EXPLANATORY MEMORANDUM TO

THE LOCAL AUTHORITIES (CAPITAL FINANCE AND ACCOUNTING) (AMENDMENT) (ENGLAND) REGULATIONS 2010

2010 No. 454

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.

2. Purpose of the instrument

2.1 The Regulations make a number of technical amendments to the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 (S.I. 2003/3146) ("the 2003 Regulations"). The 2003 Regulations set out detailed provisions in relation to local authority finances, including the spending of capital receipts, the way that local authorities account for debt and accounting practices generally.

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

3.1 None

4. Legislative Context

4.1 By section 21(1) of the Local Government Act 2003, the Secretary of State may by regulations make provision about the accounting practices to be followed by a local authority (in particular with respect to the charging of expenditure to a revenue account). Under section 21(2)(b) of the Local Government Act 2003, the Secretary of State has the power by regulations to identify a code of practice which then becomes accounting practices in relation to accounts of a local authority which are "proper practices". By regulation 31 of the 2003 Regulations, the Secretary of State has identified CIPFA's "A Statement of Recommended Practice: Code of Practice on Local Authority Accounting in the United Kingdom" as such a code of practice. By section 21(2)(a), "proper practices" means not just codes of practice identified by the Secretary of State, but also accounting practices which a local authority is required to follow by virtue of any enactment.

4.2 Section 21(3) provides that in the event of a conflict between practices falling within paragraphs (a) and (b) of subsection (2), only those falling within paragraph (a) are to be regarded as proper practices. This makes clear that the Secretary of State has power to make provision overriding aspects of a code of practice he has identified as constituting proper practices.

4.3 While the Secretary of State wishes to continue identifying CIPFA's code of practice on local authority accounting as proper practices, there are a number of modifications that are desirable. Other provisions in these Regulations update local authority accounting practice.

4.4 With the exception of the amendments made by regulation 3(2) and (3), which apply to the financial year ending 31st March 2010, the amendments will apply to the local authority financial year which begins on 1st April 2010 and to subsequent years.

5. Territorial Extent and Application

5.1 This instrument applies to England.

6. European Convention on Human Rights

6,1 As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

7. Policy background

- What is being done and why

7.1 Several of the regulations mitigate adverse financial impacts of accounting practices, including those arising because, from 2010-11, local authorities will be required to prepare their statements of accounts in accordance with *International Financial Reporting Standards* (IFRS) rather than UK standards. The new accounting provisions are in the *Code of Practice on Local Authority Accounting in the United Kingdom,* published by CIPFA (the Chartered Institute of Public Finance and Accountancy) applying with effect from 1 April 2010 (see regulation 9 of these Regulations which identifies this document for the purposes of section 21(2)(b) Local Government Act 2003).

Regulation 3: Retirement benefits

7.2 **Background** Regulations 4 and 30 in the 2003 Regulations protect authorities from what could be an unmanageable burden imposed by accounting standards in relation to long-term pension liabilities. Without this, the full value of the future liabilities would have to be charged to revenue now. Regulation 30 provides for the revenue charge for a financial year to be equal to the retirement benefits or contributions to pension funds *actually* payable in that year. For the purposes of Regulation 30, Regulation 4(2) listed by name the various specific pension schemes to which this measure applies.

7.3 **Policy** Some schemes referred to in Regulation 4(2) have recently changed their descriptions, so that they were no longer covered by the regulation. The amendment replaces all the specific scheme references in Regulation 4(2) with a description of the type of scheme covered instead, taken from the CIPFA code of practice. To offer immediate protection, these changes will be brought into force on 31 March 2010, so as to apply in the current financial year, 2009-10. The description in the CIPFA code of practice is slightly different for subsequent years, hence the need for subparagraphs (1) and (2). Following consultation, the description of the type of scheme has been extended to cover also injury awards (particularly those given in the police and fire services), which will generate similar problems from 1 April 2010.

Regulation 4: Use of capital receipts

7.4 **Background** Capital receipts are the sums authorities receive when they sell capital assets, such as land and buildings. Regulation 23(e) already allows capital receipts from disposals of *housing* land to be used to meet the "administrative costs of or incidental to" the disposals. No such concession currently applies in the case of *non-housing* property. This discourages disposals of surplus land, because the costs (eg advertising, professional fees) must be met from revenue, not sales proceeds.

