EXPLANATORY MEMORANDUM TO

THE LOCAL AUTHORITIES (CAPITAL FINANCE AND ACCOUNTING) (AMENDMENT) (ENGLAND) REGULATIONS 2007

2007 No. 573

1. This explanatory memorandum has been prepared by the Department for Communities and Local Government and is laid before Parliament by Command of Her Majesty.

This memorandum contains information for the Joint Committee on Statutory Instruments.

2. Description

2.1 The Regulations amend provisions regarding local authorities' capital finance and accounting. The amendments include provision for certain expenditure to be treated as being or as not being capital expenditure, and provisions for amounts which must be charged to a revenue account ("minimum revenue provision") to cover the costs of borrowing or credit arrangements used to finance non-housing capital expenditure. There are new provisions about charging amounts to a revenue account in relation to early repayment of loans, interest on loans, capital expenditure, and back payments where officers or employees have received unequal pay. There is a revised definition of Social HomeBuy disposal for the purposes of existing provisions regarding the amount, and reductions to the amount, a local authority must pay to the Secretary of State out of sums received from the disposal of certain housing land (known as "pooling").

3. Matters of special interest to the Joint Committee on Statutory Instruments

3.1 Regulation 3 makes reference to the "Prudential Code for Capital Finance in Local Authorities" published by CIPFA (the Chartered Institute of Public Finance and Accountancy). This is a document to which all authorities will already have access, since they are required to have regard to it by regulation 2 of the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003.

4. Legislative Background

4.1 The Regulations amend the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 ("the Principal Regulations").

4.2 The Regulations make some changes to the provisions about what is to be treated as being or as not being capital expenditure and provides that capital expenditure does not need to be charged to a revenue account of the local authority. Capital expenditure is expenditure of a local authority which falls to be capitalised in accordance with proper practices (section 16(1) Local Government Act 2003) and the Secretary of State may, by regulations or direction, provide for expenditure to be treated as being or as not being capital expenditure (section 16(2), to which section 16(1) is subject). "Proper practices" are accounting practices which a local authority is required to follow by virtue of an enactment or which (unless they conflict with accounting practices in an enactment) are contained in one of the documents, as amended from time to time, identified in regulation

31 of the Principal Regulations (made under section 21 of the Local Government Act 2003). If expenditure is, or is treated as, capital expenditure, an authority may use capital receipts (money received from the disposal of an interest in a capital asset, such as a building) or borrowed money for that expenditure, which otherwise it would be unable to use. Capital receipts may only be used to meet capital expenditure and certain other expenditure listed in regulation 23 of the Principal Regulations. In general, a local authority can use borrowed money only for capital expenditure.

4.3 The Regulations substitute a new regulation 28 in the Principal Regulations in order to simplify the calculation of minimum revenue provision.

4.4 There are new provisions which enable a local authority, where it is required to make a back payment of pay to an officer or employee who received unequal pay (where men and women were paid different amounts for similar work), to charge that payment to a revenue account only when it has to make that payment. Without these provisions the authority might have to charge the payment to its revenue account sooner, as required by proper practices, which would mean that it would have to have the amount of money for the payment available in advance (possibly several years in advance) of when it actually has to make the payment.

4.5 The Regulations include new provisions regarding a premium or discount arising where a local authority repays a loan early. At present, when a premium is charged, or a discount is credited, to a revenue account the charge or credit is normally spread over a number of years. However, changes in accounting practices will apply on and after 1st April 2007 which will prevent this spread. There are also changes to accounting practices which will treat an authority as making a loss where it lends money to someone at an interest rate which is below the market rate. The authority will be required to charge an amount to a revenue account which will cancel out the benefit of any interest due. New regulations override these accounting practices.

