Communities and Local Government

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7 March 2007

Chief Executives
Directors of Finance
Directors of Housing

Local Authorities in England

Dear Colleague

CAPITAL FINANCE AMENDMENT REGULATIONS

Local Authorities (Capital Finance and Accounting) (Amendment) (England) Regulations 2007 [Statutory Instrument No. 2007/573]

1. My letters of 20 November and 11 December 2006 invited comments on the draft of these Regulations. The consultation closed on 12 January. I wrote on 8 February summarising the outcome of the consultation and indicating certain changes being made to the text in the light of that exercise. These documents are available at:
http://www.local.communities.gov.uk/finance/capital/index.htm

2. The Regulations have now been made and laid before Parliament. Regulations 1, 3 and 5 are due to come into force on **30 March 2007** and the remainder on **1 April 2007**. The Regulations are available online at:
http://www.opsi.gov.uk/si/si2007/20070573.htm

3. The main aims of the amendments are to:

- Provide greater flexibility to **invest in property** [regulation 2(b)]
- Simplify the **Minimum Revenue Provision** rules [regulation 3]
- Confirm the accounting treatment of **capital expenditure** [regulation 4]
- Modify the revenue impact of **unequal pay back-pay awards** [regulation 5]
- Mitigate adverse effects of new **accounting changes** [regulation 6]
- Relax the rules on **pooling** Social HomeBuy capital receipts [regulation 7]

4. A detailed informal commentary is attached below.

5. Any queries should be addressed to trevor.emmott@communities.gsi.gov.uk.

Yours sincerely

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An informal commentary on

The Local Authorities (Capital Finance and Accounting) (Amendment) (England) Regulations 2007

Statutory Instrument No. 2007/573

This is a purely informal commentary and not an authoritative interpretation of the law. If you need legal advice about the meaning of the Regulations, we suggest that you consult your own legal advisers.

(1) INTRODUCTION

1.1 The *Local Authorities (Capital Finance and Accounting) (Amendment) (England) Regulations 2007* ("the Amendment Regulations") are available online at:
[Web version] http://www.opsi.gov.uk/si/si2007/20070573.htm
[Print version] http://www.opsi.gov.uk/si/si2007/uksi_20070573_en.pdf

1.2 The dates of coming into force of the Regulations are as follows:
- Regulation 1 (Commencement, Interpretation etc) – 30 March 2007
- Regulation 3 (Minimum Revenue Provision) – 30 March 2007
- Regulation 5 (Back Pay) – 30 March 2007
- All other regulations – 1 April 2007

This means that regulations 1, 3 and 5 begin to have effect in the 2006-07 financial year, while the rest apply from the start of the 2007-08 financial year.

1.3 The Amendment Regulations update the *Local Authorities (Capital Finance and Accounting) (England) Regulations 2003* [SI 2003/3146, as amended] ("the 2003 Regulations"). The 2003 Regulations were brought into force on 1 April 2004 for the purpose of implementing the Prudential capital finance system under Part 1 of the *Local Government Act 2003*. Web links to the Act, the 2003 Regulations and the earlier sets of amendments to the 2003 Regulations are as follows:

Local Government Act 2003
http://www.opsi.gov.uk/acts/acts2003/20030026.htm.

Local Authorities (Capital Finance and Accounting) (England) Regulations 2003
http://www.opsi.gov.uk/si/si2003/20033146.htm.

Earlier amendment Regulations
http://www.opsi.gov.uk/si/si2004/20040534.htm.
http://www.opsi.gov.uk/si/si2004/20043055.htm.
http://www.opsi.gov.uk/si/si2006/20060521.htm.

(2) CAPITAL EXPENDITURE DEFINITION

(a) Expenditure on equipment **[Amendment Regulation 2(a)]**

2.1 **Background.** The definition of capital expenditure is normally based on accounting practice, but may be modified by regulations; various such changes are made in existing regulation 25. One extension of the definition (regulation 25(1)(e)) is to cover works on property not owned by the local authority (eg installation of smoke alarms in the homes of disabled persons), thereby giving the authority the flexibility to fund the works out of capital resources. However, if an authority simply provides *equipment* which does not become a permanent fixture in the person's home (eg a wheelchair), accounting practice would not allow that to be treated as capital expenditure.