7.5 **Policy** Regulation 23 is extended, by the insertion of new paragraph 23(h), to allow the disposal costs of all *non-housing* capital assets to be met out of capital receipts. But, because overall costs are unpredictable and could be large, there needs to be a ceiling. The consultation paper said that the costs met out of a capital receipt would not be allowed to exceed 2% of the receipt and some respondents asked for this to be increased. We have considered that request and, while we still wish to encourage authorities to keep down disposal costs, we now consider that it would be reasonable to set a slightly higher limit, at 4%. Existing Regulation 23(e) will continue to operate exactly as before (the 4% restriction is not being applied to housing disposal costs); but the word "administrative" is being removed to improve the drafting, since it was considered this term was superfluous.

7.6 Separately, and again in response to the consultation, a new provision 23(i) is being inserted to allow "claw-back" payments to be paid out of capital receipts. Authorities may be required on selling property (for example, former New Town assets) to make payments to a previous owner and at present must use revenue resources for that purpose. The regulation allows such payments to be made out of the sales proceeds.

Regulation 5: Expenditure to be capital expenditure

7.7 **Background** Regulation 25(1)(d) provides that the acquisition of *shares* in individual companies is capital expenditure. This is intended to be a disincentive to the use of this potentially speculative form of investment. Regulation 25(3) however makes exceptions to that rule, in particular, for the purchase of shares through regulated collective investment schemes - which spread and mitigate the risk. But that exemption does not currently apply to investments in the *Local Authorities' Property Fund* (LAPF). This is an unregulated collective investment scheme and operates as an open-ended unauthorised property unit trust. It was established by local authorities and is managed on their behalf to provide local government with a way of gaining diversified access to UK commercial property investment.

7.8 **Policy** Since the LAPF is a local government investment scheme, approved by the Treasury under the Trustee Investments Act 1961 (section 11), there seems no reason why authorities should be discouraged from placing money with it (provided that they are individually satisfied that such an investment is prudent). The amendment therefore inserts new subparagraph 25(3)(d), with the effect that acquisition of shares in an investment scheme approved under the 1961 Act is not to be capital expenditure. The suggestion by some respondents in the consultation that there should be a similar exemption for property funds generally raises wider considerations but may be explored in the future.

Regulation 6: Back payment following unequal pay

7.9 **Background** Many authorities are liable to make lump-sum back-pay awards in relation to former unequal pay arrangements. Accounting practice requires financial provision for anticipated future liabilities to be made in the financial year when the liabilities are identified, rather than in the year when the actual payments fall due. It is undesirable for authorities to have to fund these often large provisions in advance of the need to make the payments. To protect authorities, regulation 30A was inserted in the 2003 Regulations (by S.I. 2007/573), with the effect that authorities need not charge back pay awards until the date on which they must make the payments. Regulation 5(1) of S.I. 2007/573 provided that regulation 30A expires on 1 April 2011.

7.10 **Policy** As noted above, the protection conferred by regulation 30A was to end on 1 April 2011. It was hoped that by then all these cases would have been settled. But equal pay claims are still going through the courts and the process will not be complete by 2010-11. The period of operation of regulation 30A is therefore extended for two years, until 1 April 2013. This is achieved jointly by regulation 10, which revokes regulation 5(1) of S.I. 2007/573; and by regulation 6, which inserts in regulation 30A new paragraph (5), specifying a revised expiry date of 1 April 2013. Also inserted in regulation 30A is new paragraph (6), which makes clear that where a liability is identified on or before 1 April 2013, the benefit of regulation 30A will apply, even though the payment falls due after that date.

Regulation 7: Short-term accumulating compensated absences

7.11 **Background** The new IFRS accounting standards will require authorities to make a charge in each year for the value of holiday entitlements that employees have not taken up by the end of the year. The amounts will be high for numerous authorities, in particular because of the nature of teachers' employment contracts.

7.12 **Policy** New regulation 30H negates this impact of the transition to the IFRS accounting basis, providing that holiday benefits are to be charged to revenue in the financial year in which the holiday absence occurs.

Regulation 8: Lease classification

7.13 **Background** Authorities often own and grant leases on buildings (eg shops, industrial units) and receive rental income from the tenants. Under the new accounting standards, such property leases are to be accounted for as separate leases of land and buildings. While this reclassification does not change the amount of money the authority receives under the lease, it can have an adverse impact on the authority’s flexibility to apply those resources to meet expenditure.

