

Briefing Paper

INTRODUCTION TO HOUSING FINANCE

Adrian Waite – July 2004

What is it about Housing Finance that makes people either shudder with horror or fall asleep? It's probably to do with the fact that it is complicated and boring!

Is it a subject on which you can get by, without knowing much about it?

Is it something that only the Housing Accountant has to struggle with?

OR

Is it something that everyone concerned with managing social housing, or its finance, has to understand?

Well, housing finance used to be seen as a specialism.

But - things have changed. Resources available for housing are constrained by complicated government controls and accounting procedures. Furthermore the pace of change is quickening. The present government has introduced initiatives including Resource Accounting, Comprehensive Performance Assessments, Supporting People and Rent Restructuring. All these are superimposed on the arrangements that they inherited based on "Ring Fencing", Housing Subsidy and the Housing Investment Programme. The present government has required all authorities to achieve the decent homes standard despite capital resources being constrained, has made major changes to the capital financing regime (especially for 2004/2005) and has obliged authorities to carry out stock options appraisals. As a result many councils are either establishing arms length management organisations or are transferring their housing stock to a registered social landlord. Then there are the existing Registered Social Landlords operating alongside the Local Authority Housing Services.

As a result, Housing Finance has become something that everyone concerned with managing social housing, or its finance, has to understand.

THE LEGISLATIVE BACKGROUND AND FRAMEWORK

Legislative Background

The Local Government and Housing Act (1989) introduced the basic rules on how money can, or cannot be used for local authority housing purposes. This Act is still the basis as far as most of the rules governing Housing Finance are concerned. In particular, it introduced the concept of 'ring fencing' under which income and expenditure relating to managing council housing must be kept separate from other council funds. It also introduced the housing subsidy system based on the notional housing revenue account that represents a calculation broadly speaking of what the government thinks that local authority should spend.

The New Financial Framework for Local Authority Housing

The present Government has introduced a 'new financial framework for local authority housing' sometimes known as 'resource accounting'. This includes a series of changes to housing finance that have been introduced from 1998 to date.

The change to the accounts is to introduce a form of accounting designed to show the true cost of capital tied up in the assets of a service and the true cost of providing resources to maintain them over the life of the asset.

There is a Major Repairs Allowance that will allow authorities to maintain their stock in good condition, but it is not designed to finance any backlog of repairs and renovations.

Rent Rebates were transferred from the Housing Revenue Account to the General Fund in 2004/2005.

Local Authorities need to produce Business Plans. This requires the collection and analysis of a large amount of data that feeds into a thirty year financial projection. This projection identifies whether the authority has sufficient resources to meet the decent houses standard.

Rent Restructuring

The government has decided that there should be a 'coherent' structure of social rents. With all local authorities and housing associations using the same formula to calculate all their rents. This re-structuring of social rents is being introduced through government guidance during the period 2002 – 2012.

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Supporting People

'Supporting People' was introduced in 2003. The concept behind 'Supporting People' is that support for vulnerable people, such as the elderly, should be based on the need to support the person rather than on a plethora of arrangements to provide various services to people in need. From 2003, funds currently used to fund support services in Housing and Social Services will be combined into a single 'Supporting People' budget. This will then be allocated between areas according to a needs formula, and spent in accordance with a strategy prepared by local authorities (the County Council in a two-tier area) in consultation with all other providers and stakeholders.

Communities Plan

On 5th February 2003, the government announced its 'Communities Plan'. It contains three main themes: Providing more affordable homes in Southeast England; Revitalising areas of low demand in Northern and Midland England; and achieving the Decent Homes Standard for all social housing. The Decent Homes Standard is to be achieved through providing more funding and debt relief to support Arms Length Management Organisations, Partial Stock Transfer and the Private Finance Initiative. There is also funding for the Market Renewal Programme that is designed to address problems associated with low demand for housing.

Stock Options

The government requires all local authorities to review their housing stock options before 2005, and to consider in particular the relative advantages of continuing as a traditional local authority housing provider, establishing an arms length management company, carrying out a private finance initiative scheme or transferring the stock to a registered social landlord.

A key question is whether an authority can expect to achieve the decent homes standard as a traditional local authority housing service. Evidence suggests that the government has allocated resources that are insufficient to meet the target that they have set. As a result, many authorities are finding that they cannot achieve the decent houses standard if they continue as a traditional local authority housing service.

Local Government Act 2003

The Local Government Act of 2003 introduced 'prudential borrowing' under which local authorities are allowed to borrow as much money as they wish for capital purposes as long as they can afford to meet the repayments. This system comes into being in April 2004. At the same time revenue support to meet the costs of borrowing for council housing is now being provided by regional housing boards.

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Basic Accounting

It is sometimes the case that people find it difficult to understand Housing Finance simply because they have not got to grips with basic accounting concepts. So, at the risk of insulting your intelligence, we are going to explain them using plain language. You may be surprised to find that the way local authorities have to account for their financial transactions is not a lot different from the way you might account for your own spending and income. It is only the size of the figures that change.

