SURREY
COUNTY COUNCIL

Audit & Governance Committee

18 March 2013

Surrey County Council self assessment on issues raised in:

- Financial sustainability of local authorities; and
- Towards a tipping point

Purpose of the report: This report summarises two recent publications on financial sustainability and good governance in local authorities. It analyses Surrey County Council's performance and highlights some areas for improvement.

Introduction:

1. This report summarises two recent national publications by the National Audit office (NAO) and our external auditors, Grant Thornton. Respectively they are:
   - Financial sustainability of local authorities (Annex 1); and
   - Towards a tipping point? (Annex 2)
2. The publications cover local authorities' performance in the current financial climate. This report assesses Surrey County Council's performance in relation to points raised in the publications.

Recommendations:

3. It is recommended that Audit & Governance Committee:
   a) notes the recent publications by NAO and Grant Thornton;
   b) considers the assessment of Surrey County Council's performance; and
   c) considers the impact of the suggested areas for improvement.

Financial sustainability of local authorities

Overview

4. National Audit Office (NAO) published *Financial sustainability of local authorities* (Annex 1) on 30 January 2013. It examines central government's approach to local authority funding, and reviews local authorities' financial sustainability in the current financial climate.

5. As part of its fiscal deficit reduction plan, the Government's 2010 spending review planned to reduce local authorities' real terms funding

by 26% (£7.6 billion) between April 2011 and March 2015 (excluding police, schools and fire). So far, local authorities have absorbed these funding decreases with some evidence of service reductions. NAO estimates local authorities still need to find about half their savings to be made before March 2015.

6. The Government is changing local government funding to increase local authorities' financial opportunities. However, this also increases their financial risks and uncertainty. Two of the biggest changes (partial retention of business rates and localisation of council tax support) take effect in April 2013.

7. The Department for Communities and Local Government (DCLG) has started to assess the combined impact of changes by different government departments on individual local authorities' financial risk profiles. The risk of financial failure will not spread evenly across local government; some authorities will be affected more than others. How DCLG and local authorities respond to possible multiple financial failures as financial difficulties intensify is untested.

8. NAO recommends DCLG and other government departments evaluate better the impact of decisions on local authority finances and services before and after implementation.

Changes to local authority funding

9. Since 2010 the Government has made several changes to local authority funding. The objectives underpinning them are localism and deficit reduction. These have driven the following changes:

   a) reduced central government grant funding;

   b) Council Tax Freeze Grant and the requirement to hold referendums for council tax increases above a set threshold;

   c) partial retention of local business rates; and

   d) local discretion over council tax support for working age people.

10. Central government's spending review plans to cut funding to local government by 26% between 2010/11 and 2014/15. Just over a third of this reduction was planned for the first year, 2011/12, with the remaining cuts spread evenly over the following three years. After taking account of local government's anticipated income from other sources, such as council tax, local government would see a 14% reduction over the spending review period to 2014/15.

11. Surrey's budgets and medium term financial plan (MTFP) for each year from 2010/11 to 2014/15 also show a 14% real terms funding reduction over the spending review period. This reduction takes account of

Surrey's actual council tax rises agreed for 2012/13 (2.99%) and 2013/14 (1.99%) and the 2.5% assumed increase built into its MTFP for 2014/15.

Council tax income

12. The Government introduced Council Tax Freeze Grant (CTFG) in late 2010 as a reward for authorities that did not increase council tax. The first CTFG offered a grant equivalent to a 2.5% rise in council tax payable in each of the four years 2011/12 to 2014/15. All authorities accepted the first CTFG. The second CTFG offered a grant equivalent to a 2.5% rise in council tax payable in 2012/13 only. 359 authorities accepted the second CTFG. The third CTFG offered a grant equivalent to a 1.0% rise in council tax payable in each of the years 2013/14 and 2014/15. As at 18 February 2013, 219 authorities had accepted the third CTFG, including 24 out of 27 county councils.

