

Striking a balance

**Improving councils' decision
making on reserves**

December 2012

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We also compare data across the public sector to identify where services could be open to abuse and help organisations fight fraud.

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Summary

1 This report presents the Audit Commission's findings from research undertaken during 2012 on the level of reserves that councils hold and on the decisions councils make relating to them.

2 Reserves are an essential part of good financial management. They help councils cope with unpredictable financial pressures and plan for their future spending commitments. The level, purpose and planned use of reserves are important factors for elected members and council officers to consider in developing medium-term financial plans and setting annual budgets.

3 In setting its budget, a council decides what it will spend and how much income it needs from fees, charges and council tax to supplement government funding. A council may choose to fund some of its spending from its reserves, or set aside some of its income to increase reserves for future spending. Whatever it chooses, the decision affects local taxpayers and service users.

4 Having the right level of reserves is important. Where councils hold very low reserves, there may be little resilience to financial shocks and sustained financial challenges. Where reserves are high, councils may hold more than they need.

5 There is no set formula for deciding what level of reserves is appropriate, too low or too high – councils are free to determine the reserves they hold. Elected members are responsible for ensuring that their council's reserves are appropriate for local circumstances, and are accountable to taxpayers for the decisions they make. Chief finance officers have a duty to provide elected members with the advice they need to make good decisions.

6 Following a sustained period of growth in public spending, councils face significant financial challenges. A 26 per cent reduction in government funding from 2010/11 to 2014/15, constrained council tax increases, a decline in other income, rising costs and growing demand for many services are all testing councils' financial management and resilience.

7 Further changes in council funding are due to take effect from April 2013, with the introduction of local business rates retention and new arrangements for providing council tax support. The impact of

these changes, and the level of further funding reductions in 2015/16 and 2016/17, is not yet known, but many councils expect their funding will reduce.

8 These current and future financial challenges pose significant, and increasing, risks for councils and present them with competing priorities in their strategy for reserves. They can:

- use their reserves to offset funding reductions and protect services – although, as reserves are a finite resource, this can only be a short-term strategy – or invest in making changes that reduce the cost of providing services in the long term; or
- increase reserves to strengthen resilience against future, uncertain cost pressures.

9 English councils held £12.9 billion in their reserves at 31 March 2012. Councils had earmarked £9.9 billion of their reserves for specific purposes, although we found earmarking does not always mean there is a plan for spending the funds.

10 There were wide variations in the level of councils' reserves that cannot be explained by contextual factors. This suggests that variations are the result of councils' different decisions about what they believe they need to hold in reserves, based on their future plans and perceptions of risks.

11 Single-tier and county councils held most of the reserves: £10.9 billion in 2012, of which £8.6 billion was earmarked. District councils held reserves of £2.0 billion. District councils generally have much higher reserves relative to their spending and are less likely to earmark them.

12 Councils' reserves increased by £4.5 billion from 2006/07 to 2011/12 – 36 per cent in real terms. Single-tier and county councils accounted for most of the increase, but 77 per cent of all councils have increased reserves, relative to spending, over this period.

13 Councils' budgets for 2012/13 show them planning to reduce reserves by a total of £0.4 billion. But more councils plan to increase their reserves in 2012/13 than planned to do so in any of the preceding three years.

14 Our analysis shows that councils often have higher reserves at the end of the year than they plan, as their spending is lower or income higher than their budgets anticipate. Variation from plans is generally greater for district councils. Councils need to understand the factors that contribute to unplanned growth in reserves and correct or explain unplanned additions to reserves at the earliest opportunity.

15 For councils in our research, recent planned increases in reserves were commonly a response to concerns, or uncertainty, around the level of future funding for services and the council's ability to deliver further savings.

16 In our review of councils' budget documentation and interviews with chief finance officers, we found that all councils were actively considering the need for, or use of, reserves in relation to their current and future risks and spending plans. However, councils took different approaches to assessing the need for reserves and reviewing the reserves they held. Information used in decision making was also of variable quality.

17 All councils, we found, could improve decision making in at least one of the following areas:

- undertaking a good-quality, annual review to ensure the purpose and level of reserves align with medium-term financial plans;
- being clear about the reasons for earmarking reserves and ensuring that earmarked reserves are sufficient, but not excessive;
- ensuring that reserves held to mitigate financial risk are set on the basis of an up-to-date assessment of factors affecting income and spending projections, and reflect the degree of contingency built into the budget;
- making sure that the advice that chief finance officers provide to elected members on the adequacy of reserves includes a clear and well-evidenced summary of issues to be considered in decision making;
- monitoring the level and use of reserves over recent years, and comparing the council's approach with others facing similar circumstances;
- ensuring elected members and the public have clear information showing the interaction between changes in the level of reserves and council tax;
- improving budget monitoring and forecasting to give elected members greater awareness of likely year-end movements on reserves; and
- examining the reasons for significant, or unexpected, budget variations and taking corrective action where necessary.

18 Given the sums involved, and the current financial challenges, councils should focus more attention on their reserves and the purposes for which they hold them. All councils should ensure that their decisions have been clearly explained to taxpayers and service users. This is especially important where councils continue to set aside funds for the benefit of future taxpayers and service users.

Recommendations

19 The following recommendations are intended to help improve councils' decision making around reserves.

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;ⁱ
- 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; and

ⁱ The Financial Resilience section of the Audit Commission's [Value for Money Profiles](#) tool can assist councils to compare reserves over time and with other councils.

- 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

20 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.

21 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? 	

5 Are the levels of the council's different reserves appropriate to the risks it faces and the scale of its future spending plans?

6 How is the need for reserves determined?

- At what point(s) in the financial year is the need for reserves assessed?
 - When was the need for reserves last reassessed?
-

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 of the variation was the result of factors within the council's 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?

Chapter 1: Introduction

22 Councils, in common with other organisations, need financial reserves to help manage unforeseen circumstances and to smooth the impact of known spending requirements over time. Reserves enable councils to:

- manage variations between their planned and actual budgets that result from unpredictable spending and income; and
- plan their finances strategically to support their activities over the medium and long term.ⁱ

23 The amount that councils need or choose to hold in their reserves varies according to local circumstance. Elected members are responsible for deciding what reserves their council holds when setting the budget; informed by their longer-term spending plans. Chief finance officers have a duty to provide members with advice to support their decision making.ⁱⁱ

24 This report builds on the analysis of reserves in our 2011 and 2012 reports on councils' responses to current financial challenges (Refs 2 and 3). It looks in more detail at what reserves councils hold and councils' decision making about reserves. It aims to help elected members understand:

- the national picture on reserves and how they have changed;
- the context in which decisions on reserves need to be considered; and
- the key questions members should seek to answer as they set, or scrutinise, the reserves held by their council.

25 The findings will also be of interest to chief finance officers. We make recommendations on how they could best support elected members' decision making.

26 The report is based on research we undertook between February and September 2012, including national data analysis, a review of 40 councils' budget documents and interviews with ten chief finance officers. Appendix 1 outlines our research approach.

ⁱ Councils also use reserves to generate investment income and defer external borrowing to secure financial savings. The Audit Commission reported on local authority treasury management in 2009 (Ref 1).