2.2 **Effect of amendment.** The definition of capital expenditure in regulation 25 is being extended to cover expenditure on the provision of equipment for use by others (where, if the equipment were for use by the authority, it would be capital expenditure).

(b) Investment in property funds **[Amendment Regulation 2(b)]**

2.3 **Background.** Local authorities have wide freedom to invest their surplus funds. However, existing regulation 25(1)(d) defines as capital expenditure the acquisition of shares and corporate bonds issued by individual companies (which means they would reduce the authority's scope for funding capital projects). But there is an exemption (regulation 25(3)) if shares or bonds are acquired through collective investment schemes, such as unit trusts - because such funds spread and reduce risk, while allowing quick access to the cash. Recently, the Government has given a boost to a new kind of investment scheme - Real Estate Investment Trusts (REITs) - based on a portfolio of commercial properties, through the *Finance Act 2006*, which amends the tax regime for such schemes complying with safeguards specified in the legislation. However, it appears that investing in such a scheme would involve acquiring shares which at present would be classed as capital expenditure.

2.4 **Effect of amendment** Regulation 25(3) is amended to ensure that buying shares in REITs does not count as capital expenditure, thereby giving authorities more options to consider this new form of investment. This should, of course, not be regarded as a recommendation to use any such investment – it is for authorities to make their own investment decisions, in the light of appropriate risk assessments and any necessary professional advice.

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(3) MINIMUM REVENUE PROVISION
[Amendment Regulation 3]

Background

3.1 Existing regulations 27, 28 and 29 set out the scheme of Minimum Revenue Provision (MRP). The current rules were designed to ensure that, on the introduction of the Prudential capital finance system in 2004, authorities were not faced with a greater MRP requirement than under the former system, simply due to the technicalities of the transition. That result was generally achieved, through some quite complex provisions. For a small number of authorities in special circumstances, however, the regulations appear to be producing an unintended impact. Attempting to tackle the anomalies within the present framework would add to the complexity of the system. Moreover, the present scheme of MRP looks out of place in the broader context of the Prudential system, which is based on simple legislation backed up by standard accounting codes and guidance, and allows authorities significant local discretion based on their own judgement as to what is prudent.

3.2 Amendment Regulation 3(1) contains a new regulation 28, replacing the present one (but see paragraph 3.8 below). The aim is to maintain the broad effect of the current regulation, but to achieve this in a more straightforward way which avoids the anomalies mentioned above. Some additional flexibility is also introduced. This regulation will come into force on 30 March 2007 and will therefore apply with effect from the 2006-07 financial year. The regulation includes various options for reducing MRP, but the Government urges authorities to consider making additional voluntary MRP – especially when undertaking self-financed borrowing – in order to achieve a *prudent* level of provision for servicing debts.

Effect of amendment

3.3 **Basic calculation.** The starting point is the Capital Financing Requirement (CFR) – as defined in the Prudential Code issued by CIPFA (the Chartered Institute of Public Finance and Accountancy) (see Appendix C of the Code). The CFR is already used in the existing regulation 28. The basic MRP is 4% of the CFR at the end of the preceding financial year [new regulation 28(1)].

3.4 **Nil MRP.** No MRP has to be made if the overall calculation produces a nil or negative amount or if the CFR at the end of the preceding financial year is nil or negative [regulation 28(3) and 28(2)].

3.5 **Housing.** There is no longer any need to charge MRP in respect of housing. Therefore, for the purpose of this calculation, the CFR is reduced by those amounts in it relating to HRA expenditure [regulation 28(4)].

3.6 **Commutation.** Existing regulation 29 remains in force and authorities may therefore still reduce MRP by reference to the adjustment relating to commutation losses [regulation 28(1)].