13. The Localism Act 2011 introduced the need for a referendum if a council wanted to raise its council tax above an excessiveness threshold determined annually by the Secretary of State for Communities and Local Government. For 2012/13, the Secretary of State set the threshold at 3.5%, for 2013/14 he set it at 2.0%.

14. Surrey accepted the first CTFG and receives £13.8m a year for it. Surrey declined the second and third CTFGs and raised council tax by 2.99% for 2012/13 and 1.99% for 2013/14. This means Surrey does not depend on variable short term grants and therefore has greater financial resilience.

Localisation of business rates

15. Partial local retention of business rates will incentivise local authorities to promote local business growth, as they will keep some of the increased business rate income. DCLG receives 50% of all local business rates collected (which it redistributes as revenue support grant). In two tier areas, districts and boroughs keep 80% of the remainder. As a county council with fire and rescue responsibilities, Surrey receives the other 20%. Because Surrey's share of the local business rates is less than our assessed spending need met from business rates, we also receive top up funding to bring us up to that business rates baseline level.

16. Surrey's business rates baseline for 2013/14 is £101m. Government estimates we will receive £44m funding from our share of business rates collected locally. Surrey's top up is £57m. The top up provides some protection from local volatility in business rates, due for example to rating revaluations as well as business growth and relocation. If business rates collected throughout Surrey rise by 5%, the county's business rates income rises by 5% too. If business rates collected throughout Surrey fall by 5%, the county council's business rates income falls by 5% too. However in both cases, this change only affects 44% of our assessed

spending need met from business rates. The top up element, being fixed, dampening the impact of volatility.

Localisation of council tax support

17. Changes to council tax support mean instead of paying benefits using the Department for Work and Pensions' (DWP) rules, local billing authorities (districts and boroughs) now set their own schemes to provide support as a discount on council tax. Nationally the government has provided local authorities 10% less money for this, but has partially mitigated it by introducing flexibilities around council tax premiums and discounts (for second homes and empty properties).

18. In Surrey, most districts and boroughs have broadly adopted a scheme in line with a county wide framework. The framework aims to minimise the impact on households least able to pay. The government's funding reduction means we receive a grant for council tax support of £38m in 2013/14 compared to £45m received in 2012/13 (as our 76% share of benefit subsidy paid into collection funds). Districts and boroughs estimate the use of new council tax flexibilities will reduce this £7m funding gap by around £5m.

19. As by far the biggest recipient of monies from collection funds, the county council bears three quarters of the risk of volatility introduced by these changes. The system itself is untried, which brings its own uncertainty, plus the economic outlook is still unsettled. So, the economic downturn reserve has been increased by £2.1m to help deal with the impact of potentially higher demand for council tax discounts arising from lower household incomes and lower collection rates from people who had previously paid little or no council tax, but now receive a bill.

Local authorities' savings requirements

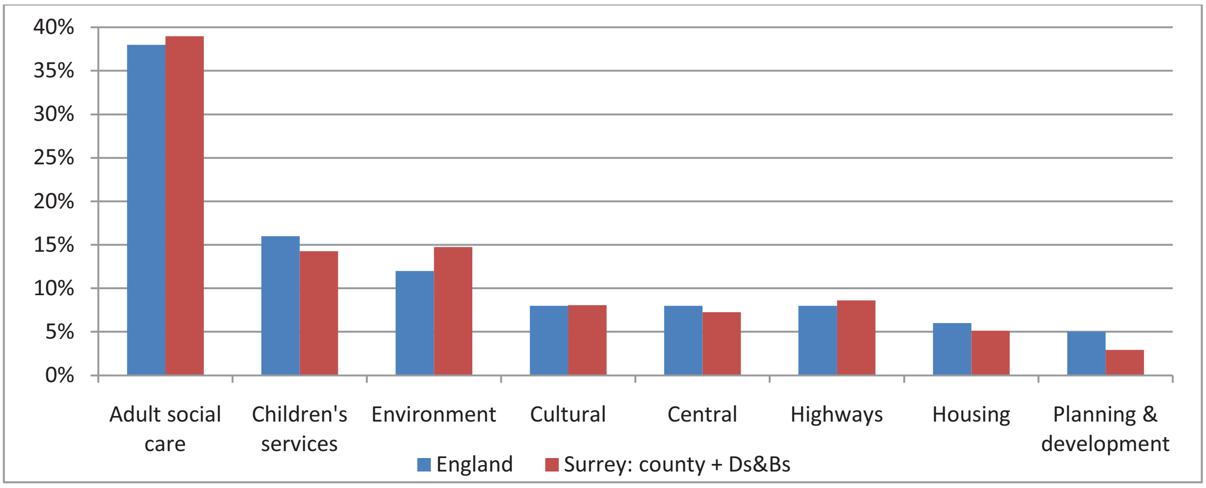
20. Local authorities have absorbed reductions in central government funding with some evidence that services have been reduced. Up to 2012/13 budgets, most local authorities had not drawn on financial reserves to make up for reduced income.