ⁱⁱ Section 25 of the Local Government Act 2003 requires local authority chief finance officers to report to elected members on the robustness of budget estimates and the adequacy of reserves; and elected members to have regard to the chief finance officer's report in making their decisions.

How we refer to reserves in this report

27 Councils use different terms to refer to their reserves depending on why they hold them. The terms we use in this report have the following meanings:

- earmarked reserves – funds councils choose to set aside to meet known or predicted future spending, or ring-fence to comply with financial regulations;
- unallocated reserves – working balances to manage cash flows, funds to protect annual budgets against multiple, less predictable, costs and uncommitted accumulated surpluses; and
- total reserves – the sum of earmarked and unallocated reserves.ⁱ

28 In practice, councils take different approaches to earmarking. Some councils hold earmarked reserves for contingent spending that is hard to predict – for example, self-insurance funds to cover the cost of property damage, or reserves to cover shortfalls in investment income. We also, therefore, use the term ‘risk-based reserves’ to refer to earmarked or unallocated reserves held to cover contingent spending.

29 Reserves, of whatever type, are distinct from:

- contingency funds, which some councils hold within their annual revenue budgets to provide a degree of flexibility around spending; and
- provisions, which councils make in their accounts for financial liabilities of uncertain timing or amount that have already been incurred (Ref 4).

Why councils have to hold reserves

30 How councils are funded and the rules governing their spending make reserves essential to their strategic financial and risk management.

Funding

31 Central government sets and provides the majority of councils’ fundingⁱⁱ in the form of grants and redistributed business rates.ⁱⁱⁱ Within constraints set by government, and subject to local circumstances, councils can raise extra income to support their spending by:

- setting and collecting council tax;
- charging for some services to recover costs;
- trading through companies; and
- earning interest on investments.

ⁱ Our analysis excludes schools’ reserves held by councils.

ⁱⁱ The proportion of individual councils’ spending funded by government varies from 16 to 76 per cent of revenue spending (Ref 3).

ⁱⁱⁱ From April 2013, councils will retain a proportion of locally collected business rates, as provided for in the Local Government Finance Act 2012.

32 By setting aside surplus income in reserves in some years, councils can reduce their need for income, or spend more than their income, in others.

Ring-fenced income

33 Councils must spend some of their income on specific purposes, for example, some ring-fenced grants, or property developers' contributions to local environmental improvements. Spending ring-fenced income before the end of a financial year is not always possible or desirable. Councils can carry forward unspent ring-fenced income from one financial year to the next in their reserves.

Delivering a balanced budget

34 The Local Government Finance Act 1992 requires billing and precepting authorities to calculate their expected outgoings and income for the year – including any additions to or use of reserves.ⁱ Where expected outgoings exceed expected income, the difference is the authority's council tax requirement for that year.ⁱⁱ

35 Councils that incur unplanned costs during the year that are not funded externally – for example, by a grant from government or an insurance policy – or experience a shortfall in expected income, have few choices if they are to deliver their budget. Raising extra income or making in-year savings may have an unacceptable impact on service users. As an alternative, councils can use their reserves to balance spending and income.

The context for councils' decisions on reserves

36 Following a sustained period of growth in public spending, councils face significant financial challenges over the medium term. A 26 per cent reduction in government funding from 2010/11 to 2014/15 (Ref 3); a decline in other income due to the recession; rising costs; and growing demand for many services, are all testing councils' financial management and resilience.

37 Council tax increases are also being constrained.

- In 2011/12, the government offered grant funding to local authorities that froze or lowered council tax. The grant was equal to a 2.5 per cent increase on the 2010/11 level; payable for four years. All local authorities accepted the grant.
- In 2012/13, the government offered a further council tax freeze grant equal to a 2.5 per cent increase; payable for one year.

ⁱ Sections 31A and 31B relate to billing authorities. Sections 42A and 42B relate to precepting authorities.

ⁱⁱ Sections 85 and 86 of the Greater London Authority Act 1999 require the GLA to calculate component and consolidated council tax requirements.

Eighty-five per cent of local authorities accepted the grant. The Localism Act 2011 required authorities that increased council tax by more than 3.5 per cent in 2012/13ⁱ to hold a referendum that would allow residents to approve or veto the rise. No councils exceeded this limit.

- For 2013/14 the government has offered grant funding equal to a 1 per cent council tax increase, payable for two years. The threshold to trigger a local referendum will be 2 per cent for 2013/14.

38 Further changes in councils' funding are due to take effect from April 2013. The Local Government Finance Act 2012:

- provides for the partial retention by councils of locally collected business rates to replace some government fundingⁱⁱ – this means that future changes in funding will be linked to changes in the local business rates base, rather than to government assessments of need (Ref 5); and
- transfers responsibility for council tax support to councils. The government will give councils grants equal to 90 per cent of the council tax benefit previously paid in each area and require councils to make their own arrangements for council tax support (Ref 6). Pensioners' entitlement will be set nationally.

39 Councils do not yet know what the full impact of these changes will be on their income. There is also uncertainty about the level of further funding reductions that might result from the government's deficit reduction plans for 2015/16 and 2016/17 (Ref 7). Many councils expect their funding will reduce.

40 Looking further ahead, there are concerns about the growing demands being placed on social care services by the ageing population. The Local Government Association predicts that, by 2019/20, without fundamental changes in the way councils operate, there will be a 29 per cent shortfall between councils' revenue and the spending pressures they face (Ref 8).

41 These financial challenges are leading many councils to hold on to, or build up, their reserves to provide financial resilience in years to come.

ⁱ 3.75 per cent in the City of London.

ⁱⁱ Under the new system, subject to certain constraints and protections, councils will be directly affected by the yearly variations in local business rates yield that are currently managed through national pooling and redistribution.

42 But councils also face an immediate pressure – from government (Refs 9 and 10), the media and local taxpayers – to spend some of their reserves now to:

- finance spending in the short termⁱ to avoid reductions in services or increases in council tax, fees and charges; or
- invest in making the changes, such as organisational restructuring, needed to deliver future savings; and to finance gaps between income and spending before new ways of working deliver anticipated savings.

43 Each council needs to balance these competing pressures within the context of their annual budget setting and medium-term financial planning. Variation in the size of councils' reserves, and the differing financial challenges they face – for example, the extent to which councils rely on government funding as a source of income and the differing scale of their funding reductions (Ref 3) – make this a more difficult balancing act for some than for others.

44 There is no set formula for determining the level of reserves that each council should have, and no consensus on what is appropriate, too low or too high. The Chartered Institute of Public Finance & Accountancy (CIPFA), however, provides guidance on the strategic, operational and financial considerations that councils should take into account when deciding a prudent level of reserves (Ref 4).

45 Where reserves are low, councils may have too little protection against one-off financial shocks, or sustained budgetary pressures. In 2011 (Ref 2), and again in 2012 (Ref 3), auditors were more likely to be concerned about budget delivery in councils with lower levels of reserves relative to spending. Where reserves are high, councils may be holding more in their reserves than they need.

46 Given the sums involved, the risks for councils of having insufficient reserves, and the opportunity cost of holding excessive reserves, it is essential that councils' decisions on reserves are communicated clearly to local taxpayers to promote accountability. As a minimum, councils are required to identify the level of earmarked and unallocated reserves, and changes made to these during the year, in their annual statement of accounts (Ref 11).

