LONDON BOROUGH OF CROYDON CAPITALISATION DIRECTION

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1. Introduction and Summary

In July 2022, Worth Technical Accounting Solutions Limited were engaged by the London Borough of Croydon to support the Council's "Opening the Books" initiative. This work included a high-level review of the current approach to calculating and accounting for Capitalisation Directions.

Sometimes referred to as "exceptional financial support", a Capitalisation Direction (CD) from the Government does not provide any additional funding, but by allowing some revenue costs to be capitalised it does relieve the immediate pressure on General Fund balances and offers a time-limited opportunity to review spending plans and re-balance revenue budgets.

Croydon obtained CDs totalling £145m between 2020/21 and 2022/23, this initial CD application was based on budget pressures identified in 2020. Since then circumstances have changed significantly and the Council is now in the process of:

- developing new financial plans for 2023/24 and future financial years, and
- as part of this process, considering whether or not to request additional support from the Government.

This financial modelling needs to take account of:

- key budget assumptions affecting grant funding and taxation income,
- the potential impact of historical accounting issues
- expected levels of General Fund reserves and balances, and
- the longer-term revenue implications of any new CDs approved.

Calculations should be updated regularly and reported to members as part of budget monitoring reports.

The Council has correctly accounted for the previous CD as Revenue Funded from Capital Under Statute (REFCUS) in 2020/21 but our detailed report has highlighted that some consistency issues and additional disclosure requirements that may need to be addressed.

The 2022/23 Treasury Management Strategy assumed that the Council will use capital receipts to fund the current CD in full by 2024/25. Members have recently approved a more ambitious asset disposal strategy, with a view to ensuring that both the current CD and any additional CDs requested can be financed from capital receipts in full. We fully support this approach. However, if sufficient asset sales cannot be generated within anticipated timescales to meet these requirements, future years' revenue budgets may need to be adjusted to reflect the debt charges associated with any element of CD support not fully financed from capital receipts.

2. Calculation of Capitalisation Direction requests

In December 2020, the Council applied for a Capitalisation Direction (CD) from the Government. This action was taken following a section 114 report being issued by the then section 151 officer the previous month.

Section 114(3) of the Local Government Finance Act 1988 states that "the *chief finance officer of a relevant authority shall make a report under this section if it appears to him [or her] that the expenditure of the authority incurred (including expenditure it proposes to incur) in a financial year is likely to exceed resources (including sums borrowed) available to it to meet that expenditure".*

The s114 report identified a potential shortfall of £66m in the Council's General Fund revenue budget, resulting from:

- forecast overspends in the 2020/21 revenue budget totalling £30m,
- failure to deliver planned efficiency savings of £10m, and
- lower than expected dividend income from Council owned companies, totalling £26m.

It was therefore apparent that the Council could not deliver a balanced budget for 2020/21 as General Fund reserves and balances did not cover this projected overspend. The s114 report also referenced the fact that the Council had been experiencing financial pressures for a number of years, and that some (but not all) of these financial pressures had been caused or exacerbated by Covid-19.

Following a process of engagement with DLUHC Croydon received Capitalisation Directions as follows, and the s114 notice issued in November 2020 was formally revoked in March 2021:

	£m	
2020/21	70	confirmed by Direction March 2021
2021/22	50	confirmed by Direction March 2022
2022/23	25	approved in principle March 2022
Total	**145**	

Source: www.gov.uk/government/publications/exceptional-financial-support-for-local-authorities-capitalisation-directions

The statutory basis for providing a Capitalisation Direction is set out in section 16(2) (b) of the Local Government Act 2003 which states that "*the Secretary of State may, by direction, provide that expenditure of a particular local authorities shall be treated…as being, or as not being, capital expenditure".*

CDs are not cash-backed and do not provide any additional funding. However, by treating revenue spending as capital, they relieve pressure on General Fund reserves and working balances. This provides a time-limited opportunity to review spending plans and re-balance revenue budgets.

