Directorate for Local Government and Communities
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Dear Director of Finance,

THE LOCAL AUTHORITY (CAPITAL FINANCING AND ACCOUNTING) (SCOTLAND) REGULATIONS 2016 – LOANS FUND ACCOUNTING

The Local Authority (Capital Finance and Accounting) (Scotland) Regulations 2016 (the 2016 Regulations) came into force on 1 April 2016. These Regulations replace the statutory provisions for local authority borrowing, lending and loans funds as set out in Schedule 3 of the Local Authority (Scotland) Act 1975. The repeal of the Schedule 3 provisions is set out in *The Local Government etc. (Scotland) Act 1994 (Commencement No. 9) Order 2016*. Finance Circular 29/1975 is only applicable to loans fund advances made before 1 April 2016.

The 2016 Regulations require the statutory loans fund to be administered in accordance with the 2016 Regulations, proper accounting practices and prudent financial management.

This circular provides guidance on proper accounting practices as it relates to the statutory loans fund and prudent financial management as it relates to the repayment of loans fund advances.

Yours faithfully

Hazel Black
Head of Local Authority Accounting

LOANS FUND ACCOUNTING

Scottish Government

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Part 1 – Commentary and Guidance
Part 2 – Statutory Guidance on loans fund accounting

Part 1 of this document provides a commentary on the statutory guidance, the statutory guidance itself is set out in Part 2.

PART 1 – COMMENTARY AND GUIDANCE

CONTENTS

1. This Part provides an overview of *The Local Authority (Capital Financing and Accounting) (Scotland) Regulations 2016* (the 2016 Regulations) and guidance on:
   a. The duty to maintain a statutory Loans Fund
   b. Loans fund advances for-
      i. Local authority capital expenditure;
      ii. Grants to third parties / expenditure on third party assets; and
      iii. Lending to third parties.
   c. Prudent repayment of loans fund advances and the Options for prudent repayment
   d. Credit arrangements
   e. Policy on prudent repayment and reporting on sums committed

Overview

2. The 2016 Regulations set out new statutory arrangements for local authority borrowing and lending and the requirement to maintain a loans fund. The 2016 Regulations replace the statutory arrangements set out in Schedule 3 of the Local Government (Scotland) Act 1975 (Schedule 3).

3. The 2016 Regulations apply from the financial year 2016-17.

4. Regulation 1 defines a local authority for the purposes of the Regulations.

5. Regulation 2 sets out the **purposes** for which a local authority may borrow. The Regulation does not itself provide the power to borrow. The power to borrow for each type of local authority is set out in other legislation. For the 32 councils the power to borrow is set out in section 69 of the Local Government (Scotland) Act 1973.

6. Regulation 12 places a duty on a local authority to maintain a loans fund, which is to be administered in accordance with the 2016 Regulations, proper accounting practices and prudent financial management.

7. Regulation 13 requires a local authority to make loans fund advances each year for expenditure of, or lending by the local authority which the authority has determined should be met from borrowing as permitted by Regulation 2. Loans fund advances may not however be made for treasury management activities (Regulation 13(2)(a)).

8. Regulation 14 requires a local authority to determine for each loans fund advance the period over which the advance will be repaid and the amount of each repayment in that period. Both the period and the annual amounts must be considered by the authority to be prudent.

9. Borrowing to lend to bodies that are not covered by the 2016 Regulations continues to require the consent of Scottish Ministers. In providing a consent to borrow Scottish Ministers will usually determine prudent repayment. Where this is not included in a borrowing consent the statutory guidance applies.

10. The statutory guidance on loans fund accounting is set out in Part 2.

Duty to maintain a statutory loans fund

Statutory purpose of the loans fund from 1 April 2016

11. Schedule 3 of the 1975 Act set out detailed arrangements for the administration of the loans fund. This required that the loans fund "shall be applicable to all money borrowed by the authority and the redemption or repayment thereof and the payment of interest or dividends thereon" (paragraph 12). Further, paragraph 14 of Schedule 3 required that borrowing should be carried to the loans fund to enable the loans fund to make advances to a borrowing account or relevant authority.

12. The 2016 Regulations do not include the same detailed arrangements. Regulation 12 requires a local authority to maintain a loans fund, and that the loans fund is to be administered in accordance with the Regulations, proper accounting practices and prudent financial management.

13. From 1 April 2016 the statutory purpose of the loans fund is simplified -

a. To recognise, by making advances from the loans fund, the expenditure incurred, or loans made to third parties, by the authority which a local authority has determined are to be financed from borrowing, as permitted by Regulation 2[1] of the 2016 Regulations.
b. To record transactions - opening balance each financial year, new advances, repayments charged to revenue (the statutory repayment of debt), and a closing balance at each financial year-end, being the value of loans fund advances still to be repaid/ charged to revenue.
c. For each loans fund advance made to record the annual repayment to be made to revenue. This will provide an authority with a profile of annual charges representing the amount of statutory repayment of debt to be charged to the General Fund/ HRA in any financial year.

Capital receipts

14. Income to the statutory loans fund is limited to the repayment of loans fund advances. Paragraph 22 of Schedule 3 of the 1975 Act permits a local authority to establish a Capital Fund. A Capital Fund may be used to provide money for the

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[1] Regulation 2 allows a local authority to borrow for specific purposes, which includes treasury management activities (Regulation 2(1)(d)). Whilst an authority may have determined they need to borrow for treasury management activities, Regulation 13 specifically excludes this activity type of expenditure from being the subject of a loans fund advance.

repayment of the principal of loans (but not any payment of interest on loans). Where the Capital Fund is used to fund the annual statutory repayment of debt this is to be treated as a separate transaction. This means that the statutory repayment of debt must still be charged, in full, to the General Fund. The transfer from the Capital Fund to the General Fund is a separate transaction. The Scottish Government recognises that a local authority may wish to use the Capital Fund to extinguish or reduce a loans fund advance. This usage is the same as applying capital receipts/capital fund to fund capital expenditure, except in this case the expenditure has taken place in previous years and has been met from borrowing. Further work is being undertaken to consider this scenario and guidance will be issued when this work has concluded.

External borrowing and the statutory loans fund

15. Regulation 2 of the 2016 Regulations sets out the purposes for which a local authority may borrow. However, the timing of the external borrowing is unlikely to match the expenditure, or the lending to third parties, that the authority has determined should be financed from borrowing in any financial year. The Prudential Code recognises that the timing of the external borrowing will be in accordance with treasury management principles. A local authority's Capital Financing Requirement (CFR) reflects the local authority's underlying need to finance capital expenditure by borrowing or credit arrangements. Actual external debt may be higher or lower than the CFR. The Prudential Code sets out the need for an authority to set boundaries for external debt reflecting capital plans and treasury management requirements. Advances from the loans fund will be made to match actual expenditure/ loans made to third parties in the financial year, on those purposes set out in Regulation 2 and which a local authority has determined will be financed from borrowing. The timing of external borrowing does not inform when a loans fund advance is made.

16. External borrowing is no longer required to be carried to the statutory loans fund. A local authority, through prudential indicators, is required to demonstrate that its borrowing is, in the medium term, for capital expenditure. Capital expenditure, for prudential and statutory purposes, includes that expenditure or lending to be financed by borrowing as permitted by Regulation 2.

17. Whilst external borrowing is no longer required to be carried to the statutory loans fund, local authorities are reminded that, as set out in the Prudential Code, any prudential indicators set locally should not associate any part of the authority's external borrowing with particular items, categories or purposes of expenditure. The authority should have an integrated treasury management strategy within which its borrowing and investments are managed in accordance with best professional practice.

Interest costs

18. The payment of interest or dividends on external borrowing is no longer a function of a statutory loans fund. Accounting for external borrowing, and the repayment of that borrowing, including any interest or other costs, is, for the purposes of statutory Annual Accounts, to be in accordance with proper accounting practices. Proper accounting practices will include relevant statutory requirements as set out in statutory guidance issued as a Circular, for example Finance Circular 4/2007.