ⁱ Funding recurrent spending from reserves is not normally considered prudent. Councils must consider how services funded from finite reserves will be funded when reserves are no longer available.

Chapter 2: What councils hold in reserves

47 At 31 March 2012, English councils held total reserves of £12.9 billion (Table 1).ⁱ This was equal to 31 per cent of their total net revenue spending in 2011/12.ⁱⁱ Overall, councils identified 76 per cent of their reserves – £9.9 billion – as earmarked for specific purposes.

Table 1: **Councils' reserves at 31 March 2012**

Type of council	Total reserves £bn	Total reserves as a % of total net revenue spending 2011/12	% of total reserves earmarked for specific purposes
Single-tier and county councils	10.9	28	78
District councils	2.0	75	64
All councils	12.9	31	76

Source: Audit Commission analysis of DCLG provisional revenue out-turn (RO) data

Total reserves

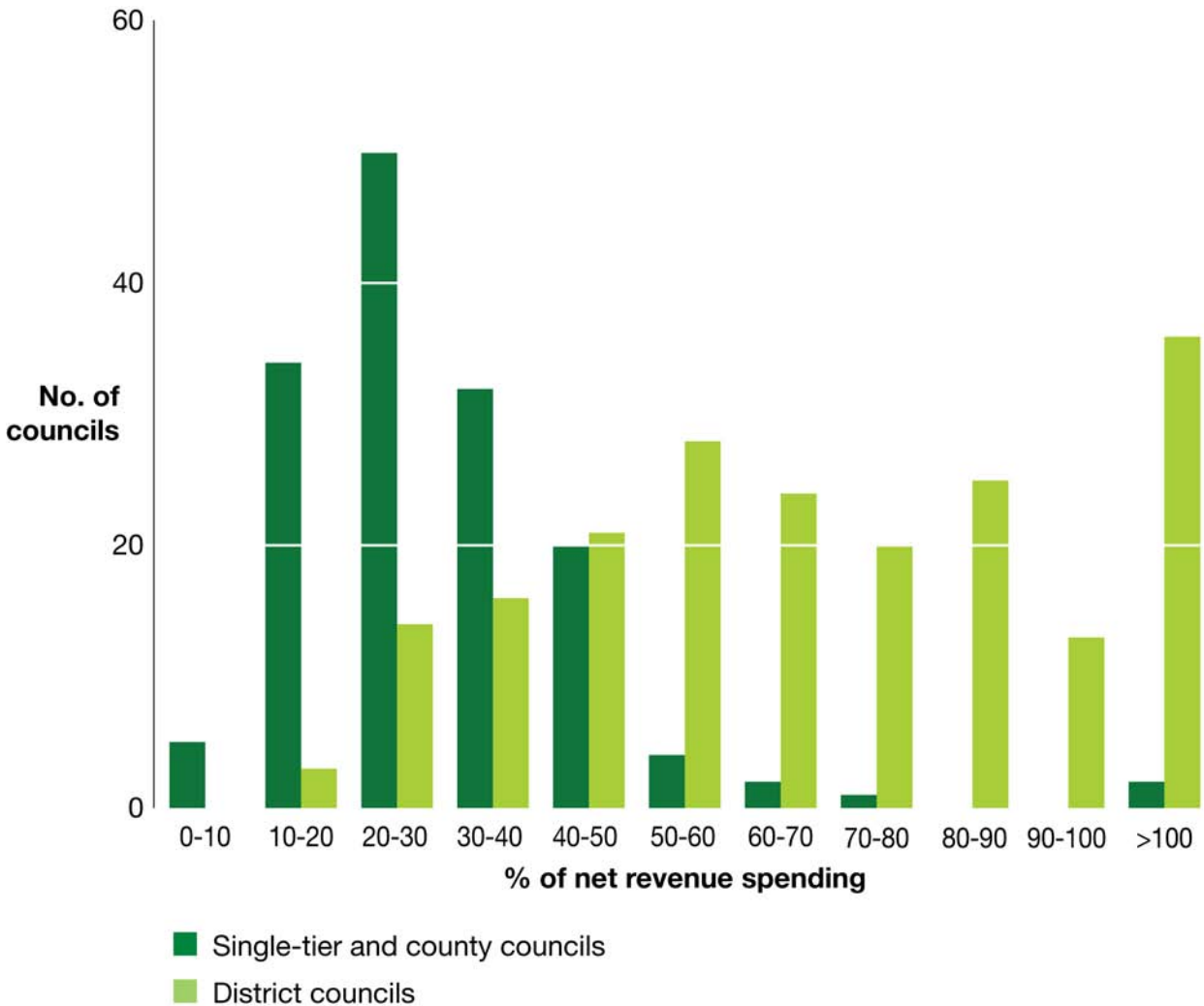
48 Relative to their spending, district councils have higher reserves, on average, than single-tier and county councils.

49 There are also variations in the level of reserves held by councils within these groups (Figure 1). These variations cannot be explained by contextual factors, such as the funding councils receive or the

- ⁱ The Department for Communities and Local Government (DCLG) provisional revenue out-turn (RO) data show English councils held total reserves of £13.5bn. Our analysis excludes three authorities with outlying data – City of London, Council of the Isles of Scilly and Woking Borough Council – which held total reserves of £0.2 billion. We have made adjustments to data for other councils which account for a further minus £0.4 billion variance from the provisional RO data. Other local authorities held total reserves of £3.4 billion.
- ⁱⁱ It is common practice to contextualise councils' reserves with reference to their annual spending. This gives an indication of the level of financial resilience that reserves provide, and enables standardised comparisons to be made between councils and over time. In this report we relate councils' reserves to their net revenue expenditure.

demands they face. This suggests they are largely the result of the decisions that councils make about what they believe they need to hold in reserves, based on their different future plans and perceptions of external and internal risks.

Figure 1: **Total reserves at 31 March 2012 as a percentage of net revenue spending 2011/12**



Source: Audit Commission analysis of DCLG provisional RO data

Single-tier and county councils

50 At 31 March 2012, single-tier and county councils had total reserves between 8 and 106 per cent of their net revenue spending – with a median value of 27 per cent.

51 Three per cent of councils held total reserves below 10 per cent of their net spending. Six per cent held reserves that exceeded 50 per cent of net spend. One per cent had reserves that exceeded net spending (Figure 1).

