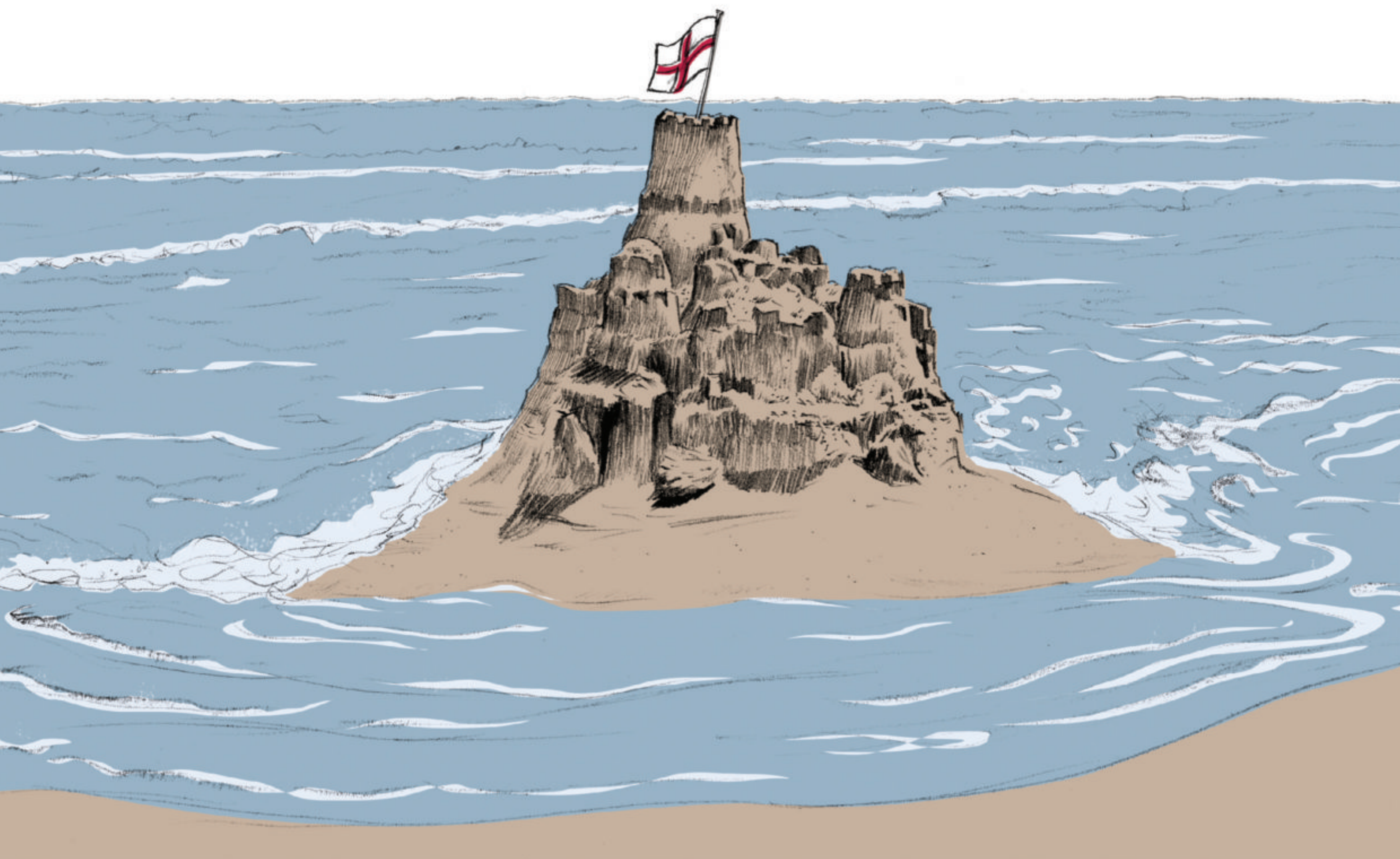
Towards a tipping point?

Summary findings from our second year of financial health checks of English local authorities
December 2012



Contents

Introduction

With financial austerity due to continue until at least 2017, our financial health review considers key indicators of financial performance, financial governance, strategic financial planning and financial controls, to provide a summary update on how the sector is coping, drawing comparisons with last year's findings.

Background

We published our report 'Surviving the storm: how resilient are local authorities?' in December 2011. The report examined the resilience of local government in responding to the financial, economic, demographic, policy and other challenges the sector was facing, and how prepared it was for the first year of the front-loaded 2010 Spending Review.

Our analysis was based on a national programme of financial health check reviews undertaken during 2011. We have repeated these reviews during 2012 and this report updates our findings and highlights the trends that are emerging in the sector.

Context

The Chancellor of the Exchequer announced the 2010 Spending Review (SR10) to Parliament on 20 October 2010. This formed a central part of the Coalition Government's response to reducing the national deficit, with the intention to bring public finances back into balance during 2014–15. The Chancellor has subsequently announced that public finances will not be brought back into balance during the lifetime of the current Parliament, and, in his Autumn Statement in November 2011, announced further public spending reductions of 0.9% in real terms in both 2015-16 and 2016-17. Financial austerity will therefore continue until at least 2017, and further funding reductions to local government funding may emerge within the SR10 period.

With or without further funding reductions, the four-year SR10 period (2011–12 to 2014–15) represents the largest reduction in public spending since the 1920s. Revenue funding to local government will reduce in real terms by 28% by 2014–15 (excluding schools, fire and police) with local government facing some of the largest funding reductions in the public sector. In addition, local government funding reductions were partially frontloaded, with 8% cash reductions in 2011–12. These reductions followed a period of sustained growth in local government spending, which increased by 45% during the period 1997 to 2007.

The funding reductions come at a time when demographic changes and recession-based economic pressures are increasing demands for services, for example rising demand for social care as well as debt, housing and benefits advice, while demand for some paid-for services is reducing, such as planning and car parking. At the same time, local authorities are managing the implications of the Government's policy agendas – such as those relating to localism and open public services – that could see a significant shift in the way that public services are provided.

> **With or without further funding reductions, the four-year SR10 period (2011–12 to 2014–15) represents the largest reduction in public spending since the 1920s.**

Purpose of this report

To meet these significant challenges, local authorities must improve their efficiency and productivity, reduce their costs and have sustainable medium-term financial plans (MTFPs) to ensure their financial health remains robust.

This report provides a summary of the key issues, trends and good practice that have emerged from our second national programme of financial health reviews. The report provides local authorities with an up-to-date picture of how local authorities are coping with the service and financial challenges being faced by the sector. This report draws on benchmarking data provided by the Audit Commission and others, as well as the broad thematic approach adopted by the Audit Commission towards the assessment of the value for money arrangements in place in local authorities.

