmem@cipfa.org.

2. AN OVERVIEW OF THE CURRENT SYSTEM

- 2.1 The focus of comment from practitioners throughout the UK was the complexity of the current accounting mechanisms. The comments broadly confirmed perceptions about the current concerns of practitioners. Short term working groups representing local authority stakeholders in the UK were convened in order to discuss concerns further and to propose practical solutions. The CIPFA/LASAAC Joint Committee will be considering those solutions in the New Year.
- 2.2 These solutions include modifications to some of the main accounting mechanisms in the current system, which might simplify them for both practitioners and the users of financial statements. Some of these proposals relate to the reformatting of the existing consolidated revenue account and are considered in the section of this summary headed *The Format of the Performance Statement*. The Secretariat considers that these changes might make the statement of accounts more readily comprehensible to elected members and non-financial managers.
- 2.3 The CIPFA Secretariat is therefore developing specific proposals for a reformatting of the consolidated revenue account – see the tables in section 7 below and the attached suite of spreadsheets. This would allow the Asset Management Revenue Account (AMRA) to be eliminated and the capital entries needed to avoid a bottom line financing impact to be identified clearly. The dual aim would be to simplify the capital entries whilst maintaining the integrity of the revenue statements.
- 2.4 A further area for potential modifications is the “reserves” on the face of the balance sheet namely, the Fixed Asset Restatement Reserve (FARR) and the Capital Financing Reserve (CFR). Practitioners found particular problems in explaining the nature and purpose of these mechanisms to non-financial managers and members, a

problem exacerbated by the very large numbers recognised in these items. The Secretariat is considering a number of options to clarify for readers of the accounts what these reserves are meant to represent. These options include:

- rename each reserve, suggestions include; fixed asset restatement account and the capital finance account
- amalgamating these “reserves” into a single “capital accounting adjustment account”
- retain the current terminology but provide clear explanation and more guidance on these reserves.

2.5 The first two options provide superficially cosmetic proposals and the impact of any change should not be exaggerated. It is not going to eliminate the need for the transactions, which currently flow through the CFR reserve and the FARR. However, such changes should dispel the understandable view of some accounts users that the CFR is available for the financing of the capital programme and that the FARR is the full equivalent of a GAAP revaluation reserve. We are particularly interested in practitioner views on these options.

2.6 The assessment of the current system also included a brief assessment of the extent to which capital accounting has improved asset management. It has been particularly challenging to evidence this aspect of the review. Additional development work in the form of a research study in Wales is currently being conducted, the results of which will contribute to the project.

3. INFRASTRUCTURE

3.1 From the international and UK accounting standard convergence perspective there is a very strong argument to move the measurement of local authorities infrastructure on to a current value basis. The Highways Agency measures its road network at current value with quinquennial valuations. Carrying values are updated annually using specified indices. There are currently, however, difficulties over the volatility of the annual capital charge. Treasury and Highways Agency are currently considering this issue.

3.2 We therefore think that second phase work on this issue for more detailed investigations into the feasibility of moving local authority infrastructure measurement on to a current value basis. Areas that need to be particularly considered are:

- the cost of any valuation exercise
- the reliability and extent of existing information
- the extent of non-road infrastructure held by local authorities
- the suitability of the indices used by the Highways Agency for local government.

We are interested in views on these issues.

4. LINKS WITH PRUDENTIAL CODE

4.1 The Prudential Code has as one of its objectives a move to a flexible capital control system in which reliance on UK GAAP is a significant component. Particularly significant, from a capital accounting perspective, is the role that depreciation might play in a new system.

4.2 A discussion paper on the role that depreciation could play in local government finance has been developed by CIPFA as a contribution to the debate on modernising public services and is being:

- considered by the Prudential Code Steering Group
- input into CIPFA's review of local authority capital accounting
- submitted to the national and devolved working groups on local government capital finance
- submitted to the HM Treasury whole of government accounts programme
- submitted to the Audit Commission and Audit Scotland
- made publicly available to stakeholders and others.

4.3 A new prudential framework for local authority capital investment has been announced in the Queen's Speech for England and Wales and in Scotland through amendments to the Local Government in Scotland Bill currently before Scottish parliament. Under the prudential framework, local authorities will be responsible for deciding how much capital investment and borrowing they can afford, drawing on a prudential code that is being developed by CIPFA.

4.4 The prudential code will require local authorities to consider the short and medium term affordability, and the long term sustainability of their capital investment. The prudential code is being designed to be operable within a number of different support mechanisms. However, full depreciation accounting, which requires the charging and resourcing of depreciation, would have a particularly good fit with the prudential code and prudential framework. This is because full depreciation accounting is specifically designed to charge to the revenue account the economic benefits that are consumed by the using up of fixed assets. It is recognised that accounting for depreciation will raise significant affordability and funding issues.

4.5 Further consideration of depreciation accounting also links well with the government's fiscal strategy. In particular, depreciation has an explicit role to play in the operation of the golden rule, because the government defines the current budget as the difference between current receipts and current expenditure including depreciation.

4.5 Full depreciation accounting will be an important element if local authority accounts are to be included within whole of government accounts. The government is committed to the production of whole of government accounts as a step in ensuring that best practice accounting methods are used to construct the public accounts and that fiscal reporting is as transparent as possible, as required by the Government's Code for Fiscal Stability. In particular, it is intended that whole of government accounts will provide audited data to underpin the operation of the golden rule, and will allow the public sector balance sheet to be used in fiscal management.

4.6 We are interested in views of any aspect of the depreciation paper which can be accessed elsewhere on the CIPFA website.