District councils

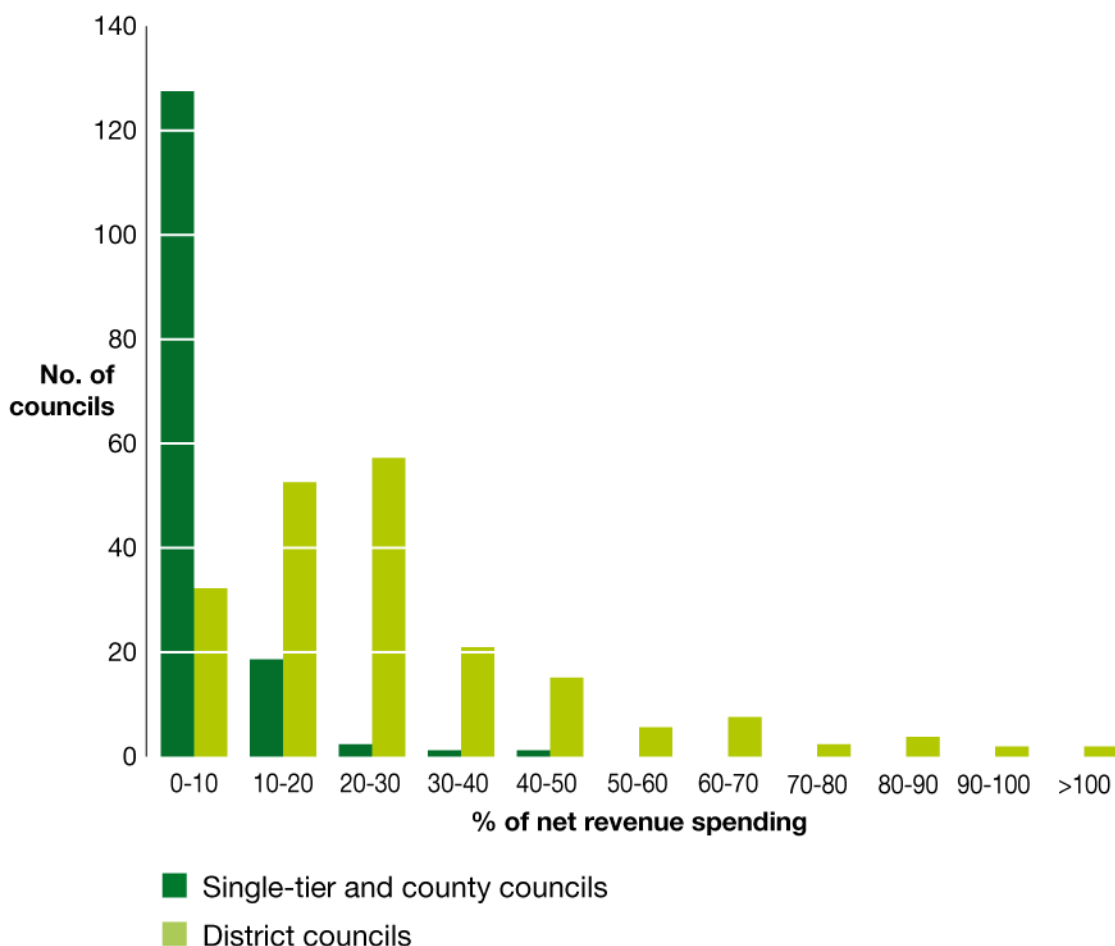
52 At 31 March 2012, district councils had total reserves between 17 and 343 per cent of their net revenue spending – with a median of 67 per cent.

53 No councils held total reserves below 10 per cent of their net revenue spending. Seventy-three per cent held reserves that exceeded 50 per cent of net spend. Eighteen per cent had reserves that exceeded net spending (Figure 1).

The balance between earmarked and unallocated reserves

54 There was also variation in the amount of reserves that councils held as earmarked or unallocated, particularly among district councils (Figure 2).ⁱ

Figure 2: **Unallocated reserves at 31 March 2012 as a percentage of net revenue spending 2011/12**



Source: Audit Commission analysis of DCLG provisional RO data

ⁱ Councils' different approaches to earmarking limit the usefulness of direct comparison.

Single-tier and county councils

55 Overall, single-tier and county councils identified £8.6 billion, 78 per cent, of their reserves as earmarked in 2011/12. Unallocated reserves in individual councils ranged from 0 to 40 per cent of net revenue spending – with a median of 5 per cent.

56 Eighty-five per cent of single tier and county councils had unallocated reserves below 10 per cent of their net revenue spending (Figure 2).

District councils

57 Overall district councils identified £1.3 billion, 64 per cent, of their reserves as earmarked in 2011/12. Unallocated reserves in individual councils ranged from 0 to 226 per cent of net revenue spending – with a median of 22 per cent.

58 Sixteen per cent of district councils had unallocated reserves below 10 per cent of their net spending. Twelve per cent had unallocated reserves exceeding 50 per cent of their net spending. One per cent had unallocated reserves that exceeded net annual spending (Figure 2).

The purposes for which councils hold reserves

59 Councils we looked at held reserves to fund a wide range of contingent and planned spending needs (Table 2).

Table 2: **Purposes for which councils held reserves**

Contingent spending	Medium and long-term plans
<ul style="list-style-type: none">■ Additional spending due to higher than expected service demand■ Lower than expected income – for example, from investments or council tax■ Uninsured losses from hard-to-predict events – for example, storms, floods, terrorism■ Uninsured legal liabilities – for example, personal injury claims■ Inability to deliver planned savings■ Higher than expected inflation – for example, on fuel, energy and salaries■ Higher than expected borrowing costs	<ul style="list-style-type: none">■ Organisational restructuring – for example, redundancy and pension costs■ Smoothing expected gaps between income and spending over the life of the medium-term financial plan■ Investing in initiatives to deliver savings■ Long-term contract costs – for example, waste management■ Repair or replacement of assets – for example, buildings, vehicles and IT equipment■ Other cyclical spending – for example, running local elections

Source: Audit Commission review of councils' budget documentation

60 We examined the information published in 2011/12 financial statements by 20 randomly selected councilsⁱ to quantify the amounts they held in their reserves for different purposes.ⁱⁱ The information councils provided was limited in some cases to just the name of the reserve. This made it difficult to know in all cases what councils intended to do with the funds.

61 On the basis of the information available we concluded that:

- reserves to provide cover for contingent spending – combining unallocated reserves with earmarked contingency funds and insurance reserves – accounted for 28 per cent of the total (27 per cent for single-tier and county councils; 33 per cent for district councils);
- revenue contributions to future capital spending – including property and asset management, vehicles, plant and equipment and information technology – accounted for 23 per cent (21 per cent for single-tier and county councils; 30 per cent for district councils);ⁱⁱⁱ
- 11 per cent of reserves (12 per cent for single-tier and county councils; 4 per cent for district councils) were unspent funds being carried forward for a specific purpose, or unspent grants and contributions for which the intended use was not always stated; and
- 8 per cent of reserves (9 per cent single-tier and county councils; 4 per cent for districts) were earmarked funds to support organisational development, restructuring, redundancy and pensions (Table 3).

ⁱ Ten single-tier and county councils and ten district councils.

ⁱⁱ These councils held total reserves at 31 March 2012 of £0.8 billion – 6 per cent of all councils' reserves.

ⁱⁱⁱ Fifty-nine per cent of these funds were for unspecified capital purposes (67 per cent for single-tier and county councils; 28 per cent for districts).

