Item 7 Appendix A LASAAC 23/10/19

LASAAC
October 2005

THE STATUTORY BASIS FOR ACCOUNTING AND DISCLOSING RESERVES IN LOCAL AUTHORITIES IN SCOTLAND

Background and Introduction

The Local Government in Scotland Act 2003 introduced a range of duties, freedoms and responsibilities for local authorities. A core theme within the

Act was accountability, represented not least by the statutory requirement of Section 12 of the Act which requires that local authorities adhere to 'proper accounting practices'. The Act effectively formalised the modern era in which local authorities now operate with the introduction of a statutory duty of best value and, inter alia, by the introduction of the concept of significant trading operations. Consequential changes were made to the Code of Practice on Local Authority Accounting – A Statement of Recommended Practice (the SORP).

Against the overall modernising agenda, local authorities increasingly deliver services and account and transact in a manner, perhaps not forseen by the original source legislative framework within which local authorities operate. More specifically, the legislative basis and the subsequent accounting treatment for reserves in Scotland has been the subject of ongoing debate. Increasingly, policy initiatives of both local authorities and the Scottish Executive may require certain monies to be separately accounted for and therefore 'ring-fenced' although the current legislative basis may preclude full transparency and reporting on the balance sheet of a local authority. By way of example, local authorities may promote budget carry forward schemes which, inter alia, have the effect of improved financial management.

This apparent tension between source legislation and the accountability required in the modern era, led the Committee to consider whether the spirit of modernisation may present the opportunity to explore whether legislative change to the statutory basis for reserves in Scotland is appropriate.

The outcome of informal discussions with both the Scottish Executive and Audit Scotland indicated that there was less requirement for legislative change than there was for clarity on the current arrangements. Indeed, it was concluded that full transparency and clarity could in fact be determined within the current framework.

Consequently, the Committee considered that it was appropriate to proactively set out useful guidance on the statutory basis for accounting and disclosing reserves in local authorities in Scotland. The specific matters to which this statement refers are:

- the accounting and disclosure treatment for reserves and funds in local authorities in Scotland; and

- a summary of the legislative basis of reserves and funds for local authorities in Scotland including commentary on the use thereof.

Scope and Status of this Guidance

This paper provides useful guidance aimed at assisting practitioners with the requirements of the "Code of Practice on Local Authority Accounting – A Statement of Recommended Practice" and upon the guidance contained in the "Code of Practice – Guidance Notes for Practitioners". In addition this statement should be considered alongside the CIPFA Local Authority Accounting Panel (LAAP) Bulletin 55 – Guidance on Reserves and Balances.

This guidance does not seek to provide guidance on, nor indeed seek to comment upon, the level of reserves held by local authorities in Scotland. Clearly, that is a matter for each local authority although the Committee has noted recent comment by the Accounts Commission on the requirement for clearly stated policies on the use of reserves and balances by each local authority.

This guidance is applicable to all bodies in Scotland to which the SORP currently applies and should be considered against the background of the SORP under Section 12 of The Local Government in Scotland Act 2003.

Accounting and Disclosure

The 2004 SORP at para 3.78 states that:

"Expenditure should not be charged direct to any reserve"

The SORP requires that for revenue reserves any movement is accounted for as an appropriation and is therefore transparent. The concept of direct reserve accounting is specifically prohibited by the SORP. This statement reinforces that concept and for clarification it is specifically stated that all transactions into and out of a reserve should be represented by appropriations from/to the consolidated revenue account.

The key characteristic of a reserve is that appropriations are made below the line at which net operating expenditure is drawn.

The entries within a reserve are effectively restricted to:

- contributions to and from the consolidated revenue account; and
- loans fund interest earned on the average reserve balance (in accordance with LASAAC Guidance Note 2.)

Movements on reserves should be accounted for in the appropriations section of the Consolidated Revenue Account. This achieves the requirement of the SORP that there should be no direct reserve accounting. Expenditure should be charged to the service revenue account. An appropriation is made from the reserve to the revenue account which neutralises the 'bottom line' impact on council tax.

