



Llywodraeth Cymru
Welsh Government

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Guidance for Local Elected Members

Scrutiny of Local Authority Holding and Utilising of Reserves

January 2016

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Foreword

In November 2014, I wrote to all Council Leaders in Wales asking for details of their holdings of reserves. I also asked for information on their strategies for holding and utilising reserves as well as details of engagement of, and scrutiny by, Elected Members.

I expect Authorities to have the appropriate arrangements in place for internal and external challenge. Such arrangements should ensure reserves are used in the best way to drive forward the transformation of services which is needed to place public services on a sustainable basis for the longer term.

An overview of the findings from the analysis of the information provided was summarised in my Written Statement in February 2015 on Reserves held by Local Authorities in Wales. Of most concern to me was the apparent lack of opportunity provided for Elected Members to engage in and scrutinise the use of reserves held by their Authority.

In my view, the existing guidance for Members to undertake effective budget scrutiny does not go far enough in supporting scrutiny of reserves. This publication has been issued to Members to support them in this, and brings together a number of different sources of information in one place, along with a guide to interpreting financial indicators.

Leighton Andrews
Minister for Public Services

Section 1: Scrutiny of Reserves

The role of councillors

1. 'Raising the Stakes: financial scrutiny in challenging times' produced by the Centre for Public Scrutiny; sets out the need for financial scrutiny and the roles and responsibilities Councillors have to ensure their Council's finances are effectively managed, including the holding and use of reserves.
2. This note builds on that guidance, drawing upon other sources of data to allow Local Elected Members to satisfy themselves that decisions about holding and using reserves deliver best value for council tax payers.
3. Councillors have a fundamental democratic right, and a responsibility, to challenge officers about financial decisions. This provides council tax payers with confidence that such decisions are subject to the appropriate scrutiny and challenge.
4. It is the responsibility of each Chief Finance Officer / Finance Director to advise his or her Authority on the levels it should hold. Levels should be prudent and not excessive. In order to assess the adequacy of reserves, the chief finance officer should consider the strategic, operational and financial risks facing the Authority.
5. The many factors involved when considering adequate levels of reserves can only be assessed properly at a local level. A considerable degree of professional judgement is required. The chief finance officer may choose to express advice on the levels of reserves 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.
6. The Local Authority Accounting Panel (LAAP) suggests the advice chief finance officers provide to members 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 used to fund shortfalls in current funding.
7. Part of the risk management process involves taking appropriate action to mitigate or remove risks, where this is possible. It is important that members question whether this in turn may lead to a lower level of reserves being required. Where appropriate action to mitigate or remove risks has been successfully undertaken, it would also be appropriate to consider reducing the level of reserves to avoid unnecessary holding of reserves.

The role of audit committees

8. As set out in 'Raising the stakes: financial scrutiny in challenging times'; Councils have a statutory duty to operate an audit committee. Whilst audit committees have responsibility for ensuring the authority has adequate financial controls and complies with proper practices within the legislative framework, it is the responsibility of every Councillor to provide comprehensive financial scrutiny.
9. Scrutiny should review policies and outcomes and challenge the executive about its actions to deliver policy goals. Audit committees should provide assurance about financial controls to mitigate key risks and that the council has effective financial management arrangements.

Section 2: Definitions of Reserves

10. Local Authorities are responsible for ensuring they follow proper accounting practices. In relation to reserves the CPIFA *Code of Practice on Local Authority Accounting in the United Kingdom* (the Code) requires the Movement in Reserves Statement to be included as part of the local authority financial statements. This Statement presents the movement in the year of the reserves of the authority analysed into what is termed 'usable' and 'unusable' reserves.

Unusable Reserves

11. 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 briefly described as follows.

Revaluation Reserves

12. *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.
13. The *Available-for-Sale Financial Instruments Reserve* – this is a reserve that records unrealised revaluation gains arising from holding available-for-sale investments, plus any unrealised losses that have not arisen from impairment of the assets.

