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Archwilydd Cyffredinol Cymru
Auditor General for Wales

Financial resilience of local authorities in Wales 2015-16



WALES AUDIT OFFICE
SWYDDFA ARCHWILIO CYMRU



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Summary report

Summary

- 1 Since 2010, the UK government has reduced spending on public services as part of its plan to reduce the deficit. With cuts to its budget, the Welsh Government has had to make difficult choices as to how to allocate those funding cuts across devolved public services. As a result, the amount of Aggregate External funding made available by the Welsh Government to local authorities has reduced each year. So far, most local authorities have managed to reduce expenditure and balance budgets, but the scale of annual reductions is set to continue. Local government receives the bulk of its general revenue funding through what is known as Aggregate External Finance (AEF). Our analysis shows that between 2010-11 and 2016-17, there will be a real-terms reduction of £761 million (17 per cent) in the AEF¹.
- 2 These reductions have created financial risks and uncertainty for local authorities and within this challenging and changing context, local authorities must continue to deliver a wide range of services which citizens in Wales depend upon. These range from adult social care to maintaining highways to collecting waste and educating young people. They also provide discretionary services according to local priorities. Ensuring that local authorities remain financially sustainable and continue to deliver their statutory services to a sufficient standard is becoming more difficult, especially as many local authorities are unable to demonstrate the impact of their budget decisions on the services they provide and do not have a good understanding of how sustainable their services are.
- 3 Whilst there is a robust financial framework in place that effectively prevents local authorities becoming insolvent, the impact on services caused by funding reductions is more difficult to discern. Oversight by the Welsh Government appears robust in preventing financial failure but it is weaker at highlighting the extent of financial pressure within authorities.
- 4 Dealing with the impact of these budget decreases therefore requires local authorities to significantly change the way they manage and govern their finances. Financial management arrangements that were once good enough, are now unlikely to be fit for purpose to continue to deliver strong financial outcomes in the future. The scale of cost reduction required also means that local authorities have to look beyond immediate short-term savings and think more radically about how to reduce costs, and how to sustain this in the longer term whilst still maintaining or improving services. Conversely, new technologies and the emerging 'social economy' also make this a period of potentially great innovation for local government.

¹ Comparing AEF across the period 2010-11 to 2016-17 is complicated for two main reasons. Firstly, the Welsh Government has incorporated grants that were previously provided separately into AEF. While this 'de-hypothecation' of grants results in an increase in AEF, it is not necessarily a net increase in funding. The net value of grants incorporated into AEF since 2010-11 is around £175 million in real terms (adjusted for inflation). In addition, the picture is complicated by the abolition of council-tax benefit which has been incorporated into the AEF.

- 5 The impact of 'BREXIT' also represents a threat to local authorities and the wider public sector in Wales. In the immediate aftermath of the decision there was reaction across financial markets resulting in volatility in, for example, share prices, currency exchange rates, oil prices and bond yields, and we continue to face a great deal of uncertainty on top of significant questions regarding the UK's future economic and trading relationships with Europe. The Welsh Local Government Association (WLGA) has expressed concerns over the implications of the EU referendum outcome, calling it a 'seismic change in UK public policy',² especially as local authorities are the largest employer in Wales and the deliverer of many important public services.
- 6 It is impossible to say how these issues will play out in the coming weeks and months. They will undoubtedly cause further and ongoing uncertainty for many public bodies, such as pension funds, who have significant exposure to these markets. In addition, with uncertainty over UK government funding projects that benefitted from the EU Structural Fund³, authorities face a number of major challenges in managing their finances in the future. Despite the uncertainties it would be prudent for local authorities to have in place arrangements to evaluate and manage the potential impact of the UK's exit from the EU on their financial position; and, where feasible, to implement any mitigation to the risks that they identify.
- 7 In this report we look at the current financial performance of the 22 local authorities⁴ in Wales and the quality of their financial management arrangements, in order to determine their level of resilience in meeting these challenges. This work builds upon our earlier reports on the financial resilience of local authorities⁵ and assesses the robustness of management and planning arrangements to support financial resilience at each authority, focusing on how they plan and then deliver their budget commitments. These reviews involved external audit teams undertaking fieldwork on behalf of the Auditor General of each local authority's financial-planning arrangements. We are currently setting up our next iteration of our financial resilience work and intend to focus on identifying good practice examples to support improvement, and will aim to support these through planned good practice activities when the report is finalised.
- 8 The focus of the review is the 2015-16 financial-planning period and the delivery of 2014-15 financial plans. We have also analysed the financial-performance track-record of local authorities in 2013-14. There were three main elements to our work.
- a the robustness of local authorities' financial-planning systems;
 - b the effectiveness of financial management controls; and
 - c the strength of financial-governance arrangements.

² Welsh Local Government Association, **Councils voice concern over service impacts of EU referendum**, 24 June 2016.

³ EU funds are supporting business, research and innovation, helping people into work, increasing skills, improving transport and digital networks, regenerating our communities, and enhancing our environment. Since 2007, EU projects have created 11,925 enterprises and 36,970 (gross) jobs, helped 72,700 people into work, 232,455 people to gain qualifications, and 56,000 people into further learning. Welsh Government, **EU funds in Wales**, 29 June 2016.

⁴ This report does not cover national parks, fire and rescue authorities or town and community councils.

⁵ Auditor General for Wales, **The financial resilience of councils in Wales**, 2 April 2015

- 9 Based on the findings of this audit, the Auditor General has concluded that since our last review **local authorities are improving their strategic planning arrangements but are having difficulty in developing and delivering the savings and changes to services at the pace required to ensure future financial resilience.**

Recommendations

- 10 In our report of 2014-15, we made a number of recommendations for local authorities. Many of these recommendations remain relevant and further work is required from authorities to address them in 2016-17. In addition, we have also made the following recommendations based on our most recent review.

Recommendations	
R1	Local authorities should strengthen their financial-planning arrangements by: <ul style="list-style-type: none"> • developing more explicit links between the Medium Term Financial Plan (MTFP) and its corporate priorities and service plans; • aligning other key strategies such as workforce and asset management plans with the MTFP; • developing comprehensive multi-year fully-costed savings plans which underpin and cover the period of the MTFP, not just the forthcoming annual budget; • categorise savings proposals so that the shift from traditional type savings to transformational savings can be monitored over the period of the MTFP; and • ensuring timescales for the delivery of specific savings proposals are realistic and accountability for delivery is properly assigned.
R2	Local authorities should develop corporate Income Generation and Charging Policies.
R3	Local authorities should ensure that they have a comprehensive reserves strategy which outlines the specific purpose of accumulated useable reserves and the impact and use of these in the MTFP.
R4	Local authorities should develop Key Performance Indicators to monitor the MTFP.
R5	Local authorities should ensure that savings plans are sufficiently detailed to ensure that members are clear as to what the plans are intended to deliver and that the delivery of those plans can be scrutinised appropriately throughout the year.
R6	Local authorities should ensure that corporate capacity and capability are at a level that can effectively support the delivery of savings plans in the MTFP at the pace required.