19. A local authority may be required, through provisions contained in the Housing (Scotland) Act 1987, to maintain a Housing Revenue Account (HRA). Where there is a requirement to maintain an HRA Part II of Schedule 15 of the 1987 Act sets out the operation of the HRA. This includes the requirement for a local authority to debit the HRA

for loan charges which the authority are liable to pay for that year in respect of money borrowed by the local authority for a number of purposes. Schedule 15 sets out those purposes. HRA loan charges are made up of the repayment of loans fund advances made for HRA expenditure, plus the HRA share of interest or other costs of external borrowing of the local authority. This includes any temporary borrowing for treasury management activities but excludes borrowing for the common good or a local government pension fund.

20. A statutory purpose of the loans fund is to enable the identification of HRA loans fund advances and to make annual repayments of loans fund advances. This does not include interest costs.

21. Neither the Local Government (Scotland) Act 1975 nor the Housing (Scotland) Act 1987 provided/s statutory guidance on how to calculate the HRA share of interest on loan charges from borrowing. The 1975 Act required the repayment of a loans fund advance to be either by equal instalments or by the annuity method. The equal instalment method makes no mention of interest. The annuity method does reference the interest component but does not provide any guidance on how the interest component of the repayment calculated applying this method is to be reconciled to the actual external interest paid in any financial year.

22. There is no Scottish Government guidance on the charge to be made to the HRA for interest or for other costs arising from the borrowing of money. A local authority's policy for allocation should however be available to tenants / tenant groups and be applied consistently. In this respect see the guidance *Operation of Local Authority Housing Revenue Accounts (HRAs) in Scotland* issued by the Scottish Government in February 2014. In making an allocation of interest costs to the HRA consideration must also be given to any statutory guidance issued in relation to accounting for interest costs and the impact any statutory guidance may have on the actual interest cost chargeable to the General Fund, and hence the HRA.

23. In March 1991, LASAAC issued Note 2. This offered guidance based on the statutory provisions set out in the 1975 Act on the allocation of interest costs. This guidance provided a common approach to interest allocation to ensure consistency. It is likely LASAAC will formally withdraw their guidance in response to the new Regulations. The Scottish Government suggests that local authorities may wish to collaborate to provide new guidance.

Cash management

24. The 1975 Act contained no provision for the loans fund to be responsible for the cash management of a local authority. A LASAAC review in 2010-11 identified this as a widespread practice in Scotland. From 1 April 2016 cash management is distinct and separate from the statutory loans fund. Those authorities required to maintain an HRA are still required to comply with the Housing (Scotland) Act 1987 and credit the HRA with any income, and receipts in the nature of income, being income or receipts arising for that year from the investment or other use of money carried to the account.

Non statutory loans fund

25. Local authorities may continue with full loans fund accounting for their own internal management purposes. This will be on a non-statutory basis.

LOANS FUND ADVANCES

26. All expenditure incurred, or lending to third parties, which the authority has determined is to be financed from borrowing as permitted by Regulation 2, must be the subject of a loans fund advance. The exception is treasury management activities, which by virtue of Regulation 13 is not to be the subject of a loans fund advance.

Capital expenditure of the local authority (Regulation 2(1)(a))

27. The capital expenditure of a local authority may be funded from a number of sources – grants from central government or other bodies, capital fund/capital receipts or from revenue.

28. Regulation 2(1)(a) enables a local authority to borrow to finance capital expenditure of the local authority. The loans fund advance/s in any financial year must equal the value of capital expenditure the authority has determined should be financed from borrowing in any financial year.

Capital grants to third parties / expenditure on third party tangible assets (Regulation 2(1)(b) and 2(1)(c))

29. The 2016 Regulations permit a local authority to borrow for other purposes as set out in Regulation 2. This includes borrowing to fund expenditure that is not capital expenditure of the local authority. By permitting borrowing for these additional purposes this expenditure is to be treated as capital expenditure for the purposes of the legislative capital control framework and the Prudential Code.

30. Regulation 2(1)(b) and 2(1)(c) allows a local authority to borrow to provide a capital grant to a third party or to finance certain expenditure on a third party's tangible assets. Scottish Government or other central government capital grant may permit the grant to be used for similar purposes. Where the central government grant conditions permit this use the expenditure is also treated as capital expenditure for statutory purposes.

31. There is no statutory power for a local authority to use other capital resources, such as the Capital Fund or capital receipts, to fund this expenditure.

32. A local authority may use revenue resources to finance the expenditure but in such cases the expenditure is not treated as capital expenditure for statutory or Prudential Code purposes and no loans fund advance is made.

33. A loans fund advance must be made which is equal in value to any expenditure incurred for the purposes set out in Regulation 2(1)(b) and/or 2(1)(c) which a local authority has determined is to be met from borrowing in any financial year.

34. The statutory guidance recommends that the repayment of the loans fund advance for the purposes set out in Regulation 2(1)(b) and/or 2(1)(c) is determined under Option 3. The repayment period being equal to the useful life of the asset/s the subject of the grant aid.

Lending to Third Parties (Regulation 2(1)(c) and Part 3)

35. Local authorities already have a number of statutory powers to make loans to third parties. However, those powers do not provide an authority with the ability to finance that expenditure from borrowing.

36. Regulation 2(1)(c) allows a local authority to borrow to lend to those bodies, and for those purposes, as set out in Part 3 of the 2016 Regulations. By permitting borrowing for this purpose the loan made must be treated as a capital transaction for the purposes of the legislative capital control framework and the Prudential Code.

37. There is no statutory power for a local authority to use other capital resources, such as the Capital Fund or capital receipts, to finance lending to third parties.

38. For Prudential Code purposes the loan made will increase a local authority's Capital Financing Requirement (CFR). When calculating the CFR from the balance sheet of the authority the debtor is included in the CFR calculation as this debtor is the subject of a capital transaction.

39. Where a local authority has determined that a loan to a third party is to be financed from borrowing in any financial year a loans fund advance must be made which is equal in value to the loan made. A local authority may only determine that the loan is to be financed from borrowing for those loans made to those bodies, and for those purposes, as set out in Regulation 2(1)(c) and Part 3.

40. Any other loans made by an authority will need be financed from cash reserves. These other loans may not to be recognised as capital and will not form part of the authority's CFR. A local authority's ability to make loans from cash backed reserves will be linked to their policy on the value of reserves held and its longer-term financial plans. A local authority making loans to third parties using cash reserves must be able to demonstrate that over the period of the loan the investment remains funded from cash surpluses and will not require a local authority to borrow, except in the short term, to maintain liquidity. No loans fund advance is to be made for loans made which use cash reserves.

41. Finance Circular 5/2010 sets out the consent of Scottish Ministers for the investment of monies by Scottish local authorities. Paragraph 9(d) of the consent provides that loans made by a local authority to another authority, or harbour authority, using powers contained in Schedule 3, paragraph 10 or 11 of the *Local Government (Scotland) Act 1975* are not investments. The power to lend to other statutory bodies is preserved in the new Regulations at Regulation 2(1)(e). For the purposes of Paragraph 9(d) of Circular 5/2010 loans made by a local authority to another statutory body using powers contained in Regulation 2(1)(e) of *The Local Authority (Capital Finance and Accounting) (Scotland) Regulations 2016* are not investments. Local authorities are still required to recognise as an investment those loans to third parties financed from cash reserves.

42. The repayment terms (covering both period and repayment) for any loan to those bodies set out in Part 3 of the 2016 Regulations is a matter for each local authority. As the loan will have an income stream (the repayments) Option 4 is likely to be the most appropriate option. If option 1 or option 3 are selected the loans fund repayment period should not exceed the useful life of the asset the subject of the loan. The useful life of the asset should be determined at the outset, and the loan period may not be extended, nor is it required to be shortened, thereafter, even if in reality the condition of the asset changes.

43. Should a local authority convert a loan to a grant at any time consideration must be given as to whether the loans fund repayments continue to be prudent. Where the loan was made on an equal instalment or annuity basis it would be prudent for the repayments to the loans fund to continue without any change. However, if the loan was made on a

maturity basis it would be prudent to amend the repayment schedule. The repayments should be re-calculated applying option 3, the asset life option. In such cases the asset life is equal to the remaining useful life of the third party asset and not the original life of the asset when first recognised by the third party.

