ICAEW
REPRESENTATION 8/22

CONSULTATION ON CHANGES TO THE CAPITAL FRAMEWORK: MINIMUM REVENUE PROVISION

Issued 8 February 2022

ICAEW welcomes the opportunity to respond to the Department for Levelling Up, Housing and Communities (DLUHC)'s consultation on changes to the capital framework: minimum revenue provision, published on 30 November 2021.

ICAEW agrees with the proposed changes to the regulations around the minimum revenue provision (MRP) but believes further action is required to improve how local authority finances are accounted for and managed

- The MRP is an important mechanism within the current system of local authority budgeting and incorrectly calculated MRPs are often indicative of wider financial management or financial sustainability issues in a local authority.
- We welcome DLUHC's proposed amendments to clarify that the MRP guidance should reflect debt-financed investment assets and capital loans and that capital receipts should not be used in lieu of a prudent charge to revenue.
- We also agree that changes to MRP calculations should only apply prospectively and welcome DLUHC's intention to support local authorities that are adversely affected.
- ICAEW believes that the problems the government has identified with the calculation of the MRP are symptomatic of wider weaknesses in local government finance and require a more substantial response than clarification of existing guidance.

Local authorities must be more transparent in how they calculate their MRP charges

- MRP calculations are poorly understood outside of finance teams and better disclosure is necessary to help the public, elected councillors and other users understand the purpose and effect of the MRP, in order to properly hold local authorities and their management teams to account.
- The risk of errors is increased significantly by not disclosing in financial statements or annual capital strategies in an understandable way the methodology used, preventing users (including councillors as representatives of local voters and DLUHC staff conducting monitoring activities on behalf of central government) from being able to scrutinise MRP policies and sense-check calculations.
- All parties involved in the local accountability system, including DLUHC, CIPFA / LASAAC, audit committees and external auditors, must do more to encourage local authorities to disclose within their financial statements the MRP methodology they have used, the key judgements made in its calculation, and how it applies to their debt-financed assets.
- The judgements taken by local authority management in calculating MRP can in some circumstances be indicative of wider financial problems so we believe that the Audit,

Reporting and Governance Authority (ARGA), as the new system leader for local audit, should encourage greater focus on the MRP calculation and disclosures by finance teams and external auditors.

ICAEW believes that the government should work with CIPFA / LASAAC to simplify the MRP calculation as part of a wider effort to align the budgetary basis used by councils with accounting principles used in preparing financial statements

- A simpler MRP calculation method would reduce the burden on local authority finance teams and their external auditors, as well as reducing the risk of errors.
- The problems with the MRP raised by this consultation highlight wider challenges in how local authorities are required to budget on a different accounting basis from how they report their financial performance and hence in how they are held to account.
- We welcome the project being undertaken by CIPFA / LASAAC to improve the presentation of local authority accounts but are concerned that they will be unable to address statutory overrides, such as the MRP, which Sir Tony Redmond identified as one of the main causes of complexity in local authority accounts.
- We believe that the government should work with CIPFA / LASAAC to reduce the differences between budgetary and financial accounting to help make council finances less “impenetrable” and so improve the ability of councillors and the public to hold local authorities to account.

ICAEW is a world-leading professional body established under a Royal Charter to serve the public interest. In pursuit of its vision of a world of strong economies, ICAEW works with governments, regulators and businesses and it leads, connects, supports and regulates more than 157,800 chartered accountant members in over 147 countries. ICAEW members work in all types of private and public organisations, including public practice firms, and are trained to provide clarity and rigour and apply the highest professional, technical and ethical standards.

As a regulator of the accountancy and audit profession, ICAEW is currently the largest Recognised Supervisory Body (RSB) for local audit in England. We have nine firms and over 90 KAPs registered under the Local Audit and Accountability Act 2014.

ICAEW’s Public Sector team supports members working in and with the public sector to deliver public priorities and sustainable public finances, including over 8,000 in ICAEW’s Public Sector Community. ICAEW engages with policy makers, public servants and others to promote the need for effective financial management, audit and assurance, financial reporting and governance and ethics across the public sector to ensure public money is spent wisely.

