

CIPFA consultation:

The Prudential Code for Capital Finance in Local Authorities

Joint response from the Accounts Commission for Scotland and Audit Scotland,
April 2021

The Accounts Commission and Audit Scotland welcome the opportunity to respond to the consultation on the Prudential Code. The Accounts Commission has a strong continuing interest in this area, as we indicated previously in our response to CIPFA's 2017 consultation. Recent outputs from our Work Programme include [Privately financed infrastructure investment: The Non-Profit Distributing \(NPD\) and hub models](#) (January 2020) and [Scotland's City Region and Growth Deals](#) (January 2020). These targeted specific topics extended our more general report on [Borrowing and Treasury Management in Councils](#) (March 2015) and the follow-up [Borrowing and Treasury Management in Councils - Impact Report](#) (November 2016). Our reports carry findings and recommendations that are relevant to CIPFA's consultation. One of our recurring themes, consistent with the Strategic Audit Priorities of the Accounts Commission, is to emphasise the need to take a longer-term approach to plans.

In our response to the 2017 CIPFA consultation we observed that there is a clear overlap between treasury management and capital finance and it is not always easy to separate the principles and objectives that underpin the two areas. We suggested at the time that combining the two codes might better facilitate clear linkage of capital finance and risk analysis associated with different financing options over the longer term. Our performance audit reports since that time serve to confirm to us the increasingly entwined linkages and we offer this suggestion as a continuation of our previous thinking.

We are pleased to provide our response to the consultations on the Prudential Code.

The Prudential Code for Capital Finance in Local Authorities - Consultation

Accounts Commission and Audit Scotland response

The Accounts Commission and Audit Scotland have noted with interest your proposals to enhance the Prudential Code. We hope you find our joint response to your questions helpful.

Borrowing in advance of need

Question 1: CIPFA is interested in stakeholders' views on the first sentence of paragraph 45? What alternatives would you suggest?

We agree that local authorities must not borrow more than or in advance of their needs primarily in order to profit from the investment. However, paragraph 45 currently refers to 'the investment of the extra sums borrowed'. In cases where the borrowing is in advance of need, there may not be any 'extra' borrowing. We suggest that for clarity the wording be amended to 'the investment of the extra or early sums borrowed'.

Question 2: Do you agree with the changes to paragraph 45 relating to the explanation of the sentence authorities must not borrow more than or in advance of need purely in order to profit from the extra sums borrowed? If not, why not? What alternatives would you suggest?

We agree that local authorities must not borrow to fund primarily yield generating Investments.

Objectives of the Code consultation

Question 3: Do you agree with CIPFA's proposal to add proportionality to the objectives within the Prudential Code especially with regard to commercial investments? If not, why not? What alternatives would you suggest?

We agree that proportionality for capital expenditure generally and for commercial investment particularly is an important consideration and that it is appropriate that this should be explicitly included in the objectives of the Prudential Code.

Question 4: Do you agree with the introduction of an objective in relation to commercial investments? If not, why not? What alternatives would you suggest?

Given the substantial increase in commercial investment in recent years, we agree that an objective related to commercial investment is appropriate. Although commercial activity is widespread in England, it is more limited and regarded with significant caution in Scotland. It will be important that the inclusion of such an objective does not compromise the message that any commercial investment needs to be robustly appraised.

Question 5: Do you agree with the proposal to add sustainability and ensuring that the capital expenditure is consistent with a local authority's corporate objectives (such as diversity and innovation) to the objectives in the Prudential Code? Please provide a reason for your response.

The profile of sustainability is increasing, and it is important that capital expenditure decisions are taken on a sustainable basis. We are very supportive of a reference to sustainability being added to the objectives of the Prudential Code.

While the consultation document refers to the pandemic and focuses on the risks of seeking to make a profit from risky investments, we believe it is also appropriate that the code considers (or at least references) the options within the financial flexibilities offered by governments throughout the UK; essentially to recognise the potential long-term implications of these short-term solutions. For example, the Scottish Government measures include a loans fund repayment 'holiday' which, although currently available for only one year, could be offered again. We therefore strongly suggest that the revised code sets out the clear risks to sustainability (and additional cost) of delaying repayments etc.

We agree with the addition of explicit references to ensuring that capital projects are consistent with corporate objectives. This is a theme that the Commission emphasises in its work, not least in our Best Value audit reports about individual councils.