Our approach

Our analysis 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 our findings. Our focus was on the 2012/13 financial planning period and the delivery of 2011/12 budgets and we analysed the following thematic areas:

- **Key indicators of financial performance**
  It is critical that local authorities maintain appropriate levels of reserve balances, regularly monitor their liquidity and long-term borrowing levels, deliver against planned budgets, and effectively manage unplanned staff absences.
- **Strategic financial planning**
  Local authorities need to be setting their budget in the context of a longer-term financial strategy and an MTFP covering, for example, a three to five year horizon. The MTFP needs to be realistic. Assumptions around inflation, income levels, demographics and future demand for services need to be modelled and based on reasonable predictions.
- **Financial governance**
  The quality of financial governance and leadership is critical in meeting the financial management challenges facing authorities, and for securing a sustainable financial position. Good basic systems, processes and controls are important, but it is the overall financial culture that makes the difference.
- **Financial controls**
  Local authorities need to manage within their budgets. They therefore need to have a robust way of challenging budget monitoring and reporting arrangements to ensure they are fit for purpose, and that they can respond to the ever greater need to demonstrate value for money and achieve efficiencies.

Within each of these themes advised by the Audit Commission, we identified a number of sub-categories (outlined in Table 1) and gave each a risk rating using the criteria provided in Table 2. A summary risk rating was also provided for each thematic area.

We have also drawn on our analysis undertaken during 2011 to identify trends in how the sector is responding to the financial challenges it faces.

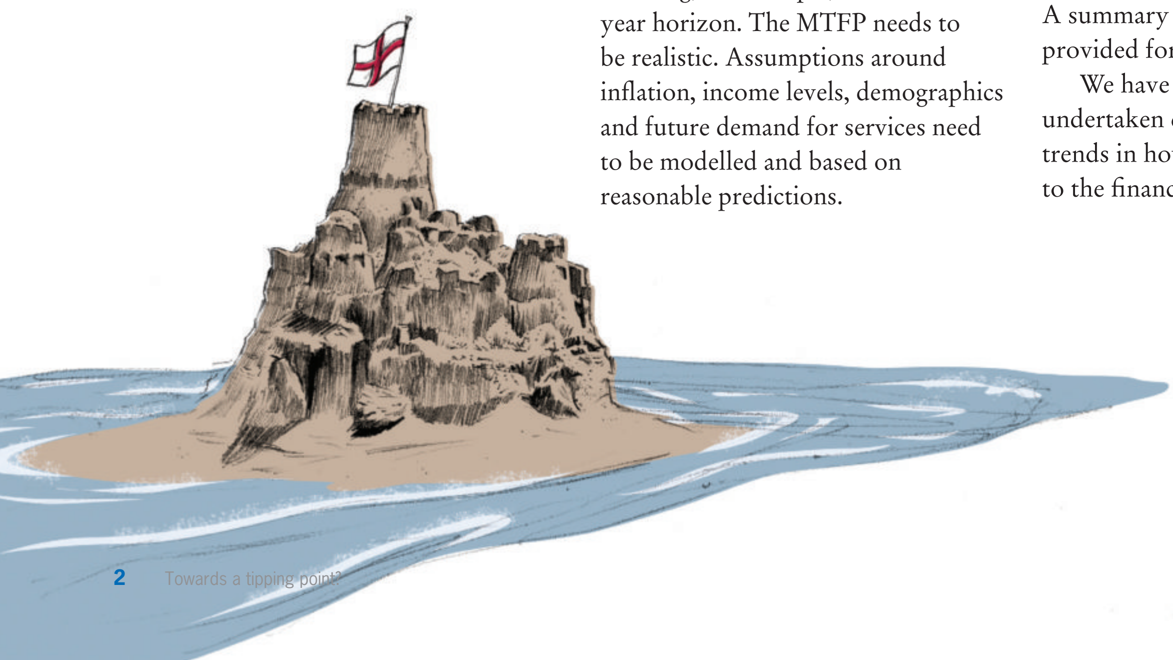


Table 1 Themes and sub-categories for analysis

Theme	Sub-category
Key indicators of financial performance*	Liquidity Borrowing Workforce Performance against budget Reserve balances Schools balances (for single tier and county council authorities)
Strategic financial planning	Focus of the MTFP Adequacy of planning assumptions Scope of the MTFP and links to annual planning Review processes Responsiveness of the plan
Financial governance	Understanding the financial environment Executive and member engagement Performance management of budgets Accuracy of committee/cabinet reporting
Financial controls	Performance management of budgets Performance against savings plans Key financial accounting systems Finance department resourcing Internal audit arrangements External audit arrangements

Table 2 Risk-rating criteria

Green	**Arrangements meet or exceed adequate standards** Adequate arrangements identified and key characteristics of good practice appear to be in place.
Amber	**Potential risks and/or weaknesses** Adequate arrangements and characteristics are in place in some respects, but not all. Evidence that the authority is taking forward areas where arrangements need to be strengthened.
Red	**High risk** The authority's arrangements are generally inadequate or may have a high risk of not succeeding.

***Note on indicators used**

While undertaking this year's programme of health checks we have had a considerable amount of debate on what are the most appropriate KPIs for local authorities' financial performance, both in terms of the type of ratio, and the industry standard of the ratios being applied. We will continue to use the ratios we have used during our first two national programmes of health checks but will ensure that, where alternative ratios are being applied by authorities, they will be identified and discussed in our 2013 report.

Towards a tipping point?

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

Our 2011 review identified a somewhat surprising level of confidence in the sector that savings targets would be achieved during 2011–12, given the context that this was the first year of SR10. Was this confidence accurate or misplaced? Our 2012 programme of reviews indicates that the sector was right to be confident as most local authorities in our sample have been able to deliver against their 2011–12 budgets, indicating the continued effective leadership of senior management and elected members.

Our 2011 review also identified that this confidence diminished when discussing the medium-term. Has this position for the medium-term improved, or are the storm clouds growing ever darker? The one area where the trend between 2010–11 and 2011–12 has seen a reduction relates to the increasing level of risk associated with strategic financial planning. The challenges facing the sector remain significant and the confidence for the medium-term is, understandably, generally weaker. Tough decisions have again been made when setting the 2012–13 budget, but managing the on-going implementation of these decisions and their impact on service users and staff will not be easy.

Historically, as a sector, local government has typically delivered whatever central government of all parties has asked of it over the past 30 years, such as the localisation of housing benefits, introduction of the Community Charge and then the Council Tax, Local Government Reorganisation (many times), and annual Gershon efficiency targets.

Our analysis of 2011–12, the first year of SR10, indicates the sector continues to deliver. However, local government's resilience over the medium-term remains far less certain. At the time of writing, we are half-way through the term of the current, fixed Parliament, but only 25% of the Government's fiscal consolidation plans have been implemented, with the majority still to be delivered over the next two and a half years.