INTRODUCTION

1. We are responding to the Department of Levelling Up, Housing and Communities' (DLUHC) consultation on changes to the capital framework: minimum revenue provision published on 30 November 2021.
2. The minimum revenue provision (MRP) is charged to revenue within local authority budgets to provide for repayment of borrowing to fund capital expenditure. Local authorities are required to calculate a "prudent" provision in line with statutory guidance.
3. The consultation follows findings and recommendations in the National Audit Office's (NAO) report into local authority investment in commercial property published in February 2020. It also incorporates recommendations made by the Public Accounts Committee (PAC) following their report into this topic in July 2020.
4. This response has been prepared in consultation with ICAEW's Public Sector Advisory Group, which includes representatives from audit firms and public sector bodies. We have also consulted officers in local authorities and elected councillors.
5. ICAEW is supportive of the proposed changes as they will help clarify the guidance used by local authorities in carrying out MRP calculations. We have not sought to respond to the individual consultation questions but would welcome the opportunity to discuss our response in more detail if that would be helpful.
6. ICAEW is a body which acts in the public interest and whose members are accountable through compliance with a code of ethics. In that context we seek to and want to play a constructive role in supporting Government and Parliament.
7. ICAEW will continue to work closely with DLUHC and other key stakeholders to develop proposals in response to Sir Tony Redmond's independent review into the oversight of local audit and the transparency of local authority financial reporting. ICAEW is represented on DLUHC's Local Authority Audit Monitoring Board and the newly formed DLUHC-chaired Liaison Committee. In addition, it is a member of the "auditor capacity and capability" working group and sub-groups set up by DLUHC that are considering changes to the Key Audit Partner (KAP) guidance and proposals for additional training.
8. Our response echoes many of the points we have made in other recent consultation responses or submissions relating to local authority finances:
   - ICAEW's response to the technical consultation on the local audit framework called on DLUHC to work with the proposed system leader to improve the quality of local authority accounts and to make them more accessible.
   - Our submission to the PAC inquiry into the timeliness of local auditor reporting on local government in England stated that audit delays were a symptom of wider issues in the local government financial reporting and audit system. It called for action to make local authority accounts more understandable.
   - ICAEW's submission to the PAC inquiry into local government finance called for the strengthening of local authority finance teams and governance arrangements, as well as urgent action to tackle the issues in local audit and reporting.
   - Our letter to the Chief Secretary to the Treasury ahead of the 2021 Spending Review called on the government to use the review to establish a firm financial platform that enables local government to deliver on the government's priorities.
   - ICAEW Chief Executive Michael Izza's letter to the Chancellor ahead of the 2021 Budget called for long-term funding for local authorities, strengthened financial management, and reforms to local audit to empower local councils to transform their areas.

MAJOR POINTS

ICAEW recognises the problems in the calculation of the MRP that DLUHC is seeking to address

9. Local authorities have in recent years sought to use commercial investments as a means of generating revenue needed to fund essential services. A National Audit Office (NAO) report on investment in commercial property stated there had been an increase in the external borrowing held by local authorities of £14.3bn between 2016 and 2019. This has exposed local authorities to significant financial risk and made it more important that they budget accurately in line with the guidance.
10. The MRP is designed for local authorities to record a charge against revenue as a mechanism to make sure they can afford to repay the principal of their debt. As the consultation notes, some local authorities have reportedly undercharged the MRP or inappropriately offset capital receipts, meaning that the mechanism has not fully served its intended purpose. The NAO have, for example, identified that Portsmouth City Council did not charge MRP on their commercial property portfolio.
11. In some local authorities, the consequences of undercharging the MRP have been severe. The Section 114 notice issued by the Section 151 Officer of Slough Council on 2 July 2021 identified the incorrect calculation of the MRP, including the incorrect use of capital receipts, as a key cause of the serious and adverse nature of the Council's financial position at that time.
12. Auditors regularly identify issues with the calculation of the MRP and these can take time to resolve. For example, Warrington Borough Council's 2017-18 and subsequent audits have still not been completed with the auditors, Grant Thornton, providing an audit progress update stating its view "… that the minimum revenue provision determined by the Council is not prudent because it excludes a significant proportion of debt relating to investment properties, finance leases and PFI". As ICAEW highlighted in its response to the technical consultation on the local audit framework, Warrington has over £1.6bn of external borrowing, meaning there are significant sums of taxpayers' money potentially at risk that need to be subject to external assurance.
13. ICAEW therefore supports DLUHC's proposals to amend the statutory guidance to clarify that:
    - capital receipts should not be used in place of a prudent charge to revenue; and
    - MRP should be charged on all debt-financed assets and capital loans including ones where the local authority plans for the asset to provide a capital receipt in future.
14. These clarifications should not have a significant impact on local authorities that are already making prudent minimum revenue provision but should help reduce the risk of further breaches of the statutory guidance. However, clarification alone will not be sufficient to prevent local authorities undercharging the MRP or to address wider issues in local authority finance.
15. ICAEW agrees with DLUHC's statement in a recent announcement about measures to address audit delays that "a whole system response is needed". We consider that once these clarifications have been implemented that the rationale and methodology for calculating the MRP within the local authority financial framework should be addressed as part of such a whole system response.