4.6 Regulation 14(1)(d) of the Principal Regulations enables a local authority to make reductions to the amount to be pooled where the disposal of a dwelling is a Social HomeBuy disposal ("SHB disposal"). A SHB disposal is defined in the Schedule to the Principal Regulations for the purposes of the pooling provisions. Such a disposal enables a person to purchase a dwelling from a local authority on shared ownership terms. This means the person may pay a percentage of the price of the dwelling and pay rent to the authority in respect of any remaining share of the dwelling. These Regulations substitute a new definition of Social HomeBuy disposal so that it includes cases where the purchaser pays 100 per cent of the price at the outset. The reductions in pooling enable authorities to use the capital receipts (the money received from the disposals of the dwellings), which would otherwise have been pooled, for the provision of affordable housing.

5. Territorial Extent and Application

5.1 This instrument applies to England.

6. European Convention on Human Rights

As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

7. Policy background

EXPENDITURE TO BE CAPITAL EXPENDITURE (Amendment regulation 2).

7.1 Provision of equipment (regulation 2(a)). For local government, the definition of "capital expenditure" is normally based on proper accounting practice. However, regulations can modify this, by providing that expenditure is treated as being or as not being capital expenditure, where accounting practice does not properly achieve required policy objectives. Expenditure which has already been treated as capital expenditure, by virtue of regulations, includes 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 work 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. The amendment regulation will broaden the definition of capital expenditure to take in expenditure on the provision of equipment to others.

7.2 Investment in property funds (regulation 2(b)). Local authorities have wide freedom to invest their surplus funds. The main constraint is that they are discouraged from using the most speculative investments – ie the acquisition of shares and corporate bonds issued by individual companies. The Regulations achieve this by providing that such transactions are treated as capital expenditure (which means they would reduce the authority's scope for funding capital projects). But there is an exemption 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 encouraged the formation of a new kind of investment scheme - Real Estate Investment Trusts (REITs) - based on a portfolio of commercial properties, through the Finance Act 2006, which changes the tax regime for such schemes complying with safeguards specified in the legislation. However, investing in such a scheme would involve acquiring shares which at present would be treated as capital expenditure. The amendment regulation provides that buying shares in REITs is not to be treated as capital expenditure and thereby it gives authorities the option to consider this new form of investment.

REVENUE PROVISION (Amendment regulation 3)

7.3 Each year, authorities have to make provision out of revenue for debt repayment. The current regulations on this "Minimum Revenue Provision" (MRP) are very complex and contain anomalies which, though affecting only a few authorities, could have a major adverse impact on their revenues in the 2006-07 financial year (ie the year ending 31st March 2007).

7.4 The amendment regulation will significantly simplify the system while preserving its overall effect. It also deals with the anomalies and ensures that no authority is worse off under the new arrangements than under the present regulations, or under those that were in force before 1 April 2004. In achieving this, the new provisions make reference to that earlier legislation. Informal guidance which we intend to issue to local authorities when the Regulations are laid will include internet links to the relevant statutory instruments on the OPSI website. Because some of the current anomalies affect

authorities in the 2006-07 financial year, regulation 3 will come into force before the end of March 2007 and thus begin to apply in that year.

7.5 The opportunity is also being taken to introduce more flexibility into the system. 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 big disincentive, since it imposes a revenue burden from the very start of a scheme. But under normal depreciation accounting, no revenue provision would be required until the asset was operating and paying for itself (though in the long term, depreciation accounting 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 amendment regulation permits this.

ACCOUNTING FOR CAPITAL EXPENDITURE (Amendment regulation 4)

7.6 This regulation makes clear that capital expenditure (including expenditure which is treated as capital expenditure in accordance with regulations or a direction) need not be charged to a revenue account. It has been generally accepted by local authorities that proper accounting practice already embodies that principle, but given its importance there seems merit in stating it explicitly in legislation so that the position is clear to all authorities. Its significance is that, where a local 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.

BACK PAYMENT FOLLOWING UNEQUAL PAY (Amendment regulation 5)

7.7 Under present accounting 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. Some authorities would have to make such provision for anticipated back-pay settlements relating to unequal pay in the past – 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. The amendment regulation provides that the local authority need not charge to the revenue account an amount in respect of back pay until the back pay must be paid. The provision would come into force in March 2007, and would apply for the 2006-07 financial year and for the following four financial years, i.e. until 31st March 2011.