We are not aware of other issues that would need to be added to the objectives to ensure that they remain fit for purpose.

Question 6: Do you consider the current objectives of the Prudential Code to be relevant? Please provide a reason for your response.

We are not aware of any factors that impact on the relevance of current objectives and therefore consider that they remain relevant.

Question 7: Do you consider that the provisions in the Prudential Code achieves these current objectives? If not, why not? Please provide reasons for your response.

We have no reason to believe that the code's provisions do not meet the objectives.

Question 8: Do you consider that there are any areas which are not fully covered by these objectives? If yes, please expand, describing how these areas could be covered within the objectives.

We have not identified any significant areas that are not covered by the objectives.

Scope and status of the prudential code

Question 8 (sic): Do you agree with the proposals to include the status of the Prudential Code within the body of the Code itself. If not, why not? What alternatives would you suggest?

Although the executive summary in the prudential code already covers its status, it is our view that there would be benefit in also including it in the body of the code itself to underline its importance and role in the statutory framework. In the Impact Report on the Borrowing and Treasury Management, the Commission were disappointed at the lack of improvement in how the Prudential Code is understood and communicated, so we support any steps that strengthen the impact.

However, the reference to Scottish legislation should be updated. It currently refers only to Part 7 of the Local Government in Scotland Act 2003 in respect of the maximum amount which can be allocated to capital expenditure. However, The Local Authority (Capital Finance and Accounting) (Scotland) Regulations 2016 require local authorities to have regard to the prudential code when exercising their powers to borrow, and these regulations should also be mentioned.

Capital Strategy

Question 9: Do you agree with the proposals to include additional commentary on the assessment of affordability and the details of risks of undertaking commercial activity within the commercial activities section on determining the capital strategy? If not, why not? What alternatives would you suggest?

We agree with the proposals. However, we consider that affordability and risks should feature in all sections of determining capital strategy, not just commercial activity.

Prudential indicators

Question 10: Please provide any suggestions that you might have for how the prudential indicators could be improved (as outlined above) in order that they might provide additional assurance for public accountability. Please explain your reasoning

We believe there is scope to enhance the explanations and descriptions in the code to ensure that local authorities understand what they measure and why they are included. In the Commission's performance audit report on Borrowing and Treasury Management, we included guidance and questions for councillors including 'What do the prudential indicators tell me'? Clarity in the code might be helpful to officers in answering that question.

In our report on Borrowing and Treasury Management, we observed (para 42) that we found the language of the codes and regulations difficult to interpret. It would be helpful to provide understandable explanations of how each indicator provides assurance for public accountability.

Question 11: Do you agree with the addition of the new indicator for external debt to net revenue stream to assess proportionality?

We agree that this ratio should allow stakeholders to assess whether the amount of debt incurred is proportionate to a local authority's total service expenditure on a funding basis. It is important to enhance understanding of the relationship between net revenue stream and external debt.

Question 12: Do you agree with the addition of the new indicators for net income from commercial and service investments to net revenue stream to assess proportionality?

We agree that this ratio should allow stakeholders to assess a local authority's direct investment in commercial and service investments compared to expenditure on delivering services on a funding basis.

However, we are unsure how this indicator would reflect commercial investments held indirectly, e.g. those made through Arm's Length External Organisations or holding companies. Local authorities have a requirement under affordability considerations to give due regard to financial commitments and obligations to companies, but the linkage with this proposed indicator is not clear.

Question 13: Do you agree with the introduction of the liability benchmark as an affordability indicator?

The Commission does not support the concept of benchmarks of this kind. We take the view that councils have flexibility to define their policy, consistent with strategy, and then be clear about how they are implementing and communicating the strategy.

In this specific case, the proposed indicator appears quite complicated. It would need to be clearly defined and set in context particularly with regard to the other two new prudential indicators. We consider that the example used in the consultation is difficult to read and its meaning is not clear.

Question 14: Do you consider that the liability benchmark should be included in the Prudential or Treasury Management Code?

Given our response to question 13, we have no further view.

Question 15: Do you agree with the removal of the prudential indicator gross debt and the capital financing requirement CFR on the basis that it is included as part of the liability benchmark which is to be introduced as a prudential indicator?

Given our response to question 13, we have no further view.