



REPORT

Committee	PRUDENTIAL CODE STEERING GROUP		
Venue	Thistle Hotel, Charing Cross	Date	11 July 2002
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Subject	Issues paper – treatment of other long term liabilities and capital expenditure unfinanced		

PURPOSE

To consider issues paper on the treatment of other long term liabilities and capital expenditure unfinanced for consideration for revisions to the draft Prudential Code.

REPORT

1 The issue

An amount which is called ‘capital expenditure unfinanced’ is proposed as a prudential indicator and a key internal management control within the draft Prudential Code. Matters arising:

- (a) It was agreed at the May meeting of the PCSG that an issues paper should be prepared on the treatment of other long term liabilities and capital expenditure unfinanced.
- (b) A significant number of responses to the draft Code raise issues in relation to capital expenditure unfinanced, principally either that the term itself is misleading and/or that more guidance is needed on questions of definition and/or meaning.
- (c) This report deals with questions of definition and PCSG 5 02/03 deals with the terminology.
- (d) The main definitional issues raised in responses and at the first set of workshops for road testing authorities is the treatment of other long term liabilities vis-à-vis capital expenditure unfinanced.

- (e) The treatment of loans made to housing associations, which have typically not been included in the accounts of the balance sheet identified in the draft Code for the calculation of capital expenditure unfinanced, has also been raised.

2 Ideas for discussion

- (a) Where capital expenditure is incurred through traditional procurement, its treatment with respect to capital expenditure unfinanced is straightforward. To the extent that capital expenditure has been charged to revenue (either as a direct charge of capital expenditure to revenue or through MRP (England and Wales)/loan fund repayment (Scotland) or their replacements in the new system), to useable capital receipts or to capital grant, then it is not part of capital expenditure unfinanced. The remaining amount will reflect the underlying need (depending upon its resource position, cash flow and treasury management policies) for the authority to borrow as a result of capital expenditure and is capital expenditure unfinanced.
- (b) The position of other long term liabilities such as finance leases is less clear. Proper accounting practice requires that the rental streams for finance leases should be apportioned between the financing charge and the reduction of the outstanding obligation. The principal part of the agreement should be capitalised, then charged to revenue as appropriate and written down over the period of the lease. The financing charge is not capitalised, as no liability for the financing charge is created until the particular financial year to which the financing relates is reached. The financing charge is allocated and charged to revenue over the term of the lease. Thus, it is clear that the principal element of a finance lease is an other long term liability and ought to be treated as part of the authority's prudential indicators for debt (other long term liability element). However, arguably, it is counterproductive to include this other long term liability within capital expenditure unfinanced. This is because
- it does not represent an underlying need for the authority to borrow cash
 - the test at paragraph 42 of the draft Code makes more sense if these types of other long term liabilities are excluded.
- (c) However, the current treatment for credit arrangements within England and Wales means that amounts for credit arrangements will have been included within the accounts on the balance sheet used for the calculation of capital expenditure unfinanced in a rather complex way. An extract from CIPFA's 'Capital accounting arrangements under Part IV of the Local Government and Housing Act 1989 – fully revised guidance notes for practitioners 2000' is included as an appendix to this report, which demonstrates this.
- (d) Unless statute decrees otherwise, it is suggested that other long term liabilities can be separated from borrowing within the prudential

framework, just as they are on the balance sheet. Other long term liabilities are by definition long term, so do not have to be included within the test within paragraph 42 of the draft Code. They should be charged to the consolidated revenue account in accordance with proper accounting practice unless statute over-rides this.

- (e) With respect to loans made to housing associations, these are a deferred charge and should be treated as other deferred charges within the new system. Ie, if statute continues to define deferred charges as capital expenditure, then they should form part of the calculation for capital expenditure unfinanced (see (a) above).

RECOMMENDATION

The PCS G is asked to consider this issues paper on the treatment of other long term liabilities and capital expenditure unfinanced for revisions to the draft Prudential Code.

