

# **LAAP BULLETIN 55 – FEBRUARY 2003**

## **GUIDANCE NOTE ON LOCAL AUTHORITY RESERVES AND BALANCES**



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# **GUIDANCE ON LOCAL AUTHORITY RESERVES AND BALANCES**

## **1 Purpose**

- 1.1 This bulletin provides guidance to local authority finance directors<sup>1</sup> in England, Northern Ireland, Scotland and Wales on the establishment and maintenance of local authority reserves and balances. The guidance represents good financial management and should be followed as a matter of course for budget processes beginning on or after 1 April 2003<sup>2</sup>. Compliance with the guidance is recommended in the Institute's 2003 Statement on the Role of the Finance Director in Local Government<sup>3</sup>.

## **2 Application**

- 2.1 In England, Scotland and Wales the guidance is applicable to local authorities, police authorities, fire authorities (other than combined authorities), joint committees and joint boards of principal authorities. In Northern Ireland the guidance applies to all district councils. This bulletin replaces the occasional paper issued by the Institute in 1995 on reserves and balances.
- 2.2 The general principles set out in this guidance apply to an authority's General Fund and, where appropriate, to the Housing Revenue Account.

## **3 The Existing Legislative/Regulatory Framework**

- 3.1 The requirement for financial reserves is acknowledged in statute. Sections 32 and 43 of the Local Government Finance Act 1992 require billing and precepting authorities in England and Wales to have regard to the level of reserves needed for meeting estimated future expenditure when calculating the budget requirement.

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<sup>1</sup> The term finance director is used throughout this guidance to refer to the most senior officer with responsibility for finance in a local authority, except for legal references where the context requires use of the relevant term.

<sup>2</sup> Local authorities in England and Wales are advised to follow the guidance in order to discharge the responsibility placed on the finance director in the Local Government Bill introduced in the House of Commons on 25 November 2002.

<sup>3</sup> See sections 4 and 6 of the 2003 CIPFA Statement on the Role of the Finance Director in Local Government available to download from the policy and technical pages of CIPFA's website – [www.cipfa.org.uk](http://www.cipfa.org.uk)

- 3.2 In Scotland there are explicit statutory powers under schedule 3 of the Local Government (Scotland) Act 1975 to establish renewal and repair funds and insurance funds alongside a requirement, as in England and Wales, to maintain a general fund under section 93 of Part VII of the Local Government (Scotland) Act 1973. In contrast to England and Wales earmarked reserves can be established in Scotland only where there are explicit statutory powers.
- 3.3 There are also a range of safeguards in place that militate against local authorities over-committing themselves financially. These include:
- the balanced budget requirement
  - chief finance officers' s114 powers<sup>4</sup>
  - the external auditor's responsibility to review and report on financial standing.
- 3.4 As evidenced by the Audit Commission's annual reports on external audits of local authorities in England and Wales the balanced budget requirement is sufficient discipline for the vast majority of local authorities. This requirement is reinforced by section 114 of the Local Government Finance Act 1988 which requires the chief finance officer in England and Wales to report to all the authority's councillors if there is or is likely to be unlawful expenditure or an unbalanced budget. This would include situations where reserves have become seriously depleted and it is forecast that the authority will not have the resources to meet its expenditure in a particular financial year. The issue of a section 114 notice cannot be taken lightly and has serious operational implications. Indeed, the authority's full council must meet within 21 days to consider the s114 notice and during that period the authority is prohibited from entering into new agreements involving the incurring of expenditure.<sup>5</sup>
- 3.5 Whilst it is primarily the responsibility of the local authority and its finance director to maintain a sound financial position, external auditors have a responsibility to review the arrangements in place to ensure that financial

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<sup>4</sup> S114 of the Local Government Finance Act 1988 Act does not apply to Scotland. In Northern Ireland, the equivalent duty – whilst not specific in statute – would rest with the local authority's CFO in keeping with the statutory responsibility under section 54 of the Local Government Act (Northern Ireland) 1972 to make safe and efficient arrangements for the issue of money payable by the authority.