The issues with the calculation of the MRP are symptomatic of wider weaknesses with the local government finance system

16. ICAEW has repeatedly highlighted that local audit delays are symptomatic of wider problems in local government financial reporting and audit and believes the non-compliance with MRP guidance is another symptom. These wider problems include:

- Many local authority finance teams lack sufficient resources or expertise to manage their finances effectively and to perform essential control activities such as calculating an adequate MRP. In some cases, MRP calculations may be seen as purely compliance exercises, despite their important role in the framework designed to ensure financial sustainability of local authorities.
- The lack of visibility over the long-term funding has led many councils to borrow significantly more than their annual revenue, creating increased audit risks including over the appropriateness of the MRP policy.
- Local authorities are under significant financial pressure and there is therefore a temptation to minimise MRP charges where possible in order to maximise available revenue reserves. Rigorous financial controls and oversight are needed to ensure that finance teams do not seek to manipulate their MRP calculations in breach of the statutory guidance.
- Local authority accounts contain many complexities, including MRP, that are unique to local government,. This makes it difficult for either the public or elected councillors to understand them, limiting their ability to hold management teams to account.
- Local authority financial statements often contain lengthy boilerplate notes rather than relevant information for key users, such as concise explanations of the judgements taken in key areas such as on the MRP.
- Many local authority audit committees lack sufficient expertise or independence to be able to challenge key judgements including MRP calculations.
- Audit Quality Reviews have in recent years focused on areas such as property valuations that whilst important from a financial reporting perspective have less effect on budgets than other aspects of local authority finances, such as the MRP.

17. The government introduced changes to the statutory guidance in 2018, which appear to have addressed issues identified at the time, such as local authorities setting unrealistically long asset lives in order to minimise their MRP charge. The fact that the government is proposing further changes to the rules governing the MRP charge so soon suggests that amending regulations alone may not be sufficient to address issues with how some local authorities calculate their MRP charge. There is a risk the government will be forced to introduce further changes to the MRP or other elements of the capital framework if it does not address the underlying problems.

Local authorities need to be more transparent about their MRP calculation

18. ICAEW believes one of the most significant issues in the local authority finance system is that local authority accounts are, in the words of Sir Tony Redmond, “impenetrable”. This has undermined their usefulness as a document upon which to make evidence-based decisions or for the public and their elected representatives to hold local authorities to account. As ICAEW argued in its submission to the PAC inquiry into the timeliness of local authority reporting, improved financial statements could help prevent some of the issues seen in local authority financial management.
19. One way that local authority accounts could be made more accessible is through more helpful and relevant disclosures that help users understand the key decisions taken. This is particularly important in areas, such as the MRP, that are unique to local government and, therefore, often not widely understood by users.
20. The accounting policies note provides a key opportunity for preparers to explain the key judgements taken to elected councillors, the public and DLUHC. However, ICAEW’s review of a sample of local authority accounts identified that many did not disclose the policy for or the key judgements used in calculating MRP and where they did so it was often not easy to understand. This is despite frequently lengthy accounting policy notes containing detailed explanations of accounting policies of irrelevant matters, such as contingent assets or finance leases for which no material balances were reported.