21. Local authorities still need to find about half of their savings to be made in the spending review period in 2013/14 and 2014/15. Surrey expects to make £131m (52%) savings in 2011/12 and 2012/13, leaving £122m (48%) to be made in 2013/14 and 2014/15.

22. Local authorities face increasing demand for services such as adult social care and children's services, which account for over half of their non-schools spending. Councils' scope to absorb these cost pressures by reducing other services is falling as authorities have already reduced spending on these services which already cost less.

23. Figure 1 shows the spending distribution for Surrey compared to England. They are broadly similar, albeit that adult social care, environment and highways form a slightly higher proportion in Surrey and children's and central services a lower proportion.

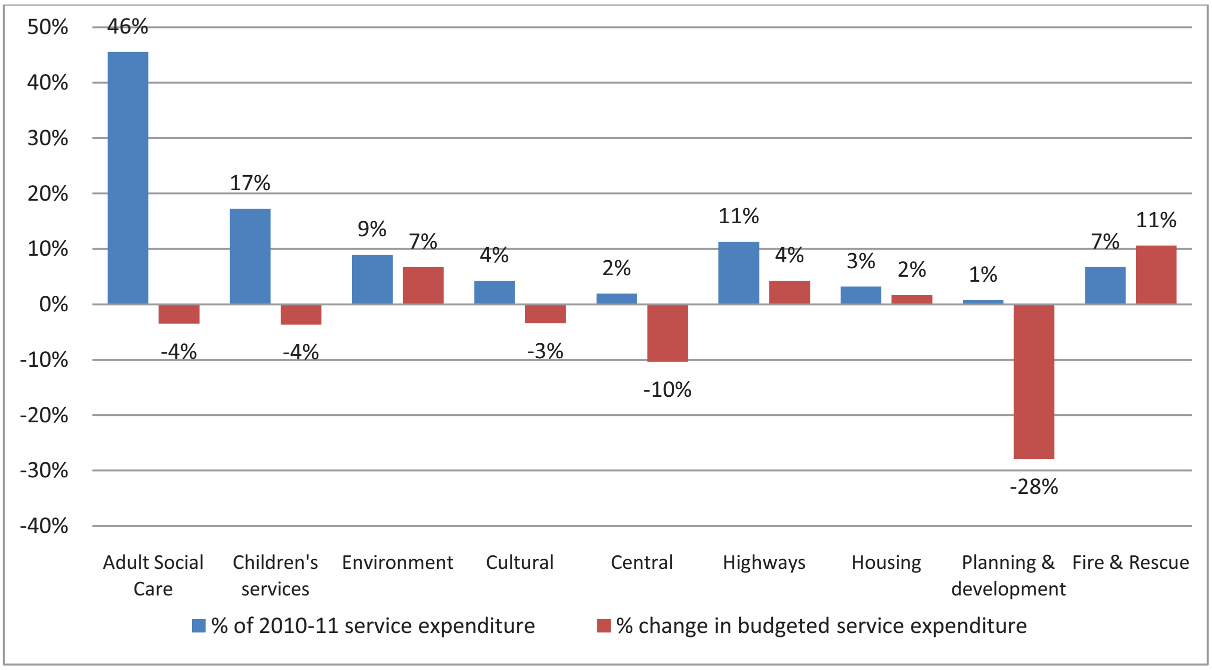
Figure 1 Comparative spending on local services in Surrey and in England 2010/11 (excludes schools and fire and rescue)