Factors leading to uncertainty in local government financial planning include:

- the delivery of on-going SR10 funding reductions, with possible further funding reductions during this spending review period, and a lack of certainty of the funding landscape post 2015
- the weakness of the economy which both depresses income sources and increases local government welfare related spending
- the timing of the 2013–14 Local Government Finance Settlement, which at the time of writing is due to be late December 2012, providing a very limited lead in period to feed into the 2013–14 financial planning cycle
- restrictions on local authorities to generate additional funding by increasing Council Tax during 2013–14 due to the Government's effective freezing of the tax for a further year
- the opportunities and challenges that arise from the localisation of business rates, the reduction to Council Tax benefit funding, and the introduction of the universal credit
- the consequences of implementing the Government's policies, such as academies, health and wellbeing boards, Local Enterprise Partnerships and the Localism Act
- the pressures of an ageing population with an increasing complexity of need impacting on social care delivery, a key spending pressure area
- limitations on the ability to finance capital projects.

Will delivering services in this context be any different to the recent past? Our analysis and discussions with the sector indicate that a 'tipping point' is on the horizon, 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.

We have identified a number of scenarios for such a tipping point. These relate to an individual local authority, rather than the local government system as a whole:

- **Statutory** – where a local authority can no longer meet its statutory responsibilities to deliver a broad range of services within the funding available, leading to legal challenges and protests from impacted stakeholders.
- **Financial** – where the Section 151 Officer is unable to set a balanced budget, leading in the first instance to an unbalanced budget report to members in line with Section 114 of the Local Government Finance Act 1988 (England and Wales); or where the increased uncertainty leads to budget overspends of a level which reduces reserves to unacceptably low levels; or where an authority demonstrates characteristics of an insolvent organisation, such as a failure to pay creditors.
- **Industrial** – as a consequence of pay restraint, changes to terms and conditions, and job losses, employees and trade unions enact prolonged strike action, leading to major service disruption and long-term industrial relations disputes.
- **External** – failure of a major supplier, leading to significant service disruption and reputational damage to the authority.
- **Incremental** – multiple, smaller tipping points relating to individual service areas, developing over a period of time, leading to an eventual critical mass of tipping points.
- **Decision paralysis** – failure to make the challenging but necessary decision required to manage financial and other challenges.

We do not believe that all authorities share the same level or types of risk. We do not therefore suggest that all authorities could experience a tipping point. We will continue to engage with the sector to explore the concept of a tipping point, to identify if any of these scenarios above (or others) could be possible for an individual authority, and what the consequences would be for stakeholders, in particular service users. Once there is greater understanding of such scenarios, we will begin to analyse what actions need to be taken to mitigate or avoid such tipping points.

"Our discussions with the sector indicate that a 'tipping point' is on the horizon, 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."

During 2012 we have had many discussions across the sector on the findings set out in 'Surviving the storm', our 2011 report. The overwhelming feedback has been that our findings, based on a significant, but relatively small, sample, were echoed across the sector. We hope that the findings in this report resonate in the same way.

We will be undertaking a third year of financial health reviews of local authorities during 2013, in relation to the 2013–14 financial planning cycle and the delivery of budgets and savings plans during the 2012–13 financial year. We will publish the summary results of this work during Autumn 2013. Our audit client base has increased to 40% of local authorities in England, so our next report will be based on a significantly increased programme of local authority financial health checks.

The summary findings from our 2012 reviews, and the trends between our 2011 and 2012 reviews, are set out in the following sections.

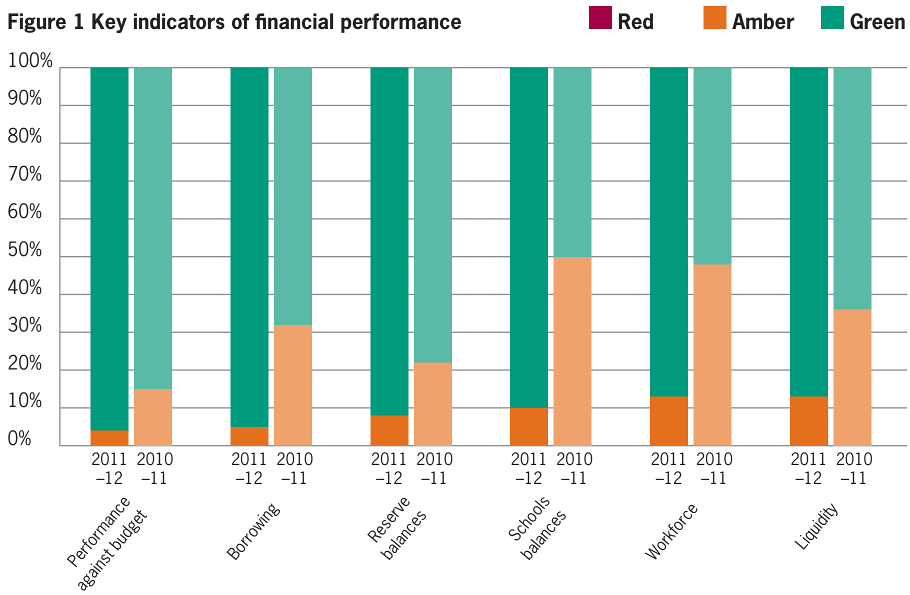
Key indicators of financial performance

Analysis of financial and other ratios for benchmarking indicates strength in performance against budget remain strong, while the gearing of long-term borrowing and reserve balances have improved on last year. Despite considerable improvement, managing the workforce remains a critical area, alongside liquidity where the trend for reducing working capital continues.

Our 2011 report noted that, while local government accountants have an understanding of the use of financial ratios to interpret financial statements, this skill has traditionally only been applied to procurement exercises. Our review last year represented one of the first times that financial ratios have been applied to local authority financial statements for the purpose of inter-authority benchmarking.

Figure 1 provides a summary of our ratings for selected key indicators of financial performance for our most recent reviews, and the results of our same review for the previous year. For each authority we benchmarked key indicators against their nearest neighbour group.

Figure 1 Key indicators of financial performance



Performance against budget

The track record of local authorities in our sample in managing revenue budgets during 2010–11, which included in-year government funding reductions, and in previous years was generally good, with 86% being rated green. The trend for 2011–12 was an improving one, with 96% rated green. Given that 2011–12 was the first year of SR10 funding reductions, and these reductions were front-loaded to 2011–12, this represents a significant achievement for the sector.

However, the challenges facing authorities are only increasing and the key question of how long the sector can continue to deliver against reduced funding has been discussed in more detail in the previous section (pages 4–5).

