



Department for
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Circular LG 02/26

CAPITALISATION

This guidance supersedes the Departments' previous guidance in respect of capitalisation directions (Circular LG 18/2011 and its subsequent reissue as part of Circular LG 02/2012). It provides further clarification on, and incorporates some agreed changes to, the procedures for requesting and considering capitalisation directions including the role of the Finance Working Group.

The Department of Finance has agreed to the widening of the capitalisation to include statutory redundancy costs and enhanced costs, the lump sum element of the pension payment arising from compensatory added years, or any payments the council makes into its pension fund in order to eliminate deficits resulting from premature retirements.

Any queries on this circular and accompanying guidance note should be directed to Local Government Finance Branch (LGFinanceBranch@communities-ni.gov.uk).

Yours sincerely,

JEFF GLASS

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CAPITALISATION DIRECTION – A GUIDANCE NOTE FOR DISTRICT COUNCILS IN NORTHERN IRELAND

1. INTRODUCTION

- 1.1 Capitalisation facilitates a relaxation of the normal accounting principle that long- term borrowing or capital receipts should only be used to finance capital expenditure
- 1.2 Section 19(3) of the Local Government Finance Act (Northern Ireland) 2011 empowers the Department to issue capitalisation directions to councils, which in turn permit expenditure that would normally be classified as revenue expenditure to be treated as capital expenditure. Applications for capitalisation directions will be considered against strict criteria, and the Department will monitor closely and control the use of capitalisation directions.

“CAPITAL EXPENDITURE”

Section 19 of the 2011 Act states:

19(1) *Subject to subsection (2) and (3), references in this Part to capital expenditure, in relation to a council, are to expenditure of the council which falls to be capitalised in accordance with proper practices.*

19(2) *Regulations may provide that expenditure of councils shall be treated for the purposes of this Part as being, or not being, capital expenditure.*

19(3) *The Department may by direction provide that expenditure of a particular council shall be treated for the purposes of this Part as being, or as not being, capital expenditure.*

- 1.3 This guidance note sets out the Departments’ procedures for considering and issuing capitalisation directions. It should be noted that the application process for a capitalisation direction is a separate process from a loan application process.

2. BACKGROUND

- 2.1 Capitalisation runs counter to the normal principles of prudent financial management in district councils, since it facilitates practice which breaches HM Treasury's rule that long-term borrowing should be used only to finance capital expenditure. The introduction of the Prudential Code removed the routine need for councils to seek Departmental approval for borrowing. Instead, councils must adhere to the principles and rules defined within the Prudential Code. A successful application to capitalise expenditure which would ordinarily be treated as revenue expenditure therefore removes the only formal obstacle to borrowing for revenue purposes. Capitalisation of expenditure that would ordinarily be treated as revenue expenditure can never permanently solve financial difficulties arising from the need to fund such expenditure through the General Fund in the financial year in which the expenditure is incurred. However, capitalisation of such expenditure and the associated funding thereof over a period in excess of one year will reduce the financial pressure by simply extending the period over which the expenditure may be funded. For example, debt incurred to fund capitalised revenue costs may have to be serviced from revenue resources over a number of years. Using capital resources to fund revenue expenditure tends to reduce long-term investment in the capital assets needed to create and maintain sustainable communities. All these issues should be strongly considered by a council before it makes an application for a capitalisation direction.
- 2.2 Even if a council intends to fund capitalised expenditure out of capital receipts instead of by new borrowing, there may still be an indirect breach of HM Treasury's rule since capital receipts arise from the sale of assets which may have been bought with borrowed money. Expending capital receipts on (capitalised) revenue expenditure may mean a council will sooner or later wish to increase its borrowing to finance capital expenditure which might otherwise have been paid for with such receipts.

2.3 It is important that councils are aware of the latest Government Resource and Budgeting Guidance (RAB) which underlines the fiscal importance of maintaining capitalisation at manageable levels within the context of the UK public expenditure framework. The capitalisation limit set by HM Treasury for councils in Northern Ireland is £3.4m per annum.