- 11 In addition we have also made the following recommendation to the Welsh Government.

Recommendations

- R7 The Welsh Government needs to ensure it has robust arrangements in place to oversee financial and service performance in all council services to ensure it is able to deliver its policy responsibilities effectively.

Part 1

Medium-term financial planning processes have been strengthened but plans are not fully integrated with other strategies and the quality and scope of savings and change programmes are mixed



- 1.1 In this section of the report, we focus on the effectiveness of local authorities' strategic financial-planning arrangements. In our report of April 2015 we concluded that most local authorities demonstrate clarity of vision and set coherent corporate objectives, but need to ensure their medium-term financial plans (MTFPs) and operational plans are sufficiently aligned to deliver their objectives. For this year we have concluded that MTFP processes have been strengthened but plans are not fully integrated with other strategies and the quality and scope of savings and change programmes are mixed.
- 1.2 Robust strategic planning is crucial to the future financial resilience of local authorities. Our analysis⁶ set out in **Exhibit 1** summarises how well authorities are currently performing against the key characteristics of effective financial planning.
- 1.3 We identified a number of areas in which strategic financial-planning arrangements need to be improved. In particular, local authorities should ensure that: their planning framework makes explicit links between corporate plan objectives and financial planning requirements; and their financial plans set out clear solutions to the medium-term challenges the authority expects to face. It is also important to emphasise that even those whose current planning frameworks are considered low or medium risk will need to continue to evolve to respond to future financial challenges.

⁶ In delivering this work, auditors risk rated each authority against the aspects of Financial Planning, Financial Control and Financial Governance. Our analysis is based on the detailed assessments conducted at the 22 local authorities, for the financial year ending 2015-16. To assist in doing so, a series of low-risk and high-risk characteristics were used to rate each aspect to help auditors come to an 'on-balance' view of relative risk.

Exhibit 1 – Characteristics of effective financial planning and our evaluation of current performance

Findings	Characteristics
<p>The majority of authorities have arrangements that reflect these characteristics</p>	<ul style="list-style-type: none"> • Ability to deliver statutory responsibilities when considering its short, medium and long-term financial plans • Assumptions around inflation, income levels, demographics, future demand for services and the costs of delivering services are modelled and based on reasonable predictions. • Operates within a level of reserves (including earmarked reserves and the general-fund balance), approved by members, and appropriate to the strategic, operational and financial risks it faces. • If not at the target level for reserves, there is planned action in place to achieve this, taking account of any associated risks to the financial position and delivery of priorities. • Models key expenditure drivers (for example, population changes and demand for services), sources of income (for example income and government grant forecasts), revenue consequences of capital and resource requirements and the use of balances.
<p>A number of authorities need to improve their arrangements in some of these areas</p>	<ul style="list-style-type: none"> • Has a good track record in delivering savings plans. • The budget is set in the context of a longer-term financial strategy and an MTFP covering a three to five-year horizon. • Medium-term financial planning and annual budgeting reflect strategic objectives and priorities for the year, and over the longer term. • Understands sources of income and risks arising from these, and has reviewed the approach to fees and charges to achieve 'Value for Money'. • Uses financial modelling to assess the likely impacts on financial plans and required savings for different scenarios, and to ensure short-term fixes are not achieved at the expense of long-term sustainability.
<p>Many authorities have weaknesses in these arrangements</p>	<ul style="list-style-type: none"> • Clearly identified the savings intended to make over a three-to-five-year term. The savings plan is underpinned by detailed costings and delivery plans for individual savings (including transformation/change savings). • Financial and corporate planning processes are integrated, linked to risk management arrangements, and incorporate strategic planning for other resources including the capital programme, asset management and workforce planning.

Source: Wales Audit Office, **Financial Resilience Report**, November 2015 to April 2016.

Medium-term financial plans are generally not well aligned with other key strategies

- 1.4 A local authority's corporate planning framework should support the development of its corporate plan and all other supporting strategic plans, including the MTFP. The framework needs to be robust to ensure that the corporate plan is fit for purpose. Without such a coherent and robust framework, there is a risk that supporting plans are developed in silos, do not support the overall strategic aims and could even inhibit their achievement.
- 1.5 We found that all authorities' corporate plans had a clear overall vision and aims which were translated into a set of improvement objectives, but in a minority of local authorities the financial planning framework and the corporate plan objectives are not fully integrated. For example, we found that over half of local authorities were in the process of reviewing their corporate plans and corporate priorities to meet the challenge of prioritising and rationalising service delivery in the context of decreasing resources.
- 1.6 In the last 12 months, auditors rated the number of local authorities with mostly adequate or better financial-planning arrangements, to have increased from approximately half of local authorities in 2014-15 to two-thirds of local authorities in 2015-16. This indicates that a third of local authorities still need to strengthen their planning arrangements. Unless planning arrangements are strengthened and continually evolve, local authorities will find it more difficult to deal with future financial pressures.
- 1.7 We reviewed how effectively local authorities linked their corporate improvement objectives to service delivery and financial plans, and if budgets are set in line with the delivery of the corporate vision, aims and improvement objectives. The findings were mixed.
 - a eight local authorities used a 'golden thread' corporate planning approach and could clearly show how the achievement of corporate objectives is underpinned by service plans and the medium-term financial strategy;
 - b 11 local authorities could show partial links, with the main weakness being links with service delivery plans; and
 - c three local authorities could not demonstrate how improvement objectives were linked to financial-savings plans or service plans.
- 1.8 Subsequently, a number of local authorities have refined and reduced the number of corporate priorities and improvement objectives and are aligning their medium-term financial strategies to reflect this.