21. We believe local authorities need to invest in improving the quality of their financial statements and especially in applying CIPFA / LASAAC Code requirements for disclosure of significant accounting policies and key judgements made. In particular, section 3.4.2.90 of the Code states that when considering whether to disclose a policy, the local authority should "consider whether disclosure would assist users in understanding how transactions, other events and conditions are reflected in reported financial performance and financial position." As the statutory guidance permits different calculation methods and the MRP charge can have a material impact on a local authority's budget, we consider that local authorities should treat their MRP methodology as a significant accounting policy.
22. Although we only identified a minority of local authority accounts from our sample that did not feature any MRP policy, we found in a majority of accounts the MRP policy was rarely explained in such a way that would have significantly assisted users, particularly those less familiar with the MRP requirements. Too many local authorities included an unhelpful generic explanation of the MRP rather than a useful explanation of how the authority applied the policy to the categories of assets held by the authorities, or the calculation method used. In the limited number of local authority accounts that did provide some information about the MRP calculation, the language was highly technical so it is unlikely that it would be helpful to those without significant knowledge of local authority accounting.
23. Most local authorities technically comply with the requirement in the statutory guidance to "prepare an annual statement of their policy on making MRP for submission to their full council". However, ICAEW is concerned about the transparency of these statements. We identified one local authority that reported significant amendments to its MRP policy on page 217 of a 462-page budget meeting report. Furthermore, too many MRP statements contain boilerplate explanations of what the MRP requirements are and do not provide useful tailored information. For example, a different local authority's MRP policy statement states that the MRP policy will either be the depreciation method or asset life method. However, it provides no details about when each of the two methods are applied or how asset lives are calculated.
24. Our conclusion is the lack of transparent MRP policy statements or accounts disclosures reflect that many local authority finance teams, which are often under-resourced, do not place sufficient importance on using financial reports to communicate with key stakeholders and allow councillors to carry out their full scrutiny duties. This should include providing sufficient information to allow a councillor to draw a conclusion over the appropriateness of the MRP policy and whether it has been applied correctly. Such scrutiny helps detect financial errors and strengthens local authority financial management.
25. We believe that in the next revision of the Code, CIPFA / LASAAC should clarify that where relevant the MRP methodology adopted by a local authority should be disclosed as a significant accounting policy. This should include clear explanations as to why the MRP policy selected has been adopted, how it has been applied in the calculation and, if applicable, the reasons for any material differences between the MRP charge and the depreciation charge recorded in the financial statements.
26. ICAEW recommended in its response to the technical consultation on the local audit framework that ARGA should set up an equivalent of the Financial Reporting Review Panel for local authorities. Such a panel could drive improvements in the transparency of disclosures around the MRP policy and other key judgements, as well as provide an opportunity for the system leader to set expectations and share good practice. More transparent disclosures would assist DLUHC with their monitoring of the appropriateness of MRP calculations as they would reduce the need to make specific contact with each local authority. DLUHC therefore has a self-interest in working with CIPFA / LASAAC, ARGA and other stakeholders to improve the quality of disclosures.

Auditors need clearer guidance on expectations regarding the MRP

27. We welcome the statement by Catherine Frances, Director General for Local Government and Public Services, in a recent PAC evidence session that auditors have been responsible for identifying several recent errors in MRP calculations. This demonstrates the value of

timely, effective audit and why it is essential that DLUHC take urgent action to address the crisis in local authority audit.

28. ICAEW has been making the case for DLUHC and the new system leader to set a clearer vision of the priorities for local audit and reporting as there is currently a disconnect between the areas of most interest to the regulator and the areas of most interest to users and preparers of accounts.

29. This consultation suggests accurate, compliant MRP calculations are a priority for DLUHC but the Financial Reporting Council (FRC) Audit Quality Reviews have heavily focused in recent years on the audit of operational property valuations, rather than areas such as the MRP that are essential to local authority budgeting. The FRC's Audit Quality Inspection report for major local audits in 2019-20 contained no findings relating to the audit of the MRP.

30. We believe that DLUHC should therefore work with the system leader to ensure the MRP is an area of focus for both finance teams and auditors. In addition to amending the statutory guidance for finance teams, we recommend that the system leader also introduce clearer guidance for auditors once it assumes responsibility for the Local Audit Code and Guidance. The Auditor Guidance Notes produced by the NAO contain eight short paragraphs about the MRP. The guidance instructs auditors to "determine whether authorities have complied with the 2003 Regulations and the revised MRP guidance when authorities review their MRP policy." However, as has been noted earlier in the consultation response, the MRP policies are often boilerplate so assessment of the policy would be insufficient to reach a conclusion as to whether the provision is "prudent".

31. ICAEW believes that the system leader should clarify expectations for auditors to clearly document considerations over whether the judgements made in determining the methodology to be used for calculating the MRP should be treated as a significant risk in line with the requirements of ISA 315, as well as challenge management on the adequacy of the MRP policies and judgements disclosed in financial statements.