<sup>5</sup> The Local Government Bill includes a clause that eases this restriction, so that chief finance officers will be able to sanction certain new agreements which are aimed at dealing with the financial difficulties. Detailed guidance on s114 is set out in CIPFA's 2003 Statement on the Role of the Finance Director in Local Government.

standing is soundly based. In the course of their duties external auditors review and report on the level of reserves taking into account their local knowledge of the authority's financial performance over a period of time. However, it is not the responsibility of auditors to prescribe the optimum or minimum level of reserves for individual authorities or authorities in general.

- 3.6 With the introduction of the new prudential approach to capital investment these safeguards will be reinforced. CIPFA's draft Code<sup>6</sup> will require finance directors in local authorities to have full regard to affordability when making recommendations about the local authority's future capital programme. Such consideration will include the level of long term revenue commitments. Indeed, in considering the affordability of its capital plans, the authority will be required to consider all of the resources available to it/estimated for the future, together with the totality of its capital plans and revenue forecasts for the forthcoming year and the following two years. The development of three year revenue forecasts across local authorities will focus greater attention on the levels and application of local authority balances and reserves.

#### **4 The Role of the Finance Director**

- 4.1 Within the existing statutory and regulatory framework, it is the responsibility of the finance director to advise local authorities about the level of reserves that they should hold and to ensure that there are clear protocols for their establishment and use (see 5.4).
- 4.2 CIPFA does not accept that a case for introducing a statutory minimum level of reserves, even in exceptional circumstances, has been made. Local authorities, on the advice of their finance directors, should make their own judgements on such matters taking into account all the relevant local circumstances. Such circumstances vary. A well-managed authority, for example, with a prudent approach to budgeting should be able to operate with a relatively low level of general reserves. There is a broad range within which authorities might reasonably operate depending on their particular circumstances.
- 4.3 Imposing a statutory minimum would also run counter to the promotion of local autonomy and would conflict with the increased financial freedoms that

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<sup>6</sup> Draft Code on a Prudential Framework for Local Authority Capital Finance, CIPFA, December 2001. Depending on progress of legislation, it is expected that a second exposure draft of the Code will be published for consultation in Spring 2003 and the final Code in Autumn 2003.

are being introduced for English and Welsh local authorities in the Local Government Bill 2002 and for Scottish authorities in the Local Government in Scotland Bill 2002. Nor is it considered appropriate or practical for CIPFA, or other external agencies, to give prescriptive guidance on the minimum (or maximum) level of reserves required, either as an absolute amount or a percentage of budget.

## 5 Types of Reserves

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

- a working balance to help cushion the impact of uneven cash flows and avoid unnecessary temporary borrowing – this forms part of general reserves
- a contingency to cushion the impact of unexpected events or emergencies – this also forms part of general reserves
- a means of building up funds, often referred to as earmarked reserves, to meet known or predicted liabilities.

5.2 The most commonly established earmarked reserves are listed below:

<b>Category of earmarked reserve</b>	<b>Rationale</b>
Sums set aside for major schemes, such as capital developments or asset purchases, or to fund major reorganisations	Where expenditure is planned in future accounting periods, it is prudent to build up resources in advance
Insurance reserves	Self – insurance is a mechanism used by a number of local authorities <sup>7</sup> . In the absence of any statutory basis sums held to meet potential and contingent liabilities are reported as earmarked reserves

<sup>7</sup> In Scotland, the Local Government (Scotland) Act 1975, schedule 3, paragraph 22 makes specific reference to the establishment of an insurance fund.

Reserves of trading and business units	Surpluses arising from in-house trading may be retained to cover potential losses in future years, or to finance capital expenditure
Reserves retained for service departmental use	Increasingly authorities have internal protocols that permit year-end underspendings at departmental level to be carried forward
School balances	These are unspent balances of budgets delegated to individual schools

5.3 Another reserve held by local authorities is the pensions reserve – this is a specific accounting mechanism used to reconcile the payments made for the year to various statutory pension schemes in accordance with those schemes' requirements and the net change in the authority's recognised liability under FRS 17 – *Retirement Benefits*, for the same period. An appropriation is made to or from the pensions reserve to ensure that the bottom line in the consolidated revenue account reflects the amount required to be raised in taxation.<sup>8</sup>

5.4 For each reserve held by a local authority there should be a clear protocol setting out:

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

5.5 When establishing reserves, local authorities need to ensure that they are complying with the Code of Practice on Local Authority Accounting in the

