ITEM 11

Report to: Executive Board 2nd December 2002

Charging staff costs to Capital

Report of: The Strategic Director for Finance & Corporate Services	WARDS AFFECTED ALL

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Lead Member Responsible: Cllr Hollingsworth

Overview and Scrutiny Committee Responsibility: Finance and Performance Management

Key Decision: NO

SUMMARY AND RECOMMENDATIONS

This report sets out a case to broaden our current policy for charging professional staff time to specific capital budgets.

Recommendations

1) The Executive Board is asked to approve inclusion of this policy change in the next Forward Plan and consultation process, in order to meet the requirements of a 'Key Decision'.

The Executive Board is asked now to approve in principle (subject to outcomes from the consultation process), with a view to recommending approval to Council at a later date:-

2) that professional staff time associated with specific capital schemes be charged against those schemes;

3) that as a general rule, staff time charged to a capital scheme should be no more than 15% (including feasibility) of the total costs of that scheme. The costs of Feasibility should be no more than 5% of the total costs of that scheme;

4) that Officers are asked to develop a robust system for vetting potential capital schemes so only legitimate capital expenditure is charged to capital;

5) that Officers, through the Capital Monitoring Group, are asked to examine the capital programme for 2003/04 to determine a prudent level of fee income for that year;

6) that this level of income is reviewed on an ongoing basis, as part of the monitoring process;

7) that this budget provision is reduced back to nil for the budget year 2004/05 and built up again, from a zero base, to reflect the level of capital scheme activity for that year;

8) that abortive costs should be minimal and be contained with the revenue budget for the relevant Business Area.

THIS REPORT HAS BEEN SEEN AND APPROVED BY:
Cllr Hollingsworth, Portfolio Holder
Mark Luntley, Strategic Director for Finance & Corporate Services

Background papers:
Capital Strategy and Asset Management Plan, July 2002

1. Background

3.3 With the growth in the Council's Capital Programme, there are more and more staff resources being used up in developing and managing new capital projects. The Council's current policy for charging staff time to Capital relates only to those staff directly associated with a specific scheme, like Surveyors and Site Workers. Other staff who are involved in the development of specific capital schemes are currently budgeted for within revenue.

3.4 There is guidance set out in accounting rules and regulations on charging staff costs to capital but these are by no means definitive. Local Authorities are, to a certain extent, left to form their own view on what the regulations mean to them. This view can be tested in the Courts, if necessary, by the District Auditor for example, however, this report sets out my advice on what staff fees can prudently be charged to capital.

3.5 Any change to our policy on charging staff time to capital will be a key decision. As such, it will need to in incorporated in to the next Forward Plan and go though the consultation process before it is implemented. These can be concluded in time for the start of the new financial year.

2. Definition of Capital

2.1 In order for staff costs to be charged to a capital scheme in the first place, the scheme itself has to conform to the definition of capital set out in statute. The Local Government and Housing Act 1989 describes those areas of work that can be charged to capital. However, the underlying premise is that "all expenditure incurred by an Authority in any year must be charged to a Revenue Account". The Act develops this further by setting out areas which are excluded from being charged to Revenue and, therefore, become charges on capital. Those definitions of capital are as follows:-

- the acquisition, construction, preparation, enhancement or replacement of a computer programme, roads, buildings and other structures; where enhancement means the carrying out of works which are intended:
- to lengthen substantially the useful life of the asset; or
- to increase substantially the open market value of the asset; or
- to increase substantially the extent to which the asset can be used for the purposes of or in connection with the local authority.

'Enhancement' involves either a substantial increase in the assets value or a substantial lengthening of its useful life. It excludes repairs, for example, re-roofing a building would normally count as capital expenditure, but replacing missing tiles would not.

Statute is silent as to the meaning of 'substantial'. In practice it is left to Local Authority Officers to exercise their judgement on the accounting treatment. However, if this judgement was challenged by the District Auditor, for example, then ultimately the Courts would decide.

3 Budget issues –Capital and Revenue

3.1 Capital implications

The Executive Board in July, as part of the Capital Strategy, agreed to a more stringent approach to approving new capital schemes. The new approach, amongst other things, was to ensure that all new schemes properly considered all the costs involved and when those costs will be incurred. A new process allowing for staff costs could readily fit in to this new framework as at the outset, the Project Manager would need to build these costs in to the scheme budget and timetable for spending.

If staff time is going to be charged against a capital scheme obviously the cost of the scheme increases but this has to go hand in hand with a budgetary control mechanism for fees. The best practice approach of getting charges in to any service area, including capital, would be by the use of timesheets or worksheets to compute the charge and some form of invoice for authorisation and controlling costs against budget. It is recommended, therefore, that any staff charges to capital have to be supported by appropriate worksheets and charging system.

3.2 Expenditure for Capital Purposes – Eligible Costs

In terms of charging staff time to Capital then the rules and regulations are not that helpful. The guidance and examples that are available[1] set out more what you can't do rather than what you are able to do and relevant extracts are as follows:

" Most authorities have taken a wide view of the definition of Capital to include incidental costs involved in a capital project, such as officers' salaries and professional fees, although such expenditure cannot be treated as capital should the scheme prove abortive".