Borrowing for other purposes with the consent of Scottish Ministers (Regulation 2(2))

44. The 2016 Regulations continue to make provision for Scottish Ministers to consent to a local authority borrowing for other purposes than those permitted under Regulation 2(1).

45. Scottish Ministers consent will continue to be required for:

a. Borrowing to lend to third parties that are not included in the list of bodies set out in Part 3 of the 2016 Regulations;
b. Borrowing to lend to bodies included in the list of bodies set out in Part 3 but for a purpose which is not authorised by any legislation;
c. Borrowing to grant aid a third party where the test of capital expenditure set out in the 2016 Regulations is not met;
d. Borrowing for any revenue expenditure.
e. Any other purpose where there is no other statutory authority to borrow.

46. Where Scottish Ministers consent to borrow is sought for non-capital investment purposes, local authorities should note that this type of consent requires the agreement of the UK Government if the borrowing is not to impact on the Scottish budget.

47. A loans fund advance must be made which is equal in value to any expenditure incurred, or lending made, for the purposes set out in Regulation 2(2) which Scottish Ministers have provided a consent, and the authority has determined is to be met from borrowing (to use the consent) in any financial year.

48. Scottish Ministers will usually advise which option applies for repayment of the loans fund advance. Where this is not set out in the borrowing consent the statutory guidance applies.

PRUDENT REPAYMENT OF LOANS FUND ADVANCES

49. The detailed statutory arrangements for the repayment of loans fund advances as set out in Schedule 3 have not been replicated in the 2016 Regulations. The 2016 Regulations require the loans fund to be administered in accordance with the Regulations, proper accounting practices and prudent financial management. Regulation 14 requires a local authority to determine for each loans fund advance made the period over which the advance is to be repaid and the amount of repayment each financial year in that period. This determination must represent prudent financial management i.e. be considered a prudent repayment of a loans fund advance. The legislation itself does not define prudent. Statutory guidance on what is considered prudent is set out in Part 2.

50. The statutory guidance identifies that the broad aim of prudent repayment is to ensure that the repayments of a loans fund advance, in relation to repayment period and each year’s repayment amount, are reasonably commensurate with the period and pattern of the benefits provided to the community from capital expenditure. Capital expenditure is defined in accordance with proper accounting practice.

51. It is anticipated that for most local authorities' own capital expenditure projects prudent repayment of a loans fund advance will reflect the same principles as those for depreciation accounting. Fixed assets such as buildings, plants and equipment depreciate and thus they are useable only for a limited time. Their cost is expensed gradually by recognising a calculated portion of their costs as a depreciation cost during each financial year. Periodic evaluations of assets are made to make sure their carrying amount does not exceed the benefits expected to be derived from the asset, and if it does exceed, the impairment of fixed assets is recorded by reducing its carrying amount. The Accounting Code of Practice requires assets to be depreciated over their useful lives. Depreciation of an asset begins when it is available for use and ceases when the asset is derecognised. An entity is required to select a depreciation method that reflects the pattern in which it expects to consume the assets future economic benefits. The possible depreciation methods include the straight-line method, the diminishing balance method and a method based on usage such as the units of production method.

52. However, the funding position of a local authority is also important, and the reason for many of the statutory adjustments which are required to be made to local authority accounts. In some cases it may be prudent to recognise grant funding or other income streams when determining both the period of the repayment and/or the annual repayment of any loans fund advance. It must however be reasonable to link that funding/ income stream to the asset the subject of a loans fund advance. Some examples of where this income approach may be considered prudent are provided below. These examples are illustrative, their inclusion does not mean that the approach outlined is always prudent, nor are the examples considered exhaustive. It is for each local authority to determine prudent repayment based on their own individual circumstances.

53. To ensure the funding/income basis continues to be prudent a local authority will need to consider the reliability of, and any changes to, that funding or income.

Town and Country Planning (Scotland) Act 1997 - Section 75 Planning Obligations

54. The Planning etc (Scotland) Act 2006 (the 2006 Act) amends the Town and Country Planning (Scotland) Act 1997 (the 1997 Act) replacing the existing section 75 with a revised section 75 and adding new sections 75A to 75G. Section 75(1) of the 1997 Act provides that "a planning authority may enter into an agreement with any person interested in land in their district (in so far as the interest of that person enables him to bind the land) for the purpose of restricting or regulating the development or use of that land, either permanently or during such period as may be prescribed by the agreement". Section 75 (2) provides that "any such agreement may contain such incidental and consequential provisions (including financial ones) as appear to the planning authority to be necessary or expedient for the purposes of the agreement''.

55. A financial provision in an agreement may require capital investment, the investment being provided by the local authority with a financial contribution from the developer, this contribution being payable at a future date/ over a future period. Some contributions may be linked to the sale of housing or other assets, with the contribution only payable if those sales are made. Where a local authority borrows (a loans fund advance) and profiles the repayment to align with the anticipated receipt of contributions there will need to be a focus on whether the anticipated receipts are prudent, and will require a continual review on whether the anticipated receipts will materialise. Changes to the loans fund repayment profile should be made in recognition of any changes in estimates or timing of anticipated receipts.

Tax Incremental Financing (TIF)
56. The Scottish Ministers have agreed a number of pilot Tax Incremental Financing (TIF) projects. TIF is a method of financing the public infrastructure investment necessary to unlock private investment. The increases in property tax from the development are used to repay the public infrastructure investment required by a project. For the pilot TIF projects a local authority retains the increased (incremental) Non Domestic Rates (NDR) revenues over a 25-year period.

57. The TIF pilots are required to demonstrate that incremental NDR (known as TIF Revenue) is sufficient to finance the TIF debt costs over the life of the TIF. It is recognised that during the investment period the incremental NDR income is likely to be less than the debt costs – a funding gap.

58. For these projects it is reasonable for a local authority to profile the repayment of the TIF loans fund advances to mirror the TIF Revenue profile. This may result in the repayment profile including zero repayments if no TIF revenue is forecast/received.

City Deals and similar arrangements
59. Central Government (UK and/ or Scottish Government) may agree to a number of financial arrangements to support local authority capital investment. It may be reasonable in certain circumstances to profile the annual loans fund repayment to reflect the profile of future grant receivable from central government.

60. In previous years the Scottish Government supported a level of local authority borrowing for capital investment. This was known as supported borrowing. This provides an example where it would be prudent for the loans fund advance period and annual repayments to mirror the grant period and grant amount expected to be included in future annual revenue settlements. This type of government support is known as loan charge support.

61. Whilst supported borrowing ceased as a method of support in 2010 other arrangements may contain **specific** grant conditions permitting grant from central government (UK and/ or Scottish Government) to be used to fund loans fund advance repayments. A capital grant from central government is usually only available to fund capital expenditure directly and for no other purpose. A recent City Deal agreement (Glasgow and Clyde Valley) includes specific provision to permit City Deal local authorities to use City Deal capital grant receivable in future years to repay loans fund advances made in prior years for City Deal expenditure. Reflecting this specific grant provision it would be reasonable for the annual repayment of a number of loans fund advances to take into consideration future central government grant.

62. Central Government may agree other types of financial arrangement resulting in a local authority undertaking capital investment and funding this from borrowing (an advance from the loans fund). A different type of arrangement may see central government funding linked not to the capital investment itself but to the outcome of that investment, such as demonstrable and sustained economic growth and job creation. This is a payment by results type arrangement. An example of this type of arrangement is the Growth Accelerator Model (GAM) agreed with the City of Edinburgh Council. Whilst there is no direct link between the central government grant and the local authority borrowing costs (loans fund advance repayments) it would be reasonable for a local authority to link the period of the repayment to the grant period and to profile the annual loans fund repayments to reflect anticipated future central government revenue grant.

OPTIONS FOR PRUDENT REPAYMENT

63. The statutory guidance identifies a number of options that are considered prudent. These options are likely to be relevant for most local authorities. Other approaches may be relevant to a particular project or scheme. What is prudent is a decision for each authority.

64. The four options included in the guidance are:

a. Option 1 – Statutory Method
b. Option 2 - Depreciation Method.
c. Option 3 – Asset Life method either
   (i) Equal Instalment method or
   (ii) Annuity method
d. Option 4 – Funding / Income profile method

65. A local authority need not select a single option but may select different options for different capital schemes/projects. However, a local authority should be consistent in applying options – for further guidance see section 'Policy on prudent repayment and reporting on sums committed'.

