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Reserves and Balances Policy

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Reserves and Balances Policy

Legislative and Regulatory Framework

The requirement for financial reserves is acknowledged in statute. Sections 31A, 32, 42A and 43 of the Local Government Finance Act 1992 require billing and precepting authorities in England and Wales to have regard to the level of reserves needed for meeting estimated future expenditure when calculating the budget requirement. Local authorities may also 'earmark' specific parts of the General Fund reserve; these are referred to as Earmarked Reserves.

There are a range of safeguards in place that help to prevent local authorities over-committing themselves financially. These include:

- the balanced budget requirement: sections 31A, 42A of the Local Government Finance Act 1992, as amended
- Director of Resources' duty to report on robustness of estimates and adequacy of reserves (under section 25 of the Local Government Act 2003) when the authority is considering its budget requirement
- the legislative requirement for each local authority to make arrangements for the proper administration of their financial affairs and that the Director of Resources / proper officer has responsibility for the administration of those affairs section 151 of the Local Government Act 1972
- the requirements of the Prudential Code.

These requirements are reinforced by section 114 of the Local Government Finance Act 1988 which requires the Director of Resources in England and Wales to report to all the authority's councillors if there is or is likely to be unlawful expenditure or an unbalanced budget. This would include situations where reserves have become seriously depleted and it is forecast that the authority will not have the resources to meet its expenditure in a particular financial year. The issue of a section 114 notice cannot be taken lightly and has serious operational implications. Indeed, the authority's full council must meet within 21 days to consider the s114 notice and during that period the authority is prohibited from entering into new agreements involving the incurring of expenditure.

Whilst it is primarily the responsibility of the local authority and its chief financial officer to maintain a sound financial position, external auditors will confirm that there are no material uncertainties about going concern. Even where as part of their wider role auditors have to report on an authority's financial position, it is not their responsibility to prescribe the optimum or minimum level of reserves for individual authorities or authorities in general.

CIPFA's Prudential Code requires Director of Resources in local authorities to have full regard to affordability when making recommendations about the local authority's future capital programme. Such consideration includes the level of long term revenue commitments. Indeed, in considering the affordability of its capital plans, the authority is required to consider all of the resources available to it/estimated for the future, together with the totality of its capital plans and revenue forecasts for the forthcoming year and the following two years.

Types of Reserve

When reviewing medium term financial plans and preparing annual budgets local authorities should consider the establishment and maintenance of reserves. These can be held for three main purposes:

- a working balance to help cushion the impact of uneven cash flows and avoid unnecessary temporary borrowing – this forms part of general reserves;
- a contingency to cushion the impact of unexpected events or emergencies – this also forms part of general reserves;
- a means of building up funds, often referred to as earmarked reserves to meet known or predicted requirements; earmarked reserves are accounted for separately but remain legally part of the General Fund.

Financial Reporting for Reserves

The IFRS-based *Code of Practice on Local Authority Accounting in the United Kingdom* (the Code) introduced the Movement in Reserves Statement to local authority financial statements in the 2010-2011 financial year. This Statement presents the movement in the year of the reserves of the authority analysed into usable reserves, (such as General Fund, HRA Balances and earmarked reserves) and unusable reserves.

Unusable reserves arise out of the interaction of legislation and proper accounting practice either to store revaluation gains or as adjustment accounts to reconcile accounting requirements driven by reporting standards to statutory requirements. These reserves, which are not resource-backed and cannot be used for any other purpose, are described below:

Revaluation Reserve

- The Revaluation Reserve - this is a reserve that records unrealised gains in the value of property, plant and equipment. The reserve increases when assets are revalued upwards, and decreases as assets are depreciated or when assets are revalued downwards or disposed of. Local authorities might benefit from these gains in the future from the continued use of the assets or from their sale. The Reserve contains only revaluation gains accumulated since 1 April 2007, the date that the Reserve was created. Accumulated gains arising before that date are consolidated into the balance on the Capital Adjustment Account.

