Approving the minimum revenue provision policy

Supporting members to take informed decisions
Spring 2014

Why is this important?

Local authority members are not expected to be financial experts. However, capital financing is complex and each year members are required to approve a policy that charges capital costs to revenue: the minimum revenue provision (MRP). This guide is designed to provide members with background information to help them make a more informed decision.

Different types of expenditure

Local government incurs two main types of expenditure – revenue and capital. In local government, as in other sectors, there are different rules which govern accounting for revenue and capital.

- Revenue expenditure refers to day-to-day expenses incurred in running services such as staff salaries, payments to contractors. The rules in respect of revenue expenditure are straightforward. The Local Government Finance Act 1992 requires authorities to set a balanced budget each year, although historic reserves may be used to fund specific items.
- Capital expenditure refers to the councils expenditure on long-term assets such as buildings, IT systems, vehicles and so on. This expenditure is different because it can commit the council to payments many years in the future, particularly when the assets are funded by borrowing.

Charging for capital expenditure

Why not charge depreciation?

Local authorities follow international financial reporting standards (IFRS). These set out how to charge for capital items and include concepts such as depreciation. However, if local authorities were required to meet these IFRS charges, many would be unable to balance their general fund without raising significant additional funds from taxpayers. This is not indicative of poor decision-making in previous years: it is a consequence of accounting charges relating to capital projects encouraged by central government in the past.

As a result, local authorities are required to follow a regulatory framework for charging for capital costs. This means that although a local authority income and expenditure statement includes accounting entries for items such as depreciation, these are removed from reserves and replaced with a charge that is determined by statute.

What are the key principles of the local authority statutory framework for capital financing?

- Capital grants and capital receipts cannot be used to fund revenue: a local authority cannot, for example, sell land to fund the running costs of the Town Hall. Local authorities place income from capital grants and receipts into specific capital reserves that can only be used to fund capital expenditure.
- Local authorities can spread the funding of capital expenditure over more than one year: where a local authority incurs capital expenditure it funds the costs from a combination of its capital grants, receipts and reserves and the general fund. It is allowed to spread this funding over several years taking on board the impact on current and future taxpayers.
- Each year members must approve the local authority's policy on how much capital expenditure to charge to the general fund: it is up to each local authority to decide how to fund its capital expenditure. However, each year it must charge an amount to the the general fund that it considers to be prudent. This is known as the Minimum Revenue Provision (or MRP). The MRP Policy must be approved by full council or (if an authority does not have a council) the nearest equivalent.

How might members go about approving a prudent MRP policy?

- Consider the Capital Financing Requirement (CFR) – this sets out how much capital expenditure still needs to be funded by the local authority. Authorities must set an MRP policy that charges this balance to reserves on a prudent basis.
- Consider the Department for Communities and Local Government's (DCLG's) guidance on setting an MRP policy – local authorities are required to 'have regard' to DCLG's guidance on MRP. This means that an authority must consider what the statutory guidance says. It does not mean that a local authority is obliged to follow the guidance. However, if an authority does decide to depart from the guidance, it must be able to show good reasons for doing so.
- Apply judgment – members are not expected to be financial experts but they are required to make an informed decision as to whether the MRP policy is prudent. In reaching this judgement members may wish to consider the following:
    1. Does the MRP policy follows DCLG's statutory guidance? If not have officers prepared a report that explains clearly the basis for any departure from the guidance?
    2. Does the MRP policy charge the CFR to the general fund over a prudent period? For example, if the length of time is excessive (more than 60 years, say) then the policy is unlikely to be prudent: tax-payers will be funding the cost of assets long after they have been scrapped.
    3. Are there are any warning signs? For example, has the MRP policy changed? If so, why? Is this part of a well-thought out capital financing strategy or a knee-jerk reaction to short-term financial pressures? Borrowing to invest in capital projects at historically low interest rates may very well be the right approach for the authority but has the authority received advice from external consultants? If so, have officers critically assessed the advice received or have recommendations been accepted without scrutiny?

How we can help?

As the leading provider of external audit to local authorities, we see part of our role as supporting members to make the best financial decisions on behalf of local residents. Not all aspects of capital accounting and financing are simple, but this guide should have helped to explain some of the principles. We hope this is useful for members looking to gain sufficient understanding to discharge their responsibilities.

Who should I contact?

For more information about local government finances, contact your usual Grant Thornton contact in the first instance or, alternatively:

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