The quality, robustness and currency of medium-term financial plans is mixed

- 1.9 The MTFP is a key component of an effective corporate-planning framework and should act as the link between the corporate strategy and the budget-setting process. Our review of authorities' MTFPs considered the timeframe of the plan, management of financial risks, underlying assumptions, sensitivity analysis and links to other key strategies. We also considered whether authorities' annual budgets flow from and influence longer-term financial strategies.
- 1.10 We found that all local authorities had an MTFP but the quality, currency and robustness of the plans are mixed. Whilst two-thirds of local authorities adequately link annual budgets and the MTFP, few local authorities specifically link their MTFPs to other strategies such as asset management and workforce strategies, and lack a 'whole-resources' focus on planning and delivering services.
- 1.11 Local authorities with more comprehensive MTFPs review them, as a minimum, on an annual basis, and some authorities also carry out mid-term reviews. Local authorities with more sophisticated financial planning regimes cover a four-to-five-year planning period and are subject to a range of assumptions and sensitivity analyses to forecast the best and worst-case revenue-budget scenarios. These authorities also consider the likely financial risks they face and also set reserve levels within a specific local policy context.
- 1.12 However, we found that one-third of local authorities still have underdeveloped MTFPs. The main weaknesses include limited links with other key strategies, plans not being updated in a timely manner, lack of risk analyses and limited scenario planning resulting in over-optimistic budget forecasts and underdeveloped savings plans.
- 1.13 Most local authorities have made comprehensive and reasonable assumptions in forecasting the budget shortfall⁷ for 2015-16, underpinned by reasonable data in relation to pay pressures, more general cost pressures, council-tax income levels and reductions in revenue support grant. However, in some local authorities the data used to model and project the impact of demographic change and increased demand for services could be improved.
- 1.14 The use of Key Performance Indicators (KPIs) within the MTFP can be useful to measure progress and financial resilience, particularly for important issues such as liquidity, return on investments and borrowing levels. In our 2014-15 review, we found that the use of financial KPIs within the MTFP to monitor and manage performance was underdeveloped. We found that there has been little improvement on this in 2015-16.

⁷ The budget shortfall is the amount local authority expenditure exceeds income from in any one financial year.

- 1.15 Our most recent review found that all local authorities review and set prudential indicators annually to satisfy treasury management requirements and set targets for the level at which to retain general reserves. However, there is no evidence that any other key financial ratios have been considered or monitored as part of routine financial or performance monitoring.
- 1.16 During 2015-16, one authority has developed a financial-performance snapshot that lists annual financial ratios for liquidity, gearing and working capital, and reserves and savings levels. It is too early to evaluate how this will be used and the impact this may have on the scrutiny and challenge of their future financial performance.

Local authorities continue to balance their budgets but the majority do not have well-developed plans with appropriate actions, and struggle to deliver intended savings

- 1.17 Most local authorities used a mixture of budget-savings proposals, increased council-tax income and increases in fees and charges to set a balanced budget. However, around one-third of local authorities planned to use general or earmarked reserves to meet any remaining shortfall between anticipated income and expenditure or fund non-recurring expenditure. Some local authorities have included the use of earmarked transformation reserves to allow services more time to develop savings plans which will yield greater savings in future years.
- 1.18 Whilst the overall budget outturn position for 2014-15 for most local authorities was positive, there were overspends and underspends on service expenditure across all local authorities. This masks underlying recurring budget pressures facing some services in some local authorities, particularly demand-led services such as adult social care and children's services. Historically, local authorities have tended to mitigate overspends in one service area by offsetting underspends in other service areas. Failure to address and resolve underlying budget issues coupled with the need to reduce budgets places those local authorities which rely on this method of mitigation at greater financial risk in the future.
- 1.19 Whilst most local authorities have a good track record of delivering an overall positive budget outturn, the majority of local authorities do not have a track record of delivering all planned identified savings. Five local authorities achieved all planned savings for 2014-15 and six identified the majority of savings. Eleven local authorities had more significant shortfalls in their savings plans for 2014-15.

- 1.20 The majority of local authorities review their savings plans but the depth and extent of reviews are mixed.
- a Some local authorities produce comprehensive savings reports and review progress regularly against specific savings proposals using a Red/Amber/Green (RAG) status or equivalent. These local authorities also identify mitigating actions required to meet planned savings which are unlikely to be achieved and consider contingency plans.
 - b Some local authorities do not review individual savings proposals and tend to focus on the overall budget outturn position and reference the achievement of savings proposals within these reports.
 - c Some local authorities review progress on a monthly or quarterly basis, others on an ad hoc basis or at the year-end.
 - d Some local authorities have a specific transformation or budget board set up which reviews the progress of savings plans. This tends to happen in those local authorities which have reviewed and prioritised services and developed specific programmes to reshape services over the medium to longer term.
- 1.21 Our review found that most local authorities achieved a surplus on their budgeted outturn position for 2014-15. This is an increase on 2013-14. Nineteen local authorities reported a surplus on their 2014-15 revenue budget compared to 15 in 2013-14. Three local authorities reported an overspend on their 2014-15 budget compared to seven in 2013-14.
- 1.22 Our review identified that the value of shortfalls varied significantly across local authorities and that 14 local authorities have carried forward unachieved identified savings from 2014-15 to 2015-16. This places additional pressure on local authorities to achieve delivery of savings in future years, which could compromise their financial resilience. Local authorities have tended to turn to alternative savings from those originally identified to meet any savings shortfalls during the year. In some cases the savings shortfalls have been bridged by the use of one-off funding from earmarked reserves, contingency funds specifically set up to address shortfalls or unplanned income received during the year.
- 1.23 Use of one-off funding by these methods to fund recurring base budgets is unsustainable in the medium to longer term. The savings shortfalls mainly relate to savings proposals and targets linked to transformational and change programmes. Conversely, a few local authorities have been able to identify and deliver savings in advance of when they are needed, placing them in a better position to develop medium to longer-term plans to meet future years' savings requirements.

- 1.24 Our review included analysis of the track record of local authorities over the last three years in delivering planned identified savings without the need to identify alternative or substitute savings. We found that whilst some local authorities have managed to achieve their savings plans as identified, around half of local authorities still struggle to deliver their identified savings proposals in full.
- 1.25 Our review indicates that most local authorities are able to fully deliver the more traditional type of savings within the timescales as planned. This is because these type of savings are usually incremental and drawn from specific base budgets when the budget is set.
- 1.26 However, local authorities continue to experience difficulty in delivering savings of a transformational or cross-cutting and collaborative nature, or those which require policy changes. These type of savings make up the majority of the unachieved in-year savings plans. Reasons for non-achievement are mainly a result of overambitious savings targets, partly a reflection of poor estimating when setting targets, and overambitious and unrealistic timescales for delivering savings when the annual budget is agreed.
- 1.27 In our 2015-16 review, we found that only one-third of local authorities had identified and fully costed savings relating to transformation and change management when their annual budgets were set. This raises concerns about the ability of some local authorities to make the stepped change required to deliver savings of the scale and at the pace required to ensure financial resilience.
- 1.28 In our previous review we considered weaknesses in savings plans to be the most crucial challenge facing local authorities in the next few years. Our report also highlighted that, as relatively easy savings have already been made, local authorities would need to develop longer-term transformational projects to address the significant budget pressures they face.
- 1.29 Around two-thirds of local authorities now have a formal process in place for tracking savings progress and consider risk and mitigation in evaluating proposals. However, the robustness of savings plans and planning actions remains weak, when measured against SMART principles, with only half of local authorities having SMART savings plans in place for 2015-16.