The total CD requested at Croydon was based on projecting current budget pressures going forward, and on the assumption that:

- these budget pressures would remain broadly the same over the next 2-3 years, and could be addressed over a similar period of time, mainly by identifying further spending reductions of over £70m in addition to the £80m of service reductions and efficiency savings already included in existing budgets

- service transformation would be built into the Council's recovery plans, initially driven by a target of reducing adult social care and children's services to average or below average cost.

The budgets and savings plans supporting the Council's initial CD request were included in a published Renewal and Improvement Plan, and in summary are set out below. It should be noted however that the CD of £5m for 2023/24, although included in current budget assumptions, has not yet been formally approved by the Government.

	Cumulative			
	2020/21 £m	2021/22 £m	2022/23 £m	2023/24 £m
Initial budget gap identified	100	108	135	160
Existing service reductions and efficiencies	(30)	(43)	(65)	(81)
Revised budget gap	70	65	70	79
Additonal savings (financial recovery plan)		(15)	(45)	(74)
	70	50	25	5
Capitalisation requirement	**(70)**	**(50)**	**(25)**	**(5)**

Source: Croydon Renewal and Improvement Plan 2021

To date, ten local authorities have obtained CDs, but only Croydon and Slough have obtained CDs over £50m. Slough's CD application in 2022 was for a significantly larger amount – over £300m compared to Croydon's £145m – mainly because it included the following:

- historic accounting issues, such as the correction of errors identified in previous years accounts going back to 2016/17. This included, for example, correction of errors in prior years' Minimum Revenue Provision (MRP) calculations and revenue costs capitalised inappropriately,
- re-instatement of General Fund balances to 5% of spending
- increasing provisions to more prudent levels
- correction of unrealistic assumptions in Council Tax calculations, including assumptions on Council Tax growth and spending pressures on adult social care.
- future spending pressures on adult social care.

This approach was supported by DLUHC, CIPFA and DLUHC's appointed Commissioners.

We have explained to Council officers how CD calculations were prepared at Slough, for information as we believe this methodology provides a comprehensive assessment of the Council's financial position and also has the benefit of clearly differentiating between financial pressures which impact on the Council's cash flow, such as service costs, and those such as MRP calculations which do not.

The above comments are not intended to imply suggest any criticism of the Council's previous approach. Croydon was one of the first local authorities to issue a s114 Notice and seek Government support and the Council worked very closely with DLUHC to ensure that all of their requirements and requests for information were fulfilled. However, since at the date of writing this report (September 2022) the Council was considering the need to issue a further section 114 Notice and seek additional CD support, we considered that an awareness of how other local authorities have tackled similar issues might be helpful.

We also believe that a comprehensive assessment of financial pressures helps to identify underlying organisational issues (which are often connected) and facilitates a more holistic approach to reducing base budgets by challenging underlying service plans, as opposed to over-reliance on:

- ambitious savings targets which may not realistically be achievable, or
- accountancy-based solutions, such as reducing MRP charges to the General Fund and reducing provisions, which do not address underlying issues with service costs.

At the time of our initial review, the Council's Period 3 monitoring report for 2022/23 was forecasting a £12.4m overspend, partially mitigated by the release of contingencies. Medium-term financial forecasts for 2023/24 and future years have identified further budget gaps resulting from both service pressures and the need to revisit previous budget assumptions on inflation, grant funding, and taxbase growth.

The combined total of these budget shortfalls over the next four years was estimated at £52m as at August 2022. Actual out-turn will obviously change as the 2022/23 financial year progresses. Also when we carried out our review some financial pressures were still being quantified. For example:

- MRP (debt charge) calculations were in the process of being re-visited,
- as identified in recent Cabinet reports, some savings plans are now considered to be over-optimistic and may not be delivered,
- the impact of proposed Government changes to funding adult social care needed some refinement, and
- accounting issues relating to Brick by Brick and Croydon Affordable Homes had not yet been resolved.

Our own work has also identified that:

- interest rate increases are likely to be significantly more than the 2022/23 Treasury Management Strategy suggests, and
- some revenue items have historically been incorrectly capitalised as Transformation costs.

