The Prudential Code for Capital Finance in Local Authorities 2011 Edition

EXECUTIVE SUMMARY

INTRODUCTION

E1 The Prudential Code plays a key role in capital finance in local authorities. Local authorities determine their own programmes for capital investment in fixed assets that are central to the delivery of quality public services. The Prudential Code was developed by CIPFA, the Chartered Institute of Public Finance and Accountancy, as a professional code of practice to support local authorities in taking their decisions. Local authorities are required by Regulation to have regard to the Prudential Code when carrying out their duties in England and Wales under Part 1 of the Local Government Act 2003, in Scotland under Part 7 of the Local Government in Scotland Act 2003 and in Northern Ireland under Part 1 of the Local Government Finance Act (Northern Ireland) 2011.

OBJECTIVES

E2 The framework established by the Prudential Code should support local strategic planning, local asset management planning and proper option appraisal. The objectives of the Prudential Code are to ensure, within a clear framework, that the capital investment plans of local authorities are affordable, prudent and sustainable, and that treasury management decisions are taken in accordance with good professional practice. In exceptional cases the Prudential Code should provide a framework which will demonstrate that there is a danger of not ensuring this, so that the local authority concerned can take timely remedial action.

E3 To demonstrate that local authorities have fulfilled these objectives, the Prudential Code sets out the indicators that must be used, and the factors that must be taken into account. The Prudential Code does not include suggested indicative limits or ratios. These will be for the local authority to set itself, subject only to any controls under section 4 of the Local Government Act 2003 (England and Wales), section 36 of the Local Government in Scotland Act 2003 (Scotland) and section 14 of the Local Government Finance Act (Northern Ireland) 2011.

E4 The prudential indicators required by the Prudential Code are designed to support and record local decision making in a manner that is publicly accountable. They are not designed to be comparative performance indicators. They should be considered in parallel with the treasury management indicators required by the CIPFA *Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes*.

SCOPE

E5 The Prudential Code applies to all local authorities, including police, fire and other authorities.

PROCESS AND GOVERNANCE ISSUES

E6 The Prudential Code sets out a clear governance procedure for the setting and revising of prudential indicators. This will be done by the same body that takes the decisions for the local authority's budget – ie usually it will be the full council for the authority concerned. The chief finance officer will be responsible for ensuring that all matters required to be taken into account are reported to the decision-making body for consideration, and for establishing procedures to monitor performance.

E7 Prudential indicators for previous years will be taken directly from information in local authorities' Statements of Accounts. If any item within a local authority's Statement of Accounts that is relied on for a prudential indicator is the subject of audit qualification, this must be highlighted when the prudential indicators are set or revised.

MATTERS REQUIRED TO BE TAKEN INTO ACCOUNT

E8 In setting or revising their prudential indicators, the local authority is required to have regard to the following matters:

- Service objectives, eg strategic planning for the authority
- Stewardship of assets, eg asset management planning
- Value for money, eg option appraisal
- Prudence and sustainability, eg implications for external debt and whole life costing
- Affordability, eg implications for council tax/district rates
- Practicality, eg achievability of the forward plan.

E9 The Local Government Act 2003 and the Local Government Finance Act (Northern Ireland) 2011 refer to affordability and the requirement that local authorities in England, Wales and Northern Ireland determine and keep under review the amount of money they can afford to borrow for capital investment. The Local Government in Scotland Act 2003 requires Scottish local authorities to keep under review the maximum amount they can afford to allocate to capital expenditure. In order to carry out their duties under legislation in respect of affordability, local authorities are required to have regard to all those aspects of the Prudential Code that relate to affordability, sustainability and prudence.

DECISION MAKING ON CAPITAL INVESTMENT

E10 A soundly formulated capital programme must be driven by the desire to provide high quality, value for money public services. The Prudential Code recognises that in making its capital investment decisions the authority must have explicit regard to option appraisal, asset management planning, strategic planning for the authority and achievability of the forward plan.

E11 The Prudential Code does not specify how the local authority should have regard to these factors. All of them represent elements of good practice for which guidance has already been provided by CIPFA and other authoritative sources. The Prudential Code instead concentrates on the means by which the authority will demonstrate that its proposals are affordable, prudent and sustainable.

