Foreword

Most of the capital expenditure incurred by authorities requires risks to be managed, particularly in relation to whether the assets acquired will provide the benefits projected for them and whether estimates of acquisition and running costings and income generation will be reliable. These considerations will impact on decisions regarding whether it would be prudent to borrow to fund such expenditure.

Reductions in government funding have meant that local authorities have been under growing pressure to incur capital expenditure with the objective of generating revenue income that will compensate for reductions in government funding. This guidance focuses on the recent concerns, that CIPFA shares, relating to the rapid expansion of acquisitions of commercial property and its relationship with CIPFA's statement in its Prudential Code that authorities **must not borrow more than or in advance of their needs purely in order to profit from the investment of the extra sums borrowed**. Where authorities exceed the limits of the Prudential Code and the wider Prudential Framework this places a strain on the credibility of the Prudential Framework to secure the prudent management of local authority finances.

The view expressed in the Prudential Code effectively reflects the circumstances where there is no specific or projected need to borrow but an opportunity has been identified to make an investment return greater than the authority's cost of borrowing. Although this guidance focusses on commercial properties, this applies to all forms of investment including the acquisition of those properties and financial instruments. For local authorities, who have access to borrowing at relatively low rates, there are tempting opportunities to generate income at no net capital or revenue cost.

However, this is not a risk-free activity as is set out in this guidance:

- All decisions to incur expenditure and to borrow must be backed by effective legal powers, which might not be available. There is an additional problem in that these decisions may subsequently be invalidated by changes in statutory provisions or developments in case law.
- The authority's returns (income and capital gains) are at risk, while, once incurred, borrowing costs are unavoidable. A reduction in returns could put the authority's revenue account into deficit. Both this guidance and the government's statutory investment guidance raise the issue of risks in relation to the fair value of the property on the balance sheet, for example, where the commercial property fair value is less than the value of the debt liability.
- Assuming the investment is purchased at market prices, the extra margin or return must reflect additional risk.

CIPFA would contend that as local government, the primary function of local authorities is to serve the public, for example, to provide public services, to have an effective placemaking role and to promote its wellbeing. In doing so local authorities have a fiduciary duty to taxpayers as well as a responsibility to their citizens generally to provide value for money and protect the value of their resources. Local authority treasury management is based on the principle that authorities should take relatively low risks when investing public money. All local authority investments, including commercial property or other property acquisitions, must comply with these basic principles of prudence in the management of public money.

An investment into commercial property is far more likely to meet the needs of the Prudential Framework where its main purpose is directly to deliver service benefits or promote its wellbeing sufficient to justify the financial risks involved. A local authority should not put public money and services at risk to the extent that an investment bank or commercial investor may legitimately do with their shareholders' funds. The authority's chief finance officer (CFO) must be alert to these risks and advise accordingly before, during and after investment decision making.

The guidance (including the Annexes) that follows explores the technical and legal issues in detail, and this is complex territory. However, if local authorities have followed the principles and provisions of both the Prudential and Treasury Management Codes it is unlikely to result in substantial change of practice, but will provide additional guidance for property acquisitions with commercial returns.

The Prudential Framework (including statutory guidance and the Prudential Code itself) allows local authorities the flexibility to take their own decisions; provided that the decisions taken are prudent, affordable and sustainable and that they have regard to the statutory guidance. However, local authorities will need to ensure if they acquire commercial property with substantial investment returns that they have a clear rationale for such acquisitions. If after having regard to the statutory guidance and the Prudential Code local authorities decide to depart from such guidance, they can only do so where a robust and reasonable argument can be put that an alternative approach will still meet the authority's various duties under Chapter 1 of the Local Government Act 2003.

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