Option 1 – Statutory Method

66. Loans fund advances made prior to 1 April 2016 should continue to be repaid /charged to revenue each year as if Schedule 3 of the Local Government (Scotland) Act 1975 had not been repealed. The repayment of loans fund advances made prior to 1 April 2016 is therefore equal to the annual amount determined in accordance with Schedule 3 of the 1975 Act.

67. Where an authority used the annuity system, the 1975 Act identified the loans fund advance being repaid as equal yearly or half-yearly instalments of principal and interest combined, the amount of each instalment being separately stated. The legislation does not however provide any guidance on how the interest component of the repayment calculated applying this method is to be reconciled to the actual external interest paid in any financial year. A LASAAC review of the loans fund in 2010-11 identified that some authorities using the annuity system were recalculating the principal element each year to reflect actual interest costs. The Scottish Government considers it reasonable for loans fund advances made prior to 1 April 2016 to be treated in the same way as any new advances made under option 3 using the annuity method, i.e. the principal amount of the annuity calculation is treated as fixed and does not change in future years. Local authorities may however continue to recalculate the pre 1 April 2016 annuity based advances, but full repayment of those advances must still be made within the fixed period set when the loans fund advance was originally made (as required by paragraph 17 of the 1975 Act).

68. Recognising that a local authority will have forward capital expenditure plans, will already have committed to that plan and the revenue implications of that plan, the statutory method may continue to be selected for a transition period. For new advances made using the annuity method the annuity calculation should be in accordance with option 3 - i.e. the principal amount of the annuity calculation is treated as fixed and does not change in future years. The transition period is for 5 years commencing 1 April 2016.

69. This option is not available for new loans fund advances after 31 March 2021.

Option 2 – Depreciation Method

70. IAS 16 *Property, Plant and Equipment* permits an entity to choose either the cost model or the revaluation model for each class of property plant or equipment. The Accounting Code sets out for each class of asset the model which a local authority is to apply. In most cases this is the valuation model. Infrastructure assets are currently required to be valued at cost but highways will move to the revaluation model from 1 April 2016.

71. In terms of revaluation IAS 16 provides:

a. Para 39. If an asset's carrying amount is increased as a result of a revaluation, the increase shall be recognised in other comprehensive income and accumulated in equity under the heading of revaluation surplus. However, the increase shall be recognised in profit or loss to the extent that it reverses a revaluation decrease of the same asset previously recognised in profit or loss.
b. Para 40. If an asset's carrying amount is decreased as a result of a revaluation, the decrease shall be recognised in profit or loss. However, the decrease shall be recognised in other comprehensive income to the extent of any credit balance existing in the revaluation surplus in respect of that asset. The decrease recognised in other comprehensive income reduces the amount accumulated in equity under the heading of revaluation surplus.
c. Para 41. The revaluation surplus included in equity in respect of an item of property, plant and equipment may be transferred directly to retained earnings when the asset is derecognised. This may involve transferring the whole of the surplus when the asset is retired or disposed of. However, some of the surplus may be transferred as the asset is used by an entity. In such a case, the amount of the surplus transferred would be the difference between depreciation based on the revalued carrying amount of the asset and depreciation based on the asset's original cost. Transfers from revaluation surplus to retained earnings are not made through profit or loss.

72. The Accounting Code reflects these requirements. For item c the Code requires that, for a revalued asset, a transfer must be made between the Revaluation Reserve and the Capital Adjustment Account for the difference between depreciation based on the revalued carrying amount of the asset and the depreciation based on the asset's historical cost.

73. For the impairment of assets IAS 36 provides:

a. Para 59. If, and only, if, the recoverable amount of an asset is less than its carrying amount, the carrying amount of the asset shall be reduced to its recoverable amount. That reduction is an impairment loss.
b. Para 60: An impairment loss shall be recognised immediately in profit or loss, unless the asset is carried at revalued amount in accordance with another Standard (for example, in accordance with the revaluation model in IAS 16). Any impairment loss of a revalued asset shall be treated as a revaluation decrease in accordance with that other Standard.
c. Para 61. An impairment loss on a non-revalued asset is recognised in other comprehensive income to the extent that the impairment loss does not exceed the amount in the revaluation surplus for that same asset. Such an impairment loss on a revalued asset reduces the revaluation surplus for that asset.
d. After the recognition of an impairment loss, the depreciation (amortisation) charge for the asset shall be adjusted in future periods to allocate the asset's

revised carrying amount, less its residual value (if any) on a systematic basis over its remaining useful life.

74. Cost versus Revaluation method – a comparison.

Cost method

31 March 20x1. Asset value on recognition £100,000. Asset life 10 years.

20x1/2 depreciation charge to Surplus or Deficit on the provision of services £10,000. Carrying value 31 March 20x2 £90,000. Loans Fund repayment is £10,000.

20x2/3 depreciation charge to Surplus or Deficit on the provision of services £10,000. Loans Fund repayment is £10,000. Carrying value 31 March 20x3 £80,000.

20x3/4 depreciation charge to Surplus or Deficit on the provision of services £10,000. Carrying value 31 March 20x4 £70,000. Impairment required to be recognised as recoverable amount at £60,000 is less than carrying amount. £10,000 impairment charge to Surplus or Deficit on the provision of services. Carrying value 31 March 20x3 £60,000.
Loans fund repayment is £20,000 (depreciation cost plus impairment). Asset life remains unchanged - future depreciation costs are adjusted to £8,571 (£60,000 / 7 years).

20x4/5 Depreciation charge £8,571. Loans Fund repayment is £8,571.

Revaluation Method

31 March 20x1. Asset value on recognition £100,000. Asset life 10 years.

20x1/2 - Depreciation £10,000 to Surplus or Deficit on the Provision of Services.
Asset revalued 31 March 20x2 to £110,000. Asset life does not change. The carrying amount before revaluation is £90,000. The £20,000 increase in the asset value is recognised in Other Comprehensive Income and accumulated in the Revaluation Reserve.

20x2/3 Depreciation charge £11,111 (£110,000 /9) is charged to Surplus or Deficit on the provision of services. The difference between the depreciation based on the original asset value and life and the new depreciation charge i.e. £1,111 is transferred from the Revaluation Reserve to the Capital Adjustment Account. The Loans Fund repayment is £10,000 (£11,111 - £1,111)
Carrying amount of the asset at 31 March 20x3 is £98,889. CAA balance for this asset is £20,000 (Depreciation £10,000 and £11,111 (statutory adjustment for depreciation) less £1,111 (accounting adjustment)

20x3/4 Depreciation charge £11,111. Carrying amount for the asset is £87,778
£1,111 is transferred from Revaluation Reserve to Capital Adjustment Account. CAA balance is £30,000 (Depreciation statutory adjustments of £32,222 less £2,222 accounting adjustment)
Asset revalued downwards on 31 March 20x4 to £60,000.
Difference between valuation and carrying amount is £27,778.
£17,778 is recognised in Other Comprehensive Income being the balance available for this asset in the Revaluation Reserve to absorb downward revaluations. The remaining £10,000 is recognised in the Surplus or Deficit on the Provision of Services.
The Loans Fund repayment is £20,000 (£11,111 less £1,111 (depreciation) plus £10,000 valuation charged to Surplus or Deficit on the Provision of Services).
Future depreciation costs are adjusted. Value of asset = £60,000/ 7 years = £8,571.

20x4/5 Depreciation charge £8,571. As there is no balance on the Revaluation Reserve for this asset there is no transfer to CAA. The loans fund repayment is £8,571.

75. IAS 16 and the Accounting Code negate any financial impact through an increase in valuation which results in an increase in depreciation on an entity/local authority by

permitting (IAS16) or requiring (Accounting Code) a transfer from the Revaluation Reserve to Retained earnings (IAS16) /CAA (Accounting Code) which is equal to the increase in depreciation. Effectively both the cost and revaluation models result in the same cost being charged to an organisation's usable reserves. Loan fund repayments under this option will be the same irrespective of whether the cost or revaluation model is used.

