Llywodraeth Cynulliad Cymru
Welsh Assembly Government

Guide to the Prudential Framework for Capital Finance for Local Authorities in Wales

June 2004

Preface

This *Guide on the Prudential Framework for Capital Finance for Local Authorities in Wales* is intended to provide an overview of the system on its introduction in April 2004. It is intended as a non-technical introduction to the system.

The Guide sets out the main features of the framework and describes the legal structure within which the regime operates and its interaction with the professional and accounting codes. It also includes a commentary on the financial management issues that underpin the new system. The Guide is likely to be useful to local government members and service managers and, as an introduction to the system, for finance staff. It is also intended to be helpful to any reader seeking a general overview of the system.

This Guide does not form a part of the statutory framework which supports the prudential regime and should not be regarded as an interpretation of any of its requirements. In some cases, the Guide summarises only the broad effect of a section of the Act or a regulation; important qualifications and conditions may not be mentioned.

The Prudential Framework in Wales applies to Welsh county and county borough councils, police authorities, fire authorities and national parks.

THE WELSH ASSEMBLY GOVERNMENT
GUIDE ON THE PRUDENTIAL FRAMEWORK FOR CAPITAL FINANCE FOR LOCAL AUTHORITIES IN WALES

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THE WELSH ASSEMBLY GOVERNMENT
GUIDE ON THE PRUDENTIAL FRAMEWORK FOR CAPITAL FINANCE FOR LOCAL AUTHORITIES IN WALES

INTRODUCTION AND OVERVIEW

1 The prudential system for local authority capital finance was introduced on 1 April 2004. Its legislative base is contained in the Local Government Act 2003 and the regulations subsequently made by the National Assembly enable local authorities, for the first time in over a decade, to determine their own levels of affordable borrowing for capital expenditure.

2 Under the prudential system Credit Approvals no longer exist and authorities have to decide for themselves how much they can afford to borrow based on a prudent assessment of their capital expenditure requirements. The duty to determine the level of affordable borrowing places reliance on self regulation under professional codes of practice including the Chartered Institute of Public Finance and Accountancy's (CIPFA's) Prudential Code for Capital Finance in Local Authorities (referred to in this document as CIPFA's Prudential Code). This Code (amongst others) has clear statutory backing.

3 Borrowing is only one side of the equation but it remains an important consideration to ensure compliance with the Treasury's fiscal strategy. However, the prudential system is intended to work from the opposite end of the capital investment spectrum. Investment decisions should start with effective asset management planning and clear longer term capital strategies. This should result in the delivery of a capital programme based on the form of finance which provides the best value for money for the type of asset or scheme concerned.

4 The previous capital finance system generated perverse incentives to look for forms of finance which did not count against the capital finance controls. This meant that value for money from financing had taken a poor second place to finding a form of finance which would deliver an asset without using up credit approvals. Perhaps one of the most important benefits of the prudential system is that it places revenue and the various capital financing decisions on an equal footing. Authorities can now consider new options – spend to save schemes, revenue intensive against new capital schemes, or properly balance investment in infrastructure against sustaining higher levels of maintenance costs etc. The key objective for these decisions is that the options chosen must provide an effective solution for service delivery, provided that the impact of the scheme on the revenue budget is assessed by the authority as affordable.

5 Instead of having a system which focuses on the initial procurement of the asset and ensuring that it is covered with appropriate capital resources the more sophisticated analysis of capital expenditure and

financing means that financial planning has to move from the medium to long term and there is an emphasis on detailed asset management information being available. Asset Management Plans are therefore essential tools providing information on the use, condition and value of the assets to feed into the development of local authorities' capital programmes and strategies. This information needs not only to cover purchase and replacement cost but must also include information on running costs and "whole of life" asset information.

6 In the prudential system capital finance decisions like all other procurement decisions are bound by the finite resources available to the authority, and authorities need to form their own controls framework to make these decisions alongside the statutory requirements of the regime. Good corporate governance is an essential feature of the system.

7 This framework provides a real opportunity to link capital expenditure plans to local authorities' corporate plans, Improvement Plans and objectives. In order to ensure the best use of the prudential system authorities will need to develop robust capital programmes based on the objective information to be provided by Asset Management Plans and hone their skills of option appraisal. Improving the relationship between strategic corporate and service plans and the development of the capital programme should lead to a coherent pattern of investment with which local authority members and local communities can identify with and support.

8 The Prudential Framework delivers a significant part of the greater freedom promised for local authority finance. But greater freedom means a different risk profile for local authorities and new duties and responsibilities emanate from the framework. This means a cultural shift for both local authorities and the Welsh Assembly Government which requires as much management as the detailed implementation of the system if authorities want to take full advantage of the opportunities offered.

9 The effectiveness of public spending is a priority for the Welsh Assembly Government. The prudential system heralds an important change in local authority capital finance. It is able to deliver a robust financing package for the capital programme within the affordability boundaries that the authority sets itself. The prudential capital finance system provides local authorities with the flexibility to undertake borrowing at levels higher than those notionally supported by the Welsh Assembly Government in the revenue support system, provided that this borrowing meets the affordability requirements and assessments of the authority.

10 The Guide sets out the framework of the prudential system i.e. the Local Government Act 2003, the subordinate regulations and guidance (including the CIPFA's Prudential Code) and the Welsh Assembly

Government support for Capital Expenditure. The latter paragraphs also include commentaries on the financial planning issues which will underpin the system. It includes Annexes that summarise the statutory framework and set out some of the technical issues related to the regime.

THE FRAMEWORK FOR THE PRUDENTIAL SYSTEM

11. There are three main elements to the framework:

- Part I of the Local Government Act 2003 (supported by the provisions in Part 2);

- The Local Authorities (Capital Finance and Accounting) (Wales) Regulations 2003[1] (the 2003 Regulations) (as amended by the 2004 Regulations[2]) which build on the framework of the Local Government Act 2003, providing the detail that will make the system operational;

- Welsh Assembly Government Support for Capital Investment.

(The table at Annex 1 sets out the structure of the statutory framework for the Prudential Regime.)

