CAPITAL EXPENDITURE AND THE NEW PRUDENTIAL FRAMEWORK

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LASAAC

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The new prudential framework became effective from April 2004. There has been, and there will continue to be, much debate on the effect on the accounting treatment of capital expenditure. LASAAC has monitored this debate and has determined that there is a role for the Committee to ensure that there is clarity surrounding accounting practice.

The purpose of this paper is therefore to add that clarity, particularly on the relationship between the prudential framework and capital expenditure. In preparing this paper, the Committee seeks to encourage the debate and not to inhibit it. The issues are set out in a series of questions and answers.

What is the prudential framework?

The Local Government in Scotland Act 2003 repealed Section 94 of the Local Government (Scotland) Act 1973. Sections 35 to 37 of the Act introduce a responsibility for local authorities to locally determine the level of capital investment. Regulations introduced under the Act require that local authorities should adhere to The CIPFA Prudential Code for Capital Finance in Local Authorities. The 'prudential framework' (or prudential regime) is the collective term for legislation, regulation and the Code under which local authorities will operate.

How will the framework operate in practice?

Local authorities will no longer be given capital consents. It will be the duty of a local authority to determine how much it can afford to allocate to capital expenditure having regard to affordability, prudence and sustainability. The local authority will formally set and monitor a series of prudential indicators as required by The Prudential Code for Capital Finance in Local Authorities. The indicators will use financial information drawn principally from the consolidated balance sheet of the local authority prepared under proper accounting practice.

When does this take effect?

Section 35 of the Act took effect from April 2003 although the prudential framework formally applies from April 2004 at which point Section 94 was be repealed.

What does this mean for accounting?

Expenditure historically referred to as 'capital expenditure' under Section 94 did not always meet the proper accounting practice definition of capital expenditure. The reason for this is historic, but enabled the Scottish Executive to control and monitor a range of types of expenditure. In effect there was definition of capital expenditure for capital control purposes and a further definition of capital expenditure under proper accounting practice. Local authorities were required to prepare a reconciliation between the two in the statement of accounts. There will now be a closer and clearer link between the balance sheet of a local authority and capital investment.

Has the accounting treatment of capital expenditure changed?

No. Proper accounting practice is expressed in The Code of Practice for Local Authorities in the United Kingdom – A Statement of Recommended Practice. This is generally referred to as 'the SORP' or as 'ACOP'. There is no change to the SORP. The capital controls system is being aligned with proper accounting practice.

So what has changed?

What is changing is that where local authorities effectively were required to account under two 'systems' they will now only be required to have regard to proper accounting practice. The capital control system enabled local authorities to borrow for items of expenditure which would not otherwise be categorised as capital expenditure. For example many local authorities may have borrowed under Section 94 for items which would otherwise have been classified as revenue expenditure under proper accounting practice. The challenge for local authorities is to identify such items of expenditure and ensure that it is properly categorised. Otherwise local authorities should continue to account for the recognition of fixed assets by capitalising all expenditure on the acquisition, creation or enhancement of fixed assets.

If there was a difference between Section 94 and proper accounting practice before, how was this dealt with?

Even though expenditure scored as 'capital' against Section 94, the expenditure should have been charged to the relevant service revenue account. However, because the local authority had received Section 94 consent, a corresponding accounting adjustment should have been made to remove the expenditure and transfer it to the capital financing reserve. This had the dual effect of adhering to proper accounting practice and also ensuring the cost neutral impact against council tax. The capital financing reserve is not a reserve for use by the council and may be referred to in future as the capital financing account.

What is capital expenditure under proper accounting practice?

The SORP states that expenditure which should be capitalised will include expenditure on the:

- Acquisition, reclamation, enhancement or laying out of land;
- Acquisition, construction, preparation, enhancement or replacement of roads, buildings and other structures; and
- Acquisition, installation or replacement of movable or immovable plant, machinery, apparatus, vehicles and vessels.

Enhancement means works which substantially lengthen the life of an asset, substantially increase the open market value of an asset or increase substantially the extent to which an asset can be used. Where major components are replaced or restored, each component is depreciated over its individual useful economic life.

But what should be capitalised and what should not?

Improvement works and structural repairs should be capitalised. Expenditure however, which ensures that the asset maintains its previously assessed standard of performance should be charged to the revenue account. This means that expenditure on fixed assets should only be capitalised in the following three circumstances:

- enhancement;
- where a separate component is replaced or restored: or
- where subsequent expenditure relates to a major inspection or overhaul of an asset which restores benefits already consumed and reflected in depreciation.

Any fixed asset acquired by a finance lease should of course also be capitalised.

At what point does a repair become an enhancement?

There is no clear cut-off point but, in a local authority an enhancement should *substantially* lengthen the life, increase the open market value or increase the extent to which an asset can or will be used. 'Substantially' is a key word to bear in mind.

Items classed as 'capital' under Section 94 were funded by borrowing. If necessary, can local authorities still borrow for items which must now be classified as revenue?

No. A local authority cannot borrow long term to fund revenue expenditure.

Is it possible to give some examples of what is capital expenditure and what is not?

It is a matter for each local authority to recognise and account for capital expenditure in accordance with the SORP and with their accounting policy. Local authorities should therefore carefully have regard to paras 3.20 to 3.59 of the 2003 SORP. Local authorities may find it useful however to produce local exemplifications of capital expenditure for the benefit of both finance practitioners and service managers. LASAAC recognises however, that while it is not desirable to attempt to produce a list of capital expenditure items, the spirit of this paper would be enhanced with some basic exemplifications. Importantly, an item of expenditure could qualify as enhancement or a repair depending on the context in which the work is being carried out. The following examples of basic capital expenditure do not represent an exhaustive list but are discussed to indicate principle:

- acquisition or construction of a building;
- acquisition of land;
- installation of double glazing to replace single glazing could be considered an enhancement and therefore capital expenditure. If would however be maintenance and therefore revenue expenditure if it was merely replaced because the existing glazing had worn out;
- modifying plant to extend the life or increase capacity;
- upgrading parts of machinery to achieve substantial improvement in output quality;
- replacement of a flat roof with a pitched roof would represent capital expenditure if that replacement increased the assessment of the useful life;
- widening of roads;
- strengthening of bridges; and
- enlargening a sports facility to increase capacity

Capital expenditure would <u>not</u> include painting, repairs to machinery and vehicles and cyclical building maintenance which merely maintains buildings in their existing state.

Are local authorities treated differently from other parts of the public sector?

Local authorities share the main principles for accounting for fixed asset accounting with most parts of the public sector. The principles of improved accountability, identifying the real economic cost of services and separating accounting from financing are now common throughout the public sector.

Will CFCR be treated differently?

No. Capital Financed From Current Revenue (CFCR) is still available as a funding mechanism for local authorities. CFCR is a mechanism which allows local authorities to provide funding for capital expenditure from revenue monies. The accounting treatment for CFCR should continue as before. In the statement of accounts the total CFCR for the local authority is 'charged' below the line at which net operating expenditure is calculated.

I would like to discuss this subject further

Comments on this paper are welcomed and can be discussed by contacting LASAAC at:8 North West Circus Place Edinburgh, EH3 6ST. Or by telephoning 0131 718 2713.

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