Table 3: **Amounts held in reserves for different purposes by 20 councils at 31 March 2012**

Reserves	All councils in sample	Single-tier and county councils	District councils
Total reserves (£m)	793	668	124
Comprising:			
Unallocated reserves	17%	15%	27%
Earmarked reserves	83%	85%	73%
Of which:			
Revenue contributions to capital	23%	21%	30%
Contingency fund / insurance	11%	12%	6%
Carry forward / unspent grants and contributions	11%	12%	4%
Other / various / unspecified	11%	10%	17%
Organisational development / restructuring / pensions	8%	9%	4%
Service investment / invest to save	6%	6%	5%
PFI	4%	5%	1%
Trading or charging surplus / deficit	4%	4%	0%
Economic development / growth / housing ⁱ	3%	3%	6%
Budget smoothing	2%	3%	1%

Note: Figures may not add due to rounding

Source: Audit Commission analysis of 2011/12 financial statements for 20 councils

ⁱ For example, homelessness, not Housing Revenue Account.

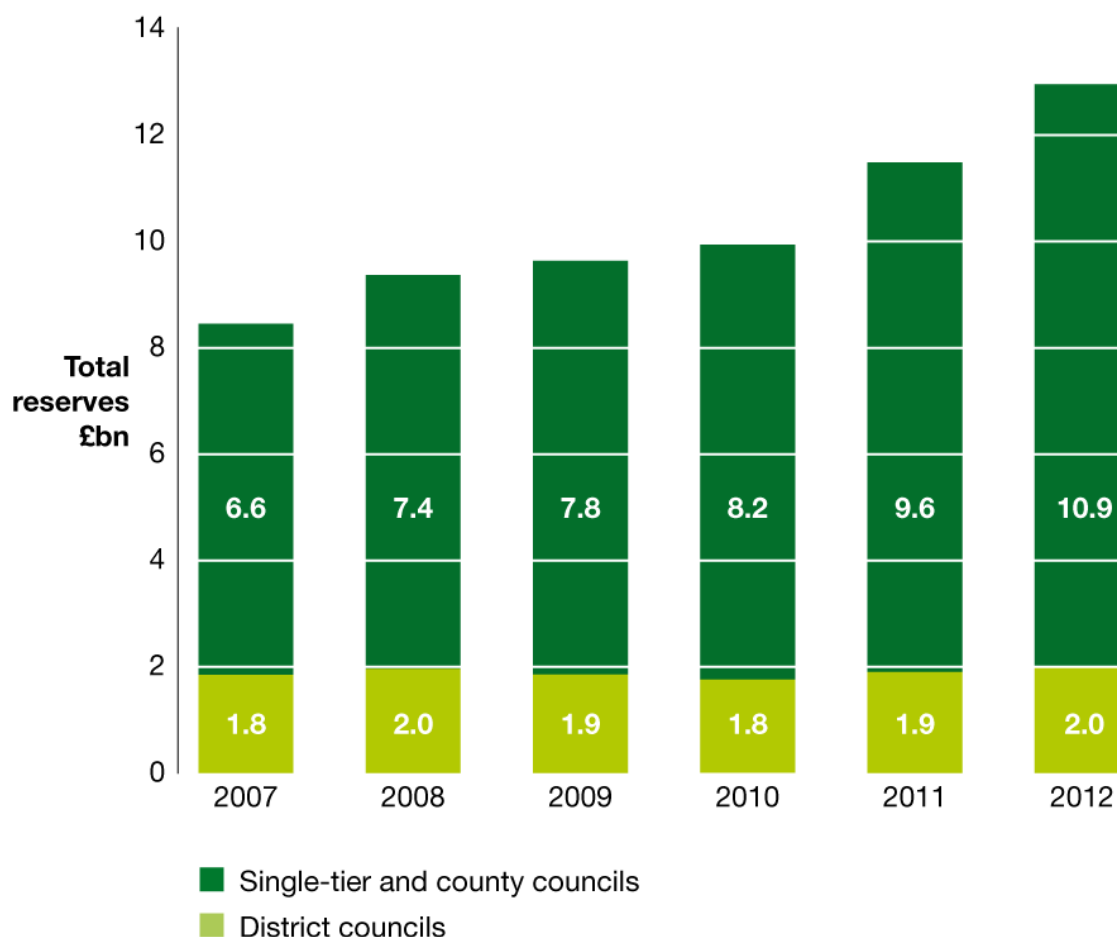
Chapter 3: Changes in councils' reserves

62 Overall, and for the majority of councils, reserves have been increasing. On the basis of recent trends, they seem likely to do so again in 2012/13.

Changes from 2006/07 to 2011/12

63 From 2007 to 2012, councils increased reserves by a total of £4.5 billion – 36 per cent in real terms (Figure 3).ⁱ Seventy-seven per cent of councils increased their reserves relative to net spending.

Figure 3: Total reserves at 31 March – 2007 to 2012



Source: Audit Commission analysis of DCLG provisional RO data

ⁱ Some of the increase in reserves between 2009/10 and 2010/11 can be attributed to changes in accounting practice.

Single tier and county councilsⁱ

64 Single-tier and county councils accounted for 90 per cent of the increase from 2007 to 2012. Their reserves grew by 46 per cent in real terms – from 20 per cent of their total net spending to 29 per cent. Growth in earmarked reserves accounted for 87 per cent of the increase.

65 Over this period, 83 per cent of single-tier and county councils increased their reserves relative to net spending. Twenty-eight per cent more than doubled their reserves relative to net spend; 2 per cent reduced their reserves by more than half.

District councilsⁱⁱ

66 District councils' reserves grew by 10 per cent in real terms from 2007 to 2012 – from 58 per cent of their total net spending to 75 per cent. Additional earmarked reserves accounted for 59 per cent of the increase.

67 During this period, 73 per cent of districts increased reserves relative to net spending. Twenty-four per cent more than doubled their reserves relative to net spend; 2 per cent reduced their reserves by more than half.

Reasons for increasing reserves

68 Our analysis of 2011/12 financial statements for ten single-tier and county councils and ten district councils found their total reserves rose by 22 per cent in 2010/11 and 2011/12.ⁱⁱⁱ Increased earmarked reserves in the single-tier and county councils accounted for 90 per cent of the increase.

69 Additional funds earmarked for purposes associated with organisational development, restructuring, redundancies and pension contributions accounted for 32 per cent of the total increase in both types of council. This suggests that councils have been setting aside funds to deliver the organisational changes needed to reduce their spending in the long term.

70 Twenty-five per cent of the rise in the single-tier and county council reserves resulted from an increase in funds being carried forward from the previous financial year and unspent grants and contributions. It is not unusual for councils to receive unexpected grant funding during

ⁱ Analysis in this section excludes changes resulting from local government reorganisation in 2009/10 when seven county councils and 37 district councils were replaced by nine new unitary authorities.

ⁱⁱ Analysis in this section excludes changes resulting from local government reorganisation in 2009/10.

ⁱⁱⁱ Analysis in this section is not adjusted for inflation.

the financial year (Ref 3), not all of which can be effectively spent before the year end.

71 An increase in revenue reserves held to fund capital spending accounted for a further 20 per cent of the increase in single-tier and county councils' reserves. These reserves declined slightly in the district councils.

Planned changes in 2012/13

72 In setting their budgets for 2012/13, councils planned to reduce total reserves by £0.4 billion (Table 4) – about 3 per cent of what they held at the end of 2011/12.

73 Our research found that planned increases in reserves were commonly a response to councils' concerns, or uncertainty, around the level of future funding for services and councils' ability to deliver further savings to offset these.