Adjustment Accounts

14. 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 proper accounting practices.
15. The *Capital Adjustment Account* - this is a specific accounting mechanism used to reconcile the different rates at which assets are depreciated and financed under proper accounting practice.
16. 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 General Fund.

17. The *Unequal Pay Back Pay Account* – this is a specific accounting mechanism used to reconcile the different rates at which payments in relation to compensation for previous unequal pay are recognised under proper accounting practice and are required by statute to be met from the General Fund.
18. 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.

Usable Reserves

19. Usable reserves are referred to as cash-backed reserves that can be used to fund future expenditure. Some reserves however will be subject to restrictions on their usage. These include Schools Reserves, Capital Grants Unapplied, Capital Receipts and Housing Revenue Account Reserves. A brief explanation of these different categories of reserves is provided below.

Schools Reserves

20. These are unspent balances of budgets delegated by the local authority to individual schools. There are specific regulations to deal with school balances which include a provision that a Local Authority should require a statement from the governing body on what it plans to do with surplus funds when they exceed 5% of the school budget or £10k, whichever is the greatest.

21. When unspent balances held by schools exceed £50k for primary schools or £100k for secondary schools and special schools, a Local Authority is able to direct schools to spend balances. The authority may, if the governing body does not comply with such a direction, require it to pay all or part of the surplus to the authority. If recovered, the funding must remain within the authority's budget for schools and so can only be reallocated amongst schools.

Capital Grants Unapplied Reserve

22. This account holds the grants and contributions received towards capital projects for which the authority has met the conditions set by the grant funding body. The funds will remain in this account until the expenditure to be funded by that grant has been incurred.

23. The funding will be restricted by the grant terms and conditions to be matched against eligible expenditure. It cannot be used to fund other expenditure or the authority could be required to pay the funding back.

Capital Receipts Reserves

24. This account holds the proceeds from the sale of assets and in accordance with regulations; these funds can only be used for capital purposes.

Housing Revenue Account Reserves

25. The Housing Revenue Account (HRA) is kept separate from other local authority income and expenditure streams, to ensure the council house rents are not used to subsidise general expenditure and prevent the general council tax payer

subsidising council housing. Therefore these funds set aside as reserves can only be used to fund expenditure relating to the HRA.

Unallocated / General Reserves

26. This is a working balance to help cushion the impact of uneven cash flows to avoid unnecessary temporary borrowing and to provide a contingency to cushion the impact of unexpected events or emergencies.
27. There is no prescriptive guidance on minimum or maximum reserves. Section 26 of the Local Government Act 2003 gives Ministers in England and Wales a general power to set a minimum level of reserves for local authorities; however this has not been applied to authorities in Wales.
28. The Chartered Institute of Public Finance and Accounting (CIPFA), the main body supporting the local authority finance profession, advises that each Local Authority, on the advice of its finance director, should make its own judgements on such matters taking into account all the relevant local circumstances.
29. CIPFA issues regular bulletins to assist local authority practitioners to apply the requirements of the accounting codes. A bulletin issued in July 2014 provided advice on Local Authority Reserves and Balances. It reminded authorities of the legislative and regulatory framework and the role of the Chief Finance Officers in assessing the adequacy of reserves. The advice suggests that in assessing the adequacy of unallocated general reserves when setting the budget, the authority should take account of strategic, operational and financial risks facing it.
30. The Wales Audit Office report indicated that 50 percent of Local Authorities in Wales set minimum reserve levels in respect of their general fund balances. The majority of which do so in percentage terms typically ranging between three and five percent of net revenue expenditure. Those authorities who do set a minimum level indicate that, whilst only a guide, it helps in terms of reporting levels of general fund balances to Members and is only used as a benchmark indicator.
31. The Wales Audit Office suggest that Members should establish minimum levels annually, based on the strategic, operational and financial risks facing the authority on advice from the Chief Finance Officer.