12. In the 'Freedom and Responsibility in Local Government' Policy Statement, published in March 2002, the Welsh Assembly Government set out its intentions for local authority finance as a whole, including Housing Revenue Account (HRA) financing. There are separate provisions in respect of certain aspects of the prudential system as it relates to the HRA (see paragraphs 24-27)

THE LOCAL GOVERNMENT ACT 2003 (CHAPTER 26)

13. Part I of the Local Government Act 2003 (the 2003 Act) provides the primary legislation on which the new system is based. The 2003 Act includes the following main powers and duties:

- A **general power to borrow** for the purposes relevant to an authority's functions, but also to borrow where the sound management of the authority's treasury management activities requires it.

- A **duty for the authority to set an affordable borrowing limit** in advance of each financial year. This duty requires that authorities monitor their position against the limit and ensure that it is not exceeded. The 2003 Act also requires that in setting these limits authorities will have regard for specified codes of practice. The specification in the 2003 Regulations is the CIPFA's Prudential Code.

[1] The Local Authorities (Capital Finance and Accounting) (Wales) Regulations (S.I. 3239 (W.319) (2003 Regulations)
[2] The Local Authorities (Capital Finance and Accounting) (Wales) (Amendment) Regulations (S.I. 1010 (W.107)) (2004 Regulations)

- A **reserve power** for the Welsh Assembly Government **to set limits on borrowing** for authorities, where this is required for "national economic reasons".

- A **new definition of credit arrangements and control of credit arrangements.** The definition of credit arrangements is based upon whether assets and liabilities need to be recognised on local authorities' balance sheets - the value of credit arrangements is added to external borrowings when measuring the position against the affordable borrowing limit. The 2003 Act definition of credit arrangements is much simpler than as defined under the Local Government and Housing Act 1989, relying on the accounting concept of long-term liabilities.

- **Capital receipts** remain defined by statute and their definition relies on the "mirror principle". A receipt arising from a disposal is defined as a capital receipt if, the authority were the buyer in such a transaction, expenditure on the acquisition of the asset would be classified as capital expenditure. The use of capital receipts is also specified in the 2003 Regulations (as amended): being reinvested in new capital expenditure (but not revenue); and to meet debts or other liabilities (further detail of the definition and the use of capital receipts is prescribed in the 2003 Regulations (as amended)). The 2003 Act also requires that capital receipts change from being recognised in the accounts on a cash basis, i.e. when the payment is received, to "when the sum becomes payable to a local authority".

- A **general power to invest** – to support any service and as a part of local authorities' prudent treasury management activities. This was not previously a specific power for local authorities. It is supported by the statutory guidance on local government investments and specification of the CIPFA's Treasury Management Code in the 2003 Regulations.

- An accounting definition for **capital expenditure** using as its starting point proper practices as defined by the 2003 Regulations (as amended). The Welsh Assembly Government also has a power to regulate that other types of expenditure can be treated as capital expenditure.

- A power to define by regulation accounting practices to be **proper practice** in relation to this and other acts.

- A power to define what is **chargeable to a revenue account**.

(A full listing of the Sections of Part 1 is included in a technical Annex to this Guide (Annex 2))

Financial Administration - Part 2 of the 2003 Act

14. The 2003 Act also includes specific requirements for financial administration which serve to encourage good financial management but will also support the financial planning requirements of the prudential regime. The requirements include:

    - budget calculations[3] and the reporting of the robustness of estimates;
    - minimum reserves;
    - reports on adequacy of controlled reserves[4] with the budget calculations[5] and
    - budget monitoring.

Generally Accepted Accounting Practice

15. The 2003 Act also includes a specific provision for the National Assembly for Wales to amend or repeal by order any enactment if it is considered appropriate to do so in the light of generally accepted accounting practice. For example, consideration may be given to developments on group accounts in the Code of Practice on Local Authority Accounting in the United Kingdom; A Statement of Recommended Practice (the SORP) issued by the CIPFA/LASAAC Joint Committee.

THE LOCAL AUTHORITIES (CAPITAL FINANCE AND ACCOUNTING) (WALES) REGULATIONS 2003 (AS AMENDED)

16 The Local Authorities (Capital Finance and Accounting) (Regulations) (Wales) 2003 provide the operational detail for the primary legislative framework. These regulations came into full effect from 1 April 2004.

17 The 2003 Regulations specify that CIPFA's Prudential Code is the code of practice to which local authorities must have regard when setting and reviewing their affordable borrowing limit. The duty automatically applies to any subsequent editions of the Code. The borrowing limit is to be **set** and **reviewed** by the full council.

18 The 2003 Regulations also specify the following:

(The following paragraphs are not intended to provide an exhaustive listing or technical commentary on the 2003 and 2004 Regulations but to give an overview of

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[3] The budget calculations referred to in the 2003 Act refer to those defined in Section 32 or 33 of the Local Government and Finance Act 1992

[4] This requirement in the 2003 Act is not commenced until 1 April 2005.

[5] Per footnote 3.

their impact. For further details see the Regulations and/or the informal commentary on the Regulations.)

Minimum Revenue Provision (MRP)

19. In the prudential system local authorities are required to charge a minimum amount to their revenue accounts annually as a provision to meet debt and qualifying (credit) liabilities[6]. This is a similar approach to the previous system. The MRP is based on the Capital Financing Requirement (a Prudential Indicator). It should be at least 4% of the Capital Financing Requirement (CFR) (net of the amount deemed attributable to the HRA) – this calculation is set out in the 2003 Regulations. **Local authorities' may decide to charge a greater percentage if they consider it would be prudent to do so.** The CFR replaces the credit ceiling and is calculated by bringing together capital balances in the balance sheet (representing the underlying need to borrow for capital purposes), plus liabilities under credit arrangements. There is also an adjustment which should ensure that local authorities' opening figures are consistent with the closing position for 2003-04. Thus for capital financing purposes, before any decisions for Prudential Borrowing have been implemented, local authorities should be starting from the same position they would have been in under the previous capital financing regime.