74 More councils planned to increase reserves in 2012/13 than planned to do so in any of the preceding three years.ⁱ We found no relationship, in any year, between the size of councils' reserves and their plans to increase or decrease them.

Table 4: **Councils' planned changes in total reserves in 2012/13**

Planned change	Single-tier and county councils		District councils		All councils	
	% of councils	Change £m	% of councils	Change £m	% of councils	Change £m
Increasing	44	251	37	37	40	288
No change	7		2		4	
Reducing	49	-563	62	-92	56	-655
Net change		-312		-55		-366

Note: Rows and columns may not add due to rounding

Source: Audit Commission analysis of DCLG revenue account (RA) data

Single-tier and county councils

75 Single-tier and county councils planned a total reduction in reserves of £312 million in 2012/13 – about 3 per cent of what they held at the end of 2011/12 (Table 4).

ⁱ Analysis of DCLG revenue account (RA) data for 2009/10 to 2012/13.

76 The proportion of councils planning to increase reserves rose from 33 per cent in 2011/12 to 44 per cent in 2012/13. The proportion planning to reduce reserves fell from 58 to 49 per cent.

District councils

77 District councils planned a total reduction in reserves of £55 million in 2012/13 – around 3 per cent of what they held at the end of 2011/12 (Table 4).

78 The proportion of councils planning to increase reserves rose from 20 per cent in 2011/12 to 37 per cent in 2012/13. The proportion planning to reduce reserves fell from 77 to 62 per cent.

Unplanned changes in the level of reserves

79 Many factors influence councils' budget delivery, such as the early or late implementation of savings plans, unexpected levels of demand for services, or the provision of unexpected funding from government. Some variation from budget is therefore to be expected, although this should be contained within tolerances agreed by the council. As we discussed in paragraph 35, a consequence for councils of variation from their budget could be the need to make unplanned changes to their reserves.

80 We compared councils' planned and actual movements on reserves,ⁱ relative to their net revenue spending, from 2009/10 to 2011/12. In each year, the majority of councils had higher reserves at the end of the year than they predicted as they:

- used less of their reserves than planned; or
- added to reserves, instead of reducing them as planned; or
- added more to reserves than planned.

81 Where reserves are significantly higher than expected in any year, or are higher than expected year after year, councils may hold more in reserves than they need.

82 Variations between planned and actual movements on reserves were lower, relative to spend, for single-tier and county councils than for district councils (Table 5).

ⁱ Analysis is based on changes to total reserves as councils may move funds between earmarked and unallocated reserves.

Table 5: **Unplanned change in reserves 2009/10 to 2011/12**

Variation from plan as % of net revenue spending		Single-tier and county councils %	District councils %
Reserves higher than planned in all three years by	>5	7	32
	>3	7	10
	>1	14	14
Reserves lower than planned in all three years by	>1	3	<1
	>3	-	<1
	>5	-	1

Source: Audit Commission analysis of DCLG RA and RO data

Single-tier and county councils

83 Over a quarter of all single-tier and county councils had reserves that were higher than planned by more than 1 per cent of their net revenue spending in every year from 2009/10 to 2011/12. Seven per cent had reserves that were consistently more than 5 per cent of net spend higher than planned. Three per cent had reserves consistently more than 1 per cent of net spend lower than planned (Table 5).

84 The extent and scale of variation from plans increased among single-tier and county councils from 2009/10 to 2011/12. In 2011/12, 88 per cent of councils had reserves that were more than 1 per cent of net spend higher or lower than planned – 76 per cent higher and 13 per cent lower.ⁱ

District councils

85 Over half of all district councils had reserves that were higher than planned by more than 1 per cent of their net revenue spending in every year from 2009/10 to 2011/12. Thirty-two per cent had reserves that were consistently more than 5 per cent of net spend higher than planned. Two per cent had reserves consistently more than 1 per cent of net spend lower than planned (Table 5).

86 There was little change in the overall extent of variation from plans for district councils between 2009/10 and 2011/12. In 2011/12, 93 per cent of district councils had reserves that were more than 1 per cent of net spend higher or lower than they had planned – 83 per cent higher and 11 per cent lower.ⁱⁱ

ⁱ Figures do not add due to rounding.

ⁱⁱ Figures do not add due to rounding.

Chapter 4: How councils set their reserves

Current practice on setting reserves

Reserves to help manage risk

87 We found the majority of councils were routinely assessing the financial impact of external and internal risks to budget delivery, usually as part of the budget-setting process, to determine what reserves they needed to help manage risk. In most cases, these assessments were clearly linked to councils' wider risk management processes and were reported to elected members in executive and scrutiny roles.ⁱ

88 Councils quantified their financial risks by combining estimates of the total cost of risk events and the likelihood of risks occurring. Councils' assessments of cost and likelihood varied according to local circumstance and were a matter of professional judgement.

89 Factors that influenced individual councils' decisions on the need for risk-based reserves and the amount required included:

- the prevalence and perceptions of external and internal risks, for example, changes in external funding or the council's ability to deliver savings;
- the political and strategic importance of managing particular risks;
- the effectiveness of risk management to reduce the likelihood of certain spending needs occurring, or the cost if they do;
- the effectiveness of budget monitoring to identify variances from spending plans and trigger timely remedial action;
- the availability of other funds to cover costs – for example, from an insurance policy, or from the government under the Bellwin Scheme for emergency financial assistance; and
- the extent to which contingency is built into individual departmental budgets and the council's overall budget.

90 Most councils used their risk assessment to identify a minimum level of unallocated reserves needed to cover risk. However, some councils set their minimum level of unallocated reserves as a percentage of their spending, even where a risk assessment suggested a lower figure, or held reserves to mitigate risk without undertaking any risk assessment (see example below).

ⁱ Some chief finance officers reported that councils occasionally need to hold risk-based reserves for purposes that are subject to negotiation with third parties, such as legal liability claims, where publicising what is held would undermine their ability to negotiate.

Setting risk-based reserves as a percentage of spending

For a number of years a unitary authority in our research has held an earmarked reserve of £4.8 million to cover ‘emergency’ costs without assessing the cost and likelihood of the risks that might lead to its use. Rather, it sets the reserve to be between 3 and 5 per cent of the council’s net budget.

Source: Audit Commission fieldwork

91 Most chief finance officers in our research regarded an amount between 3 and 5 per cent of the council’s net spending as a prudent level for risk-based reserves – and the minimum that auditors would consider prudent. Some councils’ budget reports also noted this as a principle guiding decision making. The Audit Commission has not, however, issued any guidance to auditors concerning councils’ minimum reserve levels and is not aware of any specific guidance for councils on minimum levels.

92 The level of a council’s unallocated reserves varies subject to over and underspending within the council’s budget, and the council’s decisions to move funds between earmarked and unallocated reserves. Most councils knowingly hold unallocated reserves that are higher than the minimum level that members agreed was needed to address financial risk.ⁱ Some councils made the excess funds available to support one-off spending proposals from service departments – for example, for invest-to-save initiatives. This appears to be a good short-term use of reserves that have no other specific purpose.

93 Another positive approach taken by some councils was to use their risk assessment to identify a maximum, as well as a minimum, level of financial risk. This provided elected members with the information they needed to avoid holding more than necessary in the council’s risk-based reserves.