76. For option 2, the depreciation method, the annual loans fund repayment is equal to:
   a. depreciation for the asset as charged to the Surplus or Deficit on the Provision of Services; less
   b. the difference between depreciation based on the revalued carrying amount of the asset and depreciation based on the asset's original cost (as recognised by a transfer from the Revaluation Reserve to the Capital Adjustment Account); plus
   c. any impairment or decrease in the carrying amount required to be recognised in the Surplus or Deficit on the Provision of Services; less
   d. any reversal of a revaluation decrease or impairment previously recognised in the Surplus or Deficit on the Provision of Services.

77. Any change in the useful life of an asset life is recognised as a change in accounting estimate (a change in the annual depreciation charge). The loans fund repayment would reflect this change in the annual depreciation charge.

78. Where an asset has a residual value this method will result in a loans fund advance having the same residual sum outstanding when an asset is fully depreciated. A local authority should continue to make repayments of the loans fund advance equal to the depreciation charge made in the previous financial year until the loans fund advance is fully repaid. This is to reflect that loans fund advances, unlike depreciation, are directly linked to external debt.

79. The Code requires an asset to be derecognised on disposal or when no future economic benefits or service potential are expected from its use or disposal. For these assets there is no future depreciation charge to inform the future loans fund repayment values. In such cases the loan fund repayments should either continue in accordance with the depreciation schedule as if the disposal had not taken place, or the outstanding balance on the loans fund may be repaid in full (charged to the General Fund). This is a matter for the local authority to determine. A local authority should have an approved policy on how an outstanding loans fund advance should be managed on derecognition or disposal of an asset.

80. This method is not suitable for assets, such as freehold land, where no useful life can be attributed and hence there is no depreciation charge. Option 1 (time limited), option 3 or option 4 (if the land generates income) should be chosen for land. If a structure is also acquired on the land the structure would be treated as a separate component. In such cases Option 2, the depreciation option is suitable for structure (the component).

81. This method is not suitable where the expenditure the subject of the loans fund advance is either expenditure for the purpose of giving a grant to any person (Regulation 2(1)(b)) or for expenditure on works to assets not owned by the authority (Regulation 2(1)(c).

82. This method is not suitable for the repayment of loans fund advances made for lending to third parties (Regulation 2(1)(c) or Regulation 2(2)).

Option 3 - Asset Life Method

83. This method represents a simpler alternative to the depreciation method (if using straight line). Like the depreciation method the repayments of a loans fund advance are reasonably commensurate with the period and pattern (amount of the repayment) over which the capital expenditure provides benefits to the community. This asset life method differs from the depreciation method as the residual value of an asset is not taken into consideration, and repayments continue to be based on the initial life and value of an asset and do not change if the asset life is subsequently varied or is subject to impairment.

84. The Accounting Code requires each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item to be depreciated separately. Where components of an asset have different useful lives separate loans fund advances will need to be made. The period of the repayment of the loans fund advance is the useful life of the relevant asset component, which must be the same useful life recognised for that asset component in the statutory Annual Accounts.

85. The annual repayments are calculated as either equal instalments or by the annuity method.

86. The equal instalment method is the same as straight-line depreciation ignoring the residual value of an asset. The asset life is the same asset life as recognised for that asset on initial recognition in the local authority's statutory annual accounts.

87. The **equal instalment method** results in a series of equal annual amounts over the useful life of the asset. The calculation to be made is set out in a formula in the statutory guidance. The original amount of expenditure ("A" in the formula) remains constant. The cumulative total of the repayments made to date ("B" in the formula) will increase each year. The outstanding period of the estimated life of the asset ("C" in the formula) reduces by 1 each year. For example, if the life of the asset is originally estimated at 25 years, then in the initial year when a repayment is made, C will be equal to 25. In the second year, C will be equal to 24, and so on. The useful life of the asset is determined at the outset and should not be varied thereafter, even if in reality the condition of the asset has changed significantly.

88. The alternative is the **annuity method**, which links the repayment of the borrowing to the flow of benefits from an asset where the benefits are expected to increase in later years. A local authority is required to use an appropriate interest rate to calculate the annual repayment of the loans fund advance. Once calculated it is only the principal element of the calculation that represents the annual repayment of the loans fund advance. Interest is to be disregarded after calculation, the principal element being fixed at the time of the calculation.

89. The statutory guidance does not include guidance on what is an appropriate interest rate. The 1975 Act was also silent on what interest rate to use. The statutory duty to administer the loans fund in accordance with prudent financial management extends to the interest rate selected for the annuity calculation. A local authority should set out their policy on interest rate selection and apply that policy consistently. The interest rate policy could reflect the authority's own cost of borrowing for the financial year. Alternatively, a local authority's policy could use the annuity PWLB interest rates for the period of the advance, using either the interest rate at date of the advance or the average rate for the

year. These are only suggestions. A local authority is required to determine their policy for determining the interest rate. This policy should be applied consistently.

90. The first loans fund repayment will normally be made in the financial year following the one in which the expenditure is incurred, with one exception. In the case of the provision of a new asset a local authority may defer the commencement of the repayment until the financial year following the one in which the asset is first available for use. This replicates a similar effect if option 2, the depreciation method, is selected.

91. Land generally has an unlimited useful life. For the purposes of this option land should be treated as equal to a maximum of 50 years. However, if there is a structure on the land, which the authority will depreciate over a useful life of longer than 50 years, the land may also be assigned the same repayment period as the depreciation period.

92. Whilst the Asset Life option spreads the loans fund repayment over the useful life of the asset local authorities may adopt shorter periods.

Option 4 – Funding / Income profile method

93. This method sees the annual repayments of a loans fund advance profiled to reflect a funding or other income stream that can reasonably be associated with the asset/loan to a third party the subject of the loans fund advance. The repayment of the loans fund advance will therefore have a unique profile.

94. The income stream associated with a project informs the value of the annual loans fund repayments. This may be zero in some years. The loans fund repayment (statutory repayment of debt) and the income (whether grant, tax or other income) are separate accounting transactions. Income may not be carried to the loans fund to extinguish the annual repayment. The repayment of the loans fund advance (the statutory repayment of debt) and the funding or income, are separate transactions in the statutory Annual Accounts, recorded in accordance with proper accounting practices.

95. Where the funding or income is anticipated to be less than the capital expenditure, two separate loans fund advances should be made, one being for the value of the anticipated income, profiled to reflect that income stream, with a second loans fund advance being made for the remaining balance and repaid by applying another option.

96. A local authority must keep under review any advances that have been calculated by reference to an income stream to ensure the provision for repayment remains prudent. Where an authority identifies that the income stream is, or will be, insufficient to repay the loans fund advance the authority must review the repayment schedule and address any shortfalls. This may require a reduction to the outstanding loans fund advance to match the new income value and profile, with a new loans fund advance made equal to the reduction made, applying an alternate repayment option. In such cases the asset life is equal to the remaining useful life of the asset and not the original life of the asset when first recognised. Option 2 (depreciation method) may be selected but the authority is required to make an initial loans fund repayment equal to the cumulative value of the depreciation costs charged to prior years.

Other options

97. These four options are those likely to be most relevant for the majority of local authorities for loans fund advances made for the authority's own capital expenditure. Other approaches are not ruled out but they must be considered by the local authority to

be a prudent repayment. For example, a local authority may consider it prudent to repay loans funds advances over shorter periods than the useful life of the asset, recognising the loans fund advance is linked to external debt.

Subsequently varying either the period or the amount of repayment

98. Regulation 14(2) allows a local authority to subsequently vary either the period or the amount of repayment (or both) if it considers it prudent to do so.