- 1.30 However, our review of the 2015-16 savings plans showed that:
- a When the annual budget was set most local authorities' savings plans included a mixture of fully developed plans, implementation plans at the development stage or plans yet to be developed. Around one-third of local authorities did not include clear descriptions of where savings will be made or record specific amounts against each item.
 - b A small number of local authorities did not identify sufficient savings to fill the budget gap for 2015-16 when agreeing the annual budget and have included the use of general reserves as part of their budget strategy.
 - c Less than half of local authorities are likely to achieve their planned approved savings plans in full, which means that mitigating measures will be required to achieve a balanced budget.
 - d Less than half of local authorities have savings plans which are fully integrated with service and business plans.
 - e Around half of local authorities did not have clear timescales for achieving the savings.
- 1.31 We found that most local authorities focussed on identifying savings proposals to meet the 2015-16 savings plan requirement. Some local authorities had also identified savings proposals to partially address the budget gap for 2016-17 and beyond. Our review of the savings proposals suggests that the largest proportion of savings proposals for 2015-16 related to the more traditional type of savings, for example, top slicing budgets by specific targets, vacant posts, and reduction in administrative budgets. Few local authorities had fully-costed and separately identified proposals of a transformational nature.
- 1.32 A small number of local authorities categorise their savings proposals into different types, so that the shift towards transformational and change management savings from the more traditional type of savings can be demonstrated over time.

Part 2

Financial management and control arrangements are mostly sound but managing spending within budget remains a challenge for some local authorities



- 2.1 In this section of the report we focus on the local authorities' financial management and control arrangements. In our report of April 2015 we concluded that financial management and controls are sound in most local authorities although many need to improve budget setting and monitoring and ensure there is sufficient capacity and capability in the finance team to meet the challenges ahead. For this year we have concluded that financial management and control arrangements are mostly sound but managing spending within budget remains a challenge for some local authorities.
- 2.2 **Exhibit 2** summarises how well authorities are currently performing against the key characteristics of effective financial management and control.
- 2.3 We concluded that the framework in most local authorities is mostly adequate for current needs. Arrangements are mostly sound and risks are relatively low. Two areas where arrangements need to be strengthened are in relation to managing spending within the budgets set, and developing corporate-wide approaches to generating income.

Exhibit 2 – Characteristics of effective financial management and control arrangements and our evaluation of current performance

Findings	Characteristics
<p>The majority of authorities have arrangements that reflect these characteristics</p>	<ul style="list-style-type: none"> • Appropriate and effective budget management policy that clearly sets out roles, responsibilities and accountability. The scheme of delegation is clear, and processes are set out to manage budget under and overspends. • Challenging targets for the collection of material categories of income and arrears are set and monitored and based on the age profile of debt. Where targets are not being met, appropriate corrective action is taken during the year to achieve the targets. • Significant levels of debt are not written off as uncollectable. • The Annual Governance Statement gives a true reflection of the authority’s control environment.
<p>A number of authorities need to improve their arrangements in some of these areas</p>	<ul style="list-style-type: none"> • Financial monitoring and forecasting is fit for purpose and accruals based, helping to ensure a clear link between the budget, in-year forecasts and the year-end position • Relevant trends are analysed and extrapolated and their impact on the projected final outturn is considered. • Timely action to address any budget pressures is taken, for example, corrective action to manage unfavourable variances or by revisiting corporate priorities. • Key financial ratios are monitored and benchmarked against similar bodies and action is taken as appropriate. • There is a clear policy on the use of reserves. There is a clearly justified minimum level for the general-fund reserves balance. There is a clear rationale to explain transfer from or between reserves. Clear protocols explain how and when each reserve should be used. Decisions about reserves are underpinned by a comprehensive assessment of risk and current performance. The reserves policy has been agreed by members and is subject to scrutiny.
<p>Many authorities have weaknesses in these arrangements</p>	<ul style="list-style-type: none"> • Good recent record of operating within budget with no significant overspends. • Clear policy on income generation/charging. There is a register of charges across services to help manage charges consistently. Corporate guidelines on how concessions should be applied. Charges are regularly reviewed and the policy is updated.

Source: Wales Audit Office, **Financial Resilience Report**, November 2015 to April 2016.

Financial reporting in most local authorities is well developed but the quality and timeliness of reports remain mixed

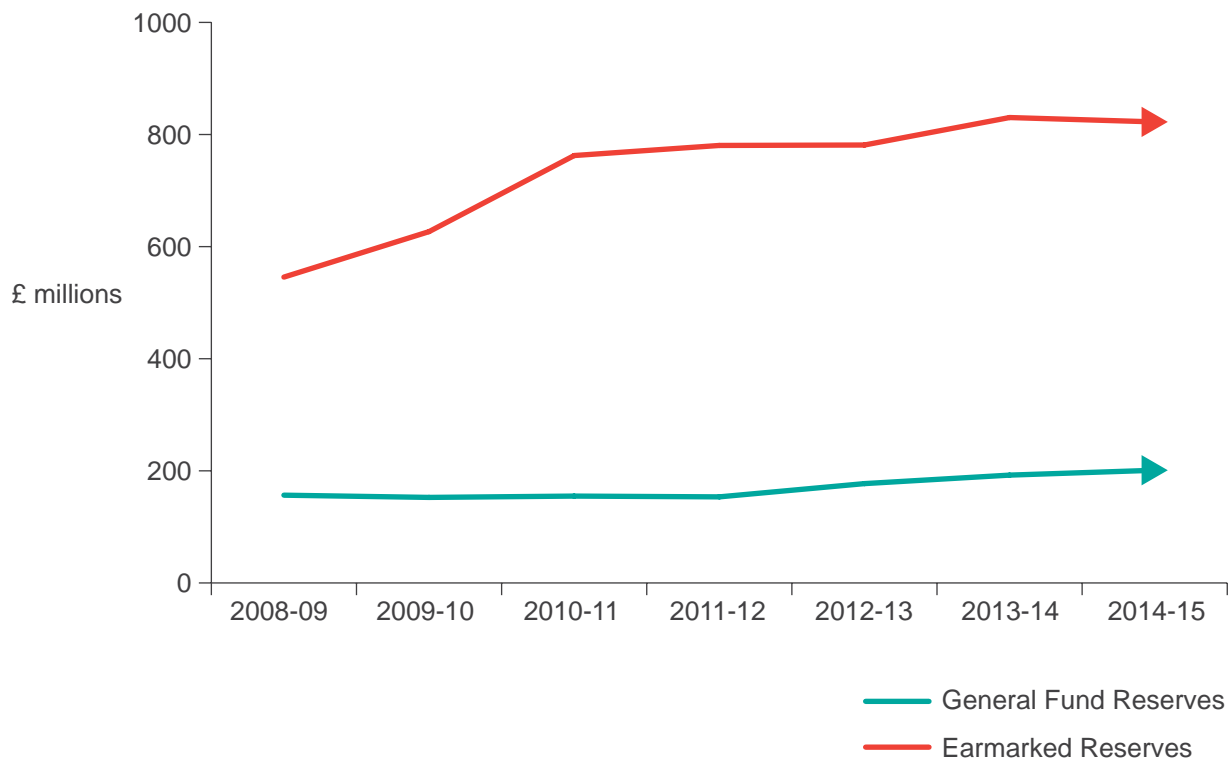
- 2.4 We found that most local authorities have good budget-setting and budget-monitoring policies, procedures and processes in place. We did not identify any fundamental weaknesses in control frameworks for financial management but we did identify that reporting processes and procedures on budget setting and financial forecasting could be improved.
- 2.5 We noted that a number of local authorities have made improvements to their budget-setting processes since our 2014-15 review. Examples of improvements include stronger engagement in the financial-planning process by: involving service managers and members in base budget reviews and setting savings targets; providing a greater number of awareness sessions for staff and members on the key financial issues facing the authority and potential changes in service delivery; and increased consultation periods for consideration of savings proposals.
- 2.6 However, whilst some local authorities include more detailed future-year indicative budgets in their budget-setting reports, a number of local authorities still focus primarily on the annual budget. Given that local authorities are considering the impact of reduced funding on services in the medium to longer term and preparing MTFPs, we think it is good practice for all local authorities to prepare indicative budgets for future years.
- 2.7 Whilst financial reporting in most local authorities is well developed the quality and timeliness of reports produced for consideration by officers and members are mixed. We found that most local authorities produce budget-monitoring reports and savings-monitoring reports on a monthly basis for consideration by budget holders and senior management. However, the format and content of reports are variable.
- 2.8 Financial forecasting at most local authorities is well developed and forecasts are subject to regular review. However, the robustness of the forecasts is variable. All local authorities produce budget-monitoring reports which include projections for the year-end outturn. We found instances of in-year financial projections being overly pessimistic or optimistic resulting in large unexpected underspends or overspends being projected in the final quarter of the financial year. This has an adverse impact on financial decision making and in particular service and financial planning.