Borrowing

We reviewed long-term borrowing as a proportion of long-term assets and as a share of tax revenue. The majority (69%) of authorities in our sample in 2010–11 had an appropriate ratio of long-term borrowing to long-term assets, and long-term borrowing as a share of tax, indicating that the level of borrowing was effectively geared. The trend across our sample has improved for 2011–12 with 95% of authorities rated green, with long-term borrowing ratios reducing. A key factor has been strategies for reducing high interest-bearing, long-term borrowing and moving to internal and short-term external borrowing to take advantage of improved lower level borrowing rates, alongside a greater degree of caution with long-term borrowing following the experience of investment in Icelandic banks.

Reserve balances

We noted in our 2011 report that authorities had generally acted prudently over a long period, but that we were starting to see General Fund Reserves being used to fund General Fund revenue expenditure. Of our sample, 79% were rated green in 2010–11 which has increased to 92% in 2011–12. The overall trend has been an increase in the level of reserves, which is supported by 2011–12 Revenue Outturn (RO) return data. This reflects the better than expected performance in delivering 2011–12 revenue budgets. Nonetheless, it will be critical that reserve levels, both general and earmarked, are carefully monitored to ensure the financial resilience of authorities during SR10 is maintained.

Schools balances

For single tier and county council (STCC) authorities with responsibility for education, we analysed the ratio of schools balances as a proportion of dedicated schools grant. There is a trend of increasing schools balances, indicated by an increase in green ratings from 50% in 2010–11 to 90% in 2011–12. A key factor in this trend is that schools appear to be adopting a cautious approach to financial management due to concerns over future funding levels, in many cases leading to underspends. In addition, the financial risks associated with schools transferring to academies are leaving deficits which authorities will need to fund.

Workforce

The focus for this indicator was the level of sickness absence. Costs that accrue from sickness absence relate to the hiring of agency staff to cover staff gaps, or from holding a larger workforce complement than is desirable. Absence also damages service levels either through staff shortage or lack of continuity. Reducing absenteeism saves money, improves productivity and can have a positive customer benefit. It is clear that most authorities continue to proactively manage absenteeism, with a reduction from 57% receiving amber scores for 2010–11 to 12% receiving amber scores for 2011–12. Absence management will continue to be a challenge for authorities during SR10, particularly given the context of significant pressures on staff to deliver ‘more for less’.

Liquidity

This indicator looks at the working capital ratio, indicating if an authority has enough current assets to cover its short-term liabilities. Of our sample, 35% scored amber in 2010–11 and 65% scored green. This has improved for 2011–12 with 12% scoring amber and 88% green.

The overall trend noted for 2010–11 was of reducing working capital. This trend has continued for 2011–12. The improvement in the risk rating scores is a result of a further analysis undertaken during our second year of reviews to better understand the context of falling liquidity. In particular, we identified local authorities’ treasury management strategies to reduce long-term borrowing resulting in a planned reduction in liquidity. The level of borrowing room available to authorities should they wish to draw down to meet liquidity issues was also a factor in this year’s ratings. Nonetheless, local authorities will need to carefully monitor their liquidity levels during SR10 to ensure financial resilience is maintained.

Best practice

- The authority operates within a locally determined appropriate level of reserves and balances.
- The General Fund balance is maintained at or above the locally agreed minimum level.
- Working capital is at, or above, a ratio set by the Section 151 officer.
- Manageable levels of long-term borrowing within prudential borrowing limits.
- Targets have been set for future periods in respect of key indicators, such as reserve balances and prudential indicators.
- The authority has a track record of spending to budget and proactively managing forecast overspends in-year.
- A robust organisational approach and focus on absence management to improve productivity, reduce costs and enhance customer service.

Strategic financial planning

Having learnt from the previous year, 2012–13 planning cycles were typically started earlier to ensure adequate time to finalise their savings programme and a few authorities have chosen to focus on setting the 2012–13 budget, over updating 2011–12 plans. Scenario planning remains generally weak, but is even more critical given uncertainty about the Government's spending plans.

Strategic financial planning had the best overall rating across our sample for 2010–11, but this is the only thematic area that has seen a reduction in its overall rating for 2011–12. Figure 2 provides a summary of our ratings for selected key indicators of strategic financial planning and the key findings are set out below.

Figure 2 Strategic financial planning

Review processes

Of our sample, 100% was rated green for this category for 2010–11. This decreased to 91% for 2011–12. This indicates that the majority of authorities still have effective processes for the regular review of the MTFP and the associated assumptions, including appropriate scrutiny from elected members, including the Audit Committee. The increase in amber ratings to 9% is a result of a minority of authorities in our sample who have not updated their plans, focusing instead on setting the 2012–13 budget.

The scope of MTFP and links to annual planning

Of our sample, 78% was rated green for this category for 2010–11. This had increased to 88% for 2011–12. The 2012–13 planning cycles typically started earlier than the previous year, reflecting a key lesson learnt from 2011–12 planning cycle: given the scale of the savings requirement, many authorities had not allowed enough time during their financial planning cycle to ensure adequate finalisation of their savings programme.

Good practice authorities demonstrate effective integration of the service and financial planning processes. However, individual services often undertake modelling of demand to understand the impact on future spending levels, but this information is often not consolidated within the plan, limiting the potential of members to understand in detail all the demand led financial challenges an authority faces.

Responsiveness of the plan

Of our sample, 86% was rated green for this category for 2010–11. This has reduced to 83% for 2011–12. Many authorities commenced the 2012–13 financial planning cycle early in the first quarter of 2011–12, having learnt from the previous financial planning period. There is a general recognition that assumptions may change during the lifetime of the plan, that the plan must evolve and be responsive to the external environment.

The focus of MTFP

Of our sample, 86% received a green rating for 2010–11. This had reduced to 79% for 2011–12. While many MTFPs have been refreshed for 2011–12 and typically receive greater challenge and scrutiny than in prior years due to the scale of savings required, many authorities have struggled to develop certainty on key factors affecting the financial position beyond 2012–13, such as the localisation of business rates and the reduction in Council Tax benefit funding, resulting in a return to a more annualised approach to financial planning for some authorities.

Developing budgets and savings plans on a departmental basis, and then reviewing them centrally by senior management and cabinet, remains the typical approach in the sector. The use of zero based budgeting (ZBB) also remains limited across our entire sample. Local authorities should consider adopting, in an appropriate and controlled way, aspects of ZBB to improve the strategic prioritisation during the financial planning cycle.

Some authorities, when updating their plans, noted that their key focus should be the maximisation of financial resilience rather than service improvement, with the aim being to ensure that the plans in place are affordable and sustainable in the light of resources that can reasonably expect to be available. This suggests that the savings are targeted where they have the least impact on priorities to ensure that there are no unplanned service reductions.