A capital reserve will receive contributions by appropriation from the consolidated revenue account or from the direct credit of capital receipts. Capital expenditure can be funded or financed directly from a capital reserve. The capital accounting requirements of the SORP require that fixed asset restatement and capital financing accounts are incorporated and disclosed on the balance sheet. These items are not reserves capable of distribution and are consequently referred to as accounts to avoid doubt. Otherwise the accounting treatment followed is that for reserves.

The SORP requires that the following information in respect of reserves should be included in the consolidated balance sheet:

- fixed asset restatement account;
- capital financing account;
- usable capital receipts reserve;
- pensions reserve; and
- fund balances and reserves.

The statement of total movement on reserves will separate movements between capital and revenue reserves. Generally, the statement will analyse the following:

- general fund;
- renewal and repair fund;
- capital fund (and useable capital receipts); and
- insurance fund.

In addition, movements on the fixed asset restatement account, capital financing account and pension reserve will also be disclosed.

The following text refers to selected areas where there has been particular debate among practitioners on the disclosure and treatment of reserves

General Fund

The general fund will be a single figure on the face of the consolidated balance sheet. Local authorities can however 'earmark' specific parts of the general reserve. A local authority is not permitted however to disclose those earmarked portions on the face of the balance sheet. The Committee has previously determined that it is good practice to identify in a separate note to the balance sheet where there are earmarked portions of the general fund within say, a budget carry forward scheme or for some other form of earmarked funds. Disclosure enables a local authority to transparently indicate financial policy intentions while adhering to the core legislative framework.

A general fund disclosure note to the balance sheet may resemble the following:

The general fund balance of £4M as at 31 March2XX includes sums set aside for a range of measures including. :

Devolved School Management Funds

Car Parks 'Trading'

Roads Winter Maintenance (and other sums as appropriate)

Crucially, the sums disclosed do not confer any legal obligation on the part of the local authority to expend the sums in the disclosed or in any specific manner. They are an indicator of the policy intention of the local authority at the balance sheet date.

Housing Revenue Account

The balance or reserve arising from the operation of the Housing Revenue Account (HRA) is worthy of specific commentary. The legislative framework does not allow for a specific housing reserve. This however is contrary in spirit to the ring-fenced nature of the HRA under the Housing (Scotland) Act 1987 which ring fences HRA monies. A local authority is specifically prohibited from budgeting for the use of general fund monies within the HRA.

The separate identification and treatment of HRA 'balances' is however within the legislative spirit of the Housing (Scotland) Act 1987 and subsequent HRA legislation. The practice of most local authorities is to separately identify a housing balance (as distinct from a reserve). Indeed, the SORP specifically refers to "..HRA and other General Fund services.." The use of any housing balance will be reflected as an appropriation and included within the statement of total movement within reserves.

It is the view of the Committee that the separate identification of the HRA balance would be the appropriate disclosure treatment. Local authorities however have discretion on whether the HRA balance is reflected either:

- on the face of the consolidated balance sheet; or
- within a note to the consolidated balance sheet.

Renewal and Repair Fund

The renewal and repair fund is worthy of comment. It is understood that in practice more than one renewals and repair fund may be operated by some local authorities. This may for example occur when a local authority earmarks funds to renew or repair a particular asset or group of assets. The statutory power exists however for a singular fund and not funds. It is expected therefore that there will be disclosure of one fund but that in disclosure, the extent of earmarking for different purposes may be disclosed. There would however continue to be one single disclosed statutory fund only. Alternatively, and where doubt may exist as to the validity of use of renewal and repairs, the local authority could earmark a portion of the general fund as described above.

Legislative Framework for Reserves in Scotland

Local authorities may only hold reserves for which there is a statutory power to do so. In Scotland the legislative framework is as follows:

Section 93 (1) of the Local Government (Scotland) Act 1973 states

"Every local authority shall have a general fund and……-

(a) all sums received by or on behalf of the authority shall be paid into that fund;
(b) all fees, commissions, discounts allowed on payment of accounts and expenses payable to or recovered by any officer of a local authority in respect of any business relating to the authority whether by reason of his office or otherwise shall be accounted for and paid into that fund;

and all sums payable by the authority shall be paid out of that fund."