Whilst funding from the Welsh Government to local authorities continues to reduce, useable reserves are growing

- 2.9 On the surface, a continuing trend of increases in local authorities' average reserve balances suggests that it is one of the strongest performing criteria of financial resilience in Wales. However, whilst it has been presumed for the purposes of this analysis that high levels of reserves are considered to reflect strong financial resilience, this is a more complicated and complex picture. Building up reserves with no clear purpose is not an effective use of resources.
- 2.10 General-fund reserves are a working balance to help cushion the impact of uneven cash flows and avoid unnecessary temporary borrowing and form a contingency to cushion the impact of unexpected events or emergencies. Earmarked reserves are a means of building up funds to meet known or predicted requirements and are accounted for separately but remain legally part of the general fund.
- 2.11 Our review considered how prudently local authorities manage their reserves and if they have clear strategies for the creation and use of reserves when determining their MTFPs. Since our last review around a quarter of local authorities have formally adopted reserves policies.
- 2.12 Over two-thirds of local authorities have protocols or policies in place for managing reserves that include a clear rationale for how and when reserves will be used. Most local authorities report transparently on the use of reserves and normally review and update the position when setting the annual budget and closing the annual accounts. All local authorities receive advice from their Section 151⁸ officers on the recommended level of reserves to be retained. Some local authorities include details on movements in reserves in their routine financial-budget monitoring statements.
- 2.13 **Exhibit 3**, which summarises our analysis of local-authority reserves taken from our review of individual Statutory Accounts, shows that in the last seven years reserves held by local authorities have grown significantly. General-fund reserves have risen by 28 per cent since 2008-09 and Earmarked Reserves by 50 per cent. In last year's review local authorities indicated that they expected earmarked and general-fund reserves to fall significantly in 2013-14 and going forward. However, the overall level of reserves increased by £64.2 million in 2013-14 from 2012-13, and increased slightly between 2013-14 and 2014-15 by £1.05 million (earmarked reserves decreased by £7.7 million while the general-fund reserve increased by £8.75 million).

⁸ Section 151 of the Local Government Act 1972 requires every local authority to make arrangements for the proper administration of their financial affairs and requires one officer to be nominated to take responsibility for the administration of those affairs. The Section 151 officer is usually the local authority's treasurer and must be a qualified accountant belonging to one of the recognised chartered accountancy bodies. The Section 151 officer has a number of statutory duties, including the duty to report any unlawful financial activity involving the authority (past, present or proposed) or failure to set or keep to a balanced budget. The Section 151 officer also has a number of statutory powers in order to allow this role to be carried out, such as the right to insist that the local authority makes sufficient financial provision for the cost of internal audit.

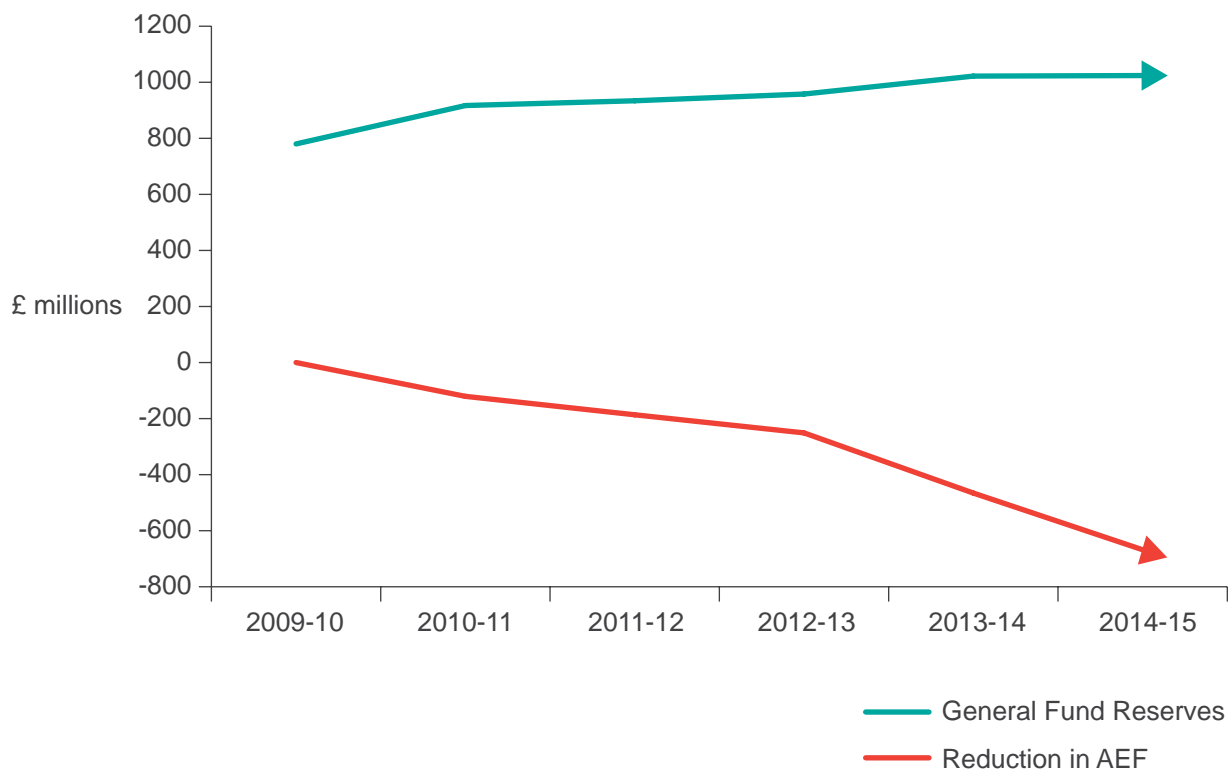
Exhibit 3 – Local Authority General Fund and Earmarked Reserves in Wales 2008-09 to 2014-15