We have recommended that the Council develop a comprehensive process for identifying current and expected financial pressures, to inform consideration of any further need for Government Capitalisation Directions. Financial modelling should also consider:

- key budget assumptions affecting grant funding and taxation income,
- the correction of any historical accounting issues, and
- potential changes to expected levels of General Fund reserves and working balances.

New and emerging financial pressures identified should be reported to members as part of budget monitoring reports, together with a summary of their expected impact on future General Fund balances. This information should help to inform consideration of the Council's overall financial position and any potential requirement for further Government support. .

Recommendation

R1. A more comprehensive process for identifying current and expected financial pressures should be implemented, to take account of:

- **future spending pressures**
- **key budget assumptions affecting grant funding and taxation income,**
- **historical accounting issues**
- **expected levels of General Fund reserves and working balances**
- **MRP and interest implications of any new CDs approved.**

R2. New and emerging financial pressures identified from R1 above should be reported to members as part of budget monitoring reports, together with a summary of their expected impact on future General Fund balances. This information should help to inform consideration of the Council's overall financial position and any potential requirement for further Government support.

3. Accounting treatment

Section 4.6 of the CIPFA Code of Practice on Local Authority Accounting states that where revenue costs have been capitalised under Government direction in accordance with section 16(2) of the 2003 Act, these items should be accounted for as Revenue Expenditure Funded from Capital under Statute (REFCUS). Paragraphs 4.6.3 and 5.6.4 go on to state that any items identified as REFCUS should in the first instance, be charged to surplus or deficit on the provision of services in accordance with the general provisions of the Code, with:

- any relevant statutory over-rides applied by debiting the capital adjustment account and crediting the General Fund balance, thus showing as a reconciling item in the Movement in Reserves Statement, and
- REFCUS separately identified and included in the note on capital expenditure and financing,

The Council's accounting statements for 2021/22 have not yet been published, however the following items were identified in relation to the accounting treatment adopted for the CD in the published (but not yet audited) financial statements for 2020/21:

- The Council has correctly accounted for the CD as REFCUS, but the CD is not separately identified in any of the core statements in the 2020/21 Statement of Accounts. As a material, unusual, and highly complex item of account, separate disclosure is a Code requirement
- Note 5 (Material items) does however state that *"the Council applied £65.8m of Capital monies towards the overspend within its GF Revenue Account as approved by the Secretary of State for Ministry of Housing, Communities and Local Government, as part of the Council's Capitalisation Direction award"*.
- This total of £65.8m is £4.2m different from the CD of £70m approved by DLUHC for 2020/21. Whilst we recognise that the CD approval is an "up to" Direction and the Council is fully entitled to utilise a lesser amount, the financial statements refer to both amounts without explaining the reason for the difference between them
- Accounting policies for 2020/21 do not provide confirmation that the accounting treatment adopted for the CD meets Code requirements.
- There is no reference to either REFCUS in general or to the CD specifically in accounting policy disclosures, but a total of £65.8m is separately identified in the Capital Expenditure and Capital Financing disclosures (CFR - note 32) and in the summary of movements in the Capital Adjustment Account (CAA- note 23), in line with Code requirements
- Although the £65.8m, together with other items of REFCUS totalling £17.2m are referred to in notes 23 and 32, only £68m is identified as REFCUS in the Council's statutory adjustments disclosure (note 7) and it is not clear how the difference of £15m has been accounted for.

As a material item of account in 2020/21, we would expect that:

- If the CD adjustment in the financial statements is significantly different from the amount set out in the Direction for that financial year, the Statement of Accounts should explain why;
- the CD should be disclosed as a separate line item in the Movement in Reserves Statement and included in the disclosure note on material items of income and

expenditure. An example of how these disclosures have presented in other local authority financial statements has been provided to officers.

- the accounting treatment adopted for the CD and for other REFCUS transactions should have been disclosed in accounting policies;
- REFCUS adjustments which include the CD should be consistently stated between the CAA, the CFR and statutory over-ride disclosure notes.

Recommendations

R1. If the CD adjustment in the financial statements is significantly different from the amount set out in the Direction for that financial year, the Statement of Accounts should explain why.

