APPENDIX 1

RESERVES

Legislative/regulatory framework and guidance

The requirement for financial reserves is acknowledged in statute. Sections 31A, 32, 42A and 43 of the Local Government Finance Act 1992 require billing and precepting authorities in England and Wales to have regard to the level of reserves needed for meeting estimated future expenditure when calculating the budget requirement.

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

- the balanced budget (or in England calculation of council tax) requirement
- chief finance officers' duty to report on robustness of estimates and adequacy of reserves (under Section 25 of the Local Government Act 2003) when the authority is considering its budget requirement.
- the legislative requirement for each local authority to make arrangements for the proper administration of their financial affairs and that the chief finance officer/proper officer has responsibility for the administration of those affairs,
- the requirements of the Prudential Code

These requirements are 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.

CIPFA's Prudential Code requires chief finance officers in local authorities to have full regard to affordability when making recommendations about the local authority's future capital programme. Such consideration includes the level of long-term revenue commitments. Indeed, in considering the affordability of its capital plans, the authority is required to consider all 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.

Role of the chief finance officer

Within the existing statutory and regulatory framework, it is the responsibility of chief finance officers 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. Reserves should not be raised without a clear purpose.

Local authorities should establish reserves and determine the level of those reserves based on the advice of their chief finance officers. Authorities 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 level of general reserves appropriate for the risks (both internal and external) to which it is exposed. In assessing the appropriate level of reserves, a well-managed authority will ensure that the reserves are not only adequate but are also necessary.

Types of reserve

For statutory purposes, there is a single revenue reserve, the General Fund Balance. When reviewing their medium-term financial plans and preparing their annual budgets local authorities should consider the establishment of sub reserves (known as earmarked reserves) and maintenance of general 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.

Principles to assess the adequacy of reserves

In order to assess the adequacy of unallocated general reserves when setting the budget, chief finance officers should take account of the strategic, operational and financial risks facing the authority.

The many factors involved when considering appropriate levels of reserves can only be assessed properly at a local level. A considerable degree of professional judgement is required. The chief finance officer may choose to express advice on the level of balances in cash and/or as a percentage of budget (to aid understanding) so long as that advice is tailored to the circumstances of the authority. also acknowledges that adding to reserves competes with service needs.

The advice should be set in the context of the authority's risk register and medium-term plans and should not focus exclusively on short-term considerations. Balancing the annual budget by drawing on general reserves may be viewed as a legitimate short-term option. However, it is not normally prudent for reserves to be deployed to finance recurrent expenditure.

In addition, authorities will hold the following two usable reserves:

- a capital receipts reserve – this reserve holds the proceeds from the sale of assets and can only be used for those purposes specified in the capital finance and accounting regulations.
- a capital grants unapplied account - this reserve will hold capital resources (from capital grants) that have been recognised as income and not yet applied to capital expenditure.

The statutory reporting regime described earlier, and effective financial management underpin the need for clear, transparent reporting arrangements for reserves. For each reserve there should be a clear protocol setting out:

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