Financial Reporting Standard 15 (Tangible Fixed Assets) is a useful source of guidance on how the cost of an asset is defined in generally accepted accounting practice. FRS15

[1] CIPFA Guide to Capital Accounting Arrangements 2000

provides support for the following arguments. The cost of an asset can comprise:

- Labour costs of an authority's own employees arising directly from the construction or acquisition of the asset (e.g. Site workers, architects and surveyors, **but not site selection activities**)
- The incremental costs to the authority that would have been avoided only if the asset had not been constructed or acquired (i.e. **administration and general overheads are excluded from the definition of expenditure for capital purposes**, BUT acquisition costs, site preparation and clearance, delivery and installation, professional fees and FRS12 provisions for eventual decommissioning are included).
- Abnormal costs such as those relating to design errors, industrial disputes, wasted resources and slippage **are not** directly attributable to bringing an asset into working condition and should not be treated as expenditure for capital purposes.
- What guidance does exist on fees clearly states that the fee element of the project should only be "incidental" to the overall costs of the project. What this means is that the total amount of staff costs charged to a scheme should be minor in relation to all other costs for that scheme. **As a general rule**, the costs of working up a scheme (feasibility) should not exceed, say, 5% of the total scheme cost. For fees in general, there is evidence that the local market rate for fees chargeable to schemes is at the 15% level. I think this is a reasonable benchmark and, therefore, including the feasibility, I would not expect us to exceed that 15% level for the majority of times.
- From time to time, there may need to be exceptions to these general rules (for specific schemes only), and I recommend that the Capital Monitoring Group is given authority to review these limits at those times and report back to the Executive Board accordingly.

3.3 Risks

- Officers will need to develop a robust system for vetting potential capital schemes so only legitimate capital expenditure is charged to capital;
- Although some new schemes will get initial outline approval, these may not proceed past the feasibility stage for any number of reasons. When this happens all costs incurred at that point have to be charged against a revenue code/budget (see revenue implications below);

3.4 Revenue Implications

From a revenue account point of view, taking capital fee income into the budget process is not quite so straightforward. I do not want to create a revenue income budget, within the General Fund or the HRA, unless there is a high degree of confidence that the budget is achievable. Any expected fee income to the revenue accounts would need to be related to specific schemes within the approved capital programme for the forthcoming year. There are a number of issues or risks here that need to be addressed, some of which impact on that degree of confidence:-

- Past experience has shown that the Council is not much good at predicting when capital spending is likely to happen. If a scheme slips forward in to another year, then the revenue fee income slips forward with it. This creates a budget problem in the planned budget income year;
- Once a scheme enters in to the 'planning / feasibility stage' there are no guarantees that these schemes will be finally approved. If they are not approved (aborted) then any

costs incurred at that time can not be charged to capital. There are no revenue budgets, both General Fund and HRA, to fund these costs. However, in theory, providing the preliminary work is carried out in line with the Capital Strategy proposals, the amount of schemes that don't make it through should be minimal. I recommend, therefore, that the onus is placed on the Business Mangers to ensure that schemes are suitable to Members and Officers before anything other the minimal costs are incurred. On that basis, I further recommend that any costs which were subsequently found to be abortive would need to be contained within the Business Manager's usual revenue budget. From time to time, there may need to be exceptions to this practice, and, providing the reasons are endorsed by the Capital Monitoring Group, Business Manager's may need to put a report to the Executive asking for a budget for these costs.

- What level of income might be expected?
  At this stage it is very difficult to predict what this might be. Each individual scheme would need to be looked at to decide whether the work falls within the definition above, whether the works will be carried out in the year in question and, indeed, if the fee element of the work can be carried out by in-house staff.
  However, I have looked at the current capital programme for 2003/04, which does not included any new schemes likely to be approved as part of the current Budget process. For the purposes of this report, if it can be assumed we live in a perfect world all of the General Fund and HRA schemes will be eligible for fees and that all these schemes will run according to the timetable then spending and fee income could be as follows:-

FUND	EXPECTED SPEND	15% FEES	Current Fee Budget (approx)	Increase
General Fund	£5m (approx)	£ 750,000	£250,000	£500,000
Housing (HRA)	£6m (approx)	£ 900,000	£400,000	£500,000

Once the schemes have been assessed for the issues above, it would only then to prudent to create a budget within the revenue accounts. Whatever level of budget this might be, I recommend that it is created for one year only with a completely new exercise carried out each year, as part of the budget cycle, to determine the fee budget in that following budget year. Additionally, as part of the usual monitoring process, Budget Holders will be asked, in particular, to review fee budgets and the timing of these fees being incurred in relation to the budget year. Any material changes will be reported back to the Executive Board at their next meeting.

4 Conclusion

4.1 There is some guidance on being able to charge fees within the law and accounting standards, however, there is no definitive guidance. Local Authorities are able to develop their own policies on these which will be tested by the process of Audit and, ultimately, the Courts. However before a policy change is considered there are certain issues that need to be well thought through to ensure the Council develops a policy that is lawful, consistent and prudent. The following issues have been discussed above and are now listed below:-

a) The policy has to be consistently applied to all Capital schemes;
b) Professional fees incurred must be on a specific capital scheme and <u>not capital in general</u>;
c) The fees incurred must be in relation to bringing an Asset in to use;
d) The work on that Asset must fall within the definition of Capital Expenditure;
e) Works than only keep assets in good repair or maintain their current market value are not capital works;
f) Professional fees charged to a scheme can only be "incidental" to the overall value of works and/or added value to the asset;
g) As a general rule, feasibility costs should be no more than 5% of the total scheme costs and fees overall should be no more than 15% of the total scheme costs;
h) A budget can be created in the revenue accounts on a year by year basis but more work needs to be carried out by Officers to determine what a prudent level of fee income might be;
i) The level of fees incurred on schemes and income generated from schemes will be reviewed and reported to the Executive Board as part of the monitoring process;
j) A system of timesheets / worksheets needs to be in place to support the costs charged to capital;
k) A costing system should be investigated to facilitate the charging of fees;
l) No additional budget should be created in the revenue accounts to reflect any anticipated increase in fee income;
m) Fee income will be reported on as part of the monitoring process;
n) A sum of £20,000 should be set aside from both General Fund and HRA balances to fund abortive costs.