The Commutation Adjustment

20. The commutation adjustment continues to be made to the MRP for the effects of the 1992 commutation exercise. This exercise commuted grant that was to be payable as annual contributions to loan charges, predominantly for housing grants, to a lump sum payment. This lump sum was then used to pay off loans from the Public Works Loans Board. It was a complex procedure and the commutation adjustment was designed to ensure that local authorities were not financially disadvantaged in the longer term. The 2003 Regulations provide that where the commutation adjustment is a negative amount i.e. serves to increase the amount of the MRP to be charged to the revenue account, there will be no requirement in that year or any future years for the authority to make the commutation adjustment to the MRP.

Credit Arrangements

21. The 2003 Act provides the National Assembly for Wales with the power to specify the cost of qualifying credit arrangements which local authorities must take into account when setting and monitoring their affordable borrowing limits i.e. these arrangements must be treated as if they were borrowing. There is an accounting test for the definition of credit arrangements - local authority procurement via lease or credit transactions which results in assets appearing on local authority

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[6] This should not be confused with the requirements in relation to the Provision for Credit Liabilities in the Local Government and Housing Act 1989

balance sheets should be captured as part of the calculations in respect of affordable borrowing limits and included in the assessment of the CFR. The calculation of these amounts should be based on proper accounting practice. The full cost of these arrangements plus any variations should be considered in meeting the requirements of the CIPFA's Prudential Code.

22. It is important in terms of local authorities' affordability assessments that those lease transactions which do not result in assets appearing on local authority balance sheets will still have to be taken into account as part of the consideration of **affordability** as specified in CIPFA's Prudential Code.

Capital Receipts

23. The 2003 Regulations (as amended) provide more detail on the definition of capital receipts and the uses that can be made of the proceeds from the disposal of local authority assets. A capital receipt is defined as such if the total proceeds from a disposal are more than £10,000. Capital receipts may be spent on (or applied against):

- capital expenditure,
- the repayment of debt,
- the payment of any premia incurred on debt redemption, or
- liabilities for credit arrangements, to the extent that those credit arrangements are treated as capital expenditure within the capital finance system.

Housing Capital Receipts

24. In line with the commitments outlined in 'Freedom and Responsibility' and the need to update the HRA for the Prudential System, the 2003 Regulations also introduce a requirement to pool some HRA capital receipts. However, cash pooling of HRA capital receipts only applies to those authorities which have a debt-free HRA (this is defined in the 2003 Regulations as authorities with a nil or negative balance for their HRA CFR). These regulations set out the quarterly payment dates for amounts which are subject to pooling and the items that are to be taken into account before the 'poolable' amount is calculated.

25. In respect of HRA capital receipts that are not the subject of pooling and the balance of pooled receipts, the policy intent of the Welsh Assembly Government is that resources within the HRA should remain within it and be reapplied for HRA purposes. Therefore, HRA capital receipts can be applied **only** for HRA:

- capital expenditure;

- debt repayment;
- premia (losses) in relation to local authority debt repayment or
- to meet the cost of HRA qualifying credit arrangements.

26. In other words, from 1 April 2004 these HRA capital receipts are not available to be recycled for non-HRA capital purposes.

27. For housing capital receipts only, the capital receipt may be set against the administration costs of the disposal.

Capital Expenditure

28. The 2003 Regulations (as amended) also provide for other items to be defined as capital expenditure even though they might not meet the accounting definition of capital expenditure. These include:

    - expenditure on computer programs;
    - the making of a grant or other financial assistance to any person towards expenditure which would be capital expenditure if incurred by the authority;
    - the acquisition of share and loan capital (further details on this definition are provided in the 2004 Regulations);
    - the repayment of grant given for capital purposes; and
    - expenditure on works on land and buildings and on assets not owned by the authority.

CIPFA's Treasury Management Code

29. The Welsh Assembly Government considers that CIPFA's Treasury Management in the Public Services: Code of Practice and Cross Sectoral Guidance (Treasury Management Code) to be best practice in respect of administration and management of debt and investments and the related aspects of financial management which underpin the successful implementation of the prudential system. The 2003 Regulations specify that local authorities will have due regard to the requirements of the current edition of this Code in carrying out its functions under Chapter 1 Part 1 of the 2003 Act. CIPFA's Treasury Management Code also underpins local authorities' activities subject to the statutory guidance on Local Government Investments issued by the Welsh Assembly Government - see paragraphs 51-53.

Accounting Practices

30. Both the legislative framework and the CIPFA's Prudential Code rely on definitions provided by accounting practices. The 2003 Act confers on the Welsh Assembly Government the power to prescribe accounting practices and define which Codes of Practice represent proper practice. The 2003 Regulations specify two codes of practice to be proper practice:

- The Code of Practice on Local Authority Accounting in the United Kingdom; A Statement of Recommended Practice (the SORP) issued by the CIPFA/LASAAC Joint Committee and

- The CIPFA Best Value Accounting Code of Practice.

31 For both of these Codes the regulations will apply to the current edition relevant to the appropriate financial year.

WELSH ASSEMBLY GOVERNMENT SUPPORT FOR CAPITAL EXPENDITURE

32 The final component of the prudential framework is Welsh Assembly financial support for local authority capital investment. In March 2003 the Assembly issued a consultation paper "Support for Local Authority Capital Expenditure in the Prudential System." It set out the context of the longer-term aim of a move to full depreciation accounting in local authorities and the medium term aim of delivering a meaningful and robust replacement for the MRP[7]. The Welsh Assembly Government does not see this longer term aim as being to fund actual depreciation itself, as it will be for local authorities to determine for themselves how the unhypothecated 'capital' element of Revenue Support Grant (RSG) should be applied. The Welsh Assembly Government is in the early stages of considering support for capital expenditure based on need as opposed to capital financing.

33 In October 2003 the Welsh Assembly Government also consulted on the provision of hypothecated support in the form of capital grant.

34 The current solution for Welsh Assembly Government support provides for Capital Support based on revenue support and capital grant. The quantum of Assembly support under the prudential system remains unchanged from the previous system and debt incurred under the old system continues to be supported through the RSG.

