

KENNET DISTRICT COUNCIL

RESOURCES EXECUTIVE COMMITTEE to be held on Tuesday, 30th June 2006

REPORT OF THE DIRECTOR OF RESOURCES

A POLICY FOR REVENUE RESERVES

1. Introduction

The purpose of this report is to recommend the adoption of a formal policy for revenue reserves.

2. Background

Traditionally, the Council has taken the view that, in an uncertain financial world the Council needs to have substantial reserves. The Council's Medium-Term Financial Strategy makes it clear that the Council wishes to fund current expenditure from current resources without reliance on the use of reserves to balance budgets. That in turn implies that the Council would wish to maintain its current levels of earmarked reserves. However, a very broad brush approach to reserves, although pragmatic, is no longer seen as being appropriate.

Members will be aware that the Audit Commission has carried out a "Use of Resources" inspection that assessed the Council's management of its financial affairs and its approach to Value for Money. The outcome from the inspection was an overall score of 3, on a scale of 1 to 4, a very creditable performance that most local authorities have failed to achieve. However, as part of the feedback from the inspection the Auditor has made suggestions as to how the Council might improve further, one of which is to "clarify the purpose and level of earmarked reserves and report to Members".

This report will go further than that and also discuss general revenue reserves.

3. Financial, Staffing, Legal and Risk Management Implications

There are no staffing or legal implications arising from the report. The management of financial risk and financial standing form the substance of the report.

4. Definitions

There are two main categories of revenue reserves, “earmarked reserves” and “general reserves”.

Earmarked reserves are funds set aside to meet particular revenue liabilities, but the exact time those liabilities will be met, and the exact amount needed to meet them is not known. A summary of the estimated amount of earmarked reserves at the end financial year 2006/07, and the purposes for which they are held is given at Appendix A.

General reserves, as the name implies, are not held for a particular purpose, but are held in support of the Council’s finances generally, and:

- provide a working balance to meet any cash flow variations arising during the year, (more money going out than in at any one point) - sometimes known as working capital;
- provide a general contingency against unforeseen, financially adverse events, and;
- provide the opportunity to fund revenue costs as a means of keeping within expenditure limits.

Both earmarked and general reserves are, of course, invested pending their use, and the investment income so derived is used to help fund current expenditure.

5. Earmarked Revenue Reserves

By definition, once the need for an earmarked reserve is accepted, the level of each reserve, and therefore the level of earmarked reserves in aggregate, is determined largely by circumstances. For example, those reserves where developer deposits are held is determined by the number and type of planning agreements the Council enters into. Similarly, the level of the Repairs and Replacement Reserve is determined by the number, life expectancy and cost of vehicles, computer and similar equipment. Therefore, the level of reserves is justified by circumstances. However, a policy of holding earmarked reserves where it is prudent to do so to meet known and potential financial liabilities should be adopted, and indeed the list of current earmarked reserves at Appendix A should be approved. Under the Council’s Constitution the decision to establish such reserves is delegated to the Finance Services Manager in consultation with the Director of Resources, but this delegation should be subject to an annual report to the Resources Executive Committee.

6. General Revenue Reserves

In contrast with earmarked reserves the decision on what level of general reserves is appropriate is a matter of judgement. However, that judgement

should be informed in relation to the purpose for holding general revenue reserves as set out at section 4 of the report above.

While the need to hold a working balance to provide working capital is obvious and necessary, the fact of the matter is that the Council's revenue cash flow has always been very positive in the first three quarters of any financial year, (because of early and front-ended collection of council tax and business rates, and the front-ended receipt of Government grants) with a deterioration in the last three months, but not sufficient deterioration to cause cash flow problems. This would imply a very low level of reserves for working capital purposes. However, there is a risk that the positive cash flow we have always experienced could be upset by events outside the Council's control, such as;

1. failure of computer systems to generate bills or reminders;
2. changes in Government grant payment profiles to favour central government cash flow at the expense of local authority cash flow.

Holding general revenue reserves to meet unforeseen events ("saving for a rainy day") is clearly a prudent thing to do. However, the question as to what level of reserves to hold should be related to possible risks, and an assessment of the likelihood and severity of the main risks involved in any revenue budget.