3.7 **Transition from old to new capital systems.** Two safeguards for authorities are built into the regulation. The first protects authorities against artificial increases in MRP arising from the transition from old to new capital finance systems on 1 April 2004. If 4% of the CFR on 31 March 2004 gives a higher amount of MRP for 2004-05 than would have applied if the former capital finance system had not been replaced by the Prudential system, the MRP may each year be reduced by the difference between those two amounts [regulations 28(9) and 28(10)]. In order to operate with the foregoing concession, authorities will need continuing access to the following legislation relevant to the former MRP calculation:

Local Government and Housing Act 1989 (part 4)
http://www.opsi.gov.uk/acts/acts1989/Ukpga_19890042_en_1.htm
Local Authorities (Capital Finance) Regulations 1997 (S.I. 1997/319)
http://www.opsi.gov.uk/si/si1997/19970319.htm.
Amendments to S.I. 1997/319:
http://www.opsi.gov.uk/si/si2000/20001773.htm.
http://www.opsi.gov.uk/si/si2001/20010723.htm

3.8 **Transition from old to new versions of regulation 28.** A further safeguard ensures that no authority should be worse off as a result of the transition from the former version of regulation 28 to the one now replacing it. The regulation therefore provides that, if the new version of regulation 28 would ever produce a higher MRP figure than the one it replaced, then MRP is to be the lesser of those two amounts [Amendment Regulation 3(2)].

3.9 **HRA determinations.** The provisions of the existing regulation 28 are also preserved for the purposes of the HRA determinations made before 30 March 2007 [Amendment Regulation 3(3)].

3.10 **Depreciation.** The regulation also takes the opportunity to begin introducing the concept of depreciation, in a way which will be helpful to authorities. There are certain capital projects requiring substantial upfront borrowing where the asset only comes into service perhaps two years later and then often begins to generate revenues or savings. MRP on the present basis is a disincentive, since it involves a revenue cost from early on. But under depreciation accounting, no revenue provision would be required for an asset under construction until it was completed (though, in the long term, depreciation could still prove more expensive). Several authorities have requested the option in such cases of making revenue provision in accordance with depreciation rules, instead of under the normal MRP regime. The new regulation allows this. Where an authority opts for the depreciation treatment in respect of a project, normal MRP may be reduced by the amount attributable to that expenditure, to avoid a double revenue charge [new regulations 28(5) to 28(8)].

3.11 MRP liability could be reduced by reference to depreciation for the first time in 2007-08, provided that the relevant expenditure was incurred in 2006-07. The regulation at present allows such a reduction for a single year. However, through what is currently clause 168(2) of the *Local Government and Public Involvement Health Bill*, the Government is seeking power to issue guidance on accounting practices. If the Bill becomes law, we will consider using that power to replace part or all of the MRP regulations with guidance in simple language, which could permit greater flexibility than is feasible through legislation. Such guidance could, in particular, allow depreciation to reduce MRP over more than one year. Other simplifications of the MRP system could also be considered. The web link to the Bill is:
http://www.publications.parliament.uk/pa/cm200607/cmbills/016/07016.118-124.html#j0245

(4) CAPITAL EXPENDITURE - ACCOUNTING TREATMENT
[Amendment Regulation 4]

4.1 **Background.** It has been generally accepted by local authorities that proper accounting practice allows capital expenditure not to be charged to revenue. The significance of that principle is that, where an authority does not charge capital expenditure to a revenue account, it is able to finance the capital expenditure out of capital resources, such as borrowed money, instead of revenue resources.

4.2 **Effect of amendment.** We felt it could be helpful to take the opportunity offered by the present regulations to state the position explicitly in legislation, so that it is absolutely clear to all authorities and their auditors. The regulation therefore provides that capital expenditure need not be charged to a revenue account.

4.3 The regulation applies to capital expenditure which is so defined in accordance with proper accounting practices [*Local Government Act 2003* - section 16(1)]. But it applies equally to anything treated as capital expenditure by virtue of *regulations* [section 16(2)(a)] or a *direction* [section 16(2)(b)].

4.4 Authorities will still have the *discretion* to charge capital expenditure to a revenue account, if they wish (many authorities routinely treat *de minimis* amounts of capital expenditure in this way).

4.5 Although this regulation was not ready for inclusion in the consultation draft, it has since been agreed with representatives of the Local Government Association, London Councils, CIPFA and the Audit Commission.

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(5) BACK PAY AWARDS FOR UNEQUAL PAY
[Amendment Regulation 5]

5.1 **Background.** Under the current arrangements, local authorities can be obliged to make financial provision for likely liabilities arising from past events, in the current financial year, rather than in the year in which they must be paid. We understand that some authorities are in the position of having to make provision for anticipated back-pay following unequal pay - even though such payments are often not expected to be due until subsequent years. Given the amounts involved, it would be undesirable for authorities to be required to fund these provisions in advance of the need to make payments.