Source: Wales Audit Office review of Statutory Accounts between 2008-09 and 2014-15.

2.14 Exhibit 4 compares the change in general-fund and earmarked reserves and the reductions in the AEF between 2009-10 and 2014-15. This shows that whilst local authorities have had to absorb and deal with £668 million of cuts, they have also increased reserves in this period by £244 million and have at least maintained reserves despite having to reduce budgets significantly. How sustainable this position is going forward is uncertain.

Exhibit 4 – Comparison of Local Authority General Fund and Earmarked Reserves with Aggregated External Finance from the Welsh Government between 2009-10 to 2014-15



Source: Wales Audit Office review of Statutory Accounts between 2008-09 and 2014-15 and Wales Audit Office analysis of real-terms change in council funding from 2010-11 baseline.

There is a growing focus on generating income but progress remains slow in developing new funding streams

- 2.15 In our 2014-15 review, we reported that most local authorities recognised the need for an explicit policy on income generation and charging, but the majority of authorities delegated decision making on fees and charges to directorate and individual service teams. In our current review, we found that six local authorities now have income generation and charging policies. Most of these were adopted in 2015-16 so it is too early to assess the impact that these could have on medium-term financial planning.
- 2.16 Some local authorities, as part of their medium-term financial savings plans, have specific projects in place to identify income-generation opportunities and examine the feasibility of setting fees and charges on a full-cost recovery basis across a range of services. In addition, THE Welsh Government and local authorities are, through the work of the Resource Efficiencies Group, taking forward work to secure savings in local-government administrative costs. This includes focussing on opportunities to assist authorities to identify more commercial and innovative approaches to income generation, and also includes the identification of areas where the Welsh Government might consider relaxing regulatory constraints to enable authorities to increase income.

- 2.17 Approximately one-third of local authorities do not have a corporate income generation/charging policy, and decision making on fees and charges is delegated to services. This does not pose a financial-control risk but the lack of a corporate approach means that income generation opportunities could be missed at a time when local authorities should be maximising and seeking new income streams to support the revenue budget.

Capacity within finance teams has improved but the scale of the challenge local authorities face requires a more strategic and innovative approach to manage future finances

- 2.18 In our 2014-15 review, the effectiveness of finance managers in terms of capacity and capability was a concern with just under half of local authorities not having a adequate numbers of finance managers. We had particular concerns about key senior finance positions being vacant or filled on an interim basis. Our current review shows that this position has improved and the majority of local authorities are not carrying key vacancies. Fourteen local authorities think that they have sufficient capacity and capability to deliver their responsibilities but eight local authorities were less certain.
- 2.19 Whilst most local authorities think that they have sufficient capacity and capability to manage their current day-to-day financial responsibilities, a common theme voiced by most local authorities is that they are likely to face capacity issues in the medium term given the financial and service support that will be required to deliver budget savings of the scale and at the pace required.
- 2.20 Local authorities also recognise that to effectively deliver some of the more innovative and transformational savings plans will require different finance skill sets. Some local authorities told us that they are already taking steps to mitigate this by either training existing staff in the skill sets required or plan to use external specialist services to address skills gaps.
- 2.21 We found that most local authorities could take assurance of the effectiveness of their financial controls from the work carried out by their internal-audit departments. In most local authorities we found that agreed internal-audit recommendations are implemented in a timely manner and that internal-audit departments have the appropriate profile in the authority.

Part 3

Financial governance arrangements are mostly sound but Member engagement and scrutiny of savings plans ARE variable and performance is not consistently challenged



- 3.1 In this section of the report, we focus on local authorities' financial-governance and accountability arrangements. In our report of April 2015, we concluded that whilst financial governance arrangements are comparatively robust, the quality of performance and cost information being used and the level of scrutiny and challenge in Welsh Local authorities vary significantly, which can undermine the effectiveness of decision making. For this year we have concluded that financial governance arrangements are mostly sound but Member engagement and scrutiny of savings plans are variable and performance is not consistently challenged.
- 3.2 **Exhibit 5** summarises our assessment of how effective authorities' financial governance arrangements are against our key characteristics. We concluded that authorities performed better on financial governance than in other areas considered in our review, although weaknesses remain with regard to oversight of delivery of savings plans.

Exhibit 5 – Characteristics of effective financial-governance arrangements and our evaluation of current performance

Findings	Characteristics
<p>The majority of authorities have arrangements that reflect these characteristics</p>	<ul style="list-style-type: none"> • The leadership team clearly understands the significant and rapidly changing financial-management challenges and risks facing the organisation and is taking appropriate action to secure a stable financial position. • The chief financial officer is a key member of the leadership team, being actively involved in all business decisions, and promoting and delivering good financial management. • The leadership team considers the financial skills required for different tiers of management and staff throughout the organisation and actively develops financial literacy and skills. • The leadership team fosters an environment where there is good understanding and routine challenge of financial assumptions and performance, and a culture of transparency about the financial position. • There is an objective, knowledgeable and effective audit committee that provides effective challenge across the council and assurance on the arrangements for risk management, maintaining effective internal control, and reporting on financial and other performance. • Internal and external audit recommendations are dealt with effectively and in a timely manner.
<p>A number of authorities need to improve their arrangements in some of these areas</p>	<ul style="list-style-type: none"> • The leadership team provides constructive scrutiny and challenge on financial matters to ensure arrangements remain robust and fit for purpose. • There is regular and transparent reporting to Members. Reports include detail of action planning and variance analysis. • There is effective engagement with stakeholders on budget issues, including public consultations.
<p>Many authorities have weaknesses in these arrangements</p>	<ul style="list-style-type: none"> • Members scrutinise and challenge financial performance effectively, holding officers to account.