AFFORDABILITY

E12 The fundamental objective in the consideration of the affordability of the authority's capital plans is to ensure that the total capital investment of the authority remains within sustainable limits, and in particular to consider its impact on the local authority's 'bottom line' and hence council tax or district rates (Northern Ireland). Affordability is ultimately determined by a judgement about acceptable council tax or rates levels.

E13 In considering the affordability of its capital plans, the authority is required to consider all of the resources currently available to it/estimated for the future, together with the totality of its capital plans, revenue income and revenue expenditure forecasts for the forthcoming year and the following two years. The authority is also required to consider known significant variations beyond this timeframe. This requires the development of three-year revenue forecasts as well as three-year capital expenditure plans. These are rolling scenarios, *not* fixed for three years.

E14 When considering affordability, the authority needs to pay due regard to risk and uncertainty. Risk analysis and risk management strategies should be taken into account.

E15 The following prudential indicators are key indicators of affordability:

Looking ahead for a three-year period:
- Estimates of the ratio of financing costs to net revenue stream
- Estimates of the incremental impact of capital investment decisions on the council tax

After the year end:
- Actual ratio of financing costs to net revenue stream.

E16 Other prudential indicators that relate to affordability are:

Looking ahead for a three-year period:
- Estimates of capital expenditure
- Estimates of capital financing requirement (underlying need to finance capital expenditure)
- Authorised limit for external debt (see paragraph E17)
- Operational boundary for external debt (see paragraph E17).

After the year end:
- Actual capital expenditure
- Actual capital financing requirement
- Actual external debt.

E17 Both the authorised limit and the operational boundary for external debt need to be consistent with the authority's plans for capital expenditure and financing; and with its treasury management policy statement and practices. Risk analysis and risk management strategies should be taken into account. The operational boundary should be based on the authority's estimate of most likely, ie prudent, but not worst-case scenario and should equate to the maximum level of external debt projected by this estimate. The operational boundary is a key management tool for in-year monitoring. It will probably not be significant if the operational boundary is breached temporarily on occasions due to variations in cash flow. However, a sustained or regular trend above the operational boundary would be significant and should lead to further investigation and action as appropriate. The authorised limit will in addition need to provide headroom over and above the operational boundary, sufficient for example for unusual cash movements.

PRUDENCE

E18 By virtue of the requirements already listed above, the prudential indicators in respect of external debt must be set and revised taking into account their affordability. It is through this means that the objectives of sustainability and prudence are addressed year on year.

E19 In order to ensure that over the medium term net debt will only be for a capital purpose, the local authority should ensure that net external debt does not, except in the short term, exceed the total of the capital financing requirement in the preceding year plus the estimates of any additional capital financing requirement for the current and next two financial years. This is a key indicator of prudence. Where there is a significant difference between the net and the gross debt position, the risks and benefits associated with this strategy should be clearly stated in the annual treasury management strategy.

E20 It is also prudent that treasury management is carried out in accordance with good professional practice. The Prudential Code requires local authorities to adopt the CIPFA *Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes*.

THE PRUDENTIAL INDICATORS

E21 The Prudential Code promotes transparency in decision making by using information contained within the published Statements of Accounts of the local authority and by having definitions for prudential indicators that are consistent with the definitions used within the Statements of Accounts.

E22 The prudential indicators specified in the Prudential Code are the minimum required. Local authorities are encouraged to set further prudential indicators where this would assist their own management processes. However, any additional prudential indicators set locally should not, unless required to do so by legislation or official guidance, associate any part of the authority's external borrowing with particular items, categories or purposes of expenditure. The authority should have an integrated treasury management strategy within which its borrowing and investments are managed in accordance with best professional practice.

CONCLUSION

E23 The Prudential Code supports the system of capital investment in local authorities. It is integrated within the wider statutory and management processes of local government. Key elements of the system continue to be determined through legislation, in particular the amount required to be charged to taxation by local authorities in respect of capital investment and the amount and method of government support for capital investment. These will be significant considerations when local government takes decisions on capital investment. However, the level of capital investment that can be supported will, subject to affordability and sustainability, be a matter for local decision.