99. A number of consultation responses queried why the asset life is fixed under the asset life method when often asset lives are extended due to good maintenance, and considered this restriction as inconsistent with the flexibility provided in regulation 14(2) to subsequently vary repayments. The provision made in the Regulations was made to enable a local authority to vary loan fund repayments arising from the depreciation method and the income method, and to allow for additional repayments to be made in excess of the repayment required based on one of the repayment methods. The asset life option takes away the uncertainty as to the annual repayment to the loans fund associated with the depreciation method. Prudence, as reflected in the accounting standards and the Code, requires an asset to be carried at no more than their recoverable amount, and for the accounts to recognise any impairment loss or any downward valuation of an asset. The standards/ Code also require the residual value, useful life and depreciation method to be reviewed at least each financial year. These two requirements are not considered to be mutually exclusive. A repayment option which permits the repayments of a loans fund advance to be recalculated when the useful life is extended but does not require an impairment or downward revaluation of an asset (a key example of the prudence principle) to be recognised through an adjustment in the annual loans fund repayment is inconsistent with the prudence principle. Option 2, the depreciation method, recognises changes in both asset value and useful life.

CREDIT ARRANGEMENTS

100. Local authorities also finance capital investment through leasing and private finance initiatives (PFI), including the Scottish non-profit distributing model (NPD). The 2016 Regulations define these as credit arrangements.

101. Local Government Finance Circular 4/2010 sets out proper accounting practices for credit arrangements, including the amount to be charged to revenue each year. Regulation 13 specifically excludes a credit arrangement from being the subject of a loans fund advance.

POLICY ON PRUDENT REPAYMENT AND REPORTING ON SUMS COMMITTED

102. Regulation 14 of the 2016 Regulations places a duty on a local authority to make statutory repayment of loans fund advances. Regulations 14(1) requires a local authority to determine, for each advance, the period over which the advance is to be repaid, and the amount of each repayment in each financial year in that period. Regulation 14(2) permits an authority to subsequently vary either the period or the amount of repayment, or both, if it considers it prudent to do so. Section 56 of the Local Government (Scotland) Act 1973 permits a local authority to discharge their function by committees, with a number of exceptions, one being borrowing money. A council's policy on repayment, together with any proposed variation on repayments requires the approval of the authority i.e. full Council or equivalent for other local authorities.

103. A local authority is required by both the CIPFA Treasury Management Code and Scottish Ministers (Circular 5/2010 Investment of Money) to prepare an annual strategy

before the start of each financial year and to produce an annual report after the financial year end. The CIPFA Prudential Code requires prudential indicators to be set before the beginning of the forthcoming year.

104. Capital investment, borrowing and the investment of money are inter-related and Scottish Ministers have previously indicated (circular 5/2010) that they recommend a local authority to have a single annual Strategy covering capital, treasury management, the setting of prudential indicators and the requirements of the investment regulations and associated consent. A single Report covering the same elements should be produced at each financial year end.

105. The disclosure requirements set out below should be included in the annual Strategy and annual Report. Where a local authority does not produce a single strategy or report the disclosure should be included in the most appropriate report.

106. A local authority is required to document its policy on the prudent repayment for loans fund advances.

107. The decisions taken each year on new advances – the period and amount of each repayment - creates a liability to repay those advances from future years' budgets. A local authority is required to report on the commitment to repay loans fund advances. The report should identify the opening balance of the loans fund as at 1 April, the value of new advances, the value of repayments, and the closing balance as at 31 March. The report should also provide a breakdown of future repayments in five-year periods. The first five-year period should detail the next financial year separately, with the balance disclosed as years' two to five. Thereafter, the disclosure is in five-year periods. This information should be reported as a table.

108. Where a local authority has a Housing Revenue Account (HRA) the HRA should be reported separately from the General Fund. The reporting on the commitment to repay loans fund advances is for loans fund repayments only and does not include any interest costs.

109. The report should include details of any subsequent changes to the period or amount of repayment, or both, as permitted by Regulation 14(2) explaining why it was prudent to make the change.

110. The statutory Annual Accounts of a local authority include a Management Commentary. The Management Commentary provides context to the financial statements, provides an analysis of performance and insight into the main objectives, strategies and risks and how these may impact future performance. Capital expenditure plans, together with financing that programme form part of that narrative. Prudential indicators, together with other performance indicators will be used to set policy and monitor performance. The annual Strategy and annual Report will give detailed consideration to these matters. The Management Commentary should direct the reader to the annual Strategy and annual Report where the more detailed narrative on capital investment plans, treasury management (borrowing and investments), prudential indicators and loans fund liabilities can be found.

111. The 2016 Regulations and the associated statutory guidance change the basis on which the loans fund is accounted for from 1 April 2016. The change in the legislative basis from prescriptive i.e. setting out how the repayment values are to calculated, to

prudent, with each local authority making a determination as to repayment, represents a change in accounting policy. Local authorities should reflect this change in their accounting policies disclosure in the Annual Accounts. As the legislation is prospective from 1 April 2016, the change in accounting policy is also to be applied prospectively from 1 April 2016.

PART 2: STATUTORY GUIDANCE ON LOANS FUND ACCOUNTING

STATUTORY GUIDANCE ON LOANS FUND ACCOUNTING

Issued by Scottish Ministers under section 12(2)(b) of the Local Government in Scotland Act 2003 [proper accounting practices]

DEFINITIONS

In this guidance –

1975 Act means *The Local Government (Scotland) Act 1975*
2016 Regulations means *The Local Authority (Capital Finance and Accounting) (Scotland) Regulations 2016* [SSI 2016 No. 123]
Accounting Code of Practice means *The Code of Practice on Local Authority Accounting in the UK* published each year by CIPFA/LASAAC.
Capital Financing Requirement (CFR) is as defined in the Prudential Code
Credit arrangement has the same definition as Regulation 6 of the 2016 Regulations
Housing Revenue Account (HRA) – is the account a local authority may be required to maintain by virtue of The Housing (Scotland) Act 1987.
Local Authority has the same definition as Regulation 1 of the 2016 Regulations
Prudential Code means *The Prudential Code for Capital Finance in Local Authorities 2011 Edition* issued published by CIPFA.

APPLICATION

1. The guidance applies to those authorities defined as a local authority in Regulation 1 of the 2016 Regulations.

2. The guidance applies from 1 April 2016.

INTRODUCTION

3. Regulation 12 of the 2016 Regulations requires a local authority to maintain a loans fund. That loans fund is required to be administered in accordance with the 2016 Regulations, proper accounting practices and prudent financial management.

4. Regulation 2 of the 2016 Regulations sets out the purposes for which a local authority may borrow money.

5. Regulation 13 of the 2016 Regulations requires a local authority to make loans fund advances equal to the amount of expenditure, as permitted by Regulation 2, the local authority has incurred and has determined is to be financed by borrowing.

6. A local authority may not make a loans fund advance for any expenditure financed by borrowing that relates to treasury management activities or expenditure the subject of a credit arrangement (Regulation 13).

7. Regulation 19 requires all sums advanced from the loans fund to be repaid, the local authority to determine the period over which the advance is to be repaid and the

amount of repayment to the loans fund in each financial year in that period. The loans fund is to be administered in accordance with prudent financial management, therefore in making a determination a local authority must consider the period and annual repayments to be prudent. A local authority may vary both the period and the amount of any repayment previously determined, if it considers it prudent to do so.

STATUTORY LOANS FUND

8. The statutory loans fund reflects the local authority's underlying need to finance, by borrowing money, the expenditure incurred in any financial year on those purposes set out in Regulation 2 (but excluding Regulation 2(1)(b) – treasury management). The value of loans fund advances will increase whenever expenditure is incurred, or loans made, which a local authority has determined should be met from borrowing. The value of loans fund advances is reduced when loans fund advances are repaid by making a charge to the General Fund or HRA.

9. The balance of a loans fund at 31 March each year represents the amount of past expenditure financed by borrowing money that a local authority has a liability to meet from future revenue budgets.

10. Loans fund accounts must be maintained in such a way as to enable any HRA advances, repayments and balances to be separately identifiable. Further, loans fund accounts must be maintained to enable advances, repayments and balances for each of the Regulation 2 purposes (but excluding Regulation 2(1)(b)) of the 2016 Regulations) to be separately identifiable.

11. The statutory loans fund is;

a. To recognise, by making advances from the loans fund, the expenditure incurred, or loans made to third parties, by the authority which a local authority has determined are to be financed from borrowing, as permitted by Regulation 2[2] of the 2016 Regulations;
b. To record transactions - opening balance each financial year, new advances, repayments charged to revenue (the statutory repayment of debt), and a closing balance at each financial year-end, being the value of loans fund advances still to be repaid/ charged to revenue;
c. To record, for each loans fund advance the annual repayment to be made to revenue. This will provide an authority with a profile of annual charges representing the amount of statutory repayment of debt to be charged to the General Fund/ HRA in any financial year.