35 Taking hypothecated support first, respondents to the consultation were in agreement that the provision of hypothecated support in the

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[7] This comment refers to the definition of MRP in the previous capital finance system. Paragraph 19 sets out the requirement to provide for an MRP in the new system.

form of capital grant would represent a simplification to the system as opposed to providing support through some form of hypothecated supported borrowing. Thus all hypothecated support (from April 2004 onwards) is provided in the form of capital grant - this includes the HRA.

36. With regard to unhypothecated support, the March consultation proposed that support for investment would be provided in the form of ‘supported borrowing so as to minimise any potential turbulence in resource distribution on transition to the prudential regime and to ensure stability in terms of the capital financing provision feeding through to the "bottom line" of local authority accounts’. This was supported by respondents to the March consultation. The approach to unhypothecated support would be accompanied by the requirement that local authorities charge an amount of MRP to their consolidated revenue accounts related to their CFR. Unhypothecated support for capital finance in the HRA is provided via the Housing Revenue Account Subsidy (HRAS) system.

37 The advantage of this approach is that an element of stability has been introduced in the early years of the prudential system. However, there is a significant difference from the old system. Whilst Assembly support is related to a notional amount of local authority long term borrowing which the Assembly is prepared to support for capital investment, under the prudential system authorities have complete discretion as to whether they borrow more or less than this, as the support is provided as an unhypothecated block in the RSG. The capital charge element of the Standard Spending Assessment (SSA) is distributed by pre-determined formula based on:

- *credit ceilings* as defined in the previous system rolled forward in respect of borrowing undertaken under the credit approval system; and

- *amounts of supported borrowing* in respect of borrowing under the prudential capital system.

38 The quantum of Supported Borrowing is determined as part of the Assembly’s Budget Planning Round and is included in the budget as capital DEL (Departmental Expenditure Limit) i.e. the Assembly is responsible for controlling this amount. The distribution of the quantum (as an SSA block) is based on a formula agreed by the Capital Sub Group of the Partnership Council.

CIPFA'S PRUDENTIAL CODE FOR CAPITAL FINANCE IN LOCAL AUTHORITIES

39 CIPFA’s Prudential Code has been developed as a professional code of practice to support the decisions local authorities have to make to plan for capital investment at a local level. Paragraphs 13 and 17

demonstrate that CIPFA's Prudential Code is an integral part of the prudential framework for capital expenditure. It has some key objectives:

- to ensure within a clear framework that capital expenditure plans are affordable, prudent and sustainable;

- that Treasury Management decisions are taken in accordance with good professional practice; and

- that local strategic planning, asset management planning and proper option appraisal are supported.

Governance Issues

40 CIPFA's Prudential Code sets out a clear governance procedure for setting and, where necessary, revising the Prudential Indicators. This is undertaken by the same body that takes the decisions on the local authority budget - for most authorities this will be the full Council. Only the body that sets the indicators will be able to revise them.

41 The Chief Finance Officer ensures that all matters required to be taken into account (see paragraph 42 below) are reported to the decision making body for consideration and, once indicators and limits are set, put in place procedures for continued measurement, monitoring, and periodic reporting so that members can be properly responsible for and involved in prudential affairs.

Matters to be taken into Account When Setting and Revising the Prudential Indicators

42 In setting or revising the Prudential Indicators, the Code requires that local authorities will have regard to the following matters:

- Affordability e.g. for Council Tax and Council Housing Rents;

- Prudence and sustainability e.g. implications for external borrowing;

- Value for Money e.g. option appraisal;

- Stewardship of assets e.g. asset management planning;

- Service objectives e.g. service planning for the authority;

- Practicality e.g. achievability of the forward plan.

The Prudential Indicators

43 CIPFA’s Prudential Code operates on a basis of a basket of indicators and limits relevant to each individual authority’s local circumstances. The Prudential Indicators fall into three broad headings (although the Code also groups indicators into headings which measure affordability and prudence):

- Capital Expenditure,
- Borrowing, and
- Treasury Management.

44 The indicators need to be set on a three year time frame and are based on accounting definitions. The intention is that the indicators are transparent and clearly understood. Prudential indicators need to be forecast for the forthcoming year and two following years. However, the estimation process for these indicators is not static and the three year information required will be rolling scenarios. Actual indicator information should be provided after the financial year end.

45 The Prudential Code does not set any indicative limits or ratios as it is a matter of individual judgement for each authority to set these for itself.

Affordability

46 In considering the affordability of the authority's capital plans authorities need to consider all of the resources currently available to them and estimate those resources available in the future both for revenue and capital. Affordability judgements should consider all the matters to be taken into account when setting and revising the indicators but should also consider all the significant influences on the resources and plans available to the authority including:

- resources available to finance proposed capital expenditure;
- revenue consequences of proposed capital expenditure, including increased revenue spending for new schemes, debt consequences or revenue savings as a result of a new scheme;
- interest costs and interest receivable;
- major commitments e.g. PFI schemes, leases;
- levels of reserves;

- planned growth or savings in revenue or capital budgets;
- revenue consequences of retirement benefits;
- any contingent liabilities;
- the extent to which financing costs are supported by government grants or contributions from other bodies;
- current and future requirements for MRP; and
- where an authority has interests in companies or similar related entities, it will need to have regard for its financial commitments and obligations to those bodies.

47 Most Prudential Indicators must be set for a three-year time frame. However, the Code requires that significant known variances beyond this time frame are also considered. The prudential system gives significant impetus to local authority medium term financial plans and financial planning strategies.

48 CIPFA's Prudential Code specifies that the fundamental objective in local authorities' consideration of affordability is to ensure that its total capital investment remains within sustainable limits and in particular to consider the impact on council tax/rent levels. The authority has to make a judgement to determine affordability by deciding upon the acceptable level of council tax and rent levels.

Prudence

49 In order to ensure that over the medium term net borrowing will only be for a capital purpose, the local authority should ensure that net external borrowing does not, except in the short term, exceed the total capital financing requirement in the preceding year plus the estimates of any additional capital financing requirement for the current and next two financial years.

50 The Prudential Code states that ensuring that good treasury management is carried out in accordance with good professional practice is an essential feature of prudence. The Treasury Management Indicators specified in CIPFA's Prudential Code are designed to help demonstrate compliance in this regard.