Earmarked Reserves

32. These reserves are a means of building up funds to meet known or predicted requirements. Earmarked reserves are accounted for separately but remain legally part of the General Fund.
33. Reviews completed by the Wales Audit Office in 2012 and more recently by the Welsh Government, identified varying levels of disclosure and clarity about the purpose, use and expected timing of earmarked reserves as part of their statutory

accounts. Given this is taxpayers' money, it is reasonable to expect authorities to provide sufficient information to assist readers of the accounts in interpreting these reserves.

34. Earmarked reserves common amongst local authorities include insurance reserves which have been set up to meet uninsured risks and mitigate the impact of potential claims. Self-insurance is a mechanism used by a number of authorities but the levels should be continually reviewed to ensure the amounts set aside are a realistic estimate based on sound rationale.
35. The Audit Commission in 'Striking a balance', suggested that any reserves held for purposes that are hard to predict should be based on an up-to-date risk assessment that reflects local circumstances. This will avoid tying up funds which may be used for other purposes or part of the general reserve.
36. Other common reserves include funding for PFI contracts, Invest to Save, redundancy schemes or specific capital programmes. One example of a capital programme is the 21st Century Schools programme to meet authorities' share of investments in building new schools.
37. The levels of usable reserves reported as part of the Whole of Government Accounts by local authority are routinely published on the Welsh Government website and can be found at:
<http://gov.wales/topics/localgovernment/finandfunding/wholegovaccounts/publications/whole-government-accounts-reserves/?lang=en>
38. This information will allow comparisons to be made across all Local Authorities in Wales.

Periodical Reviews of Reserves

39. It is important all councils undertake periodical good-quality review of reserves which considers:
 - the rationale for keeping each reserve, with reference to the council's future spending plans
 - the funds needed – including an expected minimum and maximum for risk-based reserves; and
 - how long reserves have been held, and projections for using them, which should then be monitored
40. Regular reviews are important given that councils which earmark reserves for spending that is uncertain – in timing or cost – risk holding more than necessary as the spending needs may never arise, or may cost less than the sum set aside.

Protocols for the management of reserves

41. Due to the nature of the restrictions applied to the accounts detailed above there is limited opportunity to challenge the levels held by authorities in relation to these funds. Therefore the scrutiny role should place greater focus on general and earmarked reserves.
42. When reviewing their medium term financial plans and preparing their annual budgets, Local Authorities should consider the establishment and maintenance of reserves. Authorities have been encouraged to develop protocols for establishing, maintaining and discharging general and earmarked reserves to increase accountability and transparency for reserves.
43. As set out in 'Local Authority Reserves and Unsupported Borrowing – Research Paper for Welsh Government' commissioned from the Wales Audit Office in July 2012, such protocols include the contents shown as follows.

Contents of protocols for the management of reserves

Protocol for general reserves	Protocol for earmarked reserves
<ul style="list-style-type: none"> • Who is involved in decision making and review? • Who is responsible for ensuring decisions are implemented? • What risks need to be covered? • When will the general reserve be reviewed? • When to increase or decrease the general reserve? • How much will be held in general reserves? • How will information about general reserves be reported? 	<ul style="list-style-type: none"> • Who is involved in decision making and review? • Who is responsible for ensuring decisions are implemented? • For what purposes earmarked reserves will be held? • What risks need to be covered when establishing, reviewing and utilising earmarked reserves? • When earmarked reserves will be established. • When earmarked reserves will be reviewed. • When to use or close an earmarked reserve. • When to replenish an earmarked reserve • How will information about reserves be reported?