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<sup>8</sup> The CIPFA/LASAAC Joint Committee has consulted on an exposure draft of the 2003 version of the *Code of Practice on Local Authority Accounting in the United Kingdom (the SORP)*. The exposure draft highlighted the intention of the Office of the Deputy Prime Minister, Scottish Executive and Welsh Assembly Government to clarify, by legislative means, that the pensions reserve, which will frequently be negative, need not be taken into account when calculating the annual budget requirement. In the event that this legislative reassurance is not in place the SORP consultation makes clear that the pensions reserve will not be recognised in the financial statements and that the transitional disclosure requirements as set out in the 2002 SORP will remain in place. The ODPM and Welsh Assembly Government have since issued consultation papers on this point.

United Kingdom (the SORP) and in particular the need to distinguish between reserves and provisions. The relevant extracts from the current (2002/03) SORP is included as an annex to this paper.

## **6 Principles to Assess the Adequacy of Reserves**

- 6.1 In order to assess the adequacy of unallocated general reserves when setting the budget, finance directors should take account of the strategic, operational and financial risks facing the authority. There is currently no formal requirement for an assurance statement on risk and control<sup>9</sup>. However, local authorities are increasingly conscious of the need for effective risk management and are adopting formal risk management processes. The Audit Commission and Audit Scotland Codes of Audit Practice make it clear that it is the responsibility of the audited body to identify and address its operational and financial risks, and to develop and implement proper arrangements to manage them, including adequate and effective systems of internal control. The financial risks should be assessed in the context of the authority's overall approach to risk management. The SORP requires local authorities to include a statement on the system of internal financial control with the statement of accounts. The SORP also allows authorities to publish a wider ranging statement on the system of internal control and/or a statement on the adoption of a local code of corporate governance and how they have complied with such a code and monitored its effectiveness<sup>10</sup>. The finance director needs to ensure that the authority has put in place effective arrangements for internal audit of the control environment and systems of internal control as required by professional standards<sup>11</sup>.
- 6.2 Setting the level of general reserves is just one of several related decisions in the formulation of the medium term financial strategy and the budget for a particular year. Account should be taken of the key financial assumptions underpinning the budget alongside a consideration of the authority's financial management arrangements. In addition to the cash flow requirements of the authority the following factors should be considered:

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<sup>9</sup> The ODPM's consultation paper on revised Accounts and Audit regulations 2003 for England proposed the introduction of a statutory requirement for authorities to publish a statement on internal control with the statement of accounts. Subject to parliamentary approval, the new regulations will be effective from 2003/04.

<sup>10</sup> The CIPFA/SOLACE framework – Corporate Governance in Local Government: A Keystone for Community Governance, CIPFA 2001 – recommends an approach that authorities can follow for this wider Statement.

<sup>11</sup> See CIPFA's Statement on the Role of the Finance Director in Local Government, January 2003, for more detail.

<b>Budget assumptions</b>	<b>Financial standing and management</b>
The treatment of inflation and interest rates	The overall financial standing of the authority (level of borrowing, debt outstanding, council tax collection rates etc)
Estimates of the level and timing of capital receipts	The authority's track record in budget and financial management including the robustness of the medium term plans
The treatment of demand led pressures	The authority's capacity to manage in-year budget pressures
The treatment of planned efficiency savings/productivity gains	The strength of the financial information and reporting arrangements
The financial risks inherent in any significant new funding partnerships, major outsourcing arrangements or major capital developments	The authority's virement and end of year procedures in relation to budget under/overspends at authority and departmental level
The availability of other funds to deal with major contingencies and the adequacy of provisions	The adequacy of the authority's insurance arrangements to cover major unforeseen risks

- 6.3 These factors can only be assessed properly at local level. A considerable degree of professional judgement is required. The finance director may choose to express advice on the level of balances in cash and/or as percentage of budget (to aid understanding) so long as that advice is tailored to the circumstances of the authority for that particular year.
- 6.4 The advice should be set in the context of the authority's medium term financial plan 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, where reserves are to be deployed to finance recurrent expenditure this should be made explicit. Advice should be given on the adequacy of reserves over the lifetime of the medium term financial plan.
- 6.5 As noted in the annex, the current SORP requires the purpose, usage and the basis of transactions of earmarked reserves to be identified clearly. It is recommended that a review of the level of earmarked reserves be undertaken as part of annual budget preparation.