NATIONAL ASSEMBLY FOR WALES STATUTORY GUIDANCE ON LOCAL GOVERNMENT INVESTMENTS

51 The prudential capital finance system has brought to an end the prescription of the Approved Investments Regulations[8]. In order to support local authorities in the prudential regime the Welsh Assembly Government has by power conferred on it under the 2003 Act issued statutory guidance on Local Government Investments. The guidance is intended to encourage local authorities to invest prudently without burdening local authorities with the detailed prescription of the old system.

52 This statutory guidance requires local authorities to prepare an Annual Investment Strategy (AIS) which will set out their investment plans for the following financial year. The guidance requires that the AIS differentiates between Specified and Non Specified Investments. Specified Investments are intended to be low risk and highly liquid with a maturity of no more than a year. Non Specified Investments are those which fall outside this definition and are subject to additional procedures. All investments undertaken by local authorities should be undertaken prudently and in Sterling.

53 This statutory guidance on Local Government Investments does not duplicate the material covered in the CIPFA's Treasury Code but builds upon and supplements it. The guidance also permits the requirements of the AIS to be combined with the reporting requirements of the CIPFA's Treasury Management Code.

EXTERNAL AUDIT

54 There is no explicit requirement in the 2003 Act for the audit of the Prudential Indicators or the authority's position against limits. However, it is anticipated that external auditors will have an important role to play. External auditors of local authorities have a responsibility to review and, where appropriate report on, the financial aspects of a body's arrangements in accordance with the Code of Audit Practice. This would include any issues arising from the new regime as they relate to the legality of transactions that might have significant financial consequences, the financial standing of the audited body, and systems of internal financial control. Auditors also have a similar responsibility to review and report on aspects of the audited body's arrangements to manage its performance as they relate to economy, efficiency, and effectiveness in the use of resources. Auditors' particular interest will therefore be in the arrangements that authorities have put in place to ensure that they satisfy their statutory responsibilities under the 2003 Act and to secure value for money in the stewardship of resources.

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[8] Local Authorities (Capital Finance) (Approved Investments) Regulations 1990 S.I. 426

FINANCIAL AND ASSET MANAGEMENT PLANNING

55 In order to determine what its affordable borrowing limits are the authority must make decisions about its capital expenditure plans and assess these against all of the other resource plans of the Council to determine whether the budgets as a whole are affordable. To do this effectively Chief Finance Officers should consider whole of life costings of projects and do so against the other options for service provision available to them. The three year timetable for Prudential Indicators is a minimum requirement and the Code specifically requires local authorities to consider the implications of known significant variations beyond three years.

56 Budgeting and affordability judgements need to assess the future affordability of individual capital schemes and projects on the basis of future impact on revenue accounts, allowing proper consideration of the impact of capital investment on running costs, income generation, efficiency savings and any debt consequences. This requires properly rounded decisions which need to be assessed against service and corporate priorities and objectives and which reflect the whole life of an asset.

57 In the previous system capital investment decisions were constrained by the levels or types of capital resource available to the authority at the time the investment was to be carried out. As a function of this, traditionally revenue and capital investment budgets were considered separately, and any integration of the budgets was usually a year end exercise. The prudential system enables capital and revenue investment decisions to be compared directly against each other. Affordability judgements require that the revenue consequences for any scheme are considered in detail. This breakdown of the revenue/capital split allows authorities the flexibility to concentrate on the best overall solution to service delivery, rather than one which scores most favourably against capital controls. This allows consideration of invest to save schemes - capital enhancement/refurbishment could potentially be financed out of energy and maintenance savings. Capital intensive solutions to service delivery issues can be considered fairly against alternative solutions with higher running costs. Income generated by new capital investment could fully or part finance new schemes.

58 The prudential system will also allow and encourage full consideration of all the available options for financing asset acquisition: revenue financing; borrowing; finance leases; operating leases; partnership options. All options will be available to an authority and assessed equally on a basis of objective option appraisal and affordability judgments. Under the prudential system the decision can (and should) be made according to which financing option provides the best value for money.

59 The prudential system reinforces medium term financial planning which effectively integrates strategic decisions with financial planning and with budgetary decisions. It reinforces this by having a number of requirements that encourage authorities to improve their financial planning processes i.e. by harmonising financial decisions with their corporate and service plans, by establishing a minimum of a three year budgetary planning horizon and by promoting integrated revenue and capital budgeting. The Welsh Assembly Government is considering issuing settlements on a three year basis to support medium term financial plans. However, it does not see the current annual settlement process as a barrier to fullfilling the requirements of the prudential system.

Risk Management

60 The ability to consider more options and the need to look at affordability over the whole life of new or improved capital assets introduces new risks into the investment decision and therefore will increase the risk profile for these decisions. CIPFA's Prudential Code states that when making affordability assessments authorities need to pay due regard to risk and uncertainty. Risk analysis and risk management should be an important part of an authority's arrangements for the Prudential Framework. Particular areas for consideration will be:

- ensuring that standing orders and financial regulations are robust enough to cope with the risks of the increased options afforded by the Prudential Framework;

- ensuring that financial management information is as reliable as it can be to support decisions;

- making sure that officers responsible for providing advice have appropriate skills (or support) in forecasting and estimating future trends economic circumstances, finances, service delivery, (analysis of these trends is likely to require understanding and use of techniques such as sensitivity/ scenario analysis and financial modelling) etc;

- setting appropriate standards for the quality of projections of income generation and efficiency savings that the authority might seek to rely on in assessing affordability.

Asset Management Planning

61 In order to fully comply with the objectives of the prudential regime and maximise the opportunities offered, local authorities will require increasingly sophisticated Asset Management Plans. The information on assets will need to cover not just purchase or replacement costs but maintenance costs, utilisation, and running costs to allow authorities to

consider the impact of any asset on the revenue budget. Detailed asset information will be required to ensure that the asset portfolio adequately supports the corporate and service objectives of local authorities. In addition, detailed knowledge of disposal plans and surplus assets will be required to forecast the income stream projected in capital investment plans and affordability analysis. The Welsh Assembly Government encourages and supports effective asset management planning.