Adjustment Accounts

- The Pensions Reserve – this is a specific accounting mechanism used to reconcile the payments made for the year to various statutory pension schemes in accordance with those schemes' requirements and the net change in the authority's recognised liability under the Code's adoption of IAS 19 – *Employee Benefits*, for the same period. A transfer is made to or from the pensions reserve to ensure that the charge to the General Fund reflects the amount required to be raised in taxation. For example, the debit balance on the Reserve shows that an authority has made commitments to fund pensions that the Government has permitted it to fund from contributions to be made in future years.
- The Capital Adjustment Account - this is a specific accounting mechanism used to reconcile the different rates at which assets are depreciated under proper accounting practice and are financed through the capital controls system. Statute requires that the charge to the General Fund is determined by the capital controls system. For example, the credit balance on the Account shows that an authority has generally financed capital investment in advance of receiving the benefits of that investment. The Account also contains revaluation gains accumulated on Property, Plant and Equipment before 1 April 2007, the date that the Revaluation Reserve was created to hold such gains.
- The Financial Instruments Adjustment Account – this is a specific accounting mechanism used to reconcile the different rates at which gains and losses (such as premiums on the early repayment of debt) are recognised under proper accounting practice and are required by statute to be met from the Housing Revenue Account Fund. For example, the debit balance on the Account shows that an authority has incurred expenses on borrowings that the Government has permitted it to spread over future years.
- Collection Fund Adjustment Account – this is a specific accounting mechanism used to reconcile the differences arising from the recognition of council tax and non-domestic rates income in the Comprehensive Income and Expenditure Statement to those amounts required to be charged by statute to the General Fund. For example, the credit balance on the Account shows that more tax has been collected on behalf of the authority and the precepting bodies (and central government for non-domestic rates income) than an authority is permitted to transfer out of the Collection Fund by 31 March.
- The Accumulated Absences Adjustment Account – this is a specific accounting mechanism used to absorb the differences that would otherwise arise on the General Fund and Housing Revenue Account Balances from

accruing for compensated absences earned but not taken in the year, this is annual leave entitlement carried forward at 31 March. Statutory arrangements require that the impact on the Fund Balances is neutralised by transfers to or from the Account.

Other such reserves may be created in future where developments in local authority accounting result in timing differences between the recognition of income and expenditure under proper accounting practice and under statute or regulation.

In addition authorities will hold the following usable reserves:

- Major Repairs Reserve –this reserve records the unspent amount of HRA balances for capital financing purposes in accordance with statutory requirements for the Reserve.
- Capital Receipts Reserve – this reserve holds the proceeds from the sale of assets, and can only be used for those purposes specified in the capital finance and accounting regulations.
- Capital Grants Unapplied Reserve – this reserve holds capital grants that have been received but have yet to be used to finance capital expenditure. Amounts are transferred to the Capital Adjustment Account once they have been applied to fund capital expenditure.

The Code recommends that earmarked reserves are reported on the face of the Movement in Reserves Statement. Particularly significant movements might need to be reported individually on the face of the Statement to ensure key messages are presented clearly to users.

When establishing reserves, local authorities need to ensure that they are complying with the Code and in particular the need to distinguish between reserves and provisions.

The introduction of the IFRS-based Code on 1 April 2010 has meant that grant income should be recognised in the Comprehensive Income and Expenditure Statement (and therefore against the General Fund or HRA Balances for revenue grants) where grant payment is unconditional or grant conditions have been satisfied. The Code Guidance Notes recommend that where these grants have been received prior to the expenditure having taken place authorities should consider establishing earmarked reserves. This will ensure that amounts are set aside from the General Fund and HRA balances in earmarked reserves to provide financing to meet the requirements of the grant. The amounts set aside will be posted back from earmarked reserves to meet General Fund and HRA expenditure in future years. It is likely therefore that since the introduction of the IFRS-based Code there is an increased tendency to hold earmarked reserves.

The statutory reporting regime described earlier and effective financial management underpin the need for clear, transparent reporting arrangements for reserves and therefore in addition to the financial reporting requirements above, it is recommended that for each earmarked reserve held by a local authority there should be a clear protocol setting out:

- the reason for / purpose of the reserve;
- how and when the reserve can be used;
- procedures for the reserve's management and control; and
- a process and timescale for review of the reserve to ensure continuing relevance and adequacy.