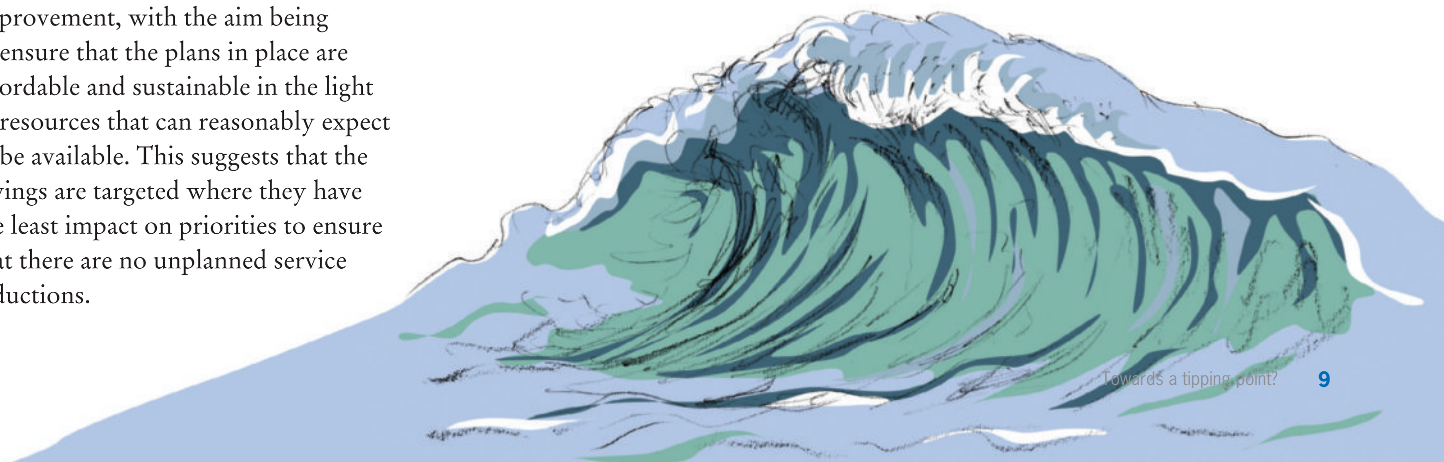
Adequacy of planning assumptions

This was the weakest category in relation to financial planning for 2010–11, with 36% of the sample receiving an amber rating. It was again the weakest category for 2011–12, with 29% receiving an amber rating.

While many plans had been updated, a number of authorities had not revisited funding assumptions for 2013–14 due to continuing uncertainties relating to the Government's spending plans. Scenario planning remains generally weak and sensitivity analysis patchy across the sample group. However, the lack of certainty should increase, not reduce, the need for effective scenario planning in relation to funding and other factors such as demographics. Local authorities will need to ensure they have the skills and capacity to develop and maintain an effective financial model that underpins their MTFP.

Best practice

- Focus on achievement of corporate priorities is evident through the financial planning process. The MTFP focuses resources on priorities.
- Service and financial planning processes are integrated.
- The MTFP includes outcome measures, scenario planning, benchmarking, resource planning and details on partnership working.
- Annual financial plans follow the longer-term financial strategy of the authority.
- There is regular review of the MTFP and the assumptions made within it. The authority responds to changing circumstances and manages its financial risks.
- The authority has performed sensitivity analysis on its financial model using a range of economic assumptions, including the impact of SR10.
- The MTFP is linked to and is consistent with other key strategies, including workforce.
- KPIs can be derived for future periods from the information included within the MTFP.
- Zero Based Budgeting is used to improve strategic prioritisation during the financial planning cycle.
- Effective treasury management arrangements are in place.

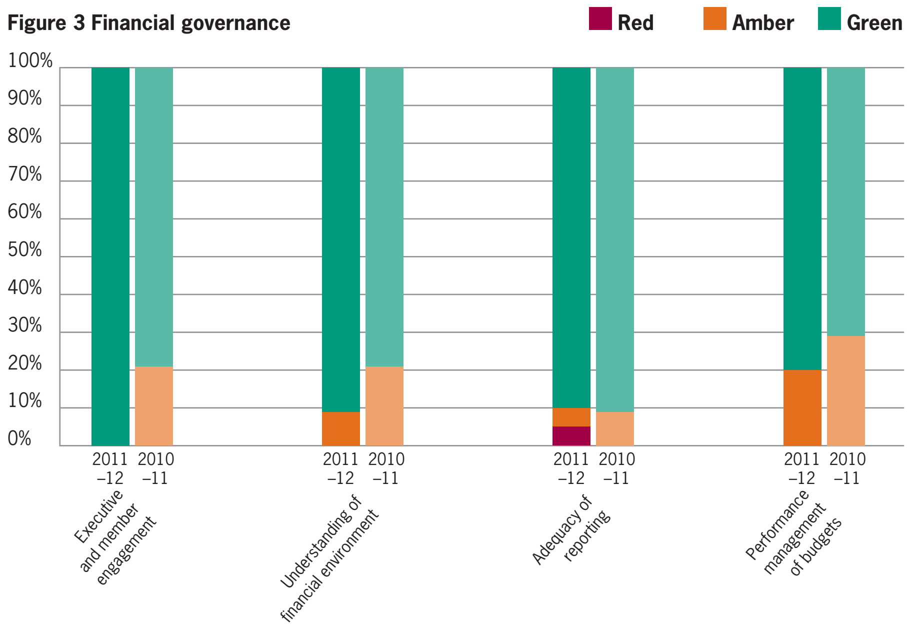


Financial governance

This year has seen a deeper engagement of senior management and members in relation to planning. While the performance management of budgets had increased, and forecast overspends are being managed corporately, rather than in departmental silos, the ability to manage volatile, demand-led budgets remains a challenge.

Figure 3 provides a summary of our ratings for selected key indicators of financial governance.

Figure 3 Financial governance



Executive and member engagement

Our 2010–11 review rated 79% of our sample as green. This increased to 100% for 2011–12. This indicates that the level of senior management and member engagement in relation to financial planning, reporting and management is appropriate in the sector.

We will continue to monitor the engagement of audit committees within local government, as the role of this committee becomes more prominent, and the demands increase on members.

Our 2011–12 reviews considered controls over key cost categories which formed part of executive and member engagement for our 2010–11 reviews. This category saw 82% of our sample rated green. Features of those receiving amber ratings included an unclear scheme of delegation, and lack of consistency in the application of unit cost data.