CONCLUSIONS

62. Compliance with the legal framework on which the prudential regime operates is an important priority for authorities. However, it is equally important that local authority members and officers work in the longer term to integrate consideration of asset management issues into the full range of decisions about the affordability of options for service delivery.

Local Government Finance Division
June 2004

SUMMARY OF THE STATUTORY FRAMEWORK FOR THE PRUDENTIAL SYSTEM FOR CAPITAL INVESTMENT

(A complete listing of the Sections of Part 1 of the Act are set out in Annex 2)

PRIMARY LEGISLATION	SECONDARY LEGISLATION	STATUTORY GUIDANCE /CODES OF PRACTICE
• Local Government Act 2003 (2003 Act)	• Local Authorities (Capital Finance And Accounting) (Wales) Regulations 2003 - 2003 Regulations • Local Authorities (Capital Finance And Accounting) (Wales) (Amendment) Regulations 2004 - 2004 Regulations	• The CIPFA Prudential Code For Capital Finance In Local Authorities (Prudential Code) • CIPFA Treasury Management In Public Services Code Of Practice And Cross Sectoral Guidance Notes (CIPFA) Treasury Management Code) • The Code Of Practice On Local Authority Accounting In The United Kingdom A Statement Of Recommended Practice (The SORP) • Best Value Accounting Code Of Practice (BVACOP) • The National Assembly for Wales Statutory Guidance on Local Government Investment

PRIMARY LEGISLATION	SECONDARY LEGISLATION	STATUTORY GUIDANCE /CODES OF PRACTICE
• General Power to Borrow • Control of Borrowing	• The 2003 Regulations give statutory backing to the CIPFA Prudential Code.	• CIPFA's Prudential Code contains the governance procedures, functions and definitions to which authorities must have due regard when setting their affordable borrowing limit.
• Duty to set an Affordable Limit to Borrow • Imposition of Borrowing Limits		• CIPFA's Prudential Code uses accounting definitions provided by the SORP to define borrowing.
• Credit arrangements - new definition defined in accordance with proper practices	• The 2003 Regulations (as amended) define liabilities which do not meet the definition of credit arrangements. • The 2003 Regulations also define the calculations of the costs of credit arrangements based on proper practices.	• The SORP recognition criteria defines when an asset is created on local authorities balance sheets. This is the accounting test, which defines when an authority is deemed to have entered into a credit arrangement under the prudential capital finance system.

PRIMARY LEGISLATION	SECONDARY LEGISLATION	STATUTORY GUIDANCE /CODES OF PRACTICE
	• The 2004 Regulations set the process to define the treatment on lease transactions not deemed to be credit arrangements under the old system but which when varied become credit arrangements under the prudential system.	
• Capital Receipts • Use of Capital Receipts • Non money receipts	• The 2003 Regulations add further detail to the definition in the Act. They define sums to be and not to be treated as capital receipts. A capital receipt is only defined as such if the total proceeds from a disposal are more than £10,000. • The 2003 Regulations define the requirements and arrangements for Pooling HRA capital receipts.	

PRIMARY LEGISLATION	SECONDARY LEGISLATION	STATUTORY GUIDANCE /CODES OF PRACTICE
	• The 2003 and 2004 Regulations set out that capital receipts may only be used to repay debt, to pay premia and for capital expenditure and qualifying credit arrangements. • The 2003 Regulations also define notional capital receipts	
• General power to invest	• Section 15 of the Act provides the Assembly with the power to specify guidance to which authorities should have due regard when undertaking the duties in respect of Chapter 1 Part I of the 2003 Act. The Assembly has used this power to require that authorities have regard to the CIPFA Treasury Management Code.	• CIPFA's Treasury Management Code sets out clear foundations, practices and procedures for effective treasury management in public services which underpin the Prudential Regime, the Prudential Indicators and the statutory guidance on Local Government Investments (see paragraphs 29 and 51-53). • The Welsh Assembly Government has also issued Statutory Guidance on Local Government Investments using its powers under Section 15 (see paragraphs 51-53).

PRIMARY LEGISLATION	SECONDARY LEGISLATION	STATUTORY GUIDANCE /CODES OF PRACTICE
• Capital Expenditure - expenditure of the authority falls to be capitalised in accordance with proper practices. • Power to direct expenditure to be capital expenditure.	• 2003 and 2004 Regulations provide which types of expenditure are defined as being capital expenditure. See paragraph 27, which sets out a small number of clarifications to confirm Welsh Assembly Government's intentions with regard to capital expenditure.	• The SORP defines the proper practice on which capital expenditure should be recognised in local authorities' balance sheets. • CIPFA's Prudential Code sets indicators for capital expenditure based on definitions in SORP.
• Proper Practices - the National Assembly for Wales may make provisions on accounting practices.	• The 2003 Regulations specify the SORP and BVACOP as Codes of Practice under this power.	• The SORP sets out the principles and practices of accounting required to prepare a statement of accounts which "presents fairly" the financial position and transactions of the authority. • SORP and BVACOP set out detailed requirements for financial reporting for local authorities.

PRIMARY LEGISLATION	SECONDARY LEGISLATION	STATUTORY GUIDANCE /CODES OF PRACTICE
• Revenue Account	• The Regulations define what is chargeable to a revenue account in respect of debt and credit liabilities and provides for the formula for the MRP prudential system.	