3. GENERAL PRINCIPLES

3.1 Capitalisation directions will normally only be available for either of the purposes shown below:

(a) To help a council manage exceptional financial difficulties

The following 3 conditions must be met:

- (i) The costs which the council seeks to capitalise are unavoidable (for example, because they relate to statutory duties or contractual or other commitments
- (ii) The council could not meet the costs out of revenue resources without their being an unacceptable adverse impact on those who use or pay for its services; and
- (iii) There is no alternative affordable way of ensuring that the costs could be met.

(b) To facilitate the use of cost-cutting measures

The capitalised expenditure must relate to measures with an immediate and demonstrable cost-cutting effect

3.2 In relation to paragraph 3.1(b) this includes statutory redundancy costs and enhanced costs, the lump sum element of the pension payment arising from compensatory added years, or any payments the council makes into its pension fund in order to eliminate deficits resulting from premature retirements.

- 3.3 Statutory redundancy costs are those costs required and calculated in accordance with Part 12 of the Employment Rights (Northern Ireland) Order 1996 (see in particular Article 197).
- 3.4 A capitalisation direction will only apply to one financial year therefore it is important to note that if costs span two financial years, then two separate applications will be required. A council will only be able to capitalise costs that have been incurred in the year that the direction applies.
- 3.5 For the avoidance of doubt, **it will not be acceptable to include estimates** for applications to the Department for capitalisation directions. Councils are required to provide detailed supporting information/calculations along with their application to substantiate the figures. When councils advise the Department how much of their allocation was used in the previous financial year (see paragraph 5.2 below), and this is a different amount to that included in the initial application, councils will receive a new capitalisation direction and will not be able to capitalise amounts more than that approved in the new capitalisation direction.

4. APPLICATION PROCEDURE

- 4.1 Applications for capitalisation directions should be made by 30 June of the financial year in which the expenditure is to be incurred. In exceptional circumstances the Department may allow applications received shortly after 30 June to be processed normally. The Department will acknowledge all applications within 10 working days of receipt
- 4.2 The Department will provide, insofar as is practicable, if requested, an indication of whether the application appears to meet the specified criteria. However no formal capitalisation direction will be given prior to the consideration of all applications which will take place in consultation with the Finance Working Group (FWG) after 30 June of the financial year in which the expenditure is to be incurred. Where an indication is requested, the applicant

council is required to advise the Department that they wish to proceed with their application (as submitted) or resubmit a new application by the specified date (30 June) if the application is to be considered for a formal capitalisation direction. **Estimates are acceptable for the purposes of receiving an indication from the Department, however it will not be acceptable to include estimates for an application that is to be considered for a formal capitalisation direction.** The Department will acknowledge both applications received for the purposes of receiving an indication, and any new application resubmitted, within 10 working days of receipt. For applications received without the request for an indication, the application will be considered for a formal capitalisation direction, and no further advice or resubmission will need to be given to the Department.

- 4.3 Normally applications received after 30 June of the financial year in which the expenditure is to be incurred will be considered separately from those made by the due date. Such applications will be considered in light of any margin between the aggregate value of that year's approved applications and the annual capitalisation limit, and any surplus that may ultimately be available as a result of councils not calling down the full value of their approved applications. This will be undertaken in consultation with members of the FWG.
- 4.4 An outline of the minimum information required in relation to an application for a capitalisation direction is attached at Annex A. All applications for a capitalisation direction must include:
- a. details of the amount of expenditure the council is requesting to be capitalised;
 - b. details of when the expenditure will be incurred; and
 - c. sufficient information to demonstrate that the relevant tests have been met, including robust figures to satisfy the affordability test.

- 4.5 The Department will aim each year to issue formal capitalisation directions by **16 September** of the financial year in which the application was received by the Department.
- 4.6 To ensure the capitalisation limit of £3.4m is allocated fairly, the Department will consult members of the FWG prior to issuing formal capitalisation directions each year. While the Department will assess applications against the criteria, the formal agreement of all members of FWG (regardless of whether they are in attendance at the meeting(s) of the FWG at which the Department consults with the members) will be required in respect of the decision to issue individual capitalisation directions. In circumstances where unanimity cannot be obtained within a reasonable time period which will facilitate the issuing of the formal capitalisation directions by the 16 September, the Department may accept a majority agreement.
- 4.7 A council which makes a request for a capitalisation direction which does not satisfy the criteria indicated in this note should give the fullest reasons why it considers that a capitalisation direction is necessary and appropriate. The Department shall consider such explanation(s) but is not bound to accept it as being sufficient to support the issue of a capitalisation direction.