Understanding of the financial environment

Of our sample, 79% was rated green for 2010–11. This increased to 92% for 2011–12. Senior leadership continue to recognise the importance of communicating the impact of SR10 to all staff and elected members. Many also recognise the need for greater consultation with their local communities on spending and saving priorities. With a focus on protecting front-line services, back office functions such as finance have seen significant reductions in staff numbers during 2011–12. As noted in our 2011 report, a key trend across many authorities in response to these reductions is greater financial management responsibilities being placed on service managers and budget holders, with job descriptions and competencies being enhanced to reflect this change. In parallel to this, the finance function is providing higher level and more targeted support to services. Our follow up reviews indicate that the implementation of these changes by both finance and service staff has been mixed. Clearly these cultural and process changes will take time to embed, and it will be essential that authorities monitor such changes, given the significant risks to effective financial management that failure to embed these changes could create.

Adequacy of reporting

We continue to find comprehensive levels of timely financial reporting to senior management and members, with a growing trend to consider financial monitoring reports alongside performance and workforce data, which is good practice. 93% of our sample was rated green for 2010–11; this had reduced slightly to 92% for 2011–12. The overall position has not changed, with most authorities continuing to utilise risk based exception reports allowing decisions to be made on corrective action and to allocate responsibilities for these actions. In most cases, year-end forecasts are effective in providing no surprises; however, a minority of authorities do not fully apply commitment accounting, which poses a risk to the provision of accurate outturn forecasts.

It is worth noting that this category included the only red rating (5%) in this year's programme. Factors leading to this rating included the timing and the period against which performance was reported during 2011–12 was not consistent and differed between bodies receiving reports, limited frequency of reporting, lack of reporting on savings, failure to use graphics and propensity to use lengthy narrative, and Cabinet reports only including forecast year-end outturn position, and not the actual position against a profiled budget.

Performance management of budgets

Of our sample, 71% were rated green for 2010–11. This increased to 79% for 2011–12. This was the lowest score for a category in Financial Governance for 2010–11, and it was the joint lowest category score for 2011–12, although it reflects a reasonable position overall. Local authorities continue to face challenges managing volatile, demand led, budgets. Our sample indicates a growing maturity amongst authorities in managing forecast overspends corporately, rather than within departmental silos, which is good practice. However, the challenges of setting appropriate budgets and then spending within them (or generating forecast levels of income) continues to be one of the key risks and challenges.

Best practice

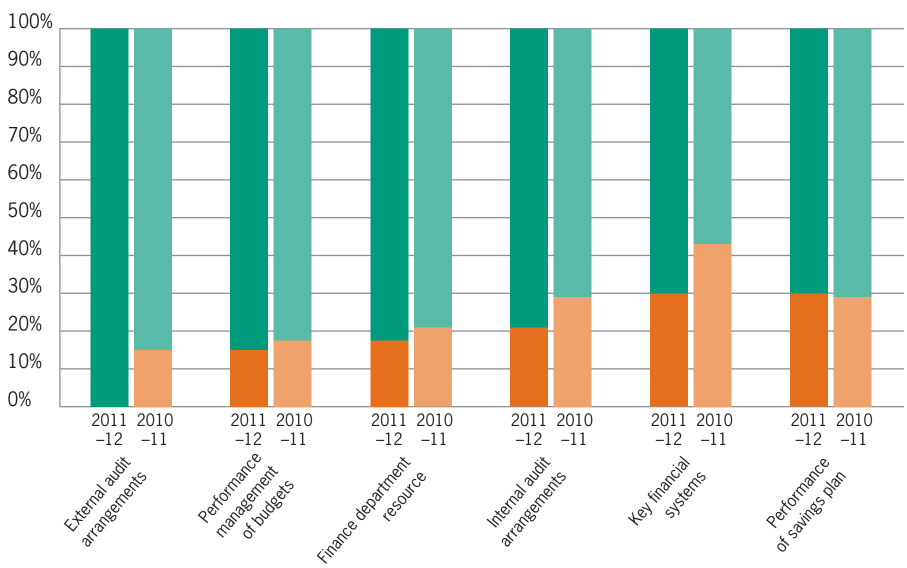
- Regular reporting to members. Reports include detail of action planning and variance analysis.
- Actions have been taken to address key risk areas.
- The CFO is a key member of the leadership team.
- Officers and managers across the authority understand the financial implications of current and alternative policies, programmes and activities.
- The leadership ensure appropriate financial skills are in place across all levels of the organisation, for example a good understanding of unit costs and cost drivers.
- The leadership foster an open environment of open challenge to financial assumptions and performance.
- There is an effective scheme of delegation, ensuring clarity of financial responsibilities and accountabilities.
- There is engagement with stakeholders, including budget consultations.
- There are comprehensive policies and procedures in place for members, officers and budget holders which clearly outline responsibilities.
- Internal and external audit recommendations are not overdue for implementation.
- Committees and cabinet regularly review.

Financial controls

The use of financial controls had improved on the prior year. Impressively, in-year savings are being delivered, although there is a lack of transparency in reporting performance against budgeted savings and demonstrating that the savings agreed have been delivered as planned.

Figure 4 provides a summary of our ratings for selected key indicators of financial controls.

Figure 4 Financial controls



External audit arrangements

We rated 86% of our sample green for 2010–11. This increased to 100% for 2011–12, the highest level for this, or any, theme. This indicates that IFRS accounting and associated budget and chart of account restructurings have been effectively embedded, and external audit had not identified serious issues in relation to the accounts or in relation to the value for money conclusion.

Performance management of budgets

The financial controls in place to ensure effective performance management of budgets were generally good for 2010–11, with 83% of our sample rated green. This has improved slightly for 2011–12 with 86% rated green. Those authorities who scored amber typically still need to improve the accuracy of financial reporting, for example by having accurate budget profiles, an improved understanding of cost drivers, and better use of benchmarking, trend analysis and unit costs. A more effective approach to presenting financial information is also required.

Finance department resource

Of our sample, 78% was rated green for 2010–11. This has increased to 83% for 2011–12. This indicates that the majority of authorities have been able to manage the impact of funding reductions to this part of the back office. Our 2012 reviews were undertaken prior to the finalisation of 2011–12 accounts, so we have not reviewed the effectiveness of reduced finance resources for a complete annual financial cycle. This is something we will focus on during our 2013 reviews. The ability of finance teams to withstand planned and unplanned absences in providing support to services remains a key risk for authorities, given widespread reductions in staff numbers and the context of the delivery of major savings at a time when services are taking on enhanced financial management responsibilities.

Internal audit arrangements

The majority of authorities in our sample (71%) were rated green for 2010–11. This has increased to 79% for 2011–12. Most authorities continue to apply a risk based approach to audit planning and involve services in this process, have a robust process for preparing and reporting the Annual

Governance Statement, and an engaged audit committee. Those authorities who were rated amber had weaknesses such as audit plans that are traditional, process driven and not based on risk prioritisation, for example audit plans that do not vary year on year.