Reserves to support future spending plans

94 Councils should manage their reserves in a way that supports their medium-term financial plans. Medium-term financial planning helps councils to consider how the spending needed to deliver the council’s ambitions, and the council’s income from various sources, will change

ⁱ Research in 2011 (Ref 12) found 71 per cent of responding councils expected to hold unallocated reserves above their agreed minimum level at 31 March 2012. One fifth predicted reserves would be more than twice their agreed minimum. Seventeen per cent of councils expected unallocated reserves to be below their agreed minimum.

over time.ⁱ It enables councils to plan how to address expected gaps between spending and funding – for example, through changes in service levels, the achievement of savings, increases in income, or the planned use of reserves.

95 All the councils in our research were routinely considering the way that reserves would need to increase or decrease to support their financial plans and the consequences of this for annual budgets. Budget reports provided extensive commentary for elected members on the current and future financial challenges councils were facing, spending pressures, the potential of savings programmes and the prospects for council tax and other income.

96 Medium-term plans identified whether, and when, the council would:

- need to use funds from reserves to supplement savings plans – for example, where savings would take time to deliver; and
- opportunities to add to reserves to meet future need – for example, where savings could be achieved quickly.

97 Many councils had planned to use some of their reserves to support their annual budgets, while undertaking service reviews to identify longer-term savings. Commonly councils had created a specific earmarked reserve that would be used, or increased, as required in response to annual variations between funding and spending over the life of their financial plans.

98 As part of their medium-term financial planning, councils in our research generally reported conducting some form of annual review of the reserves they held to support future spending plans. How reviews were conducted was not always apparent from councils' budget documentation. Chief finance officers reported leading reviews, with input from service managers. Sensibly, some reviews focused particular attention on reserves whose level had remained unchanged for, say, three years. The outcome of reviews was reported to the council's executive and in some cases the full council (see example that follows).

ⁱ The Commission's 2010 report on strategic financial management discusses the importance for councils of anticipating changing circumstances and managing financial risks (Ref 13).

Reviewing the need for reserves

A district council requires its budget holders to prepare a short report each year for reserves within their responsibility.

The reports, using a standard template, detail:

- the ongoing rationale for each reserve, and its required level; and
- use of the reserve against plan and the timeline for future use, which provides the basis for subsequent monitoring.

The council's chief finance officer and the executive member for resources scrutinise the annual reports.

Every three years a full review is undertaken and reported to the cabinet, to the scrutiny committee and to the full council. The council's last triennial review released funds of £1.8 million to support other spending plans.

Source: Audit Commission fieldwork

99 Councils mostly carried out reviews:

- during budget preparation – to inform budget proposals and the chief finance officer's advice to the council on the adequacy of reserves; or
- when closing their accounts – to inform decisions about movements on reserves needed to achieve a balanced budget.

100 A small number of councils reported conducting reviews at both the beginning and end of the financial cycle, which they felt was beneficial to decision making, or during the financial year, as a response to emerging financial pressures.

Improving decision making

101 All councils, we found, could improve decision making in at least one of the areas discussed below.

Reviewing the need for reserves

102 Councils' priorities and the need for reserves can change over a short period of time. For example, in 2011, a unitary authority released funds from an earmarked reserve that it had set up two years earlier and no longer considered necessary.

103 In some councils, annual reviews of reserves were a recent development, suggesting the practice may not yet be widespread.

104 All councils should undertake a good-quality, annual 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.

Earmarking

105 Councils can choose whether to earmark some of their reserves. Earmarking is desirable where councils wish to protect funds for specific purposes – for example, to deliver strategic investments or to underpin self-insurance arrangements. But councils that 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 (see example below).

The needs that councils anticipate may be slow to materialise

In 2008/09, a unitary authority created an earmarked reserve of £4.4 million to soften the impact of spending pressures during 2009/10 and 2010/11 caused by the credit crunch. By the end of 2010/11, the reserve remained at £3.5 million, as the council had successfully managed most of the added spending pressures in other ways. In 2011/12, the council used £2.4 million from the reserve to support the budget and to contribute to severance costs.

Source: Audit Commission fieldwork

106 Councils should consider how earmarking affects their reserves. Elected members should seek confirmation from the council's chief finance officer on which reserves are earmarked at the council's discretion, and the basis on which these are set. Members should ensure there is a clearly communicated rationale for earmarking reserves for specific purposes.

107 Councils may be able to reduce their total reserves by not earmarking funds for purposes that are hard to predict (see example below).

Pooling funds to mitigate risk can reduce reserves

A unitary authority holds unallocated reserves to cover costs associated with thirteen areas of financial risk. For 2012/13, it assessed the total level of risk as £10 million, having considered the cost and likelihood of individual risks occurring. The council routinely sets its minimum level for unallocated reserves at 50 per cent of the total risk as it does not expect all risks to occur in the same year.

Source: Audit Commission fieldwork

108 Councils should set any reserves held for purposes that are hard to predict on the basis of an up-to-date risk assessment that reflects local circumstances. This will help them avoid tying up funds they might use for other purposes.

Considering other mitigation for financial risk

109 As well as risk-based reserves, around half the councils in our study held a corporate contingency fund within their budget to provide protection against, for example, service overspends, or failure to deliver savings.

Some councils hold reserves and contingency funds to cover unplanned spending

A unitary authority with unallocated reserves that were about 4.5 per cent of the council's budget in 2012/13 also holds a corporate contingency of about 2 per cent of spending.

Source: Audit Commission fieldwork

110 Where councils have included contingency funds in the budget, officers can act decisively if risks occur, subject to local schemes of delegation. However, it was not clear from our review of budget documentation whether elected members were routinely taking account of budget contingencies when setting risk-based reserves.

Chief finance officer advice when setting the budget

111 When they are setting the budget, chief finance officers have a statutory dutyⁱ to report publicly to elected members on the adequacy of reserves. CIPFA's guidance identifies issues to consider in determining an appropriate level of reserves (Ref 4). We support CIPFA's view that chief finance officers should, for example, take account of:

- strategic, operational and financial risks that are both internal and external to the authority;
- the assumptions underpinning the budget and the longer-term financial strategy;
- the authority's financial management arrangements and cash flow requirements; and
- the general financial climate and expected levels of future funding.

112 Chief finance officers in our research were fulfilling their duty to report on the adequacy of reserves, but the amount of information provided in their reports on the factors they had considered in preparing their advice varied greatly.

113 In advising elected members on setting reserves, chief finance officers have to strike a balance between comprehensiveness and clarity. As elected members receive a large amount of complex information when setting the budget – often hundreds of pages – they need advice from the chief finance officer that is easy to understand and well evidenced, clearly setting out the key issues affecting decision making.

Comparative data

114 We found few examples of council budget reports containing data that would enable elected members to monitor change in reserves beyond the previous year, or to compare the level of reserves with councils facing similar circumstances.

115 Even where present, this comparative data tended to be limited. For example:

- commenting on the cash value of reserves without relating this to the council's spending – both are helpful to decision making; or
- making broad comparisons with all councils of the same type, rather than those facing similar circumstancesⁱⁱ – reducing the opportunity to identify differences in approach that might warrant further enquiry.