EARLY REPAYMENT OF LOANS AND INTEREST ON LOANS (Amendment regulation 6)

7.8 These amendments arise from new national accounting standards, which CIPFA (the Chartered Institute of Public Finance and Accountancy) will impose on local authorities from 1 April 2007. They relate mainly to what happens when local authorities choose to repay loans earlier than required by the original agreement. In those circumstances, they may be liable either to pay a premium or to receive a discount. A premium is an extra payment required on top of the principal repayment. A discount is a reduction in the principal repayment. Whether a premium or discount applies, and its amount, depends upon the relationship between current interest rates at the time of repayment and the interest being charged on the loan.

7.9 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, a tougher accounting standard will apply to local authorities as from 1 April 2007. Balances of premiums in the course of being spread under the old rules at 1 April 2007 will often have to be charged to revenue in full in 2007-08. In addition, many new premiums incurred on or after that date will have to be charged to revenue in full in the financial year when incurred. The Government considers that it would be unreasonable for local authorities to face those revenue implications. The amendment regulation overrides the accounting standards and allows authorities 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.

7.10 Discounts due to an authority on early repayment of a debt are normally credited to the revenue account over a number of years. The new standard in force from 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. The Government considers that discounts should be treated in a broadly similar way to premiums. The amendment regulation will require the discount to be credited to revenue over either the unexpired term of the repaid loan or 10 years, whichever is the lesser.

7.11 Loans at low interest rates. Local authorities sometimes give financial assistance to local organisations by offering loans at interest rates which are lower than the market rate. The new accounting changes will treat the authority as having made a loss and require a charge to revenue which cancels out the benefit of any interest it eventually receives. The amendment regulation will override that requirement and allow the authority each financial year to take the benefit of the interest actually due to it in that year.

SOCIAL HOMEBUY DISPOSAL (Amendment regulation 7)

7.12 Authorities normally have to “pool” (that is, pay to the Secretary of State) 75% of the proceeds from sales of council dwellings. The recycling of housing capital receipts is a fundamental principal of housing finance. The Government considers that it would be wrong to allow an authority, rich in receipts but with relatively little housing need, to retain all its receipts, while another authority, poor in receipts but with relatively greater housing need, is starved of resources. “Pooling” is the mechanism by which part of an authority’s housing capital receipts are made available to the Government for redistribution. There are relaxations in that rule, based on treating the capital receipt as reduced by certain kinds of past or planned expenditure. One current relaxation relates to Social HomeBuy (SHB). This is a shared ownership scheme, under which local authority tenants buy a share in their homes at a discount proportionate to the size of the initial share. Normally, the initial share bought is less than 100% and tenants purchase subsequent shares if and when they can afford to do so. The receipts from such sales are exempted from pooling to the extent that they are recycled into funding the provision of affordable housing.

7.13 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. The regulations do not currently allow the pooling relaxation to apply to a 100% SHB disposal. The amendment regulations will remove that restriction.

CONSULTATION PROCESS

7.14 The proposals for these amendments were developed in liaison with representatives of the Local Government Association, CIPFA and the Audit Commission. Draft regulations were issued to all local authorities and other interested parties for consultation on 20 November 2006 and were made available on the Department's website, with a closing date for responses of 12 January 2007. Nearly 90 responses were received. An announcement of the outcome of the consultation was circulated to all authorities on 8 February 2007 and also published on the website. The amendments were generally welcomed. Some technical deficiencies were identified and rectified in the final draft. The consultation draft contained two further amendments to the "pooling" regulations, which have now been withdrawn, since the consultation revealed the need for more development work; consideration will be given to incorporating revised provisions in a possible future set of amendments.

8. Impact

8.1 A Regulatory Impact Assessment has not been prepared for this instrument as it has no impact on business, charities or voluntary bodies.

8.2 The overall impact on the public sector is beneficial: none of the measures significantly increases costs or imposes extra burdens on local government.

9. Contact

Trevor Emmott at the Department for Communities and Local Government, tel: 020 7944 4226 or e-mail: trevor.emmott@communities.gsi.gov.uk, can answer any queries regarding the instrument.