Key financial systems

Of our sample 57% was rated green for 2010–11, which was the lowest level for Financial Controls. This rating has increased to 71% for 2011–12 which is the joint lowest green rating for Financial Controls.

Local authorities typically have well established systems and procedures for producing reliable financial monitoring and forecasting information, which is used alongside related performance information to support decisions. We noted in our 2011 report that many authorities are considering enhancing the functionality of their key financial systems to ensure the burden of producing work around financial information does not fall to non-financial managers, given the reduction in finance staff, previously discussed. While progress is being made, such changes take time to specify, procure and implement. The risks associated with such work around solutions, in the context of reducing finance resource and increasing financial management responsibilities within services, will require careful monitoring by authorities in this position.

Performance of savings plan

Local authorities have a good track record of delivering efficiencies. Most authorities were able to effectively manage the 2010–11 in-year funding reductions with 71% of our sample rated green. For 2011–12 the position remained at 71% receiving a green rating. Given the context of front-loaded year one SR10 savings this indicates a considerable achievement.

A key factor to emerge from this year's reviews is that there is a lack of transparency in the way some authorities report performance against budgeted savings. While there have been undoubted improvements in the way local authorities manage and monitor their savings plans, the sector does not effectively report countervailing (alternative) savings that may be being achieved. Therefore, so long as a reduced budget, which incorporates agreed savings, does not overspend at year end, it can be considered a success. The reality, however, may be that other factors have led to the break-even position or underspend. For example, management decisions to hold vacancies that did not form part of the original savings plan may be hidden from management information (and the consequent impact on service delivery may not be identified). This approach is not unique to local government; indeed it is common across the public sector. But given the level of savings being delivered, and that are still to be delivered, it is critical that key stakeholders understand if the savings agreed have been delivered as planned.

Best practice

- Budgets are robust and prepared in a timely fashion and the authority has a good track record of operating within its budget.
- Budgets are monitored at an officer, member and cabinet level and officers are held accountable for budgetary performance.
- Financial forecasting is well-developed and forecasts are subject to regular review, including trend analysis, benchmarking of unit costs, risk and sensitivity analysis.
- Budget profiles are accurate and regularly monitored.
- There is particular focus on monitoring income-related budgets.
- Savings programme reporting includes effective management information on countervailing savings.
- The capacity and capability of the finance department and service departments are fit for purpose for effective financial planning and financial management.
- Key financial systems have received satisfactory reports from internal and external audit.
- Financial systems are adequate for future needs, for example commitment accounting functionality is available.
- There is an effective internal audit which has the proper profile within the organisation and agreed internal audit recommendations are routinely implemented in a timely manner.
- There is an assurance framework in place which is used effectively by the authority and is how business risks are managed and controlled.
- The Annual Governance Statement gives a true reflection of the organisation.

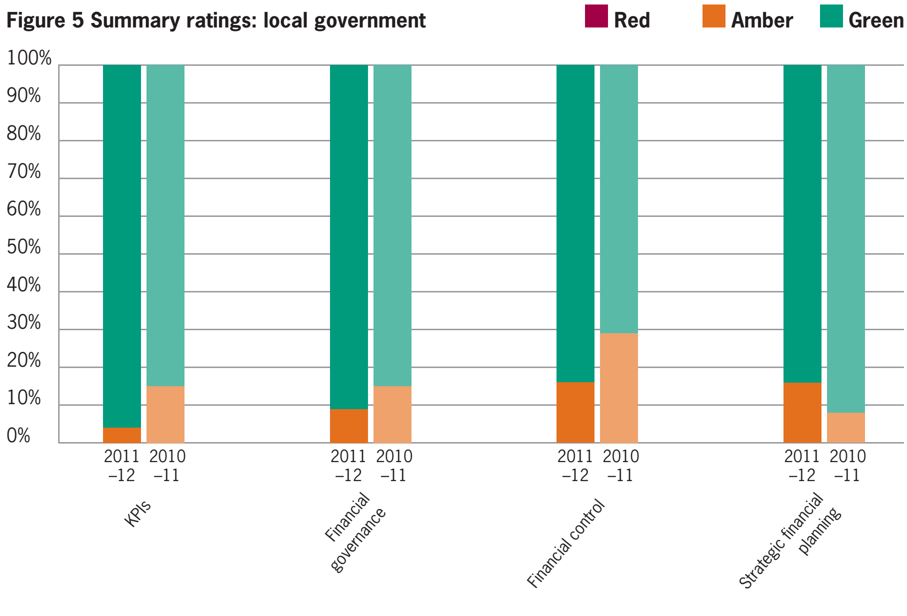
Summary and conclusions

Overall, local authorities have continued to manage in the current environment, but improving scenario planning, sensitivity analysis and reporting of savings programmes as well as ensuring financial governance arrangements remain robust will help finance management to influence key stakeholders in the uncertain times ahead.

The overall trend for many of the categories we have rated is a slightly improving position between 2010–11 and 2011–12. This is replicated in three of the four themes in Figure 5. Overall, local authorities have coped very well with delivering the first year of SR10. A summary for each theme follows.

86% of authorities were rated green for **key indicators of financial performance** for 2010–11, and this has increased to 96% for 2011–12. For each category in this thematic area the trend has been an increasing level of green ratings and reducing levels of amber ratings, with liquidity receiving the lowest overall rating (87%). While for many authorities their Treasury Management Strategy is leading to a planned reduction in liquidity, and borrowing headroom provides a degree of confidence for the medium-term, authorities will need to ensure that their liquidity is carefully monitored, for example in the collection of council taxes and business rates during challenging economic times. The overall position indicates that local authorities are both treating the financial challenges being faced seriously, and delivering against their financial plans. It was pleasing to see during our 2012 reviews that a number of authorities reflected some of our 2010–11 KPI recommendations in their updated MTFPs.

Figure 5 Summary ratings: local government



Local authorities demonstrated good **financial governance** during our 2010–11 reviews, with 86% receiving green ratings. This has increased to 92% for 2011–12. Local authorities will need to continue to ensure financial governance arrangements remain robust. Given the generationally significant financial challenges facing authorities, it will be particularly important that the chief financial officer is a key member of the authority's leadership team. This theme has the first sub category to receive a red rating (Adequacy of Reporting) and it will be critical that financial information is reported accurately, at the right frequency, and in a format that ensures effective monitoring and decision making. This includes where services are not delivered in-house, which will be an increasing trend for the sector.