7.14 **Policy** To protect authorities, there are two new regulations. Regulation 30I applies where *operating* leases become *finance* leases, and the reverse situation is dealt with by regulation 30J, which was inserted following the consultation at the request of respondents. Authorities are permitted to continue to apply the proper practices which applied to the lease before the reclassification. The concessions apply, as a transitional measure, only to leases already in existence; authorities granting leases in future will do so in full knowledge of the new accounting standards. Some respondents to the consultation requested that the benefits should apply to all future new leases. However, Ministers consider that overriding new accounting practices should be undertaken only exceptionally, to protect authorities from severe unforeseeable and unbudgeted revenue impacts of new accounting rules. Ministers have therefore decided against widening the provisions in that way; but they have extended the cut-off date specified in the consultation paper. Both regulations will now apply to leases in existence on 31 March 2010, rather than on 16 November 2009 (the consultation date).

Regulation 9: Proper practices

7.15 **Background** Regulation 31 lists accounting codes which are "proper practices". The code identified in regulation 31(a) is to be re-named in 2010-11, so the reference in the regulation needed to be updated.

7.16 **Policy** The old title of the code in Regulation 31(a) is to be changed to the new one.

Regulation 10: Revocation

7.17 This is explained above in relation to regulation 6.

- Consolidation

7.18 No consolidation is proposed at this stage since further amendments may be required in the near future in relation to changes in the housing finance system.

8. Consultation outcome

8.1 All local authorities were consulted about the proposals on 16 November 2009. Responses were requested by 4 January, in accordance with the agreement with local government that consultations on urgent technical changes should be limited to 6 weeks. Over 100 responses were received from individual authorities and other stakeholders including the local government associations, the Audit Commission and CIPFA. The main points made in the responses, and the Government's decisions, have been published on the CLG website at: http://www.communities.gov.uk/documents/localgovernment/pdf/1482264. Relevant decisions are also indicated above, in paragraphs 7.3, 7.5, 7.6, 7.8 and 7.14.

9. Guidance

9.1 There will be no formal Government guidance associated with this instrument. An informal letter will be sent to authorities when it is laid. It is normal practice for CIPFA to issue guidance on the accounting implications of regulations of this kind, but the decision on that and the timing would be entirely a matter for CIPFA.

10. Impact

10.1 There is no impact on business, charities or voluntary bodies.

10.2 The impact on the public sector is wholly beneficial – the measures protect local authorities from adverse effects of accounting rules and increase their flexibility.

10.3 An Impact Assessment has not been prepared for this instrument.

11. Regulating small business

11.1 The legislation does not apply to small business.

12. Monitoring & review

12.1 These measures, along with the rest of the capital finance system, will be kept under review by CLG in liaison with the local government associations, the Audit Commission and CIPFA.

13. Contact

Sarah Blackman at the Department for Communities and Local Government tel: 0303 44 41765 or email: sarah.blackman@communities.gsi.gov.uk can answer any queries regarding the instrument.

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SI 2010 No. 454**

SUPPLEMENTARY MEMORANDUM BY CLG ON THE MAIN POLICY INTENTIONS

Introduction

1. This note amplifies the key policy points made in section 7 of the original Explanatory Memorandum to SI 2019/454.

2. The regulations make various amendments to the Capital Finance Regulations, all of which are helpful to local authorities. Without them, a significant number of authorities would face serious difficulties in the coming financial year.

3. Although the amendments are independent of each other, several have a common theme. They are designed to override the effects of **standard accounting practices**, which apply to commercial bodies but which for local authorities would be too onerous. New international standards which begin to apply to local government from 1 April 2010 present a number of difficulties, which these regulations seek to address.

Regulation 3: Retirement benefits

4. This regulation helps authorities manage their liabilities towards retired staff.

5. The existing regulations which are being amended (Regulations 4 and 30 in the 2003 Regulations) already protect authorities from the full effects of normal accounting practice as it applies to pension liabilities. Without this, the full value of all the future liabilities would have to be charged to revenue now. For some authorities, that would be an immense and unaffordable cost.

6. So the regulations override accounting practice and allow the revenue charge to be spread evenly over a longer period. The revenue charge for a financial year is simply equal to the retirement benefits or contributions to pension funds *actually* payable in that year.

7. There are 8 specific pension schemes to which this measure applies and these are listed in the regulations by reference to the legislation under which they operate (eg *the Local Government Pension Scheme Regulations 1997*).

8. The problem with listing specific legislation is that the legislative framework may change and some descriptions may become out of date. That is what has happened. Some of the descriptions no longer apply, so the schemes are not covered by the regulations.