5. RETURNS TO LOCAL GOVERNMENT & HOUSING REGULATION DIVISION

- 5.1 The capitalisation direction letter will ask councils to notify the Department by 1 December that they intend to use the direction in its entirety or that they have not used the full amount of their direction. Where a council has notified the Department that they have not used the full amount of their approved capitalisation direction the Department will issue a revised direction for the appropriate amount. The sum-total of any unused allocations may then be made available for any late or unmet capitalisation direction applications.
- 5.2 Councils are also required to advise the Department of how much of their allocation was used in the previous financial year. This information will be

requested in tandem with the accounts direction and should be provided no later than 30 June of the following financial year in which the expenditure is to be incurred. These returns are required by this date to enable the Department and members of the FWG to monitor the operation of the system, and to facilitate the Department's timely update of the final position to DoF. There is no template form for returns, an email or hard copy return will suffice.

5.3 Where the Department is advised that all / part of a capitalisation direction will not be used, either a new capitalisation direction will be issued which will supersede the previous capitalisation direction, or the previous capitalisation direction will be withdrawn.

5.4 CAPITALISATION TIMETABLE

Capitalisation Timetable	Dates
Application for Capitalisation Directions	By 30 June
Departmental Acknowledgment	Within 10 working days
Formal Capitalisation Directions issued	By 16 September
Council notification to the Department of intention to use the Direction	By 1 December
Council notification to the Department of the actual allocation used in previous financial year	By 30 June of financial year after the year expenditure was incurred

6. CONTACTS

6.1 Queries and applications should be directed to Local Government Finance Branch as follows - LGFinanceBranch@communities-ni.gov.uk

ANNEX A

OUTLINE OF MINIMUM INFORMATION REQUIRED TO SUPPORT A CAPITALISATION DIRECTION REQUEST

APPLICATIONS FOR [current financial year] – COSTS MUST BE INCURRED IN THIS FINANCIAL YEAR.

1. Name of council:

2. Address:

3. Council contact for application queries:

4. Telephone number:

5. Financial year in which costs are to be incurred:
(E.G. current financial year)

6. Amount the council is applying to capitalise:

7. Please indicate if the amount requested to be capitalised is the final figure or an estimate (if estimation state when final figure will be available):

8. Description of application: 8(a) & (b) or 8 (c) should be completed:

The general principles of a capitalisation direction are outlined in paragraph 3 of the guidance. With reference to paragraph 3.1 where the application is made to:

- help a council manage exceptional financial difficulties please complete 8(a) and 8(b), or
- facilitate the use of cost-cutting measures please complete 8(c).

8(a) Explain the capitalization direction is required to enable the District Councils to manage exceptional financial difficulties

8(b) Explain how the following three conditions have been met:

(i) The costs which the council seeks to capitalize are unavoidable
(for example, because they relate to statutory duties or contractual
or other commitments)

(ii) the council could not meet the costs out of revenue resources
without there being an unacceptable adverse impact on those who
us or pray for its services

(iii) there is no alternative affordable way of ensuring that the costs
could be met

8(c) Explain why the capitalisation direction is required to facilitate cost-cutting measures

9. Indicate the likelihood of further applications for capitalisation for this purpose in future years – in particular if any applications are pending:



10. Please confirm that the costs cannot be funded from revenue resources without there being an unacceptable adverse impact on those who use or pay for services:

11. Please indicate whether a successful bid for capitalisation would be funded by capital receipts or by borrowing:

12. Please include any further information which you consider relevant to your application.

DECLARATION

To the best of my knowledge the information contained in this application is correct.

Signature: _____ (Chief Executive or Deputy)

Date: _____

Completed applications or any queries about this document should be addressed to:

LGFinanceBranch@communities-ni.gov.uk
