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<b>Report To:</b>	<b>Policy &amp; Resources Committee</b>	<b>Date:</b>	<b>6 February 2018</b>
<b>Report By:</b>	<b>Chief Financial Officer</b>	<b>Report No:</b>	<b>FIN/06/18/AP/LA</b>
<b>Contact Officer:</b>	<b>Alan Puckrin</b>	<b>Contact No:</b>	<b>01475 712223</b>
<b>Subject:</b>	<b>Accounts Commission Report - Local Government Financial Overview 2016/17</b>		

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## 1.0 PURPOSE

- 1.1 The purpose of this report is to present the main issues raised in the recent Local Government Financial Overview report by the Accounts Commission and to highlight actions proposed by officers.

## 2.0 SUMMARY

- 2.1 The report represents the third year where the annual overview of Local Government by the Accounts Commission is split into two separate reports with the financial overview being issued in November and the wider overview of Council's performance being issued in March. As has been the case for several years, the CMT has reviewed the report and its key findings and has prepared an assessment of where the Council is placed against the actions highlighted.
- 2.2 The report's Key Messages are listed on Page 7 of the document and are summarised as follows:
- Councils are under continued financial pressure arising from increased demand and reductions in funding.
  - More and more Councils are using reserves to balance their revenue budgets.
  - Debt is increasing and the sustainability of this is questioned.
  - Budget setting is becoming more complex and uncertain with the creation of IJBs and continued annual budget settlements.
  - All Councils received an Unqualified Audit Opinion for the 6<sup>th</sup> year in a row.
  - Robust Medium Term Financial Strategies and effective leadership is more important than ever.
- 2.3 The report also contains a large number of exhibits many of which show where the Council is placed compared to other Councils. The body of this report provides some context and commentary for the Committee to consider but there is nothing in these exhibits which the CMT would raise as a matter of concern.
- 2.4 The report is timely given the current focus on the 2018/20 budget and confirms many of the matters raised with Members via the Financial Strategy and various reports and briefings on the challenging financial position Inverclyde along with all other Scottish Councils face.

## 3.0 RECOMMENDATIONS

- 3.1 It is recommended that the Committee consider the contents of the Accounts Commission report and thereafter approve the Action Plan in Appendix 1.

**Alan Puckrin**  
**Chief Financial Officer**

## **4.0 BACKGROUND**

- 4.1 For the last 3 years the Accounts Commission has produced a Local Government Financial Overview in November in order to assist Councils in the development of their forthcoming budgets. As has been the case previously, the report has been presented to the Policy & Resources Committee for consideration.
- 4.2 A further Accounts Commission report covering the overall performance of Councils is produced in March and is also presented to the Committee.

## **5.0 ACCOUNTS COMMISSION'S REPORT & FINDINGS**

- 5.1 The report's Key Messages are listed on Page 7 of the document and are summarised as follows:
  - Councils are under continued financial pressure arising from increased demand and reductions in funding.
  - More and more Councils are using reserves to balance their revenue budgets.
  - Debt is increasing and the sustainability of this is questioned.
  - Budget setting is becoming more complex and uncertain with the creation of IJBs and continued annual budget settlements.
  - All Councils received an Unqualified Audit Opinion for the 6<sup>th</sup> year in a row.
  - Robust Medium Term Financial Strategies and effective leadership is more important than ever.
- 5.2 The report also contains a large number of exhibits many of which show where the Council is placed compared to other Councils.

Exhibit 3 – This shows that Inverclyde received the highest per capita revenue support of all the “non-island” Councils in Scotland in 2016/17. This is a function of the distribution system which allocates resources on the basis of need.

Exhibits 9, 13 & 14 – These exhibits focus on Reserves and in particular the annual movement in reserves, the current size of reserves (Inverclyde has the largest General Fund Reserves relative to its size in Scotland) and initial information on the size of IJB Reserves.

Exhibits 15 & 16 – These exhibits show the size of debt relative to “turnover” and the proportion of the Councils turnover spent on debt servicing. Inverclyde is ranked 3<sup>rd</sup> highest in both. As has been highlighted a number of times previously, the high level of debt is largely driven by policy choices and is reflected in the recent significant investment in the School, Leisure, Office and Depot estate plus the ongoing Roads investment.

Exhibit 19 – This shows the percentage increase in income arising from the 2017/18 changes to Council Tax plus any Council Tax increase. Inverclyde is ranked 3<sup>rd</sup> lowest.

Exhibit 21 – The final exhibit is the one which made the headlines regarding the sustainability of using reserves to balance the budget. From this it can be seen that Inverclyde has proportionally the largest General Fund Reserves in Scotland albeit the vast bulk is allocated to projects/funding models. Therefore the Council is not in danger of running a deficit in its reserves in the medium to long term.

- 5.3 Throughout the report questions are asked of Councillors and many of these are addressed by the CMT in the Appendix.

