POLICY NOTE

THE LOCAL AUTHORITY (CAPITAL FINANCE AND ACCOUNTING) (SCOTLAND) AMENDMENT REGULATIONS 2024

SSI 2024/XXX

The above instrument will, if approved by the Scottish Parliament, be made in exercise of the powers conferred by section 165 of the Local Government etc. (Scotland) Act 1994. The instrument is subject to affirmative procedure.

Summary Box

The Local Authority (Capital Finance and Accounting) (Scotland) Regulations 2016 (the 2016 Regulations) require a local authority to make an annual charge against the revenue of the authority to meet the costs of borrowing, known as 'the statutory repayment of debt' or 'loan fund repayment'. This replaces the requirement of accounting standards for an annual charge for depreciation to be made against revenue, to reflect the declining value of an asset as it is used and to allocate in the annual accounts the original cost of the asset to periods in which the asset is used. (References in this document to "accounting standards" are to International Financial Reporting Standards).

The statutory arrangements are intended to ensure that a local authority sets aside sufficient revenue, in the form of 'loan fund repayments' (the 'statutory repayment of debt'), to meet the costs of capital investment. These arrangements have been superseded by advances in accounting standards which have introduced greater rigour to the recognition of such costs. Despite this, the statutory arrangements, which permit far greater flexibility for calculating the charge against revenue than would be permitted by accounting standards, have continued.

The Local Authority (Capital Finance and Accounting) (Scotland) Amendment Regulations 2024 will amend the Local Authority (Capital Finance and Accounting) (Scotland) Regulations 2016 to address the following financial risks:

Current statutory arrangements allow a local authority to make capital investments that would not be affordable applying accounting standards.

The statutory arrangements allow a local authority to defer a substantial proportion of the costs of borrowing to later years, creating a future affordability risk.

There is evidence that the statutory arrangements are being widely interpreted by local authorities as permitting the retrospective restatement of borrowing costs, which was not the intention of the statutory arrangements.

'Retrospective restatement' refers to the practice of reassessing previous borrowing costs charged against revenue in prior years' annual accounts and subsequently reprofiling the repayments to produce a lower cost profile to-date. This allows a local authority to defer a large proportion of the borrowing costs to later years, in order to generate a one-off surplus to reserves and an immediate budget saving for the authority.

The deferred costs (which have previously been charged to tax payers) will result in an increased cost to future Council Tax payers which may not align with the benefits to the community of the capital investment.

Accounting standards do not permit the retrospective restatement of accounting estimates, such as depreciation, already charged in prior years' accounts. Given that loans fund

repayments are akin to depreciation and replace depreciation as the charge against revenue in the annual accounts of a local authority it is inconsistent to permit the retrospective restatement of loans fund repayments.

The deferral of borrowing costs to future years creates a significant financial sustainability risk for the local authority as the deferred costs still have to be met in future, but has wider implications for the Scottish budget and the future of public services.

There is also evidence that local authorities are retrospectively reprofiling or restating historic borrowing costs as an affordability measure in place of sustainable long term financial plans.

A local authority is required to assess the affordability of borrowing at the time of the capital investment, in accordance with the Prudential Code for Capital Finance in Local Authorities. A variation to the pattern of charges for borrowing should only be undertaken to better align the repayment period with the period and pattern of benefits to the community, not as an affordability measure.

The 2016 Regulations will be amended to incorporate the following provisions:

New Regulation 14(4)(c) and (d)

A variation to a loans fund repayment must only be calculated on the balance of the loans fund advance as it applies on the first day of the financial year in which the variation is made and must never give rise to a nil or negative repayment.

This amendment will prevent a local authority from reprofiling historic borrowing costs in order to produce a negative charge as a means to increase reserves.

New Regulations 14(4)(a) and (b)

A variation must not result in the repayment period exceeding the useful life of the asset, as determined in accordance with proper accounting practices, in relation to which the loans fund advance was made; and may not result in the repayment period exceeding 50 years if the loans fund advance does not relate to an asset for which a useful asset life can reasonably be determined.

This amendment will prevent a local authority from assigning a loans fund repayment term that does not align either/both to the life of the asset for which the capital expenditure was incurred and/or the period over which benefit will be provided to the community of the capital expenditure. It will also prevent such an approach from being used as a means to reprofile historic loans fund repayments in order to generate an ‘overpayment’ to increase reserves, by the reversal of borrowing costs charged in prior years’ annual accounts. This will also bring the 2016 Regulations into alignment with the equivalent statutory requirements for local authorities in England and Wales. “Useful life of an asset” is set out, for every category and class of asset, within the CIPFA (Chartered Institute of Public Finance and Accountancy) code of practice for local authority accounting. This is a recognised code of practice for the purposes of section 12 of the Local Government in Scotland Act 2003 (“the 2003 Act”). As a result, local authorities will be required to comply with it, in line with section 12 of the 2003 Act. Section 12 sets out what are proper accounting practices, and this includes practices which local authorities are required to observe in the preparation of their accounts in line with generally recognised and published codes. The CIPFA code falls into this category.