32. ARGA should also review the Auditor Guidance Notes around auditors' work on VFM arrangements as these make no mention of the MRP. However, in local authorities with significant commercial investments, highly geared balance sheets or low levels of reserves, the auditors need to consider the appropriateness of the MRP policy and its application when determining the risks of weaknesses in the local authority's arrangements for securing value for money. ARGA could helpfully demonstrate its commitment to improving transparency by sharing examples of good practice in financial statement disclosures relating to MRP calculations, in how to audit them and in how they are dealt with in commentaries on value for money arrangements.

The proposals are a missed opportunity to simplify local authority finances

33. ICAEW believes the proposed changes to the 2003 regulations help clarify MRP guidance but the government should go further to ensure the guidance is readily understandable by finance teams, auditors and elected councillors.

34. Revising the terminology used in the guidance and regulations could help prevent unnecessary confusion. For example, the use of the term 'MRP payment' is confusing given that there are no cash payments involved, but rather a budgetary charge used to hypothecate financial resources by reducing reserve balances available for general use.

35. Equally, the government should avoid using phrases such as "having regard to" that suggest the possibility for flexibilities or differing interpretations if this is not the government's intention. This would not only help ensure local authorities apply the guidance in a consistent manner but also provide clarity for auditors in reviewing their compliance with the guidance and acting appropriately when they identify areas of non-compliance.

36. Redmond identified the "difference between the budget analysis of information for council tax purposes and the statutory basis of year end accounts" as the primary cause of the complexity of local authority accounts. This difference is created by the statutory overrides that have been introduced by successive governments including the removal of depreciation

and its replacement with MRP, which Redmond described as the most significant of these overrides.

37. The government should, therefore, explore ways to simplify the MRP calculation. This would bring several significant advantages:

- It would reduce the burden on local authority finance teams tasked with making judgements about the MRP policy and applying it to their assets, thus reducing the risk of errors.
- It would improve the understanding amongst elected councillors and audit committees, and, as a result, strengthen their ability to scrutinise the policy applied.
- It would largely eliminate the risk of local authority finance teams seeking to manipulate the MRP charge to achieve a certain financial outcome.
- It would reduce one of the key complexities in local authority accounting, better enabling those audit firms or individuals, experienced in corporate audit, to perform local audits and help alleviate capacity issues in the market.

38. This could include reviewing whether the legacy methods of calculating MRP should be removed from the guidance to encourage councils to have a single methodology for all debt-financed assets to aid simplicity.

39. ICAEW believes that simplification of the MRP calculation should take place alongside a wider simplification of local authority finances to reduce the burden on finance teams and auditors and make financial reports more accessible to users. Such a simplification would include greater alignment between the accounting and budgeting bases.

40. HM Treasury carried out an alignment project in 2009 for central government accounts and removed a substantial number of differences between the budgeting and accounting basis. This is one reason why central government financial statements tend to be significantly shorter and easier to understand than their local authority counterparts. Nevertheless, the Public Administration and Constitutional Affairs Committee’s 2017 report Accounting for democracy: making sure Parliament, the people and ministers know how and why public money is spent recommended that HM Treasury consider further alignment, demonstrating its value to key users. ICAEW believes that local authority accounts would benefit from a similar exercise.

41. ICAEW strongly welcomes that CIPFA / LASAAC are undertaking a project to improve the presentation of local authority accounts but CIPFA / LASAAC’s ability to make the radical simplifications required is hampered by the complexities created by the need to align with the requirements of the Whole of Government Accounts and the statutory framework that governs local authority finance.

42. Therefore, DLUHC should work closely with CIPFA / LASAAC to identify ways of aligning local authority budgeting rules with the accounting requirements as part of the wider accounts presentation project. This should include, but not be limited to, consideration as to whether the statutory adjustment involving the removal of depreciation and the charging of MRP is necessary and supports transparent, understandable reporting.

43. We recognise that changes to the budgeting framework could potentially have a significant impact on the ability of some local authorities to set balanced budgets, at least in the short term. We welcome DLUHC’s intention expressed in the consultation document to support councils adversely affected by the changes to the MRP regulations and would urge them to take a similar approach to any wider budget simplification.

44. We also agree that any changes to the MRP rules or budgeting framework should be prospective to prevent local authorities undertaking complicated prior period adjustments and to allow them to create future budgets with sufficient certainty. Although there may still be a need for prior period restatements in the case of material error, we welcome confirmation that this should not be required where local authorities re-evaluate their MRP methodologies as a result of changes to the regulations.