## **6.0 CORPORATE MANGEMENT TEAM'S ASSESSMENT & PROPOSED ACTIONS**

- 6.1 The Corporate Management Team has reviewed the report and the various tables and issues raised. The assessment of the CMT is that there is nothing raised in the report that comes as a surprise and has not been reported in recent Annual Audit Reports.

- 6.2 The Council has large reserves relative to its size but officers report these each Committee cycle and through the 6 monthly Financial Strategy. The Council also has had an ambitious programme of investment in its key assets and therefore the relative size of its debt is expected to be higher than many other Councils. The critical issue is that this debt remains affordable and that is demonstrated in the medium/longer term within the Financial Strategy.
- 6.3 In order to assist the Committee in assessing the report, the CMT has created an Action Plan in Appendix 1 which highlights many of the issues raised in the report and provides an assessment of where the Council currently sits. The Committee is asked to review and approve the Action Plan.

## 7.0 IMPLICATIONS

### 7.1 Finance

There are no financial implications arising from this report albeit the report captures some of the financial challenges faced by the Council at this time.

#### Financial Implications:

One off Costs

Cost Centre	Budget Heading	Budget Years	Proposed Spend this Report £000	Virement From	Other Comments
N/A					

Annually Recurring Costs/ (Savings)

Cost Centre	Budget Heading	With Effect from	Annual Net Impact £000	Virement From (If Applicable)	Other Comments
N/A					

### 7.2 Legal

There are no legal implications arising from this report.

### 7.3 Human Resources

There are no HR issues arising from this report.

### 7.4 Equalities

Has an Equality Impact Assessment been carried out?

Yes See attached appendix

No This report does not introduce a new policy, function or strategy or recommend a change to an existing policy, function or strategy. Therefore, no Equality Impact Assessment is required.

### 7.5 Repopulation

There are no direct repopulation issues arising from this report.

## **8.0 CONSULTATIONS**

8.1 The Corporate Management Team endorse the contents of the report and the associated Action Plan.

## **9.0 LIST OF BACKGROUND PAPERS**

9.1 None

**Financial Overview 2016/17 - Actions**

**Appendix 1**

<u>Issue Raised</u>	<u>Officer Response</u>	<u>Further Action/By Whom</u>	<u>Target Date</u>
1.Does your Council have a Charging Policy? Is it in line with Corporate Plans and when was it last reviewed?	The Council has a Charging Policy which was approved in 2014. The Policy brings a consistency in approach to calculating and approving charges.	Policy due to be reviewed during 2018.  <b>Chief Financial Officer</b>	December, 2018
2. What information do you need to be able to explain increases in fees and charges to your constituents?	Increases in fees and charges are supported by benchmarking information as part of the overall Budget Consultation exercise.	No further action proposed	
3. Do Management Commentaries clearly explain Council performance and any changes to plans	The Management Commentary is a key part of the Annual Accounts and is reviewed by Members and Auditors prior to the approval of the Accounts	Review and development of the Management Commentary will continue  <b>Chief Financial Officer</b>	On going
4. Are staff severances in line with the Council's workforce plan?	The Council's People & OD Strategy 2017/20 focuses on managing workforce reductions and updates are reported to Committee on an annual basis.  All staff severances comply with the Council's Policy and approved budget plans	No further action proposed	

<p>5. How does the Council ensure that Council staff have the capacity to deliver transformational change?</p>	<p>The Council's People &amp; OD Strategy sets out plans and key actions to support employees through transformational change to ensure we meet the challenges ahead.</p> <p>The CMT and Directorates review the capacity to deliver the Change projects on a regular basis and report to Committee as part of the Delivering Differently Programme.</p>	<p>No further action proposed</p>	
<p>6. What have the reserves been used for in recent years?</p>	<p>Reserves support a variety of areas such as asset plans, early release costs, smoothing reserves and specific projects. All are approved by Committee and reported as part of Committee reports or the Financial Strategy.</p>	<p>No further action proposed</p>	
<p>7. What is your Council's Reserves Policy?</p> <p>What different type of reserves are held by your Council?</p>	<p>Reserves Policy last approved in 2016 and all reserves reviewed as part of the 2018/20 Budget.</p> <p>Council holds a variety of reserves to fund asset plans, smooth areas of variable spend, fund large one off costs, create contingencies and deliver specific projects.</p>	<p>No further action proposed</p>	
<p>8. What are the level of reserves held by your IJB and are they in line with the IJB Reserves Policy?</p>	<p>At 31.3.17 the IJB reserves were £3.96 million and were held in line with the IJB Reserves Policy.</p>	<p>No further action proposed</p>	