Technical Annex 2

LISTING OFSECTIONS IN PART 1 OF THE LOCAL GOVERNMENT ACT 2003	
Section 1	**Power to Borrow** - see paragraph 13
Section 2	**Control of Borrowing** – see paragraph 13
Section 3	**Duty to determine affordable borrowing limit** – see paragraph 13
Section 4	**Imposition of borrowing limit** – see paragraph 13
Section 5	**Temporary Borrowing** – This section allows extra flexibility in the event of unforeseen needs, by providing for the borrowing limits (required by Section 3 of the 2003 Act) to increase by the amounts of any payments which are due to the authority in the year but have not yet been received.
Section 6	**Protection of Lenders** – This section of the 2003 Act permits lenders to local authorities not to make enquiries about whether or not the authority has the power to borrow and ensures that lenders are not prejudiced by any such power.
Section 7	**“Credit arrangements”** – see paragraph 13
Section 8	**Control of credit arrangements** – see paragraph 13
Section 9	**“Capital receipt”** –

LISTING OFSECTIONS IN PART 1 OF THE LOCAL GOVERNMENT ACT 2003	
	see paragraph 13
Section 10	**Non money receipts** – see paragraph 13
Section 11	**Use of Capital Receipts** – see paragraph 13
Section 12	**Power to Invest** – see paragraph 13
Section 13	**Security of Money Borrowed** All money borrowed by local authorities together with interest will be charged indifferently on the revenues of the authority.
Section 14	**Information** Allows the National Assembly to specify information requirements in the prudential system for example statistical returns.
Section 15	**Guidance** This section enables the Welsh Assembly Government to issue guidance on any part of Part 1 of the Act. Local authorities will need to have due regard for such guidance**.**
Section 16	**"Capital expenditure"** – see paragraph 13
Section 17	**External funds** Section 17 of the 2003 Act excludes external funds e.g. pension funds from the prudential system.
Section 18	**Local Authority Companies** – Provides the power by Regulations to make provision for things done by or to Local Authority companies, Passenger Transport Executives or trusts influenced by local

LISTING OFSECTIONS IN PART 1 OF THE LOCAL GOVERNMENT ACT 2003	
	authorities.
Section 19	**Application to parish and community councils** This section specifies the application of Part 1 of the 2003 Act to parish and community councils.
Section 20	**Directions** – Sets out the form of directions under chapter 1 of the 2003 Act.
Section 21	**Accounting practices** – see paragraph 13
Section 22	**Revenue Account** – see paragraph 13
Section 23	**Local Authorities** – lists the authorities to which the prudential system applies.
Section 24	**Wales** – Sets out the application of chapter 1 of the Act to Wales.

CREDIT ARRANGEMENTS

Paragraph 12 of the Guide explains that the definition of credit arrangements is much simpler than defined under the Local Government and Housing Act 1989, relying on the accounting concept of long-term liabilities. The test for credit arrangements under the 1989 Act were complex and covered all types of leases (except for operating leases of vehicles plant or equipment) and any other contractual agreements where, at some point during their term, a situation would hold for more than one financial year that the authority had paid less than the value of the benefits it had received.

The definition of credit arrangements under the 1989 Act should not be confused with the accounting recognition criteria which categorises lease transactions or hire purchase arrangements as operating or finance leases. This is an important distinction. If authorities have transactions not meeting the definition of a credit arrangement under the old system they would still need to consider under proper practices whether or not they should recognise an asset on their balance sheet. However, provided the lease transaction has not been varied the authority would not be deemed to have “entered into a credit arrangement (Section 7)” under the 2003 Act.

WEBSITE LINKS

- The ***Local Government Act 2003*** is at:

http://www.legislation.hmso.gov.uk/acts/acts2003/20030026.htm.

- ***Explanatory notes*** on the 2003 Act are at:

http://www.legislation.hmso.gov.uk/acts/en/2003en26.htm

- The ***Local Authorities (Capital Finance and Accounting) (Wales) Regulations 2003*** *[S.I. 2003/3239 (W.319)]*, are on the HMSO website at:

http://www.wales-legislation.hmso.gov.uk/legislation/wales/w-stat.htm

- The Local Government Wales, the ***Local Authorities Capital Finance and Accounting) (Wales) (Amendment) Regulations 2004***

http://www.legislation.hmso.gov.uk/legislation/wales/wsi2004/20041010e.htm

- The ***Local Government Act 2003 (Commencement) (Wales) Order 2003*** *[S.I. 2003/3034 (W.282)]*, which brings Part 1 of the 2003 Act into force and includes provisions on the transition from the 1989 Act system to the new one, is at:

http://www.wales-legislation.hmso.gov.uk/legislation/wales/wsi2003/20033034e.htm

- The ***Local Government, England and Wales, the Local Authorities (Capital Finance) (Consequential, Transitional and Savings Provisions Order 2004*** (*S.I 2004/533)* is at*:*

http://www.hmso.gov.uk/si/si2004/20040533.htm

- ***CIPFA's Prudential Code*** and other CIPFA documents mentioned in this commentary can be ordered from CIPFA at:

    http://secure.cipfa.org.uk/cgi-bin/CIPFA.storefront/EN/Catalog/1018

- More information on Local Government Finance and Modernisation can be found on the Local Government subject pages of the ***National Assembly for Wales*** is:

http://www.wales.gov.uk/subilocalgov/topics-e.htm

Enquiries

Enquiries in respect of this Guide and the prudential system should be made to:

Local Government Finance Division
Welsh Assembly Government
Cathays Park
Cardiff
CF10 3NQ

Email:LGF3L@wales.gsi.gov.uk

GLOSSARY OF TERMS AND ABBREVIATIONS USED

The following explanations are provided for ease of reference to be read as a part of this Guide. They are not intended to be technical, accounting or legal definitions or interpretations of any enactment. For detailed interpretations direct reference should be made to the provisions in of the following Acts or regulations, or appropriate code of practice and legal or professional advice sought.

Term	Explanation or Description
2003 Act	The Local Government Act 2003 (Chapter 26).
2003 Regulations	The Local Authorities (Capital Finance and Accounting) (Wales) Regulations 2003 (SI 2003 No 3239 (W.319)).
2004 Regulations	The Local Authorities (Capital Finance and Accounting) (Amendment) (Wales) Regulations 2004 (SI 2004 No 1010 (W107)).
Asset Management Plan (AMP)	Plans produced by local authorities which set out: • the value and condition of their assets; • proposals to safeguard the value and condition of these assets; • capital implications of community plans, corporate needs and service priorities; and • the revenue implications of capital investment decisions.
Annual Investment Strategy (AIS)	The National Assembly for Wales Statutory Guidance on Local Government Investment requires that local authorities produce an Annual Investment Strategy which will set out their categories of both Specified and Non Specified Investments.