Schedule 3, Section 12 (1) of the Local Government (Scotland) Act 1975 prescribes the requirement for each local authority to establish a loans fund and states that it shall be part of the general fund of the authority.

Schedule 3, Section 22 (1) of the Local Government (Scotland) Act 1975 states that:

> *"Subject to the provisions of this Schedule, a local authority may establish either or both of the following funds-*
>
> *(a) a capital fund, to be used for defraying any expenditure of the authority to which capital is properly applicable, or in providing money for repayment of the principal of loans (but not any payment of interest on loans);*
> *(b) a renewal and repair fund, to be used for the purpose of defraying expenditure to be incurred from time to time in repairing, maintaining, and renewing any buildings, works, plant, equipment or articles belonging to the authority."*

Schedule 3, Section 24 para (4) refers also to funds established for insurance which was subject to further primary legislation with the enactment of the Local Government etc (Scotland) Act 1994. Schedule 13 of that Act amended the 1975 Act by, inter alia, expressly introducing the following amendment in respect of the use of insurance funds

> *"(ba) an insurance fund, to be used for the following purposes, namely-*
>
> *(i) where the authority could have insured against a risk but have not done so, defraying any loss or damage suffered, or expenses incurred, by the authority as a consequence of that risk;*
>
> *(ii) paying premiums on a policy of insurance against a risk "*

Useable capital receipts reserves are considered to be allowable under the power contained within Schedule 3, para 22 of the 1975 Act. Such a reserve effectively acts as a subset of the capital reserve specifically permitted by legislation.

More recently, the Local Government in Scotland Act 2003 (supported by the Local Government Pension Reserve Regulations) provided the statutory basis for local authorities to create and maintain a 'pension reserve'. This reserve was the necessary consequence of the implementation mechanism for FRS 17 to ensure that the impact of the standard remained cost-neutral.

There are no statutory powers to hold and maintain reserves beyond those referred to. For the avoidance of doubt, local authorities are not permitted to disclose separate reserves which relate to devolved school management or for significant trading operations.

It is understood however that there may be powers of a more local nature which also exist. An example of such a power is the City of Glasgow District Council Order Confirmation Act 1988. Part II, Sections 3 to 5 of the Order enable the then district council (and subsequently Glasgow City Council) to maintain a fire insurance fund, a social, cultural and recreational reserve fund and separately defined repairs and renewals fund. It is not the intention of this statement to address each and every local power which may be available. In such cases local authorities should have regard to the power and to the general disclosure and accounting matters addressed in this statement.

The terms reserve and fund are both used within legislation. In practice they are treated as being synonymous. Indeed, there should be consistent accounting treatment irrespective of whether the term fund or reserve is used.

It is the view of this committee that there is no difference in substance by use of the terms. This statement therefore formally acknowledges the synonymous nature of funds and reserves and where the statement uses the term reserves, this refers to both reserves and funds.

Practical Operation of Reserves

Although not the formal role of this statement to identify the uses for reserves it is appropriate for the benefit of practitioners to briefly consider and comment upon the practical operation of statutory reserves. Reserves, as required by legislation, enable a local authority to do three things:

- create a working balance to help cushion the impact of uneven cash flows and avoid unnecessary temporary borrowing – this forms part of general reserves;

- create a contingency to cushion the impact of unexpected events or emergencies – this also forms part of general reserves; and

- creates a means of building up funds, often referred to as earmarked reserves, to meet known or predicted liabilities

The 2004 SORP also provides an explanation on the use of reserves at para 3.78, where is states that:

"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"

A renewal and repair fund receives contributions as directed by resolution of the local authority. Typically, the reserve is then utilised to provide underlying financing for the repair of assets, maintenance of assets and the replacement and/or renewal of assets. A renewal and repair fund can be for the authority as a whole or for certain parts or functions thereof.

A capital reserve may typically be used to receive the proceeds from sales of assets and other contributions. The reserve would then be utilised to finance the repayment of principal and more typically to directly finance capital expenditure.

Insurance funds may generally be used to defray a loss where a local authority is not insured and also for meeting the costs of an insurance policy premiums. This fund also receives contributions as directed by resolution of the local authority.

LASAAC can be contacted at lasaac@cipfa.org