Section 3: Financial Indicators – Reserves

44. The comparison of information on reserves across authorities can assist Councillors in their scrutiny function.
45. The Welsh Government publication ‘Local Authority Financial Indicators, Wales’ presents some key indicators including some on reserves which provide insights into the historic performance of authorities in Wales. The report makes clear these indicators are not intended to be measures of good or poor performance but to be used by Elected Members, taxpayers and auditors to allow benchmarking, scrutiny and challenge of authority finances.
46. This information can be found on the Welsh Government website at: <http://gov.wales/topics/localgovernment/finandfunding/wholegovaccounts/publications/local-authority-financial-indicators/?lang=en>
47. The financial indicators publication includes three indicators for the reserves of Local Authorities. These are;
- Usable reserves as a percentage of gross revenue expenditure,
 - Earmarked reserves as a percentage of gross revenue expenditure
 - General reserves days turnover.
48. These measure the level of funds authorities are retaining for future plans and unforeseen expenditure. A brief explanation of each of these indicators is set out below.

Usable reserves as a percentage of gross revenue expenditure

49. This indicator measures the relationship between an authority’s usable reserves and its annual gross revenue expenditure. This excludes those reserves which are restricted for use by the authorities as indicated previously (ie. HRA balances, schools balances and capital grants unapplied). Those reserves included in the indicator are:
- General or Unallocated Reserves
 - Capital Receipts Reserves
 - Earmarked Reserves.
50. If an authority has a high percentage for this indicator, it suggests it holds high levels of reserves relative to its expenditure levels. The next two indicators provide an indication of whether this is a result of high levels of reserves being held for general or earmarked purposes, or both.

Earmarked Reserves as a percentage of gross revenue expenditure

51. This measures the relationship between an authority's earmarked reserves and its annual gross revenue expenditure.
52. This could be an indication of reserves increasing proportionately more than gross revenue expenditure or vice versa.
53. Councils need to ensure that these reserves remain adequate for planned future needs and contingencies without placing undue constraints on current expenditure.
54. Councils with very high levels of earmarked reserves relative to their spending should review the purposes for which these are held to ensure they are still required. The purposes for holding reserves, particularly where reserves are increasing, should be clearly communicated in presentation to the Council and through the annual accounts.

General Reserves days turnover

55. While the equivalent indicator for general reserves is also relevant, an alternative indicator is general reserves days' turnover. This indicator measures the number of days an authority would have financial cover if it needed to utilise solely general reserves to fund day to day expenditure.
56. General reserves are intended to provide a working balance to help cushion the impact of uneven cash flows and a contingency for unexpected emergencies. An authority with a substantial amount of days cover suggests the authority adopts a low-risk strategy by ensuring it has sufficient funds available to meet any immediate funding needs. An authority with a low number of days cover, suggests it adopts a higher risk strategy. This may be from choice or, possibly due to lack of other funds.
57. An authority which has a high value for these indicators suggests it would be quite well-buffered with funds in reserves. This means it should have little difficulty meeting short-term spending needs and would not need to resort to long-term borrowing to finance future investment projects unless it chooses to do so. In comparison, an authority which has low levels of reserves could potentially be dependent on long-term borrowing to fund expenditure as it does not have the fall back on reserves to meet future large-scale investment projects.

Section 4: 'Striking a balance – Improving councils' decision making on reserves'

58. In December 2012, the Audit Commission issued a report 'Striking a balance – Improving councils' decision making on reserves'. This report presented findings from research undertaken during 2012 on the levels of reserves that councils held and on the decisions councils made relating to them.

59. This report contained a number of recommendations intended to help improve councils' decision making around reserves. The following is an extract from that report detailing the recommendations and questions to help Elected Members.

Recommendations

60. To better assist Elected Members in their decision making, chief finance officers should provide them with:

- information showing the current level of reserves, relative to spending; how reserves have changed over time; and how reserves compare with those held by councils facing similar circumstances;
- details of the forward strategy for reserves needed to support the council's medium and long-term spending plans;
- information that shows clearly the interaction between the council's planned spending, income, movements on reserves and council tax;
- a clear summary of the financial risks facing the council; how it will mitigate these risks, including any contingency within the council's budget; and the minimum and maximum level of residual risk for which the council may need to hold funds in its reserves;
- an explanation of the purpose and level of any earmarked reserves, clarifying which are earmarked at the council's discretion and their expected timescale for use; and
- accurate forecasts, during the year, of variation from budget and the expected effect of over or underspending on reserves at the end of the financial year.