24. Nationally, local authority spending has reduced in real terms for all services. The largest reductions have been to lower spending services such as planning and development (36%), housing (22%) cultural (19%) and highways (14%). In contrast, adult social care, which forms the biggest part of councils' overall spending has reduced on average by 6% and children's services by 5%.

25. Figure 2 shows that since 2010/11, spending by Surrey County Council on adult social care and on children's services have each fallen by 4%, while planning and development services' spending has fallen by 28%. These are similar to the national trend. However, over the same period, Surrey's spending on environment and highways have both risen and Surrey's spending on fire and rescue grew by 11%.

Figure 2 Spending by Surrey County Council 2010/11 and planned changes for 2012/13 (excluding schools)



Use of reserves

26. Local authorities have a legal requirement to maintain adequate reserves to manage financial risks. The level of reserves is a matter for each local authority to decide. At 31 March 2012, local authorities held total reserves of £13.5 billion. Of this total, reserves earmarked for specific purposes amounted to £9.9 billion and unallocated general reserves £3.6 billion (4% of local authority spending). NAO analysed changes to local authorities' general reserves. NAO considers them particularly important for financial sustainability as they protect against unforeseen events.

27. In 2011/12 most local authorities (209) increased their general reserves and 93 reduced their general reserves. Surrey increased its level of general reserves to around £30m in anticipation of the continuation of volatility in future funding. Surrey also continued to provide a budget risk contingency of £8m to mitigate non delivery of service efficiencies.

Financial outlook

28. NAO found 12% of local authorities as at risk of not balancing future budgets. Of 52 local authority finance directors responding to a survey, most expected to make the largest savings through efficiency improvements. However, nearly all saw reducing the services their local authorities provided as contributing to meeting savings requirements.

29. Surrey's MTFP 2013-18 includes planned use of £23m of reserves in 2013/14 – in recognition of the strategy to smooth spending across financial years and follow the strategy of long term planning, rather than short term service reduction measures. A review of this during quarter 1

2013/14 will focus on specifying how further savings required will be delivered.

Towards a tipping point?

30. Grant Thornton succeeded the Audit Commission as Surrey County Council's external auditors in autumn 2012. *Towards a tipping point?* (Annex 2) summarises findings from Grant Thornton's second year of financial health checks of English local authorities. In 2012, Grant Thornton increased its local government audit portfolio by more than 100 clients. This will increase the breadth of data supporting its future financial health check reviews. Data from Surrey will therefore be reflected in the up-date of this review later this calendar year.

31. With financial austerity due to continue until at least 2017, *Towards a tipping point?* considers key indicators of financial performance, financial governance, strategic financial planning and financial controls across local government, to provide a summary update on how the sector is coping, drawing comparisons with the findings Grant Thornton published in December 2011 as *Surviving the storm: how resilient are local authorities?*.

32. *Towards a tipping point?* is based on reviews of 24 (7%) English local authorities undertaken between May and September 2012. This included a desk top review of key documents and interviews with key stakeholders to validate findings. The report focuses on the 2012/13 financial planning period and delivery of 2011/12 budgets.

33. The analysis followed the Audit Commission's broad approach to assessing value for money using themes and risk rating criteria. As Surrey received an unqualified value for money conclusion for 2011/12, our auditors rated us to be at high risk for no themes.

34. Grant Thornton also includes a best practice checklist under each theme. This report considers Surrey's performance against each theme's checklist and also highlights potential areas for improvement.

