

Striking A Balance

Improving councils' decision making on reserves
Report of the Audit Commission (December 2012)

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;¹
- 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

¹ 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.

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** 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.

Conclusions

20. 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.
21. 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.
22. 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.
23. 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.
24. 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.

25. 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.
26. 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.