The risk of needing substantial revenue reserves to avoid increases in local taxation is a risk that is within the control of the local authority. Where there is a propensity to use revenue reserves to avoid making difficult spending or taxing decisions, (as is the case in some local authorities) the need for a high level of reserves for this purpose might be necessary, albeit unlikely to be achieved because they will have been used for that purpose before. Given that the Council's Medium Term Financial Strategy is to reduce reliance on general revenue reserves to fund current expenditure, this risk is not significant.

In short, decisions on the level of general revenue reserves come down to an assessment of risk. Appendix B to the report seeks to make that assessment more transparent to Members and other stakeholders.

Appendix B indicates that a figure of around £830,000 for general revenue reserves would be appropriate. That figure relates to a maximum in-year risk. On the one hand one might argue that the Council would have to be exceptionally unfortunate for all risks to become reality in the same year, and that in turn might lead one to argue for a lower general reserves figure. However, there is a countervailing argument. Up until recently a significant call on reserves to meet an unforeseen event in one year could be rectified in the following year by increasing council tax to restore lost reserves. Now that we have a national council tax limit above which capping will be imposed, (currently 5% but likely to be reduced further in the future) the Council's ability to restore reserves once used is significantly impaired. The Council already finds it very difficult to produce a balanced budget without having to find money to add to replace reserves used to meet unforeseen expenditure.

Without recourse to additional taxation the Council would have to reduce budgets elsewhere to meet losses and restore balances, and this takes time.

Given the tax situation, it is my judgement that the Council should:

- (a) halve the total figure given at Appendix B to reflect the unlikelihood of all adverse events happening at one time, but;
- (b) multiply the resulting figure by 5 to reflect the reality that it would take a number of years to replace reserves lost because of an adverse event or events.

This in turn would lead to the need for a general revenue reserve of around £2m. Deciding on the level of general reserves required will never be a scientific exercise, but it should be a rational exercise. Given the imprecision of any rationale for deciding reserve levels, it may be more helpful to think in terms of an acceptable range of reserve levels, around a central, calculated figure. Based on a calculated figure of £2m the Council should in my view certainly be looking at general revenue reserves in the range of no less £1.7m, and preferably closer to £2.3m. The estimated general reserves at the end of 2006/07 total £2.05m.

7. Recommendations

It is **RECOMMENDED THAT:**

1. The practice of maintaining earmarked reserves to meet known and potential financial liabilities should be continued.
2. The level of earmarked reserves and their purpose, including any new reserves set up under delegated powers, should be reported to the Resources Executive Committee each year.
3. The Council should maintain general revenue reserves at a level consistent with its financial risk exposure, currently in the range of £1.6m (minimum) to £2.4m (maximum).
4. The level of general revenue reserves needed should be assessed each year as part of the budget-setting process.

Director of Resources

APPENDIX A

ESTIMATED EARMARKED RESERVES 31.03.07

Earmarked Reserve	Estimated Balance 31.03.07
<u>Training Reserve.</u> The purpose of which is to fund staff and member training when peaks in training needs exceed the available annual budget, and to smooth out the impact of the different start dates for academic and financial years.	£60,929
<u>Amenity Areas Reserve.</u> This allows (by definition) irregular contributions from developers for the maintenance of amenity areas to be released in a regular pattern to meet known amenity area costs, currently the management of Council-owned trees.	£140,570
<u>Play Equipment Reserve.</u> Contributions from developers are deposited in this reserve pending their use to provide and maintain play equipment required under planning agreements.	£109,986
<u>Building Control Reserve.</u> The Council is required to maintain a separate account for the fee-earning aspects of building control work, and any deficit or surplus on the account is carried forward here.	-£57,384
<u>Leisure Section 106 Reserve.</u> Contributions from developers are deposited in this reserve pending their use to provide and maintain leisure/community facilities required under planning agreements.	£239,647
<u>Insurance Reserve.</u> The Council self insures against some minor insurable risks and this reserve would be used in the event of a loss from the uninsured risks involved.	£28,183
<u>Community Initiatives Reserve.</u> This reserve is maintained to meet Council contributions to community projects that Members would wish to support but for which no specific budget provision has been made.	£66,835
<u>Planning Delivery Grant Reserve.</u> Planning Delivery Grant is paid into the reserve, and used to meet additional development control and other planning costs that are designed to maintain the Council's performance in these areas.	£640,180
<u>Repairs and Replacements Reserve.</u> The revenue accounts are charged with what is effectively depreciation on vehicles, computer and similar assets so that the money is available to replace those assets at the end of their useful life.	£807,874
ESTIMATED TOTAL 31.03.06	£2,036,820