## 7 A New Reporting Framework

- 7.1 The finance director has a fiduciary duty to local taxpayers, and must be satisfied that the decisions taken on balances and reserves represent proper stewardship of public funds.
- 7.2 The level and utilisation of reserves will be determined formally by the Council, informed by the advice and judgement of the finance director. To enable the Council to reach its decision, the finance director should report the factors that influenced his or her judgement, (in accordance with paragraph 6.2) and ensure that the advice given is recorded formally. Where the finance director's advice is not accepted this should be recorded formally in the minutes of the council meeting.
- 7.3 It is recommended that:
- the budget report to the Council should include a statement showing the estimated opening general reserve fund balance for the year ahead, the addition to/withdrawal from balances, and the estimated end of year balance. Reference should be made as to the extent to which such reserves are to be used to finance recurrent expenditure
  - this should be accompanied by a statement from the finance director on the adequacy of the general reserves and provisions in respect of the forthcoming financial year and the authority's medium term financial strategy
  - a statement reporting on the annual review of earmarked reserves (including schools' reserves)<sup>12</sup> should also be made at the same time to the Council. The review itself should be undertaken as part of the budget preparation process. The statement should list the various earmarked reserves, the purposes for which they are held and provide advice on the appropriate levels. It should also show the estimated opening balances for the year, planned additions/withdrawals and the estimated closing balances.

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<sup>12</sup> See the annex for details of what the SORP Guidance Notes for Practitioners says on this point.

## 8 Good Governance

8.1 It is important that local authority councillors take responsibility for ensuring the adequacy of reserves and provisions when they set the budget. The respective roles of officers and councillors in relation to reserves should be codified locally and given due recognition in local authorities' constitutions where they are required<sup>13</sup>. This codification should:

- state which council bodies are empowered to establish reserves
- set out the responsibilities of the finance director and councillor – or group of councillors – responsible for finance
- specify the reporting arrangements.

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<sup>13</sup> Every local authority in England and Wales is required to have a written constitution under the Local Government Act 2000.

## Annex

### **Extract from the Code of Practice on Local Authority Accounting in the United Kingdom (the SORP), 2002/03**

The Code of Practice on Local Authority Accounting 2002 makes the important distinction between reserves and provisions. The circumstances in which provisions are required are spelt out in the following terms:

“Provisions are required for any liabilities of uncertain timing or amount that have been incurred.

Provisions are required to be recognised when:

- (a) the local authority has a present obligation (legal or constructive) as a result of a past event
- (b) it is probable that a transfer of economic benefits will be required to settle the obligation, and
- (c) a reliable estimate can be made of the amount of the obligation.

A transfer of economic benefits is regarded as probable if the event is more likely than not to occur. If these conditions are not met no provision should be recognised.”

“Amounts set aside for purposes falling outside the definition of provisions should be considered as reserves, and transfers to and from them should be distinguished from service expenditure disclosed in the Statement of Accounts. Expenditure should not be charged direct to any reserve. For each reserve established, the purpose, usage and the basis of transactions should be clearly identified. Reserves include earmarked reserves set aside for specific policy purposes and balances which represent resources set aside for purposes such as general contingencies and cash flow management.”

“Capital reserves are not available for revenue purposes and certain of them can only be used for specific statutory purposes. The fixed asset restatement reserve, usable capital receipts, and capital financing reserves are examples of such reserves<sup>14</sup>.”

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<sup>14</sup> Neither the capital financing reserve nor the fixed asset restatement reserve are resource-backed reserves.

The SORP Guidance Notes for Practitioners offers further details on reserves as follows:

“Revenue reserves result from events which have allowed monies to be set aside, surpluses, or decisions causing anticipated expenditure to have been postponed or cancelled. Reserves of this nature are available and can be spent or earmarked at the discretion of an authority. Earmarking of revenue reserves can be used to set aside available monies for major anticipated capital schemes for projects or service arrangements the authority may wish to carry out. Other examples of earmarked reserves include business unit surpluses, service efficiency savings, contingent liabilities (where a provision is not required).

The amount of unspent budgets by LMS schools are also usable revenue reserves but the authority does not have the discretion to spend that money and it has different characteristics to other usable revenue reserves.”