Our 2010–11 reviews indicated that the weakest thematic area was **financial controls**, with 71% of authorities receiving a green rating. Our 2011–12 reviews indicate an improvement, with 83% of our sample receiving a green rating. However, this is the joint lowest overall rating, along with strategic financial planning. A key risk to be managed in this area continues to be embedding the changes resulting from reductions in finance staff and

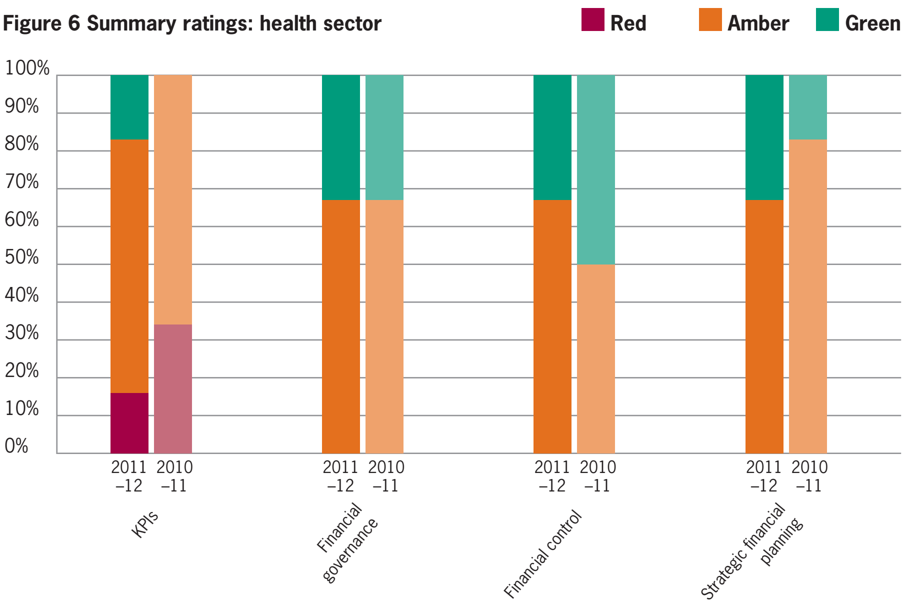
Key findings from health sector reviews

- Liquidity problems for more bodies, manifested by the need for working capital loans to be taken out during 2010–11 or 2011–12 or expected in 2012–13.
- Cost improvement programmes (CIPs) increasing, in some cases to unprecedented levels, with some 2012–13 programmes lacking headroom, or with schemes not being fully identified, or lacking effective detail.
- Failure to achieve CIP savings during 2011–12 for some bodies, leading to doubt over the planned achievements for 2012–13.
- A continued environment of extreme uncertainty, leading to merger proposals in several cases for trusts that have not yet achieved foundation trust status.
- Weak performance against the Public Sector Payments Policy targets.

the associated increase in financial responsibilities of service managers and budget holders. Local authorities also need to improve the management information relating to the reporting of savings programmes, in particular with the inclusion of greater detail on the use of countervailing savings, so that key stakeholders can better understand the impact on service delivery and policy decisions, where such alternative savings are being applied to pre-agreed targets.

Local authorities demonstrated strong **strategic financial planning**, during our 2010–11 review, with 93% in our sample receiving a green rating. This declined to 83% for 2011–12, the only thematic area that saw a fall in the overall green rating. While this remains at a high level overall, the reduction highlights the increasing difficulty local authorities face in planning for the medium-term in what remains a greatly challenging and uncertain period. It remains critical that authorities improve their scenario planning and the use of sensitivity analysis on key assumptions in their financial models. As we noted in our 2011 report, we believe authorities can learn directly from the financial modelling analysis required by Foundation Trust applicants in the NHS.

Figure 6 Summary ratings: health sector



Comparison to the health sector

We undertook similar reviews of a sample of NHS trusts and primary care trusts (PCTs) for both 2010–11 and 2011–12.

The methodology used for our reviews of health bodies was the same as that used for local authorities, and the summary results for our sample of health bodies are set out in Figure 6. Our 2011 report observed that, despite NHS funding levels being maintained by the Government, health bodies received lower ratings than local authorities for 2010–11, with significantly lower levels of green ratings across themes, and with no green ratings for key indicators of financial performance. There has been some improvement for 2011–12. For example, and unlike local authorities, strategic financial planning for health bodies has improved. Health bodies have also seen an improvement for KPIs and the overall position for financial governance has stabilised. However, the overall ratings remain significantly lower than the overall local authority ratings.

As we noted in our 2011 report, the underlying causes of these findings predate SR10, and relate to long-term structural issues, particularly within the acute sector. Like local government, performance is varied, but the higher performing trusts are often very good at scenario planning and sensitivity analysis as a response to volatile demand-led costs and income, although the sector as a whole has difficulty in delivering to these budgets.

About us

Grant Thornton UK LLP is a leading business and financial adviser with client-facing offices in 24 locations nationwide. While we understand regional differences and can respond to needs of local authorities, our clients can also have confidence that our team of local government specialists is part of a firm led by 200 partners and employing nearly 4,000 professionals, providing personalised audit, tax and specialist advisory services to over 40,000 clients.

Grant Thornton has a well-established market in the public sector, and has been working with local authorities for over 30 years. Our national team of experienced local government specialists, including those who have held senior positions within the sector, providing the growing range of assurance, tax and advisory services that our clients require.

We are the leading firm in the local government audit market, as the largest supplier of audit and related services to the Audit Commission with 40% of local authorities in England as external audit clients. We also audit local authorities in Wales and Scotland via framework contracts with Audit Scotland and the Wales Audit Office. We have over 180 local government and related body audit clients in the UK and over 75 local authority advisory clients. This includes London boroughs, county councils, district councils, city councils, unitaries and metropolitan authorities, as well as fire and police authorities. This depth of experience ensures that our solutions are grounded in reality and draw on best practice. Through proactive, client-focused relationships, our teams deliver solutions in a distinctive and personal way, not pre-packaged products and services.

Our approach combines a deep knowledge of local government, supported by an understanding of wider public sector issues, drawn from working with associated delivery bodies, relevant central government departments and with private-sector organisations working in the sector. We take an active role in influencing and interpreting policy developments affecting local government and responding to Government consultation documents and their agencies. We regularly produce sector-related thought leadership reports, typically based on national studies, and client briefings on key issues. We also run seminars and events to share our thinking on local government and, more importantly, understand the challenges and issues facing our clients.

Contact us

Sarah Howard
Head of Local Government
T 0113 200 2530
E sarah.howard@uk.gt.com

Guy Clifton
Local Government Advisory Lead
T 020 7728 2903
E guy.clifton@uk.gt.com
Twitter @guy_clifton

Paul Dossett
Partner
T 020 7728 3180
E paul.dossett@uk.gt.com
Twitter @paul_dossett

Grant Thornton

www.grant-thornton.co.uk

EPI957