New Regulation 14(5)

A variation may result in a repayment period exceeding the useful life of an asset, or in the repayment period exceeding 50 years, with the consent of the Scottish Ministers.

This will allow the Scottish Ministers to vary the standard requirements where there is a compelling reason to do so.

New Regulation 14(6)

The useful life of an asset is to be determined in accordance with proper accounting practices.

This will ensure that the loans fund repayment term aligns to the useful life of an asset, as determined applying accounting standards, for which the capital expenditure was incurred and will therefore align the loans fund repayment term to the period over which the benefit of the capital expenditure is provided to the community.

Amendment to Existing Regulation 14(3)(b)

A loans fund repayment may not be varied where the borrowing was with the consent of the Scottish Ministers.

This amendment will prevent the variation of loans fund advances where Scottish Ministers have consented to that borrowing, regardless of whether the Scottish Ministers have determined the amount and period of repayment. Ministerial consent will usually be required for borrowing where an exception to proper accounting practice is required, for example to permit a local authority to borrow to incur expenditure which is not capital in nature and therefore requires an exception to current rules. In such cases, the Ministerial consent will specify a reasonable repayment period for the expenditure to be treated as capital. As the repayments will not align to a specific asset, there is no basis to permit a future variation.

These amendments will apply to variations of repayment of loans fund advances where the loans fund advance was made on or before 31 March 2023 but the variation takes place on or after 1 April 2024.

Policy Objectives

Local authorities in Scotland are interpreting the flexibility of the statutory framework as permitting the reversal of borrowing costs which have already been incurred (and passed on to council tax payers) and that, under accounting standards, would be required to be recognised in the current financial year. Local authorities are also using the flexibility of the statutory framework to then defer the reversed costs to future financial years in order to make further borrowing appear more affordable and to generate one-off reserves for use towards budget pressures, in place of sustainable, long-term financial strategies. This approach introduces serious affordability risks in the medium to longer term.

Disproportionate borrowing and failure to make adequate provision from revenue to meet the costs of borrowing have been a significant cause of financial failure in England. The Department for Levelling Up, Housing and Communities has made significant improvements to the equivalent statutory arrangements in England and Wales to address the financial sustainability risks of these practices and to specifically prohibit the accounting practices which

continue to be adopted in Scotland. The amendments to the 2016 Regulations will bring alignment with the measures introduced for England and Wales.

The statutory framework must ensure a transparent and prudent approach to financing capital investment, ensure an equitable charge to Council Tax payers for that investment and incorporate the right balance of flexibility and financial controls to support local authorities to be financially sustainable whilst requiring fiscal prudence in order to protect public services and the Scottish budget from undue risk.

EU Alignment Consideration

This instrument is not relevant to the Scottish Government's policy to maintain alignment with the EU.

Consultation

The Scottish Government issued a consultation paper to COSLA, CIPFA, LASAAC (Local Authority Scotland Accounts Advisory Committee), and all local authorities, setting out the intended improvements to the statutory accounting framework and the reasons for those improvements and allowed a 4-week period for consultees to respond.

The consultation included the draft amendment regulations and accompanying statutory guidance. A summary of the original and revised amendments to regulations, to strike a balance between the requirement to better constrain financial risk whilst addressing the concerns expressed by Local Government within the consultation responses received, is included as Annex A.

Impact Assessments and Financial Effects

A Business and Regulatory Impact Assessment (BRIA) has been completed. The financial effect of this policy applies only to local government and the only effect will be to require greater prudence in determining the amount of borrowing a local authority can afford to undertake and in setting aside revenue resources to meet the costs of financing capital investment plans.

The amendments do not change the total amount to be repaid to the loans fund, i.e. the amendments are cost neutral over the life of a loans fund advance but prevent a local authority from reversing costs already charged in prior years' annual accounts or from deferring borrowing costs as an affordability measure.

There are no impacts on child rights and wellbeing, equalities, data protection, strategic environmental, fairer Scotland or Island Communities.

Scottish Government
Directorate for Local Government and Housing
January 2024

ANNEX A

CONSULTATION WITH LOCAL GOVERNMENT ON THE LOCAL AUTHORITY (CAPITAL FINANCE AND ACCOUNTING) (SCOTLAND) AMENDMENT REGULATIONS 2024

1. Local Government, LASAAC, Audit Scotland and COSLA were consulted on proposed amendments to The Local Authority (Capital Finance and Accounting) (Scotland) Amendment Regulations 2016 (the 2016 Regulations) to address financial risks arising from the interpretation of flexibilities within the statutory capital financing framework for the recognition in the annual accounts of borrowing costs.

2. The original draft amendments, commentary on the consultation responses received with regards to those amendments and the subsequently revised amendments to regulations which are intended to strike a balance between the requirement to better constrain financial risk whilst addressing the concerns expressed by Local Government within the consultation responses received, are set out below.

New Regulation 14(4)(c) and (d) – No Change to Original Proposal

3. A variation to a loans fund repayment must only be calculated on the balance of the loans fund advance as it applies on the first day of the financial year in which the variation is made and must never give rise to a nil or negative repayment.