Principles to Assess the Adequacy of Reserves

In order to assess the adequacy of unallocated general reserves when setting the budget, Director of Resources should take account of the strategic, operational and financial risks facing the authority. The assessment of risks should include external risks, such as flooding, as well as internal risks, for example, the ability to deliver planned efficiency savings. Statutory provisions require authorities to review at least once in a year the effectiveness of their system of internal control, which will include risk management. The CIPFA/SOLACE framework *Delivering Good Governance in Local Government* details an approach to giving assurance that risk, control and governance matters are being addressed in accordance with best practice.

The Codes of Audit Practice make it clear that it is the responsibility of the authority body to identify and address its operational and financial risks, and to develop and implement proper arrangements to manage them, including adequate and effective systems of internal control. The financial risks should be assessed in the context of the authority's overall approach to risk management.

Budget Assumptions	**Financial standing and management assessment/impact**
The treatment of inflation and interest rates.	The overall financial standing of the authority (level of borrowing, debt outstanding, council tax collection rates and so on). Rises in the prices of some commodities, such as fuel, highlight the relevance of using a number of inflation rates in the budget and financial strategy, and considering whether general reserves are adequate to deal with unexpected increases. Volatility in the financial markets also points to the need to consider investment and borrowing risks and their impact on income.

Budget Assumptions	Financial standing and management assessment/impact
Estimates of the level and timing of capital receipts.	The authority's track record in budget and financial management including the robustness of the medium term plans. Authorities will also need to take into account changes in the property market, and adjust estimates and assumptions for reserves accordingly.
The treatment of demand led pressures.	The authority's capacity to manage in-year budget pressures, and its strategy for managing both demand and service delivery in the longer term.
The treatment of planned efficiency savings/productivity gains.	The authority's virement and end of year procedures in relation to budget under/overspends at authority and department/directorate level. Risk management measures in relation to partnerships, including consideration of risk allocation. Contract provisions designed to safeguard the authority's position in the event of problems arising from outsourcing arrangements.
The availability of reserves, government grants and other funds to deal with major contingencies and the adequacy of provisions.	The adequacy of the authority's insurance arrangements to cover major unforeseen risks. When considering insurance cover, the structure of the cover as well as the overall level of risk should be taken into account. Risk assessments should be used when balancing the levels of insurance premiums and reserves.
The general financial climate to which the authority is subject.	External factors, such as future funding levels expected to be included in Spending Reviews and expected referenda principles and limits, will influence an authority's ability to replenish reserves once they have been used. Any plans for using reserves will need to consider the need and ability of the authority to replenish the reserves, and the risks to which the authority will be exposed whilst replenishing the reserves.

Whist many of these factors relate to setting the annual budget, the level of risk and uncertainty associated with these factors will be relevant in determining an appropriate level of reserves.

Authorities have been faced by increasing financial pressures since 2008. This has been followed by a period of significant reduction in government funding which is anticipated to continue for some time. Demands on local government services continue to increase.

In addition to reduction in government funding other pressures include:

- councils striving to constrain council tax increases,
- reductions of income,
- new service demands and responsibilities such as:
    - the localisation of non-domestic rates retention, and
    - council tax support
- severe weather and floods.

Furthermore, events such as the losses in Icelandic banks and the problems in global financial markets are likely to mean that Councils will focus on cautious investment strategies. Council budgets and reserves have remained under pressure and are likely to continue to do so for some time.

The many factors involved when considering appropriate levels of reserves can only be assessed properly at a local level. A considerable degree of professional judgement is required. The Director of Resources may choose to express advice on the level of balances in cash and/or as a percentage of budget (to aid understanding) so long as that advice is tailored to the circumstances of the authority. The Audit Commission Report (December 2012) *Striking a Balance* makes a number of recommendations to both Director of Resources and elected members to better assist councils in their decision making.