Receipts and Payments and Accruals

The simplest form of accounting is called "Receipts and Payments". This consists of recording all the money that comes in (receipts), and all the money that goes out (payments). However, this method is seen as being too simple for large organisations like public companies and local authorities. Consequently, they not only record receipts and payments, but also record "accruals".

Accruals allow accountants to take into account things such as money that is due but not received, or money that is owed but not paid. This means that they can draw up an account that in a private company is called a 'Profit and Loss Account' and in a local authority is called a 'revenue account'. The revenue account for a particular year therefore shows all the expenditure and income related to that year.

However, not all expenditure is included in the revenue account, because some expenditure is treated as Capital Expenditure.

Accountants also draw up a balance sheet. This is a list of all the assets and liabilities of the organisation and their values, and shows the organisation's net worth in financial terms.

The Difference between Capital and Revenue Expenditure

If you buy a house, this is your capital expenditure. If you buy fish and chips, this is revenue expenditure. The justification for this simple classification is that the house you bought will hopefully have a long life and retain its value, whereas the fish and chips will be consumed immediately.

The same principle applies to local authority finance. If a local authority modernises a house, it is capital. If it unblocks a drain, it is revenue.

There are two main reasons why local authority spending is required to be classified as Capital or Revenue. Firstly, capital spending results in the acquisition of a new asset or adds value to an asset and therefore it is necessary to record what the asset is worth. Secondly, the capital expenditure results in a long term benefit over a number of years and so the cost is spread over those years. Governments also like to control how much local authorities borrow to pay for large projects, whilst at the same time trying to ensure that local authorities do not borrow money to pay for spending on minor items.

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Capital Income (or Capital Receipts) and Revenue Income

A person's wage or salary is their revenue income. They will use this to pay for their daily living expenses (revenue expenditure). If a person sells a house or a car, they may get a capital receipt.

The same principle applies to local authorities. When a local authority sells a council house it gets a capital receipt. The rent that is collected is revenue income.

Paying for Revenue and Capital Expenditure

It's quite in order for a private individual to sell a house or car, get a capital receipt and use some of the money to pay for a holiday, or to borrow to pay for the holiday. However, a local authority cannot pay for revenue spending by borrowing or using capital receipts. It is not good financial management to borrow to pay for revenue expenditure.

Revenue money can be used to finance capital expenditure. Just as a private individual may choose to use some of their salary to buy outright a quaint Cumbrian cottage a local authority can also choose to use its revenues to meet capital spending. Doing this is called making a Revenue Contribution to Capital Outlay.

The government changed the way in which Major Repairs are financed and accounted for with effect from 1st April 2001. There is a new Major Repairs Allowance paid to local authorities through the Housing Subsidy system that pays for Major Repairs. Local authorities have to have a separate Major Repairs Account to which Major Repairs are charged.

Capital expenditure is funded from government grants, borrowing and capital receipts, or revenue contributions (RCCO) from the Housing Revenue Account or The General Fund, as appropriate.

Borrowing and Capital Financing Charges

If an authority decides to meet capital expenditure from the current year's revenue income, then that is the end of the story. However, if it borrows to pay for capital expenditure (just like borrowing, to buy a house) it will have to meet loan interest, as well as gradually paying back the loan, over a number of years. They will pay for this out of future revenue income.

A similar thing happens if capital expenditure is met from a capital receipt, because the authority foregoes the opportunity to earn interest from investing that receipt.

Under the new financial framework, there have been significant changes to the way in which capital-financing charges are calculated and presented. This is because the government wants local authorities to calculate the 'true cost' of their housing assets. The argument is that councils are in a similar position to people who own their own home with a mortgage that covers only part of the cost. The 'true cost' of the house in this case is not only the mortgage repayments, but also the loss of interest that could have been earned if the deposit had been invested in the bank. Similarly councils' housing debt is often less than the value of their housing stock. However, this does not affect the amount of capital financing charges that a Council actually pays.

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Budget and Closedown

Accountants often refer to 'budgets' and 'closedown'.

A Council sets a budget, usually in February, for a financial year that runs from 1st April to 31st March. Preparation of the budget and calculation of all the figures normally starts in the preceding summer, with most of the work done from November to January.

After the end of a financial year on 31st March, the accounts are 'closed down'. This means that all the final figures are calculated, entered into the accounts and reported. This usually takes place between April and June.

The difference between a Local Authority Housing Revenue Account and General Fund

A local authority has to keep a "Housing Revenue Account". This records revenue income and expenditure in relation to Council Houses and providing services to tenants, such as rents and repairs. Any expenditure or income not to do with Council Houses and providing services to tenants is recorded in the authority's General Fund.

General Fund expenditure is met in the main from Council Tax, Revenue Support Grant (a Government Grant) or National Non-Domestic Rates.

If an authority wishes to increase its expenditure (such as expenditure on Maintenance) on the Housing Revenue Account it must fund this from within the Housing Revenue Account.

If an authority wishes to increase expenditure on General Fund Services then it must fund this from general fund resources.

While the 'housing ring fence' prevents an authority from transferring resources between the Housing Revenue Account and the General Fund, there is nothing to stop an authority transferring resources between Housing General Fund and other General Fund Services.

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