ⁱ Section 25 of the Local Government Act 2003 requires the chief finance officer to report to members on the robustness of budget estimates and the adequacy of reserves, and elected members to have regard to the chief finance officer's report in making their decisions.

ⁱⁱ For example, using CIPFA's statistical nearest neighbour groupings.

116 Benchmarking, over time and with others, can be a useful aid to decision making. Councils can use the Financial Resilience section of the Audit Commission's [Value for Money Profiles](#) tool, which uses data councils supply to government, to compare levels of reserves, relative to spending, over time and with different groups of councils.

The relationship between reserves and council tax

117 When setting the budget, councils balance their spending plans with available funding. There is a direct interaction between decisions on spending and income, including the level of council tax, and the decision to add to, or use, reserves.

118 We found that councils' budget documentation sometimes presented a confusing picture about the effect that additions to, or use of, reserves had on council tax. This was particularly the case where councils' budgets included both additions to earmarked reserves and the use of unallocated reserves to fund revenue spending.

119 We recognise that these presentational issues are a matter of convention, but:

- where they occur in budget reports, they limit elected members' ability to make well-informed decisions; and
- where they occur in budget information aimed at the public (see example below), they limit the public's ability to hold their council to account for decisions on reserves.

The interaction between changes in reserves and council tax is not always clear

A district council's 2012/13 budget book shows how it is using a £0.6 million contribution from its unallocated reserves to fund its net expenditure, reducing the Band D council tax requirement by 3 per cent. However, the council's net expenditure includes a contribution to earmarked reserves of £1.1 million. The combined effect of these changes in the council's earmarked and unallocated reserves increases the Band D council tax requirement in 2012/13 by 3 per cent.

While the council kept its level of council tax unchanged from the previous year, the budget book gives a confusing picture of the effect that movements on reserves have had on council tax.

Source: A district council's budget book

120 Councils should ensure there is greater degree of transparency about the effect of changes in reserves on council tax, to enhance decision making by elected members and improve accountability to local taxpayers.

In-year monitoring

121 Some chief finance officers reported using their routine budget monitoring reports to inform elected members about the use of reserves against plans and the year-end forecast for reserves. In some cases, reporting also highlighted changes in the status of the risks that reserves were being held to mitigate. We recommend this approach.

122 However, forecasts were sometimes unnecessarily prudent. Chief finance officers reported giving cautious forecasts of the likely year-end budget position to elected members. Chief finance officers regarded this as prudent financial management, but acknowledged it had contributed in some cases to councils delivering a significant budget surplus. Where this occurred, elected members were reported to be rightly concerned about the effect that the forecasts had had on decision making.

123 Inaccurate budget monitoring and year-end forecasting limits elected members' ability to influence the achievement of their planned budget and affects how they plan for the next financial year. Overly cautious forecasting increases the likelihood that the council will return a surplus at the end of the financial year, resulting in unplanned additions to reserves.

Unplanned movements on reserves

124 Our data analysis in paragraphs 79-86 shows that councils are most likely to underspend their budgets and, as a consequence, have higher reserves at the end of the year than predicted.

125 In our research, some of the unplanned increases in reserves were unspent funds, which councils were carrying forward for inclusion in the budget for the next financial year.ⁱ Most councils in our research had explicit policies on how much they would carry forward in any year, and schemes of delegation for decision making. Some, usefully, also had policies on how quickly funds carried forward should be spent before they would become available for other purposes.

126 Where councils had surpluses that were not being carried forward for a specific purpose, elected members were also required to agree how these would be used, either to create or increase existing earmarked reserves or to increase unallocated reserves.

ⁱ The alternative would see councils spending surplus funds before the end of the financial year, which may not result in the best value for taxpayers.

127 It is important that councils apply the same degree of scrutiny to unplanned additions to reserves as they do to those they plan when setting the budget. Regularly reviewing the level of reserves can assure elected members that reserves remain at an appropriate level for intended purposes.

128 Councils should examine the reasons for budget variance and address factors within their control. This might mean, for example, updating the assumptions on which budgets are set, or improving overall financial management.

Conclusions

129 Councils hold a significant amount of money in their reserves to fund future spending plans and manage financial risk. The financial challenges and risks that councils face are also significant, and increasing. It is important that councils make well-informed decisions about their reserves and are accountable for these to local taxpayers and service users.

130 There is wide variation in the level of reserves that councils hold, even among councils in similar circumstances. While there is no universally appropriate level for councils' reserves, this variation suggests some councils might successfully operate with reserves at a different level to the one they currently have. The reserves a council holds should be proportionate to the scale of its future spending plans and the risks it faces as a consequence of these.

131 Single-tier and county councils hold the majority of reserves and have been responsible for most of the growth in recent years. This places an added responsibility on these councils to ensure their reserves are at an appropriate level.

132 District councils, have reserves that are lower, but generally a much higher percentage of their revenue spending. These councils' reserves provide greater resilience to funding reductions and greater flexibility to invest in tackling financial challenges.

133 Councils have earmarked the majority of their reserves, but our research shows that earmarking does not always mean there is a specific plan for how the funds will be spent. Elected members need to examine closely the purposes for which earmarked reserves are held and consider whether these funds could be better used. Councils should ensure there is a clearly communicated rationale for earmarking reserves for specific purposes.

134 The majority of councils increased reserves relative to spending from 2007 to 2012. Some councils continue to plan increases in their reserves despite, or because of, reductions in their funding from government. The justification for setting aside additional funds in reserves, for the benefit of future taxpayers and service users, needs to be better explained to current taxpayers and service users.

135 Most councils have higher reserves at the end of the year than they expect, due to unplanned budget surpluses. Councils need to understand and apply learning about the factors that contribute to unplanned growth in reserves. They should also correct unnecessary additions to reserves or explain clearly to taxpayers why they are retaining these unexpected funds.

Appendix 1: Research approach

Aims

The aims of our research were to:

- examine the level of councils' reserves and the purposes for which they hold them;
- evaluate councils' approaches to setting and reviewing reserves; and
- identify issues and good practices that will help councils, and other local authorities, improve their decision making around reserves.

Methods

From February to September 2012 we:

- analysed budget and out-turn data supplied by councils to, and published by, the Department for Communities and Local Government on the size of councils' earmarked and unallocated reserves from 2006/07 to 2011/12, and their plans for reserves in 2012/13;
- reviewed publicly available documentation, such as financial statements, budget reports and minutes of budget-setting meetings, in 40 councils; and
- interviewed chief finance officers in ten councils of different types and with different levels of reserves.

During our research we have also sought views from organisations that have an interest in how councils manage their finances, including:

- Chartered Institute of Public Finance and Accountancy;
- Department for Communities and Local Government;
- Local Government Association;
- local government treasurers' societies; and
- other national audit agencies.

Scope

Our research has focused on councils' cash-backed General Fund reserves. Our analysis excludes other reserves councils hold but which are not available to fund their general spending:

- schools' reserves held by councils;
- some reserves with statutory restrictions on how they can be spent, such as capital receipts or Housing Revenue Account reserves; and
- non-cash-backed reserves that councils hold to comply with accounting practice, such as their pensions reserves.

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