EXTRACT FROM 'CAPITAL ACCOUNTING ARRANGEMENTS UNDER PART IV OF THE LOCAL GOVERNMENT AND HOUSING ACT 1989 – FULLY REVISED GUIDANCE NOTES FOR PRACTITIONERS 2000

Accounting for Credit Arrangements

3.49 The conflicts between the requirements of proper accounting practice and those of the 1989 Act controls regime make accounting for credit arrangements a complex task. The basic principles are as follows:

- Upon entry into the arrangement, an authority should consider the dates when it will have legal title to assets or gain rights to substantial economic benefits and plan to recognise assets on its balance sheet on those dates. Where these assets are fixed assets, they will then be brought within the scope of capital accounting: henceforth it will be recorded in the balance sheet at its current value to the authority and the services making use of it will be debited with capital charges calculated in the normal way
- Upon entry, an authority should also consider the dates when it should recognise liabilities under the arrangement – these will usually match the dates when assets are recognised. The liability will only comprise the principal part of the agreement, as no liability for financing charges is created until the particular financial year to which the financing relates is reached. Authorities will need to establish the split between principal and interest represented by the annual payments under the agreements: the calculations are those expected by SSAP 21. When repayments are made under the arrangement, interest payable is chargeable to the Asset Management Revenue Account (as an expenditure item, although not an absolute charge against council tax (see below)) and the principal element is debited to the creditor balance for the liability.
- The conflicts between proper accounting practice and the 1989 Act are clearest in the accounting treatment required in the Consolidated Revenue Account: very different charges have to be made against the three most important sub-headings in the Account:
 - *net cost of services*: services are required to be debited with the capital charge calculated on the value at which the asset is currently being carried in the balance sheet per the expectations of the SORP
 - *net operating expenditure*: in order to convert cost to expenditure as recognised under the capital accounting framework, the capital charges are reversed out through the Asset Management Revenue Account and replaced by depreciation based on the balance sheet valuation and actual external interest payable under the arrangement

- *amount to be met from local taxation:* the charge against local taxes will comprise any credit cover made from revenue upon entry into or variation of the arrangement and MRP arising from credit cover secured through credit approvals and notional interest; the former is calculated as an integral part of multiplying the credit ceiling by the statutory 2% and 4%, the latter by way of the formula set out in Part IV of Schedule 3 of the 1989 Act. These notional amounts are the only items required to be charged on an annual basis against revenue resources: section 42 (2) (a) exempts the actual payments that might be made as they are substituted fully by the notional charges. Actual payments are instead diverted to the Capital Financing Reserve by making reconciling adjustments in the appropriation section of the Consolidated Revenue Account so that only MRP-related debits (including notional interest) are left as a charge against council tax.
- the criteria for establishing whether assets should be recognised under capital accounting and those for determining that a credit arrangement exists are not identical. For example, most leases of land and buildings will be operating leases according to the definitions of SSAP 21 but the 1997 Regulations allow only operating leases of vehicles, vessels, plant, machinery and apparatus to be exempt from being credit arrangements. Where land and buildings are occupied under operating leases, capital charges are not applicable and most authorities will charge the rentals payable to services as an operating cost.

In most cases this will be legitimised by the status of the leases as excluded credit arrangements (see paragraph 3.52), where the requirement of the 1989 Act is to charge actual expenditure to revenue. Where leases do not qualify as excluded credit arrangements, authorities should still ensure that the charge against council tax is not the rentals payable (as charged to services) but the MRP elements attributable to the credit arrangement and will need to make the appropriate reconciling transactions between the Consolidated Revenue Account and the Capital Financing Reserve.

- Debits and credits to the memorandum PCL account made in accordance with the 1989 Act will record the resources which have been earmarked for the financing of credit arrangements and the resources which have actually been applied. Credits will comprise credit cover secured from capital receipts or revenue, MRP contributions arising following the use of credit approvals for credit cover, and the notional interest element of MRP; debits will comprise the actual payments made to discharge any liabilities arising under the arrangement. The mathematics involved do not guarantee that over the life of the arrangement the debits will eventually balance with the credits, but the impact of this will be kept in the PCL account: there is no provision for any over- or under-funding which might arise for individual arrangements to be cancelled out by a compensating transfer from revenue.

3.50 These principles can be summarised as follows (overleaf):