Is local government reaching a tipping point?

35. While authorities met their 2011/12 targets as they anticipated, their confidence in achieving medium-term targets has fallen in the last year. With many factors leading to an uncertain environment for setting financial plans, the report asks is a critical point coming where local authorities can no longer deliver?

36. *Surviving the storm: how resilient are local authorities?* identified confidence among local authorities about achieving 2011/12's savings. This was borne out as most authorities delivered their 2011/12 targets. However confidence waned over the medium term. *Towards a tipping point?* reinforces this. Strategic financial planning was the area where

risk rating increased between 2010/11 and 2011/12. The challenges and uncertainties facing the sector remain significant and confidence for the medium-term is generally weaker.

37. Grant Thornton lists factors that bring uncertainty in local government financial planning, including:

    a) the possibility of further funding reductions during the current spending review period, and a lack of certainty after 2015;

    b) the weakness of the economy which both depresses income sources and increases local government welfare related spending;

    c) the lateness of the 2013/14 Local Government Finance Settlement, providing a very limited lead in to the 2013/14 financial planning cycle;

    d) restrictions on local authorities' ability to raise additional council tax funding due to CTFG and council tax increase threshold;

    e) the opportunities and challenges from the partial localisation of business rates and the change to council tax support;

    f) the pressures of an ageing population with increasing complexity of need affecting social care delivery, a key spending pressure area; and

    g) limitations on the ability to finance capital projects.

38. Grant Thornton's analysis suggests a 'tipping point' is approaching, but what form this could take remains unclear. A tipping point has been described as the critical point in an evolving situation that leads to a new and irreversible development. The report identifies several tipping point scenarios related to individual local authorities, rather than local government as a whole:

    a) Statutory –a local authority can no longer meet its statutory responsibilities.

    b) Financial –the Section 151 Officer is unable to set a balanced budget.

    c) Industrial –industrial relations disputes lead to major service disruption.

    d) External –a major supplier fails.

    e) Incremental –small tipping points, accumulate to a critical mass.

    f) Decision paralysis –a council fails to make the difficult decisions needed to manage its financial and other challenges.

39. Grant Thornton will work with local authorities to explore the concept of a tipping point further. When it has better understanding, the firm will begin to analyse the actions needed to avoid and mitigate such tipping points.

Key indicators of financial performance

40. Overall, Grant Thornton found use of financial and other ratios improved from 2010/11 to 2011/12. Despite considerable improvement, managing the workforce remains a critical area, alongside liquidity where the trend for reducing working capital continues.

41. Surrey performs well against the best practice checklist. For example, we:

    a) operate within appropriate, locally determined levels of reserves and balances; and

    b) have a track record of spending to budget and managing overspends within year

42. Over the last 12 months, we have also made progress on absence management, including:

    a) monthly meetings between HR and Heads of Service to discuss absence cases;

    b) support for managers on conducting return to work discussions;

    c) improving data quality of sickness reporting; and

    d) a pilot for occupational health intervention on day one of any sickness absence.

Strategic financial planning

43. Grant Thornton found authorities typically started their 2012/13 planning cycles earlier to provide time to finalise savings programmes. Overall scenario planning remains weak. However, it is ever more critical given the uncertainty about Government spending plans and the volatility introduced by the partial retention of local business rates.

44. Surrey performs well against the best practice checklist. For example we:

    a) integrate financial and service plans well and follow the corporate and financial strategies over the longer term;

    b) use sensitivity analysis on our financial modelling; and

    c) regularly review the MTFP and the assumptions within it.

45. An area for improvement we are progressing is developing our approach to workforce planning. We have a new approach in place, which we are incorporating into preparation of the Corporate Plan. We are developing a toolkit to enable local workforce planning and structure analysis and Finance, Policy and HR are working to integrate the new approach into service and financial planning.

Financial governance

46. Grant Thornton found an increase in member and senior manager engagement on financial planning. Budget management has also improved. However, authorities' ability to manage volatile, demand led budgets remains a challenge.