Source: Wales Audit Office, **Financial Resilience Report**, November 2015 to April 2016.

The quality of financial management reports has improved but reporting to members on individual savings often lacks sufficient detail

- 3.3 Our 2014-15 review identified that approximately half of local authorities faced some risk in one or more key governance areas. Our 2015-16 review, shows an improvement with over two-thirds of Welsh local authorities now having fewer weaknesses in key areas.
- 3.4 Our review found that most local authorities are making improvements to their existing reporting frameworks for internal reporting with increased emphasis on promoting continuous improvement and accountability. Examples of improvements identified include:
- a inclusion of savings targets in managers' performance appraisals;
 - b Section 151 officers meeting routinely with Director and Heads of Service to discuss budget and savings plans performance; and
 - c use of 'Hotspot' budget reports to highlight specific issues.
- 3.5 However, improvements in reporting to members are not as positive. A key area of weakness relates to reporting progress against savings plans, as was identified in our 2014-15 review. The main weaknesses are that:
- a some local authorities fail to ensure that the delivery and progress of savings plans are separately analysed and routinely reported to members as part of the Council's overall financial monitoring arrangements;
 - b the majority of local authorities limit reports on the progress of savings plans to the current financial year;
 - c there is a lack of transparency in the way the savings plans are shown to have been delivered, for example, the extent to which planned savings have been substituted or met from alternative funding sources; and
 - d some local authorities do not report financial and service performance information together.

- 3.6 We consider it good practice for local authorities to regularly report individual savings to identify over and underachievement and to ensure appropriate and timely action is taken to deliver agreed savings plans. If local authorities do not monitor specific savings areas, their ability to evaluate and scrutinise savings plans is compromised. We also think it is good practice to report financial and service performance together because it provides a holistic view of services and considers the impact of financial issues on services and vice versa. As local authorities have to set more difficult and challenging savings targets it is increasingly important that integrated reports are produced to enable effective monitoring and scrutiny of the financial impacts on service performance.
- 3.7 In our 2014-15 review, we reported that there were instances at some local authorities where members had been resistant or slow to appreciate the need for a more radical outlook in the sustainability of services. These local authorities were still tending to focus on the reduction of back-office functions or finding more traditional piecemeal type savings to provide the required savings. In our 2015-16 review, we identified a marked increase in financial awareness across a number of local authorities with members and officers working together to identify ways of reshaping and delivering services for the future.

The arrangements for challenge and scrutiny of financial performance by members are not sufficiently robust across Wales

- 3.8 In most local authorities, those responsible for managing financial performance are held to account at an individual and departmental level by the leadership team and Section 151 officers. However, we also found that a few local authorities still experience larger-than-expected over and underspends at the year-end, which suggests that there are weaknesses in terms of monitoring financial performance and holding budget holders to account.
- 3.9 Our review identified that a number of local authorities have strengthened their arrangements for reviewing and challenging financial performance and have budget boards or the equivalent in place to monitor and track financial performance. The more sophisticated boards review in-year budget performance, track progress on the delivery of identified savings proposals, consider service performance and examine financial risks. They also consider mitigation plans. The membership of these programme boards varies. They are usually chaired by the chief executive and comprise directors, heads of service, the Section 151 officer and in some cases members such as the Leader and cabinet portfolio holders.

- 3.10 Some local authorities have also established separate change-management or transformational boards to drive, develop and monitor action plans required to deliver the target savings required in the medium to longer term. These boards usually comprise a mixture of the leadership team, cabinet members and project-support officers.
- 3.11 The effectiveness of arrangements for scrutiny and challenge of financial performance by members is mixed. Whilst the majority of local authorities submit quarterly or monthly financial-monitoring reports to cabinet and scrutiny committees a few local authorities do not submit financial-monitoring reports to scrutiny committees or cabinet on a regular basis. Financial monitoring reports are poor in some local authorities and lack sufficient detail to enable members to constructively and effectively challenge financial performance. We consider these to be major weaknesses which local authorities need to address to enable members to effectively hold officers to account.

Part 4

Whilst the Welsh Government has established systems to provide oversight of performance and expenditure, these do not always provide adequate assurance on the sustainability of services



- 4.1 In this part we describe how the Welsh Government assures itself that local authorities remain solvent and helps to prevent financial failure. We assess how the Welsh Government monitors the risks of financial failure and evaluate the Welsh Government's understanding of the impact of funding reductions on services and the risk of service failures.

Longer-term certainty when setting local-authority budgets would improve medium term financial planning and better support local transformation

- 4.2 Most local-government-related policies and functions, from education to planning, or social services to housing, are devolved to the Welsh Government. The Welsh Government sets the national priorities, strategic context and overall level of funding for services. It is then the responsibility of the 22 local authorities in Wales to deliver these services on a local level within the national context. Approximately a third of the Welsh Government's budget is spent through local authorities, reflecting the importance of local services.
- 4.3 The Welsh Government has, through the Finance Sub-Group of the Partnership Council for Wales⁹, established a key support mechanism to understand the pressures facing local authorities when agreeing the budget settlement. The Group provides the formal mechanism for the Welsh Government to discuss designated local-government finance matters with nominated local-government representatives. The Finance Sub-Group provides an advisory and consultative role rather than a decision-making one. The Terms of Reference¹⁰ for the Group note that its remit is to focus on aspects of local-government finance, which may benefit from more detailed consideration. The Group considers substantive matters regarding the revenue and capital funding in order to advise the Partnership Council on key financial arrangements in relation to local-government finance.
- 4.4 The Welsh Government publishes its budget annually and provides multi-year indicative settlements on its likely levels of expenditure. However, because of the timing of the UK general election in May 2015, and uncertainty over the financial settlement for devolved spending, the Welsh Government only set annual budgets for 2014-15 and 2015-16 (although it has provided multi-year indicative budgets in the past). Nonetheless, the annual budget setting, together with some late changes to budget settlements and in-year reductions to grant funding, has impacted upon local authorities' ability to effectively plan and agree their own budgets.

⁹ The Partnership Council for Wales provides political accountability and leadership for public-service reform and collaboration, and drives the pace of improvement of public services in Wales. Its key responsibilities are to encourage dialogue between the Welsh Ministers and local government on matters affecting local government, and to provide collective political accountability for action to improve the effectiveness and efficiency of public services.

¹⁰ Partnership Council for Wales: Finance Sub Group (2013), **Paper No 01, Terms of Reference**

- 4.5 The annual budget setting and late changes to the indicative figures are a consistent criticism that local authorities have made of the Welsh Government and this is seen by them as a key stumbling block to authorities being able to develop a longer-term focus on planning budgets and implementing transformational work. However, whilst it is clear that late changes to budgets did cause authorities real difficulties in finalising spending plans, the direction of travel on funding of local services in the current period of austerity is well understood and authorities should still be able to plan the likely impact of funding cuts. This is especially salient as the Welsh Government has been increasingly clear about its priorities. In addition, it is ultimately for each local authority to determine its budget and decide how and where it wants to prioritise expenditure taking account of all its sources of funding.