9. One option is simply to update the individual references. But the better long-term solution is to dispense with the individual descriptions and apply the concession to *any* local government pension scheme where charges for future liabilities would be required by standard accounting practice. That is what the new regulation does. It thus ensures that authorities will continue to enjoy the protection provided by the existing regulation. The opportunity has also been taken to broaden the wording, so that the regulation applies to benefits to staff arising from injuries.

Regulation 4: Use of capital receipts

10. This regulation facilitates the disposal of property by local authorities.

11. ***Capital receipts*** are the sales proceeds that authorities obtain when they dispose of property assets (such as land and buildings). The Government's long-established policy is that capital receipts should normally be used only for ***capital expenditure*** (eg buying land and constructing buildings) and *not* ***revenue expenditure*** (eg running costs, salaries and consultants' fees)

12. This policy on the use of capital receipts is given effect by existing regulation 23, which specifies the purposes that capital expenditure may be used for, including the exceptions to the policy. The amendment regulation adds the following two separate exceptions to the policy, allowing capital receipts to be used in ways not currently permitted. Both relate to the costs of property disposal.

(a) Disposal costs

13. When authorities sell land or buildings, various administrative costs are involved (eg advertising, professional fees). These do not count as capital expenditure and so cannot at present be met out of the proceeds of the sale. Instead they have to come out of the authority's revenues, which may be already tightly constrained. That may make a sale unaffordable and can prevent the disposal of surplus property.

14. There is already a concession in regulation 23 allowing the disposal costs of sales of *housing property* to be met out of the capital receipts. New regulation 23(h) will allow capital receipts to be used to pay the disposal costs of sales of *non-housing land and buildings*.

15. The Government is however keen that as much of the capital receipt as possible should still be left available for capital expenditure. The intention is that authorities should minimise the disposal costs that they meet out of the receipts. There is a concern that for certain kinds of non-housing property the disposal costs could significantly eat into the receipt unless firmly controlled (eg advertising costs could easily escalate). So the regulation sets a ceiling and says the costs met out of a capital receipt are not to exceed 4% of the receipt. That figure has been increased from 2% following the consultation. The Government believes that the 4% ceiling strikes a reasonable balance, providing the safeguard it seeks, while still allowing authorities useful additional flexibility.

(b) Claw-back payments

16. This is particularly relevant to authorities selling former New Town assets. An illustration was given by one authority in this position. Under the original agreement by which the property was transferred to the authority, there is a requirement, in the event of subsequent sale, for the authority to make a payment to the New Towns Commission or its legal successor. Such a payment is not capital expenditure and cannot at present be met out of the capital receipt. That

seems unreasonable, since the payments can be substantial, and so the new regulation, 23(i), allows such payments to be made out of the sales proceeds.

Regulation 5: Expenditure to be capital expenditure

17. This regulation increases authorities' flexibility to invest surplus funds.

18. Since 2004, local authorities have been free to decide how and where to invest their surplus cash, subject to having regard to Government guidance on prudent investment practice. However, there does remain one constraint on investment in the existing regulations. Regulation 25(1)(d) discourages authorities from highly risky investments, such as buying shares in individual companies. The regulation does not actually prohibit such investments, but it achieves its result by defining such transactions as "capital expenditure". The authority therefore has to score the expenditure against its capital resources, leaving it with less to spend on real capital projects. This makes such investments unattractive.

19. There are however some exceptions to that rule, in particular for the use of regulated collective investment schemes. That includes unit trusts, which spread the investment over a "basket" of shares, thus reducing the risk of loss. There is no need to discourage the use of such schemes, so regulation 25(3) says that investments in such schemes do not have to be treated as "capital expenditure". Authorities are therefore free to use them if they wish.

20. One investment scheme not covered by that exemption is the Local Authorities' Property Fund (LAPF). This is a property unit trust which was established by local authorities and is managed on their behalf to provide local government with a way of gaining diversified access to UK commercial property investment.

21. Because this is an unusual and indeed unique scheme, not regulated in the same way as normal unit trusts, it is not covered by the general exemption in regulation 25(3). So investments in it are treated as capital expenditure and, as explained above, that acts as a disincentive.

22. However, the LAPF was approved by the Treasury under the Trustee Investments Act 1961 (section 11) (and is in fact the only scheme so far approved under that power). There seems no reason to discourage authorities from placing money in this fund which they themselves created.