4. This amendment will prevent a local authority from reprofiling historic borrowing costs in order to produce a negative charge as a means to increase reserves.

5. **Consultation response:** Consultation responses asserted that a local authority should be allowed to recognise an overpayment of loans fund repayments and make a retrospective adjustment to address the overpayment. Responses noted that being unable to apply the effects of an overpayment retrospectively would be unfair to current taxpayers.

6. In practice, local authorities have applied ‘overpayments’ as a means to increase General Fund reserves to address budgetary pressures. Accounting standards do not permit the retrospective adjustment or reversal of expenditure reported in the annual accounts of an entity in prior financial years. A sufficient argument has not been made, or evidence provided, to substantiate such a departure from accounting standards. The above amendment will therefore be taken forward without alteration in order to align with accounting standards and remove the risk of a local authority restating prior years’ costs or deferring costs to future years as an alternative to sustainable financial planning.

New Regulation 14(4) – (Original Proposal)

7. A variation to a loans fund repayment must not extend the repayment period beyond whichever is the earlier of—

    a) the end of the useful life of an asset for which the loans fund advance is made, where proper accounting practices require that useful life be determined,
    b) the end of the period of 50 years beginning with the date on which the loans fund advance was made.

8. This amendment will prevent a local authority from assigning a loans fund repayment term that does not align either/both to the life of the asset for which the capital expenditure was incurred and/or the period over which benefit will be provided to the community of the capital expenditure. It will also prevent such an approach from being used as a means to reprofile historic loans fund repayments in order to generate an 'overpayment' to increase reserves, by the reversal of borrowing costs charged in prior years' annual accounts. This will also bring the 2016 Regulations into alignment with the equivalent statutory requirements for local authorities in England and Wales.

9. **Consultation responses:** Some consultation responses noted that this change would not align with asset design lives, or the professional judgements and assessments relating to asset useful lives, for example for a new bridge, a flood prevention scheme, or a flood defence wall, which may have a whole life design period of up to 120 years. Consultation responses noted specifically that there would be implications for future Learning Estate Investment Programmes, borrowing for which is currently repaid over 60 years in order to make the programmes affordable.

10. The amendment regulation has therefore been revised as follows:

Revised Regulations 14(4) and 14(5)

New Regulation 14(4)(a) and (b)

11. A variation must not result in the repayment period exceeding the useful life of the asset, as determined in accordance with proper accounting practices, in relation to which the loans fund advance was made and may not result in the repayment period exceeding 50 years if the loans fund advance does not relate to an asset for which a useful asset life can reasonably be determined.

12. This amendment will prevent a local authority from extending an asset's useful life in order to extend the loans fund repayment term as a mechanism for generating an 'overpayment' of loans fund repayments as a means to reverse historic borrowing costs charged in prior years' annual accounts in order to increase revenue reserves. This will also bring the 2016 Regulations into alignment with the equivalent statutory requirements for local authorities in England and Wales.

New Regulation 14(5)

13. A variation may result in a repayment period exceeding the useful life of an asset, or in the repayment period exceeding 50 years, with the consent of the Scottish Ministers.

14. This will allow the Scottish Ministers to vary the standard requirements where there is a compelling reason to do so.

New Regulation 14(6)

15. The useful life of an asset is to be determined in accordance with proper accounting practices.

16. This will ensure that the loans fund repayment term assigns to the useful life of an asset, as determined applying accounting standards, for which the capital expenditure was incurred and will therefore align the loans fund repayment term to the period over which benefit of the capital expenditure is provided to the community.

Amendment to existing regulation 14(3)(b) – No change to original amendment

17. A loans fund repayment may not be varied where the borrowing was with the consent of the Scottish Ministers..

18. This amendment will prevent the variation of loans fund advances where Scottish Ministers have consented to that borrowing, regardless of whether the Scottish Ministers have consented to the amount and period of repayment. Ministerial consent will usually be required for borrowing where an exception to defined proper accounting practice is required, for example to permit a local authority to borrow to incur expenditure which is not capital in nature and therefore requires an exception to current rules. In such cases, the Ministerial consent will specify a reasonable repayment period for the expenditure to be treated as capital. As the repayments will not align to a specific asset, there is no accounting basis for a future variation.

19. **Consultation responses:** No consultation responses were received to this proposal.

20. No concerns have been raised therefore this amendment will be taken forward without alteration.

New Regulation 14(7) – Withdrawn

21. A further regulation was proposed, but withdrawn in light of consultation responses:

22. Any decision to make a variation to a loans fund repayment must be made by the whole council and may not be delegated to individual members of the council.

23. **Consultation responses:** Consultation responses advised that the Capital and Treasury Management strategies of an authority, within which capital investment and repayment policies are defined, are subject to full Council consideration and are audited as part of the annual accounts audit process, therefore this amendment to regulations would introduce unnecessary additional bureaucracy.

24. The internal governance and external audit arrangements should provide sufficient assurance that such decisions are taken by full council in line with agreed capital and treasury management strategies and therefore this amendment has been withdrawn.