47. Surrey performs well against the best practice checklist. For example we:

    a) report regularly to members on our financial position and our developing financial plans;

    b) respond promptly to internal and external audit recommendations; and

    c) address key areas of financial risk.

48. An area for improvement is to spread good understanding of unit costs and cost drivers. This is in place in parts, but not consistently throughout the Council. More widespread good understanding of unit costs would enhance understanding and analysis of financial implications of different options for management plans and actions.

Financial controls

49. Grant Thornton found in 2011/12 authorities' financial control had improved over that in 2010/11 and authorities had delivered in-year savings. However, Grant Thornton noted a key issue in 2011/12's reviews was a lack of transparency in how some authorities report performance against budgeted savings.

50. Many local authorities do not report effectively the savings they might or might not achieve. For example, a reduced budget incorporating savings agreed by Cabinet does not overspend at year end and is considered a success. However, the reality may be that other factors have led to the underspend, but are not apparent as reporting focuses on the savings target. So, management decisions to hold vacancies that were not part of the agreed savings plan may be absent from management information (and the consequent impact on service delivery may not be identified). Given the scale of savings local authorities are making and sensitivities about how they make them, it is vital key stakeholders understand whether managers have delivered agreed savings as planned.

51. Surrey performs well against the best practice checklist. For example:

    a) our budgets are robust and timely and the Council has a good track record of operating within its budget;

    b) budgets are monitored at officer, member and cabinet levels each month;

    c) the system of internal audit is effective;

d) the Annual Governance Statement represents the Council fairly; and

e) we were shortlisted in the LGC Awards Corporate Governance category.

52. An area for improvement is to increase the focus on income related budgets. Generating income will grow in significance as a source of funding for the Council over the coming years. As such, effective and reliable monitoring and forecasting of income streams will become even more important to our financial sustainability. The Funding Strategy with a focus covering 2012-17 will continue to drive this in 2014/15.

Conclusions:

53. NAO and Grant Thornton both found that so far, local authorities have generally absorbed central government funding reductions and are performing well overall in challenging circumstances. However, evidence is emerging of some service level reductions.

54. Overall funding continues to decline, while financial pressures and uncertainty rise. Consequently more local authorities are finding it hard to sustain their financial position and meet statutory responsibilities. Some local authorities will be more affected than others. DCLG and local authorities must identify this risk early so they can manage it effectively.

55. NAO considered a range of indicators, such as levels of local authority reserves and projections of service demand, to see what they showed about financial sustainability. NAO concluded financial sustainability depends on factors that go beyond the balance sheet, including strengths of financial management and governance arrangements. Coming to a view of the likely financial sustainability of a local authority using a single set of indicators is therefore problematic, and needs to consider local circumstances.

56. *Towards a tipping point?* Is based on analyses of local practices and circumstances. It suggests finance will remain an important factor for key stakeholders through the uncertain times ahead. As such, local authorities should aim to:

a) improve scenario planning, sensitivity analysis and fuller reporting of savings programmes; and

b) maintain the robustness of its financial governance arrangements.

57. Assessing Surrey's performance against the themes and best practices in the report helps reach a view about our financial sustainability. The findings bring some comfort, but no cause for complacency.

Financial and value for money implications

58. There are no specific additional financial implications from this report.

Equalities Implications

59. None.

Risk Management Implications

60. There are no specific additional risk management implications from this report.

Implications for the Council's Priorities or Community Strategy

61. None.

Next steps:

Grant Thornton will assess the Council's financial health as part of its audit of 2012/13 financial statements.

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Sources/background papers:

Annex 1 - Financial sustainability of local authorities, National Audit Office

Annex 2 - Towards a tipping point?, Grant Thornton

Surrey County Council Statement of Accounts 2010/11

Surrey County Council Medium Term Financial Plans: 2010-2014, 2011-2015 and 2012-2017.

CIPFA Statistics Revenue Outturn data 2010/11 and 2011/12