23. The amendment therefore provides that investments in a scheme approved under the 1961 Act are not to be capital expenditure. That leaves authorities free to consider using the scheme (provided that they are satisfied that such an investment is prudent).

Regulation 6: Back payment following unequal pay

24. This regulation helps authorities manage liabilities under equal pay legislation.

25. Many authorities are faced with making large lump-sum payments in relation to former unequal pay arrangements. These are typically awarded by tribunals where female staff have been paid less than male staff doing work considered to be of equal value, or where such a situation is recognised after the authority has conducted a pay review.

26. The problem arises when (as often happens) the authority recognises in one financial year that it will have to make such a payment in a future year. In that case, accounting practice requires the authority to make financial provision for the payment in the financial year when the liabilities are identified, rather than in the year when the actual payments fall due. In other words, the need to fund the payments will arise well in advance of the need to make the actual payments. That is undesirable, given the large amounts often involved.

27. To protect authorities, existing regulation 30A provides that authorities need not charge these payments until the date on which they must be made.

28. The protection conferred by regulation 30A was due to end on 1 April 2011, by which date it was hoped that all these cases would have been settled. But equal pay claims are still being identified and are still going through the courts; and thus the process will not be complete by that date.

29. The amendment regulation therefore extends the period of operation of regulation 30A for another two years, until 1 April 2013, which is considered to be sufficient. (The revocation of the old deadline is achieved by amendment regulation 10).

Regulation 7: Short-term accumulating compensated absences

30. This regulation enables authorities to manage their liabilities on holiday pay.

31. New accounting standards will require authorities to make a charge in each year for the value of holiday entitlements that employees have not taken up by the end of the year.

32. For example, some employees with 6 weeks' paid annual holiday entitlement may take 5 weeks' leave in the current financial year and the remaining week in the next financial year. The new accounting requirement is that the amount of the pay for that remaining week must be charged to revenue in the current financial year – even though the actual salary payment will not have to be made until the next financial year.

33. This can create budgeting difficulties, especially in the first year of the new accounting arrangements. The amounts will be high for numerous authorities, in particular because of the nature of teachers' employment contracts.

34. New regulation 30H negates this impact of the transition to the new accounting basis. It provides that holiday benefits are to be charged to revenue in the financial year in which the holiday absence occurs.

Regulation 8: Lease classification

35. This regulation protects authorities from adverse implications of the new accounting treatment of leases.

36. Authorities often own and grant leases on buildings (eg shops, industrial units) and receive rental income from the tenants. For some authorities, this is an important source of revenue.

37. Under the new accounting standards which come in on 1 April 2010, such property leases are to be accounted for as separate leases of land and buildings. The effect of this is to change

the classification of some leases. It may be necessary to reclassify ***finance leases*** as ***operating leases*** and vice versa. These technical terms can be defined as follows:

> A ***finance lease*** is a lease that transfers substantially all the risks and rewards incidental to ownership of the asset to the lessee. The lease therefore becomes a way of the lessee acquiring the asset, but paying for it by a rent over the life of the asset rather than having to make the upfront payment involved in purchase of the asset. Equipment and vehicles are commonly the subject of leasing, and if the period of the lease corresponds to the effective life of the asset the lease is likely to rank as a finance lease.
>
> An ***operating lease*** is any lease other than a finance lease. Property leases are commonly, but not invariably, classed as operating leases, especially when the lease period is significantly less than the life of the property.

38. While this reclassification of course does not change the amount of money the authority actually receives under the lease, it has complex effects on the accounting treatment of that income and can thus have an adverse impact on the authority's flexibility to apply those resources to meet expenditure. The practical result is that authorities may have less money available for revenue expenditure than under the old rules.

39. The amendment regulation protects authorities by allowing them to continue to apply the old accounting practices which applied on 31 March 2010.

40. This is a transitional concession which only applies to leases in existence on 31 March 2010. The Government considers that the overriding of accounting practices should be undertaken only exceptionally, to protect authorities from severe unforeseeable and unbudgeted revenue impacts of new accounting rules. Authorities considering the granting of leases after that date will do so in full knowledge of the new accounting standards.

Regulation 9: Proper practices

41. This regulation simply updates the title of an accounting code.

42. Existing regulation 31 lists accounting codes which are "proper practices". The code identified in regulation 31(a) is to be re-named in 2010-11, so the reference in the regulation needed to be updated. The amendment regulation does this.

Regulation 10: Revocation

43. This is explained above in relation to regulation 6 (see paragraph 29).

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