Elected Members should:

- request and make use of information that will enable them to assess the adequacy and necessity of reserves; monitor change in reserves over time, relative to spending; and understand how reserves compare with those held by councils facing similar circumstances;
- ensure that reserves held to protect against financial risks are set prudently; and are informed by an up-to-date, comprehensive risk assessment, which takes account of other risk mitigation measures, including any contingency within the council's budget;
- review the purpose, level, historic use and planned use of other reserves annually, to ensure they are still necessary to support medium and long-term spending plans;
- examine the causes of variation between planned and actual changes in reserves, especially where variations are large, or where in-year budget monitoring has not accurately forecast the year-end position on reserves;
- ensure the council provides clear information about the level of reserves and their purpose in published budget information as well as in their annual statement of accounts.

Questions to help Elected Members

61. Elected Members are responsible for agreeing the level of reserves when setting the council's budget and for scrutinising unplanned movements on reserves when councils are closing their accounts.

62. The following questions are intended to help Elected Members gather information that will assist them in their decision making and scrutiny roles.

How much is held in reserves	
<p>1. How much does the council have in its reserves – in cash terms and relative to spending?</p> <ul style="list-style-type: none"> How do total reserves compare with those held by councils facing similar circumstances? 	
<p>2. How have reserves changed in recent years – in cash terms and as a percentage of spending?</p> <ul style="list-style-type: none"> How do changes compare with those made by councils facing similar circumstances? 	
What reserves are held for	
<p>3. What are the risks or future spending plans for which the council is holding reserves?</p>	
<p>4. What proportion of reserves is:</p> <ul style="list-style-type: none"> Held to cover short-term financial risk? Held for medium and long-term risks or spending plans? Ring-fenced income that can only be used for specific purposes? 	
<p>5. Are the levels of the council's different reserves appropriate to the risks it faces and the scale of its future spending plans?</p>	
<p>6. How is the need for reserves determined?</p> <ul style="list-style-type: none"> At what point(s) in the financial year is the need for reserves assessed? When was the need for reserves last assessed? 	

Contingency funds

7. Apart from reserves, what, if any, funds does the council hold, corporately or within service budgets, to provide protection against unplanned costs?

The relationship between reserves and council tax

8. Is the interaction between spending, income, movements on reserves and council tax clear to Elected Members and the public?

Unplanned movements on reserves

9. In each of the last three years, what difference has there been between the movements on reserves the council expected when setting its budget and the movements that occurred when closing the accounts (as a percentage of spending)?

- How much variation was the result of factors within the councils control?
- What can the council learn to improve the accuracy of future budget projections and financial management?
- Are any adjustments needed to correct unplanned movements on reserves?

Information for decision making

10. Does advice from the chief finance officer on the adequacy of reserves make clear what reserves are needed and why?

11. Do Elected Members need any additional support to make informed decisions on the level of reserves?

References

1. Audit Commission 2012, ***Striking a balance, improving councils' decision making on reserves***
2. Centre for Public Scrutiny 2014, ***Raising the Stakes: financial scrutiny in challenging times.***
3. Wales Audit Office 2012, ***Local Authority Reserves and Unsupported Borrowing – Research paper for Welsh Government.***
4. CIPFA Local Authority Accounting Panel (LAAP) 2014, ***LAAP Bulletin 99, Local Authority Reserves and Balances.***
5. Leighton Andrews AM, Written Statement 2015, ***Reserves Held by Local Authorities in Wales***
6. Audit Commission 2014, ***Interpreting the accounts, a review of local government financial ratios 2007/08 to 2012/13***
7. Welsh Government 2015, ***Local Authority Financial Indicators, Wales***