LOANS FUND ADVANCES

12. Regulation 13 of the 2016 Regulations, requires a local authority to make loans fund advances equal to the amount of expenditure incurred, or lending the authority has made, that the local authority has determined is to be financed by borrowing in that financial year. Regulation 2 of the 2016 Regulations sets out the purposes for which a local authority may borrow.

[2] Regulation 2 allows a local authority to borrow for specific purposes, which includes treasury management activities (Regulation 2(1)(d)). Whilst an authority may have determined they need to borrow for treasury management activities, Regulation 13 specifically excludes this activity type of expenditure from being the subject of a loans fund advance.

13. Only expenditure on the purposes set out in Regulation 2 may be the subject of a loans fund advance, with one exception. A loans fund advance may not be made for any treasury management activities (this restriction is set out in Regulation 13 of the 2016 Regulations).

Capital expenditure of the local authority (Regulation 2(1)(a) of the 2016 Regulations)

14. Capital expenditure of a local authority, which an authority has determined should be met from borrowing, must be the subject of a loans fund advance in the financial year the expenditure is incurred. The loans fund advance/s is/are equal to the expenditure the authority has determined should be met from borrowing. For the purposes of the statutory Annual Accounts this expenditure is to be accounted for in accordance with the Accounting Code of Practice.

15. No statutory adjustment is to be made to the statutory Annual Accounts for this expenditure.

16. Applying the Prudential Code a local authority's Capital Financing Requirement (CFR) is increased by this expenditure. When estimating the CFR this expenditure should be included in the local authority's estimate of capital expenditure. When calculating the CFR from the balance sheet the CFR is increased as the capital expenditure will be reflected in the value of tangible or intangible fixed assets of the local authority.

Capital grants to third parties / expenditure on third party tangible assets (Regulation 2(1)(b) and 2(1)(c) of the 2016 Regulations)

17. Expenditure on the purposes set out in Regulation 2(1)(b) or 2(1)(c), which an authority has determined should be met from borrowing, must be the subject of a loans fund advance in the financial year the expenditure is incurred. The loans fund advance/s made is/are equal to the expenditure the authority has determined should be met from borrowing. For the purposes of the statutory Annual Accounts this should be accounted for in accordance with the Accounting Code of Practice as revenue expenditure.

18. For statutory capital framework purposes and the Prudential Code the expenditure is to be treated as capital expenditure.

19. For statutory purposes a statutory adjustment is made to the statutory Annual Accounts. A local authority's Capital Adjustment Account is to be debited and the General Fund (or HRA) credited with a sum equal to the expenditure an authority has determined should be met from borrowing.

20. Under the Prudential Code a local authority's Capital Financing Requirement (CFR) is increased by this expenditure. When estimating the CFR this expenditure should be included in the local authority's estimate of capital expenditure. When calculating the CFR from the balance sheet the CFR is increased due to the debit to the Capital Adjustment Account for this expenditure.

Lending to Third Parties (Regulation 2(1)(c), Part 3 and Regulation 2(2))

21. Lending for the purposes set out in Regulation 2(1)(c) and Part 3, or as permitted by a Regulation 2(2) borrowing consent, which an authority has determined should be met from borrowing, must be the subject of a loans fund advance. The loans fund advance/s is/are equal to the value of loans the authority has determined should be met from borrowing. For the purposes of the statutory Annual Accounts the loans are to be accounted for in accordance with the Accounting Code of Practice. These loans are likely to require recognition as a debtor.

22. For statutory capital framework purposes and the Prudential Code the loans are to be treated as a capital transaction.

23. No statutory adjustment is to be made to the statutory Annual Accounts for these loans.

24. Applying the Prudential Code a local authority's Capital Financing Requirement (CFR) is increased by these loans. When estimating the CFR these loans should be included in the local authority's estimate of capital expenditure. When calculating the CFR from the balance sheet the CFR is increased as the debtor (or investment) is to be considered a capital transaction.

Expenditure on those purposes for which a borrowing consent has been issued (Regulation 2(2) of the 2016 Regulations)

25. Where an authority has been provided with a statutory borrowing consent the expenditure which an authority has incurred and has determined should be met from borrowing, must be the subject of a loans fund advance in the financial year the expenditure is incurred. The loans fund advance/s made is/are equal to the expenditure the authority has determined should be met from borrowing relying on the consent. For the purposes of the statutory Annual Accounts this should be accounted for in accordance with the Accounting Code of Practice as revenue expenditure.

26. For statutory capital framework purposes and the Prudential Code the expenditure is to be treated as capital expenditure.

27. A statutory adjustment is to be made to the statutory Annual Accounts. A local authority's Capital Adjustment Account is to be debited and the General Fund (or HRA) credited with a sum equal to the expenditure an authority has determined should be met from borrowing.

28. Under the Prudential Code a local authority's Capital Financing Requirement (CFR) is increased by this expenditure. When estimating the CFR this expenditure should be included in the local authority's estimate of capital expenditure. When calculating the CFR from the balance sheet the CFR is increased due to the debit to the Capital Adjustment Account for this expenditure.

REPAYMENT OF LOANS FUND ADVANCES

29. Regulation 14 of the 2016 Regulations requires a local authority to repay loans fund advances. A local authority must determine both the period of repayment and the amount of repayment in any financial year in that period.

30. In making the determination the period and the annual repayment must be considered by the local authority to be prudent. The 2016 Regulations do not define prudent.

MEANING OF PRUDENT REPAYMENT

31. Prudent repayment of a loans fund advance is one which is reasonably commensurate with the period and pattern of benefits provided to the community from the capital expenditure.

32. There may be circumstances where prudent repayment reflects a funding or other income stream, and the period and amounts are based on the period and amounts of this income stream. It must however be prudent and reasonable to associate the income stream with the asset the subject of a loans fund advance. The repayment of a loans fund advance may therefore have a unique profile.

OPTIONS FOR PRUDENT REPAYMENT

Option 1 – Statutory Method

33. Paragraph 15 of Schedule 3 to the Act of 1975 required all loans fund advances to be repaid in equal instalments of principal or by the annuity method. The period of the repayment is aligned to a proxy asset life as set out in Finance Circular 29/1975. This is known as the “fixed” period. All loans fund advances made prior to 1 April 2016 should continue to be repaid as if paragraph 15 of Schedule 3 had not been repealed.

34. Recognising that a local authority will have forward capital expenditure plans, will already have committed to that plan, and the revenue implications of that plan, the statutory method may continue to be used for a transition period. The transition period is for 5 years commencing 1 April 2016.

35. There is one small variation to the statutory annuity method during the transition period. After calculation of the annuity the principal amount of the annuity calculation is to be treated as fixed and should not to be changed in future years to reflect changes in actual interest costs.

36. This option is not available after 31 March 2021.

Option 2 – Depreciation Method

37. The annual repayment of the loans fund advance for an asset, or a component of an asset, the subject of a loans fund advance is equal to

a. depreciation for the asset, as charged to the Surplus or Deficit on the Provision of Services; less
b. the difference between depreciation based on the revalued carrying amount of the asset and depreciation based on the asset’s original cost (as recognised by a transfer from the Revaluation Reserve to the Capital Adjustment Account); plus
c. any impairment or decrease in the carrying amount required to be recognised in the Surplus or Deficit on the Provision of Services; less

d. any reversal of a revaluation decrease or impairment previously recognised in the Surplus or Deficit on the Provision of Services.

38. Where the percentage of the expenditure on the asset financed by the loans fund advance is less than 100%, the repayment should be equal to the same percentage of the charge calculated in paragraph 36 above.

39. Regulation 14 of the 2016 Regulations requires a local authority to repay loans fund advances. If the asset is sold or is required to be de-recognised, the calculation at paragraph 36 above will provide a repayment value of zero. In such circumstances a local authority should continue to repay the loans fund advance in accordance with the original depreciation schedule i.e. as if the de-recognition had not taken place. A local authority may choose to repay all or part of the outstanding loans fund advance as an immediate charge to the General Fund/HRA.