Term	Explanation or Description
Best Value Accounting Code of Practice (BVACOP)	A Code of Practice produced by CIPFA to provide a consistent approach to reporting the total cost of services. The 2003 Regulations specify that the accounting practices set out in this Code are "proper practices" as defined in the 2003 Act.
Capital Expenditure	Expenditure (defined by proper practices) on, or for, the creation of tangible fixed assets (see Section 16 of the 2003 Act and the SORP). Such expenditure may be financed out of capital receipts, capital grant, direct revenue financing or by borrowing.
Capital Financing Requirement	A prudential indicator defined in the CIPFA Prudential Code. This indicator can be derived by aggregating information in local authorities' balance sheets. The indicator generally represents the underlying need to borrow for capital expenditure.
Capital Receipts	Receipts from the disposal of an interest in fixed assets (See Sections 9, 10 and 11 of the 2003 Act).
CIPFA	Chartered Institute of Public Finance and Accountancy.
Credit Arrangements	Lease or hire purchase transactions and deferred purchase arrangements meeting the definition of Section 7 of the 2003 Act. The definition of credit arrangements relies on proper practices as defined by the SORP. If the lease transaction or arrangement results in a fixed asset being recognised on the local authority's balance sheet matched by long-term liabilities it will meet the definition of the credit arrangement in the Act.
Credit Ceiling	Measurement of the underlying need to borrow for capital expenditure in the Local Government and Housing

Term	Explanation or Description
	Act 1989. The credit ceiling increased when credit approvals were used to finance local authority capital expenditure and decreased when capital receipts and revenue (MRP) were set aside to meet credit liabilities.
Code of Audit Practice	The Audit Commission Act 1998 requires the Audit Commission to "prepare and keep under review, a code of audit practice prescribing the way in which auditors [appointed by the Audit Commission] are to carry out their functions under this (Audit Commission 1998) Act and which embodies "what appears to the [Audit] Commission to be the best professional practice with respect to the standards, procedures and techniques to be adopted by auditors". The current edition of the Code came into effect on 29 March 2000 (as amended in 2002).
Depreciation	An accounting charge that measures the wearing out or consumption of fixed assets over their useful lives. The accounting definition of depreciation is provided in the local authority SORP.
Housing Revenue Account (HRA)	Local authorities are required to maintain a separate account, the Housing Revenue Account, defined by Section 74 and Schedule 4 of the Local Government and Housing Act 1989. This account sets out the expenditure and income arising from council housing provision.
Housing Revenue Account Subsidy	A grant issued by the Welsh Assembly Government towards the cost of providing, managing and maintaining council housing dwellings.
Hypothecated Support	Specific government support for expenditure on particular services, or

Term	Explanation or Description
	service initiatives.
Improvement Plans	An Improvement Plan is a statutory performance plan produced by Welsh local authorities on an annual basis to enable it to demonstrate corporate and service performance and meet its obligations under Section 6 of the Local Government Act 1999.
Invest to Save Schemes	Capital projects or schemes which allow the cost of investment in new and more efficient infrastructure or capital build to be met wholly or in part from reductions in maintenance costs and energy bills.
Minimum Revenue Provision (MRP)	Minimum provision for borrowing or credit liabilities chargeable annually to revenue accounts, defined in the prudential system by a formula in the 2003 Regulations as 4% of the Capital Financing Requirement.
Non Specified Investments	A term defined by the National Assembly for Wales Statutory Guidance on Local Government Investment. Non Specified Investments are those outside the definition of Specified Investments – additional procedures are required for these investments.
Option Appraisal	The process of defining objectives, examining options and weighing up the costs benefits, risks and uncertainties before a decision is made. Under the prudential system option appraisal can consider different capital schemes or revenue and capital schemes. .
Prudential Code (CIPFA's)	The CIPFA Prudential Code for Capital Finance in Local Authorities sets out the procedures and indicators (see below) which will assist local authorities in meeting their requirements under Part I of the 2003 Act. The 2003 Regulations

Term	Explanation or Description
	provide statutory backing to the Code.
Prudential Indicators/Limits	Indicators set out in the Prudential Code which will help authorities meet the statutory requirements in relation to borrowing limits or which will help authorities demonstrate affordability and prudence with regard to their prudential capital investment.
Revenue Support Grant (RSG)	A grant paid by the Welsh Assembly Government to support local authority services in general.
SORP	The Code of Practice on Local Authority Accounting in the United Kingdom, A Statement of Recommended Practice (the SORP). This code is produced by the CIPFA/LASAAC Joint Committee and sets out the requirements for the annual statement of accounts. The 2003 Regulations specify that the accounting practices set out in this Code are "proper practices" as defined in the 2003 Act
Specified investment	A term defined by the National Assembly for Wales Statutory Guidance on Local Government Investment. This term concentrates on prudent and highly liquid investments of a maturity of no more than a year.
Standard spending assessment (SSA)	A calculation of the level of spending that authorities would have to incur in providing a standard level of services. The SSA is used to calculate the local authority’s revenue support grant.
Supported Borrowing	Assumed level of borrowing that the Welsh Assembly Government will support by Revenue Grants towards principle repayments and interest.
Treasury Management Code (CIPFA’s)	The CIPFA's Treasury Management in the Public Services: Code of Practice and Cross Sectoral

Term	Explanation or Description
	Guidance. The 2003 Regulations require that local authorities have due regard for this Code. This sets out practices, procedures and reporting requirements which underpin the prudential system.
Treasury's Fiscal Strategy	On a high level basis the Treasury's Fiscal Strategy is represented by the Golden Rule and the Sustainable Investment Rule: • **The Golden Rule**: Over the economic cycle, the Government will borrow only to invest and not to fund current spending • **Sustainable investment rule:** public sector net debt as a proportion of GDP will be held at a stable and prudent level (other things being equal below 40%).
Unsupported Borrowing	Borrowing undertaken in the prudential system not supported by Welsh Assembly Government grants which local authorities have assessed to be affordable.
Unhypothecated Support	Government support for expenditure or services not linked to any specific scheme or initiative.
Whole of Life Costing	Costing information analysed for an asset over the whole period that it will be useful for an authority, including purchase price, repairs and maintenance costs, energy bills, asset utilisation charges, income generated from the asset, and any residual value. Provides full information on the revenue implications of ownership of the asset.