The advice should be set in the context of the authority's risk register and medium term plans and should not focus exclusively on short-term considerations. Balancing the annual budget by drawing on general reserves may be viewed as a legitimate short-term option. However, it is not normally prudent for reserves to be deployed to finance recurrent expenditure. CIPFA has commented that Councils should be particularly wary about using one off reserves to deal with shortfalls in current funding. Where such action is to be taken, this should be made explicit, and an explanation given as to how such expenditure will be funded in the medium to long term. Advice should be given on the adequacy of reserves over the lifetime of the medium term financial plan, and should also take account of the expected need for reserves in the longer term.

Events such as the floods and severe weather that occurred in recent years have emphasised the need for authorities to be prepared for major unforeseen events. Adequate insurance cover combined with appropriate levels of reserves will enable authorities to manage the demands placed on them in such circumstances. However, these arrangements need to take account of all possible scenarios. An example quoted in the Audit Commission report *Staying Afloat* is that the total cost of the flooding was reduced where authorities had specifically considered the impact of a wide scale, serious event affecting many assets, and had taken appropriate action, for example, negotiating insurance policies that capped the total excesses linked to one event.

Part of the risk management process involves taking appropriate action to mitigate or remove risks, where this is possible. This in turn may lead to a lower level of reserves being required, and it would be appropriate to consider reducing the level of balances held where appropriate action to mitigate or remove risks has been successfully undertaken. A balance will need to be found between maintaining adequate levels of reserves and investing in risk reduction measures. This balance should form part of the risk management process and be considered as part of the annual budget process.

Emergency financial assistance from central government may be available to assist authorities in dealing with the immediate consequences of major unforeseen events, normally under the Emergency Financial Assistance to Local Authorities scheme (commonly known as the 'Bellwin' scheme). However, there is no automatic entitlement to financial assistance, and where financial assistance is given, it will not cover all of the costs even in exceptional circumstances. Authorities should plan to have access to sufficient resources (through reserves, insurance or a combination of both) to cover the costs of recovering from events that are likely to be unavoidable.

When considering the level of reserves, it would be appropriate for authorities to take into account the likely level of Government support that would be available, and to consider how the balance would be funded in the event of an unforeseen event occurring.

Flooding, the effects of severe weather and the impact of the problems experienced by the global financial markets are examples of external risks which local authorities may need to take into account in setting levels of reserves and wider financial planning. An assessment of external risks should not be limited to those issues, but should range more widely, to take account of all significant external risks identified through the authority's risk management processes.

<u>Director of Resources Reporting</u>

The Director of Resources director has a fiduciary duty to local taxpayers, and must be satisfied that the decisions taken on balances and reserves represent proper stewardship of public funds.

The level and utilisation of reserves will be determined formally by the Council, informed by the advice and judgement of the Director of Resources. To enable the Council to reach its decision, the Director of Resources should report the factors that influenced their judgement, and ensure that the advice given is recorded formally.

Where the Director of Resources's advice is not accepted this should be recorded formally in the minutes of the Council meeting.

It is recommended that:

- the budget report to the Council should include a statement showing the estimated opening general reserve fund balance for the year ahead, the addition to/withdrawal from balances, and the estimated end of year balance. Reference should be made as to the extent to which such reserves are to be used to finance recurrent expenditure
- this should be accompanied by a statement from the Director of Resources on the adequacy of the general reserves and provisions in respect of the forthcoming financial year and the authority's medium term financial strategy
- a statement reporting on the annual review of earmarked reserves should also be made at the same time to the Council. The review itself should be undertaken as part of the budget preparation process. The statement should list the various earmarked reserves, the purposes for which they are held and provide advice on the appropriate levels. It should also show the estimated opening balances for the year, planned additions/withdrawals and the estimated closing balances.

Reserves Held

The Council will not hold a general reserve as this is accounted for within the General Fund balance. General reserves have no restriction on their use and can be used to smooth the impact of significant pressures across years, offset the budget requirement in year, and to mitigate the risks of unexpected events or emergencies. The restructuring reserve is used to smooth budget pressures over the medium term.