5.2 **Effect of amendment.** Amendment Regulation 5 inserts a new regulation 30A into the 2003 Regulations. This provides that the local authority need not charge to a revenue account an amount in respect of back-pay until the date on which the local authority must make the back-payment. The provision will come into force on 30 March 2007, and will apply for the financial year 2006-07 and for the following four financial years, i.e. until 31st March 2011. This will apply to any back-pay which is required to be paid, either as a result of a requirement by an employment tribunal or court, or in accordance with an agreement between a local authority and an employee or officer.

5.3 The regulation will not affect the obligation to follow normal accounting practices in the authority's Income and Expenditure Account, ie to make a charge for a provision when required. The regulation does permit entries in the Statement of Movement on the General Fund Balance to ensure these charges only have to be funded when the payments must be made. It is not mandatory for a local authority to take up the options presented in this regulation.

5.4 **Changes following consultation.** The draft regulation was amended to reflect responses from local authorities during consultation. These included ensuring that the regulation covers financial liabilities such as national insurance directly associated with the back-payments to employees, clarifying that the regulation does not apply to ongoing pay increases but only the one-off costs of back-pay, and that back-payment to *former* local authority officers and employees does come within the scope of the regulation.

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(6) PREMIUMS, DISCOUNTS AND LOANS
[Amendment Regulation 6]

Introduction

6.1 Amendments are being proposed to the CIPFA/LASAAC Code of Practice on Local Authority Accounting to incorporate the requirements of new accounting standards on financial instruments. The amendments are proposed to take effect from the 2007-08 financial year. The revisions to the Code have been cleared by the Accounting Standards Board to be published for comment, and CIPFA is now considering the submitted comments. These developments give rise to the need for three new regulations in the 2003 Regulations (numbered 30B, 30C and 30D). Details of CIPFA's proposals are at http://www.cipfa.org.uk/pt/consultations.cfm.

6.2 The regulations will not affect the obligation to follow the requirements of the new accounting standards, as set out in the CIPFA/LASAAC Code, in the authority's Income and Expenditure Account. What the regulations change is the amount which has to be charged to a revenue account at different times. Thus, accounting transparency is achieved, while protecting authorities from possibly adverse impacts on their resources.

6.3 Two of the issues relate to early debt repayment. Local authorities often choose to repay loans to the Public Works Loan Board (and other lenders) earlier than required by the original agreement. They may simply wish to reduce their level of debt, or they may be refinancing the loan. When loans are repaid early authorities may be liable either to pay a ***premium*** or to receive a ***discount***.

Premiums

6.4 **Background.** Premiums normally have to be met out of revenue. When premiums are charged to the revenue account, at present the normal practice is to spread that charge over a number of years. This is allowed in defined circumstances by proper accounting practice as it now stands. However, the new accounting standard will introduce a tougher definition of the circumstances in which a premium can be spread. Balances of premiums in the course of being spread under the old rules at 1 April 2007 that do not meet the new rules will have to be charged to revenue in full in 2007-08. In addition, any new premiums incurred on or after that date will have to be charged to revenue in full in the year when incurred if they do not meet the new criteria.

6.5 **Effect of amendment.** The new regulations override the accounting standard and allow authorities to spread the revenue charge for all premiums over a period longer than one year. The regulations apply both where a loan is being repaid outright and where it is being refinanced by a new loan. **Authorities will be able to spread the charge over either the outstanding period of the loan repaid or (where applicable) the outstanding period of any replacement loan, whichever is the greater.** In the case of refinancing, it will be up to the authority to decide which loan (or loans) is to be treated as the “replacement loan” [30B(8)].

6.6 Authorities will, if they wish, always be able to spread the charge over a *shorter* period than the regulations allow (including making the whole charge in the first year). The formulae at 30B(6) and 30C(5) automatically take account of any voluntary additional charge by decreasing the outstanding liability in subsequent years. Once the formula produces a nil result, there is no longer any obligation to make a revenue charge [30B(4); 30C(3)].

Discounts

6.7 **Background.** When a discount is due to an authority on early repayment of a debt, the authority simply makes the lender a payment lower by an agreed amount than the principal outstanding. The change in accounting practice on 1 April 2007 would allow the authority in many cases to treat its revenue resources increased in that financial year by the full amount of the discount received.