The impact on services and citizens of reductions in funding is not fully understood because of limitations in the use of data and the focus of evaluation

- 4.6 On occasions it may be necessary for the Welsh Government to provide formal support, directions or intervention to seek improvements. Intervention is usually a last resort or for emergencies only. To assist in this process the Welsh Government has introduced the Support and Intervention Protocol¹¹. The protocol sets out the circumstances where support may be offered, or Government intervention undertaken in relation to authorities experiencing specific governance or performance challenges.
- 4.7 Support and intervention are both aimed at identifying and resolving governance or delivery weaknesses within an authority. The Protocol defines the difference as 'support is provided by agreement, and full local autonomy is retained. Intervention entails Ministers requiring the authority to act in some way, imposing constraints on how it exercises its functions, or in extreme cases removing those functions altogether and conferring them on another organisation or on commissioners appointed for that purpose.' Support and intervention are both concerned with circumstances where a local authority is consistently or repeatedly failing (for whatever reason) to discharge certain of its broader legal duties effectively – or is at clear risk of doing so.
- 4.8 A number of local authorities have been subject to both support and intervention in recent years, primarily focused on corporate failings or underperformance in education services. Many of these have benefited from interventions with risks being addressed and standards improving. However, we identified some limitations in this oversight system.

11 Local Government Support & Intervention Protocol

- 4.9 Authorities noted that the Welsh Government is not well placed to understand the scale of financial pressures within all local-authority services. The current support and intervention arrangements focus on the authority and its corporate arrangements, and do not identify pressure within all authority services and whether these services are either sustainable or able to deliver their statutory responsibilities. This creates the risk that the Welsh Government may not be aware of potential failures in statutory services that could generate significant costs to the public purse.
- 4.10 For example, the Finance Sub-Group does not consider matters relating to the funding of specific services or functions except where these are of national importance and/or have a direct and substantive bearing on the overall financial arrangements for local government in Wales. The expectation is that service-specific matters should be raised directly with the relevant portfolio Minister(s)¹² who are responsible for these matters.
- 4.11 Authorities acknowledged that the Welsh Government has intervened in both education and social services, but given social care and education are also the service areas which have been afforded greater protection in budget settlements, it is likely these are not subject to the same pressures as others. The lack of failure in adult social care is therefore not a good or appropriate barometer of a local authority's financial resilience. Indeed, there is the potential for service quality to significantly reduce in many local-authority statutory and discretionary services before it becomes apparent, especially given the risks we have highlighted in **Part 1** of this report on the quality and robustness of financial information within services.
- 4.12 For example, **Exhibit 6** shows the change in budgets for core local-authority services between 2008-09 and 2014-15. This shows that education and social service budgets have increased in this period, by 2.3 per cent and 18 per cent respectively – whilst other council services have seen reductions of between 3.7 per cent and 24.4 per cent.

¹² Partnership Council for Wales, **Terms of Reference**

Exhibit 6 – Gross Revenue Outturn expenditure by major local-authority service areas in Wales from 2009-10 to 2014-15

Service Area	2009-10 £'000	2010-11 £'000	2011-12 £'000	2012-13 £'000	2013-14 £'000	2014-15 £'000	% Change
Education	2,550,437	2,584,331	2,590,523	2,630,360	2,616,865	2,610,336	2.3
Social services	1,418,044	1,146,078	1,486,524.091	1,536,238	1,640,010	1,673,329	18
General fund housing and housing benefit	985,254	999,461	1,058,643	1,109,978	1,149,553	1,151,088	16.8
Local environmental services	433,521	438,504	433,062	446,454	439,689	417,581	-3.7
Roads and transport	325,336	330,697	317,902	314,686	306,751	278,887	-14.3
Libraries, culture, heritage, sport and recreation	296,014	288,203	284,186	283,015	269,717	252,720	-14.6
Planning and economic development	152,367	159,004	147,897	132,313	138,733	115,133	-24.4
Council-tax benefit and administration	32,363	31,281	28,939	29,588	35,583	36,083	11.5
Other revenue expenditure	543,029	567,926	624,825	670,827	664,158	671,056	23.6

Source: LGFS0023, StatsWales, Welsh Government, October 2015 Stats Wales, **Revenue outturn expenditure, by service**

- 4.13 Our recent report on devolved public services' response to the financial challenges they have been facing and their plans to face future pressures noted that the Welsh Government has taken steps to understand the impact of budget decisions on services and service users, particularly vulnerable groups¹³. The Welsh Government's approach to equalities impact assessments has been sharpened based on a review by the Equalities and Human Rights Commission. The assessments recognise that such impacts may affect some groups with protected characteristics (women and black/ethnic minority) more than others. However, we concluded that these impact assessments could have been clearer as to the risks to protected groups given the likelihood that cuts to local-government funding would fall on discretionary services.
- 4.14 The Welsh Government cites the relative absence of qualified opinions on local authorities' accounts from external audit as one source of evidence that the sector is coping well under financial pressure. This is helped by the fact that local authorities cannot run deficits and are required to set and operate balanced budgets. However, this on its own does not necessarily provide insight into an authority's financial sustainability, and may provide a misleading picture if used for this purpose. Whilst external audit will provide an external sign-off of accounts, this work does not consider the financial sustainability of local-authority services.
- 4.15 Ultimately, local authorities are responsible for managing their own performance and the Welsh Government primarily relies on the local-government accountability system for assurance that reducing funding will not lead to financial or service failure. In Section 3 above we have highlighted concerns with the effectiveness of scrutiny arrangements and member oversight of performance. Given these weaknesses, the Welsh Government cannot rely on council arrangements and needs to understand service sustainability across all council services and not just social care and education. This is especially important if the Welsh Government is to effectively carry out its function as the principal funder of many local-authority services and the policy and legislative body accountable for many of the statutory and other responsibilities of local government.

¹³ Wales Audit Office, **A Picture of Public Services 2015**, December 2015.

Appendices

Appendix 1 – Study methodology



Appendix 1 – Study methodology

Review of literature, data and statistics

We have reviewed a wide range of documents and media, including:

- Welsh Government and Department of Communities and Local Government policy and guidance documents;
- reports and briefings from the Welsh Local Government Association and Local Government Association in England; and
- relevant research and guidance from CIPFA.

Local-authority fieldwork

This report is a summary of the local reports and did not involve any additional fieldwork. For our local reports we visited all 22 local authorities in Wales, between June 2015 and December 2015. During the visits, we interviewed a range local authority staff, elected members, and produced local reports for each council summarising our key findings on each authority's financial resilience.

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