Earmarked reserves are usually created and held for one of the five main reasons below:

1. Service restructuring – to fund the costs of organisational changes so that the beneficial impact of savings achieved may be immediately realised in revenue budgets.
2. Renewals – to enable services to plan and finance an effective programme of equipment replacement and planned property maintenance. These reserves are a mechanism to smooth expenditure so that a sensible replacement programme can be achieved without the need to vary budgets.
3. Insurance – to meet the estimate of future claims to enable the Council to meet excesses not covered by insurance.
4. Losses – such as breaching the partial exemption VAT threshold, uninsured losses and other liabilities.
5. Other earmarked reserves will be set up from time to time to meet known or predicted liabilities, such as future predicted budget demand pressures.

The Council has the following financial reserves:

1. Medium Term Financial Plan Support reserve - budget support identified in the Medium Term Financial Plan.
2. Service Transformation - funds for service redesign and investment in efficiencies from the Budget Strategy; funds set aside for efficiency bids from services.
3. Renewals - revenue funds set aside for capital projects and cyclical renewal of major items.
4. Insurance - funds set aside for excesses payable over the medium term.
5. Losses - funds set aside for the partial exemption VAT threshold, the MMI scheme of arrangement and any uninsured losses.
6. Earmarked reserves - contingency reserve for the funds set aside to cover one-off items that are not set in the revenue budget; apprenticeships reserve for the funds set aside for the apprentice positions created by the Council; welfare support reserve for the funds set aside to support discretionary housing payments and external funding.

There are also ring-fenced reserves which are funds received and set aside in accordance with the grant funding source. These can only be used for specific expenditure and are not available for transfer or general use.

Holding Reserves

The Council recognises the need to hold and maintain reserves but also recognises the opportunity cost of holding balances as reserves. For this reason it is important to set out clearly, and regularly review, the framework through which reserves are managed.

The management of financial reserves is a key tool of the Council's overall strategy which has two key objectives:

- achieving stable and sustainable budgets throughout the medium term; and
- ensuring resources are effectively focussed on priorities.

Underpinning the achievement of these objectives is the recognition of the need to manage risk. This could be the increased risks of volatility in planning assumptions in uncertain economic times, or the risks to Government funding as a result of significant future funding reviews.

Building Reserves

The Director of Resources is authorised to annually review and recommend the appropriate level of revenue balances during the budget setting process and at the end of the financial year. The Director of Resources will take into consideration all relevant factors at the time of the review. The bases and reasons for recommending a certain level will be reported to committee as part of the budget setting process and/or as part of the final accounts reporting stage.

Earmarked reserves may be established, as part of setting the budget, for a specific purpose to be used in the future. Or they can be created at the end of the financial year if the final outturn allows the creation of a new reserve or the addition to an existing reserve. Adding funds into financial reserves is the responsibility of full Council.

Using Reserves

Revenue balances can be used to meet the cost of emergencies, unexpected events or un-budgeted statutory items. The Director of Resources can authorise this type of expenditure but must report it to committee at the earliest opportunity.

Revenue balances may be used to supplement un-budgeted but necessary expenditure that could impact on service delivery if not incurred. The Director of Resources can authorise this expenditure up to a limit of 1% of the net revenue budget after consultation with the Executive Director. The Director of Resources must also ensure that such expenditure would not have a detrimental effect on the overall finances of the Council.

Earmarked reserves can only be used for the purpose for which they were created. The Executive Committee, however, can change the use of the earmarked reserve if it so wishes or move funds between reserves but cannot increase the overall reserves of the Council.

Earmarked reserves created for general use must have the Executive Committee approval before they are used for a specific purpose. The Executive Committee, on the recommendation of the Director of Resources, can eliminate or reduce the funds in the earmarked reserves by adding them to the revenue balances.

Other Protocols

Any under spending on the revenue budget is not permitted to be carried forward to the following year. It will revert back to the revenue balance.

This policy will be subject to periodic review and approval by the Executive Committee and where necessary, full Council.

Minimum Reserves

The General Fund minimum balance for 2016-2017 has been assessed as £2.3m and should preferably be held above that level if possible.