6.8 **Effect of amendment.** The new regulation produces arrangements analogous to that described for premiums above. The benefit to the revenue account will be spread over a number of years, rather than taken in one year. The period over which the amount is to be credited to revenue is either the unexpired term of the repaid loan or 10 financial years, whichever is the lesser.

6.9 Where an authority has already credited the full amount of a discount to revenue before 1 April 2007, the regulation has no retrospective effect and does not cancel any part of the benefit that has been gained [30B(2)].

Loans at low interest rates

6.10 **Background.** Local authorities sometimes give financial assistance to local organisations by offering loans at interest rates which are lower than the market rate (known informally as “soft loans”). The new accounting changes will treat the authority as having made a loss and require a charge to revenue in the year the loan is made.

6.11 **Effect of amendment.** The new regulation 30D provides that each year the authority is to take the benefit of the interest actually due to it in that year. This also has the effect of overriding the requirement to charge a loss to revenue in the opening year. The overall result is that, for accounting purposes, the authority is treated exactly as if it were receiving a market rate of interest on a normal commercial loan.

Possible future amendments relating to financial instruments

6.12 The consultation exercise indicated that certain other issues associated with the new rules on financial instruments were not dealt with in the draft regulations and could adversely affect revenues in 2007-08. These were:

- *stepped interest loans* – also known as LOBO (Lender's Option Borrower's Option) loans – ie loans with initially low interest rates taken out by authorities
- *guarantees* given by authorities.

There was no opportunity to address these issues in the final regulations. However, we are urgently exploring them in liaison with the LGA, CIPFA and the Audit Commission, with a view to the possible making of further regulations before the end of the financial year 2007-08, which would apply to that year.

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(7) POOLING OF HOUSING CAPITAL RECEIPTS

Social HomeBuy: 100% shares
[Amendment Regulation 7]

7.1 **Background.** Authorities normally have to "pool" (ie pay to the Government) 75% of the proceeds from sales of HRA dwellings. There are relaxations of that rule, based on treating the capital receipt as reduced by certain kinds of past or planned expenditure. That in turn reduces the proportion which has to be pooled, often to nil. The current pooling rules are set out in regulations 12 to 22 of the 2003 Regulations. The following amendment will extend the relaxations and remove some anomalies.

7.2 The Social HomeBuy (SHB) shared ownership scheme enables local authority tenants to buy a share in their homes for a premium proportionate to the size of the initial share (subject to any discount). Normally, the initial share is less than 100% and tenants purchase subsequent shares if and when they can afford to do so. The receipts from such sales are in principle subject to pooling, but are exempted to the extent that they are recycled into funding the provision of affordable housing or the operation of the Social HomeBuy scheme. Outside London, the SHB discount is lower than the discount available under the Right to Buy (RTB) scheme. However, in London, the two discount levels are often the same and buying a 100% share in the dwelling under the SHB scheme could be an alternative to a RTB purchase. The effect for the tenant would be the same but it would help the local authority landlord if it could benefit from the relaxation in the pooling rules and use the receipts for affordable housing. Currently, however, the wording of the regulations makes it doubtful whether the pooling relaxation could apply to a 100% SHB disposal.

7.3 **Effect of amendment.** The amendment revises the Schedule to the 2003 Regulations, widening the definition of a SHB disposal to ensure that the capital receipt from disposal of a 100% share is able to be reduced by the SHB allowance (existing regulations 14(1)(d) and (2C), 16A and 16B).

Withdrawn amendments on pooling

7.4 The consultation draft of these Regulations (20 November 2006) also included the following two further amendments to the pooling rules, which, in the light of the consultation responses, we have decided should not form part of the present set of Regulations.

- **Equity Share Schemes** [*Regulation 2 in the consultation draft*]. This amendment would have allowed authorities to retain the capital receipt generated by certain, non-Social HomeBuy, equity share disposals of HRA property. We are not implementing this amendment at present but will consider the issues raised in the consultation and explore the need for further development of the measure.

- **Social HomeBuy: Buy-back incentive** [*Regulation 3 in the consultation draft*]. This amendment would have extended to Social HomeBuy disposals the existing incentive in Regulation 20 to help local authorities to buy back ex-council homes. Following the consultation, this amendment has also been withdrawn for further consideration.

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