R2. As CD adjustments represent material items of account they should be separately identified in the Movement in Reserves Statement and the material items note.

R3. The accounting treatment adopted for material CD adjustments should be set out in accounting policy disclosures.

R4. Disclosure notes which reference the CD should be internally consistent.

4. Capital Financing Implications

As it effectively increases capital spending, the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 require CDs to be financed from permitted sources of capital funding, either external borrowing, capital receipts, capital contributions or direct funding from revenue.

If the CD is financed from external borrowing, Minimum Revenue Provision (MRP) must be set aside in line with current requirements. Statutory Guidance on the MRP (updated 2018) states that *"where expenditure has been capitalised by virtue of a direction under section 16(2) of the 2003 Act… the authority should calculate MRP in accordance with Option 3 (the asset life method), using a maximum asset life of 20 years".* Croydon's Direction Letters, received in March 2020 and March 2021, specifically confirm that this accounting treatment should be applied.

The Council's 2022/23 Treasury Management Strategy (TMS) correctly identifies the CD as an item of expenditure that needs to be financed from capital resources. The TMS does not, however, explain in detail how the CD will be funded or how any MRP arising as a result will be calculated.

Looking at the Council's more detailed MRP calculations, the following approach seems to have been adopted:

	£m 2020/21	£m 2021/22	£m 22/23	£m 2023/24
CD applied - year 1	65			
Less: MRP calculated on a straight line basis over 20 years		(3)		
MRP requirement at 1 April 2022			62	
Less: MRP calculated on an annuity basis over 20 years			(2)	
Plus: CD applied - year 2			50	
Less: Capital receipts applied			(62)	
MRP requirement at 1 April 2023				48
Plus CD applied - year 3				25
Less: capital receipts applied				(73)
MRP requirement at 1 April 2024				**0**

Source: Croydon MRP calculations 2020/21 onwards

This approach is in line with the Regulations, and as it prioritises the use of capital receipts to fund the CD it minimises future MRP charges to the General Fund. However, the total CD requirement of £140m (£65m + £50m + £25m) is £5m less than the CD of £145m approved by the Government and £10m less than the £150m included in the Council's current Renewal and Improvement Plan.

It is not clear why the Council changed from using a straight-line method as opposed to an annuity method in 2021/22 given that the Council moved to an annuity method for calculating MRP on all other types of unsupported borrowing back in 2015/16. Applying the annuity method to the MRP set-aside for CD adjustments in 2021/22 would reduce the charge to the General Fund by c£1m but, whichever method is adopted, detailed MRP calculations should be consistent with Treasury Management and budget reports.

More importantly, the above calculation assumes that £135m of capital receipts will be available for the purposes of funding the CD between 1 April 2022 and 31 March 2024.This would leave a shortfall of c£10m between available capital receipts and CDs currently approved by the Government, resulting in an additional MRP requirement of, on average c£0.5m pa until 2044.

Using capital receipts to fund the CD is clearly the preferred approach in terms of minimising future debt charges to the General Fund. The Chief Executive has confirmed to us that the Council will prioritise the use of capital receipts to fund current and future CDs, and members have recently approved a more ambitious asset disposal strategy to support this plan.

However, future budget forecasts and financial modelling may need to reflect the fact that if sufficient capital receipts are not generated within relatively short timescales, any CDs not funded from capital receipts would attract MRP at 5% for the next 20 years

Recommendation

R1. The Council's Treasury Management Strategy should be more transparent about:

- **how forecast capital receipts are being used to finance different types of capital expenditure,**
- **how CDs are funded, and**
- **how MRP charges are being calculated.**

R2. Detailed MRP calculations should be consistent with Treasury Management and budget reports.

R3. The Council is prioritising the use of capital receipts to fund current and future CDs and has recently approved a more ambitious asset disposal strategy to generate additional capital receipts. However, future budget forecasts and financial modelling may need to reflect the fact that if sufficient capital receipts are not generated within anticipated timescales, any CDs not funded from capital receipts would attract MRP at 5% for the next 20 years.