The losses reserve also has a minimum level as the items that this covers are not included in the General Fund balance; these are different in nature and do not lend themselves to risk analysis, being fully payable when they are triggered. The losses reserve includes the partial exemption VAT threshold £171k, the MMI scheme of arrangement £210k and any uninsured losses £250k.

The Housing Revenue Account minimum level calculated differently to the General Fund. In previous years a blended risk factor of 5% has been applied to the gross expenditure (or gross income as it is a balanced budget). However, given the challenges that welfare reforms create for rent collection, it is prudent to increase the risk factor to 10%. This makes the 2016-2017 HRA minimum balance £1.2m.

The Housing Revenue Account has maintained balances above the minimum level for a number of years. The levels will be reviewed annually and for both the introduction of Universal Credit and the investment plans in the 30-year Business Plan.

The following Section sets out the calculation of the General Fund balance for 2016-2017 based on the estimated impact of the risks facing the Council and the likelihood of the financial impact if it materialises.

Risk Based Assessment of the Level of General Fund Balance

Risk Area	**Comments including any mitigation factors**		
Changes since the budget was set	Potential risk that things change since the budget estimates were made and the estimates are then under budgeted for.		
		Calculated Risk	
Specific Areas	**Estimated Exposure £**	**Likelihood Percentage**	**Balance Required £**
Staff pay	4,847,850	1%	48,478.50
Contractual inflation	6,603,620	1%	66,036.20
Utility inflation	704,150	1%	7,041.50
Total			**121,556.20**

Risk Area	Comments including any mitigation factors		
Income from areas within the base budget where the Council raises fees and charges	Potential risk that the budgeted level of income from activities where the Council is charging for services will not be achieved. This is anticipated largely to be as a result of a downturn in the economy, but could also be as a result of poor weather or new competition. All fees and charges income is reviewed as part of the monthly/quarterly budget monitoring process. All budgets are set based on previous experience and to reflect any new requirements.		
		Calculated Risk	
Specific Areas	**Estimated Income £**	**Likelihood Percentage**	**Balance Required £**
Car parking pay and display ticket sales	612,950	10%	61,295.00
Development and building control	405,100	10%	40,510.00
Land charges income	120,880	10%	12,088.00
Recycling income	574,210	20%	114,842.00
Indoor market	272,110	5%	13,605.50
Leisure income	828,130	10%	82,813.00
Commercial property income	1,208,830	5%	60,441.50
Total			**385,595.00**

Risk Area	Comments including any mitigation factors		
Demand led budgets	Potential risk that spending on parts of the budget where the Council has a legal duty to provide the service increases significantly. Individual budgets are reviewed as part of the budget monitoring process.		
		Calculated Risk	
Specific Areas	**Estimated Exposure £**	**Likelihood Percentage**	**Balance Required £**
Housing benefit maximum risk based on not meeting minimum threshold for Local Authority errors.	101,572.94	90%	91,415.65
Total			**91,415.65**

Risk Area	Comments including any mitigation factors		
Estimated balances required for any over spend or under recovery of expenditure and income	This calculation is based on the Council's net revenue budget and services to cushion the impact of uneven cash flows.		
		Calculated Risk	
Specific Areas	**Estimated Exposure £**	**Likelihood Percentage**	**Balance Required £**
Gross income	38,134,340	1.5%	572,015.10
Gross expenditure	40,009,580	1.5%	600,143.70
Total			**1,172,158.80**

Risk Area	Comments including any mitigation factors		
Other risks	Potential risk that savings will not be realised, that contract renewals require additional funding, that under-borrowing for cashflow purposes cannot be maintained and that Business Rates drop below the Safety Net.		
		Calculated Risk	
Specific Areas	**Estimated Exposure £**	**Likelihood Percentage**	**Balance Required £**
Service saving options	774,290	5%	38,714.50
Service saving options	502,605	40%	251,302.50
Major contract renewals	2,977,760	5%	148,888.00
Borrowing costs	1,345,850	2.89%	38,895.07
Safety Net for Business Rates	214,803	10%	21,480.30
Total			**499,280.37**

Calculated level of balance for General Fund based on risk	2,270,006.02
Minimum level of General Fund balance	**2,300,000**