40. When an asset is fully depreciated the calculation at paragraph 36 above will result in the associated loans fund advance having a balance outstanding equal to any residual value for that asset. Loans fund repayments should continue to be made annually until the cumulative amount of repayments is equal to the original loans fund advance.

41. This method is not suitable for assets, such as freehold land, where no useful life can be attributed and hence there is no depreciation charge.

42. This method is not suitable where the expenditure the subject of the loans fund advance is either expenditure for the purpose of giving a grant to any person (Regulation 2(1)(b)) or for expenditure on works to assets not owned by the authority (Regulation 2(1)(c).

43. This method is not suitable for the repayment of loans fund advances made for lending to third parties (Regulation 2(1)(c) or Regulation 2(2)).

Option 3 – Asset Life Method

44. A loans fund advance is repaid by reference to the life of an asset. The life of the asset is the life attributed to that asset in accordance with proper accounting practices. There are two main methods.

a. The **equal instalment** method, similar to straight-line depreciation but is a simpler alternative. This method is calculated by the formula -

The annual repayment is the amount given by the following formula:

$$\frac{A - B}{C}$$

where-
A is the amount of the capital expenditure in respect of the asset financed by borrowing (the loans fund advance)
B is the total repayment made before the current financial year in respect of that expenditure
C is the inclusive number of financial years from the current year to that in which the estimated life of the asset expires.

b. The **annuity method**, which links the flow of benefits from an asset where the benefits are expected to increase in later years. The annual repayment is the principal element for the year of the annuity required to repay over the asset life. A local authority should use an appropriate interest rate to calculate the amount.

45. The repayment of the loans fund advance normally **commences** in the financial year following the one in which the expenditure is incurred. However, where the borrowing is for an asset that is not yet in use an authority may postpone beginning to make repayments until the financial year following the one the asset first comes into use.

46. The **asset life** is determined in the year the loans fund advance is made and is not subsequently revised, even if in reality the condition of the asset changes that life significantly. If no life can reasonable be attributed to an asset, such as freehold land, the life should be taken as a maximum of 50 years. However, in the case of freehold land on which a building or other structure is constructed, the life of the land may be treated as equal to that of the structure, where this would exceed 50 years.

47. Where the loans fund advance relates to a grant paid to a third party for capital purposes (Regulation 2(1)(b), the asset life may not exceed the useful life of the asset the subject of the grant.

48. Where the loans fund advance is for expenditure on assets not owned by the local authority (Regulation 2(1)(c)) the asset life may not exceed the useful life of the asset the subject of the expenditure.

Option 4 – Funding / Income profile method

49. This method allows the annual repayment of a loans fund advance to be calculated by reference to an income stream. It must be reasonable to link that funding/ income stream to the asset the subject of a loans fund advance.

50. A loans fund advance may not exceed the value of the expected funding/ income. Where the expenditure is greater than the expected income a second loans fund advance must be made, with repayments based on an alternate option.

51. A local authority must keep under review any advances that have been calculated by reference to an income stream to ensure the provision for repayment remains prudent

VARYING THE PERIOD OF ANY REPAYMENT AND THE ANNUAL REPAYMENTS AMOUNTS

52. Regulation 14(2) of the 2016 Regulations allows a local authority to vary the period of any advance or the repayment amount, or both, where the local authority considers it prudent to do so.

53. This provision enables a local authority to make additional voluntary repayments of any loans fund advance.

54. Where the depreciation method is selected this provision enables a local authority to vary its annual repayment for a loans fund advance to reflect changes in charges arising from application of proper accounting practices relating to depreciation, impairment or revaluations.

55. Where the funding/ income method is selected this provision enables a local authority to vary the repayment to reflect any change in funding / income.

56. For the asset life method the useful life of an asset is determined in the year the loans fund advance is made and should not subsequently be revised. The asset life option takes away the uncertainty as to the annual repayment to the loans fund which may arise with the depreciation method. Prudence, as reflected in the accounting standards and the Code, requires an asset to be carried at no more than their recoverable amount, and for the accounts to recognise any impairment loss or any downward valuation of an asset. The standards/ Code also require the residual value, useful life and depreciation method to be reviewed at least each financial year. These two requirements are not considered to be mutually exclusive. A repayment option which permits the repayments of a loans fund advance to be recalculated when the useful life is extended but does not require an impairment or downward revaluation of an asset (a key example of the prudence principle) to be recognised through an adjustment in the annual loans fund repayment is inconsistent with the prudence principle. It is not considered prudent to recognise any changes in the asset life without also recognising any impairment or downward revaluations for an asset.

ACCOUNTING FOR LOANS FUND REPAYMENTS

57. Depreciation, revaluation gains or losses and impairment loss and reversal of impairment loss charged to Surplus or deficit on the Provision of Services are not proper charges to the General Fund. Such amounts shall be transferred to the Capital Adjustment Account.

58. For each financial year a local authority is required to charge the General Fund with the value of loans fund repayments the local authority has determined under Regulation 14 of the 2016 Regulations. The determination should be based on a local authority's policy on prudent repayment, that policy to reflect the meaning of prudent as set out in this guidance. A local authority is required to debit the General Fund (the statutory repayment of debt) and credit the Capital Adjustment Account with the value of loans fund repayments the local authority has determined under Regulation 14 of the 2016 Regulations. Where the local authority is required to maintain an HRA the HRA shall be debited with the value of HRA loans fund repayments.

POLICY ON PRUDENT REPAYMENT AND REPORTING ON SUMS COMMITTED

59. Capital investment, borrowing and the investment of money are inter-related and Scottish Ministers have previously indicated (circular 5/2010) that they recommend a local authority to have a single annual Strategy covering capital, treasury management, the setting of prudential indicators and the requirements of the investment regulations and associated consent. A single Report covering the same elements should be produced at each financial year end. The reporting requirements set out below should be included in the annual Strategy and annual Report. Where a local authority does not produce a single strategy or report the information should be included in the most appropriate reports.

60. Section 56 of the Local Government (Scotland) Act 1973 permits a local authority to discharge their functions by committee. An exception is borrowing money which is to be discharged by the authority. The reporting requirements set out below are to be reported in the annual Strategy or annual Report and hence will be subject to approval by the local authority (i.e. full Council or equivalent for other local authorities).

61. A local authority is to set out its policy for the statutory repayment of debt (repayment of loans fund advances).

62. A local authority is to disclosure the following loans fund account information:

a. Balance 1 April (anticipated / actual)
b. Advances for the financial year (anticipated / actual)
c. Repayments made for the year (anticipated / actual)
d. Balance 31 March (anticipated / actual)

63. A prior year comparator is required.

64. The disclosure must also identify the liability to make future repayments of loans fund advances. The disclosure is to provide a breakdown of the balance as at 31 March into five-year periods. The first five-year period should detail the amount repayable in the next financial year and, separately years' two to five. This should be in table format.

65. Where a local authority is required to keep an HRA, the information which relates to the HRA should be reported separately from the General Fund.

66. Should a local authority wish to include interest costs in the disclosure these costs must be shown separately to the amounts disclosed for the loans fund. There is no requirement to include interest costs in the report.

67. The disclosure should include narrative explaining the purpose of the loans fund and what the balance on the loans fund represents.

68. Regulation 14(2) of the 2016 Regulations permits a local authority to subsequently vary either the period or the amount of repayment, or both, if it considers it prudent to do so. Subsequent changes require a narrative to explain why any change is considered to be prudent.

69. The Management Commentary, a component of the statutory Annual Accounts, should include narrative as to how the capital plans of the authority are meeting the objectives of the council. Where that capital investment is financed from borrowing this is required to be prudent, affordable and sustainable. Key performance indicators are likely to be used to set policy and to demonstrate compliance with that policy. Any risks associated with a policy would be identified through the Commentary. The information contained in an annual Strategy and an annual Report will provide the detailed information, and narrative on an authority's capital investment plans, treasury management (borrowing and investments), prudential indicators and the loans fund liabilities. The Management Commentary should direct the reader to the annual Strategy and annual Report to find this additional information.