5. NON-OPERATIONAL AND COMMUNITY ASSETS

5.1 The main problem has been the differentiation of operational and non-operational assets. There may be a case for replacing the current terminology with revised and plainer English wording such as 'assets used in the provision of services' and 'assets not used in the direct provision of services'. However, regardless of the terminology, it will still be necessary for authorities to form a view as to whether a physical asset is held primarily for income-generating purposes or for social purposes. In the view of the Secretariat there should be a rebuttable presumption that physical assets are used in the provision of services unless there is clear evidence that such physical assets are leased out on a full commercial basis – this would not merely imply full cost recovery, but a commercial rate of return.

5.2 It is the view of the Secretariat that there is a case in principle for charging depreciation on non-operational assets, except investment properties- under SSAP 19 investment properties are not subject to depreciation except leased property with an unexpired term of 20 years or less. However, the Secretariat does not think that there is a strong case for charging notional interest on non-operational assets. We are interested in the views of accounts preparers on these issues.

5.3 Currently the guidance on community assets is slightly ambiguous. The guidance highlights as a characteristic of community assets that they are not used for operational purposes. In fact it is arguable that a number of community assets are used for operational purposes, particularly for leisure related purposes.

5.6 The central government Resource Accounting Manual (RAM) recognises this in distinguishing operational and non-operational heritage assets. The RAM requires operational assets to be measured at current value. Thus, even a listed building that is used for operational purposes – a Napoleonic fort used as a barracks would be measured at current value.

5.7 It is likely that the IFAC Public Sector Committee will initiate a project on heritage assets in late 2003 or early in 2004. We do not think that it is sensible to propose amendments to the SORP in advance of that project. However, we are interested in views on differentiating community assets between those used for operational purposes and those not used for operational purposes as in central government.

6. COST OF CAPITAL CHARGE – BASIS AND LEVEL OF INTEREST RATES

- 6.1 These separate but related components of the Review examined the basis on which the cost of capital charge is determined and the level of the notional interest rates.
- 6.2 A number of alternative systems from the UK and international public sector were considered. A number of options were examined. The interim conclusion is that the current system, possibly subject to certain minor amendments, is a sound basis for calculating the cost of capital charge.
- 6.3 The Treasury has consulted on the revision of its standard discount rate from 6% to 3.5%. This has been one of the key triggers for CIPFA/LASAAC to adjust its notional interest rates for fixed assets carried at current value. A ‘nominal’ rate is still required for assets at historical cost. Currently this is related to PWLB loan rates and for 2003-4 has been fixed at 4.625%. However, a more robust methodology might be to relate the nominal rate to an indicator of inflation such as the GDP Deflator.
- 6.4 The Secretariat would welcome views on these issues.

7. CHANGING THE FORMAT OF THE PERFORMANCE STATEMENT (currently the Consolidated Revenue Account (England, Scotland and Wales))

- 7.1 This part of the Review has examined whether a modification of the current format of the consolidated revenue account might make the financial performance of a local authority more transparent. Such an approach would replace the existing consolidated revenue account with two separate statements.
- 7.2 An *Operating Financial Statement* could show the service performance of the authority and corporate income and expenditure of the authority. This purpose of this new performance statement would be to show the transactions of the authority in accordance with generally accepted accounting practice. A separate *Statement of Tax Funding* would reconcile from the net operating expenditure figure to the taxation requirement for the year.
- 7.3 The provisional findings of the project are that such an approach would be technically feasible in local government. Possible formats have been developed and the initial impression these give is that presentation is simpler and easier to understand. However, more work might be required in preparing the statements.
- 7.4 An example of what this new format might look like is shown in tables 1 and 2 below. The attached demonstration suite of spreadsheets illustrate how the new statements can be drawn from local authorities’ trial balance sheets and also include an example consolidated revenue account in current format for comparison purposes.

Table 1

Example Operating Financial Statement			
Services:	Gross Expenditure £'000	200Y/Z Income £'000	Net Expenditure £'000
Cultural Environmental and Planning Services	58,578	(11,584)	46,994
Education Services	144,914	(27,077)	117,837
Highways Roads and Transportation Services	36,617	(13,950)	22,667
Social Services	127,203	(36,622)	90,581
Central Services	16,355	(4,231)	12,124
NET COST OF SERVICES	383,897	(93,694)	290,203
Treasury and Financing:			
Interest payable			5,983
Interest receivable			(1,959)
(Gains)/Loss on Disposal of assets			(1,400)
NET OPERATING EXPENDITURE			292,827

(Note this example statement does not include comparators – this is for demonstration purposes only. Any changed format of the performance statements for local authorities would require previous year comparators)

Table 2

		2000Y/0Z	
		£'000	£'000
Net Operating Expenditure			292,827
Reconciliation to Tax Basis:			
<i>Plus</i>	amounts to be funded from tax this year:		
	provision for the repayment of debt <i>(currently MRP or loans fund charges Scotland)</i>	17,783	
	parish council precepts	100	
	direct funding of capital expenditure	<u>1,750</u>	19,633
<i>Less</i>	amounts not funded from tax this year:		
	depreciation & impairment of fixed assets	(21,966)	
	cost of capital charge	<u>(32,895)</u>	(54,861)
<i>Plus/Less</i>	gains/(losses) on asset disposals set aside		1,400
<i>Plus/Less</i>	transactions with reserves set aside for specific purposes: schools' resources retained in / (expenditure funded from) schools balances	1,384	
	transfer to / (use of) other special purpose reserves	<u>(2,300)</u>	(916)
TAX FUNDING REQUIREMENT FOR THE YEAR			(258,083)
	General support from central government	(159,078)	
	Business rates	(73,719)	
	Council tax	(39,398)	(272,195)
NET CALL ON/(TRANSFER TO) THE GENERAL FUND			14,112
GENERAL FUND BALANCE AT 01/04/0Y			10,346
GENERAL FUND BALANCE AT 31/03/0Z			24,458