<p>9. What share of the Council's budget is taken up with interest payments and debt repayment?</p> <p>What proportion of your Council's debt is linked to inflation?</p>	<p>As per the 2016/17 audited accounts, 13.5% of the Council's revenue stream was spent on debt and interest payments.</p> <p>The only debt linked to inflation is the Council's PPP debt and represents 23.5% of the Council's debt.</p>	<p>No further action proposed</p>	
<p>10. Has capital programme slippage been significant at your Council in recent years?</p>	<p>Slippage has reduced significantly in recent years and in 2016/17 the Council reported net "advancement"</p>	<p>No further action proposed</p>	
<p>11. Do you know the pension liabilities of staff retiring early?</p>	<p>Pension costs for staff being released early are reported to the Policy &amp; Resources Committee annually and a specific budget is held by the Council to meet the on going pension costs for early release.</p>	<p>No further action proposed</p>	
<p>12. How is your Council preparing for any further real terms reductions in Scottish Government funding?</p>	<p>Members receive regular updates, including scenarios, as part of the medium term Financial Strategy. This feeds into options developed by the CMT and considered by the Members Budget Working Group.</p>	<p>No further action proposed.</p>	
<p>13. Do you know how much an increase in Council Tax will raise and how will you communicate and explain the reasons for the rise to constituents?</p>	<p>A 3% increase in Council Tax will raise approximately £860k.</p> <p>Communicated with constituents via the Budget Consultation and Council Tax annual billing</p>	<p>No further action proposed.</p>	

<p>14. Does your Council have a savings plan and what are the options to close future funding gaps?</p>	<p>The Council operates a multi-year budget and the MBWG is therefore always planning ahead. Options are prepared by the CMT supported by the Delivering Differently Programme.</p>	<p>No further action proposed</p>	
<p>15. What is the likely use of reserves in 2017/18 and how does this compare to forecast funding gaps?</p>	<p>The last Policy &amp; Resources update advised that the Council would not require to use the planned £1.14m of reserves in 2017/18 and this has been factored into the 2018/20 budget plans.</p>	<p>No further action proposed.</p>	
<p>16. What is your Council's financial position and what particular challenges does it face?</p>	<p>The financial position and challenges are set out in the Financial Strategy with the main risks being stabilising the population and demographic changes.</p>	<p>No further action proposed</p>	
<p>17. Does your Council have a medium term Financial Strategy aligned to corporate initiatives?</p>	<p>Yes, reported to Council 6 monthly</p>	<p>No further action proposed</p>	
<p>18. How does your annual budget setting link to medium term financial planning?</p>	<p>The start point for the annual budget is the medium term financial position and vice versa.</p>	<p>No further action proposed</p>	
<p>19. What impact will savings have on the delivery of services and what are the potential risks?</p>	<p>The impacts are clearly laid out in the detailed savings sheets and in reports to Committee</p>	<p>No further action proposed</p>	
<p>20. How clearly does the Council's capital programme link with asset management plans and corporate objectives?</p>	<p>The Council has a Corporate Asset Management Plan supported by a number of individual asset plans. These account for the vast majority of capital programme spend.</p>	<p>No further action proposed</p>	



<p>21. What additional training would Councillors like to receive to develop knowledge and skills in financial scrutiny?</p>	<p>Councillors receive a detailed induction programme and on-going briefings/training on various financial matters. All this is recorded via personal development plans.</p>	<p>Dependent on Members' views.</p>	<p>TBC</p>
<p>22. What measures in the Council's corporate plans are aimed at addressing the underlying demand for services?</p>	<p>A wide range of initiatives in the CDIPs aim to reduce demand and address causation. It is acknowledged that as financial pressures increase these areas can become at risk.</p>	<p>Continue to develop ways of taking pressure "out of the system" whilst developing future CDIPs</p> <p><b>Corporate Management Team</b></p>	<p>On going</p>

Local government in Scotland

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# Financial overview 2016/17



ACCOUNTS COMMISSION 

Prepared by Audit Scotland  
November 2017




# The Accounts Commission

The Accounts Commission is the public spending watchdog for local government. We hold councils in Scotland to account and help them improve. We operate impartially and independently of councils and of the Scottish Government, and we meet and report in public.

We expect councils to achieve the highest standards of governance and financial stewardship, and value for money in how they use their resources and provide their services.

Our work includes:

- securing and acting upon the external audit of Scotland's councils and various joint boards and committees
- assessing the performance of councils in relation to Best Value and community planning
- carrying out national performance audits to help councils improve their services
- requiring councils to publish information to help the public assess their performance.

You can find out more about the work of the Accounts Commission on our website: [www.audit-scotland.gov.uk/about-us/accounts-commission](http://www.audit-scotland.gov.uk/about-us/accounts-commission) 

Audit Scotland is a statutory body set up in April 2000 under the Public Finance and Accountability (Scotland) Act 2000. We help the Auditor General for Scotland and the Accounts Commission check that organisations spending public money use it properly, efficiently and effectively.

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## Links

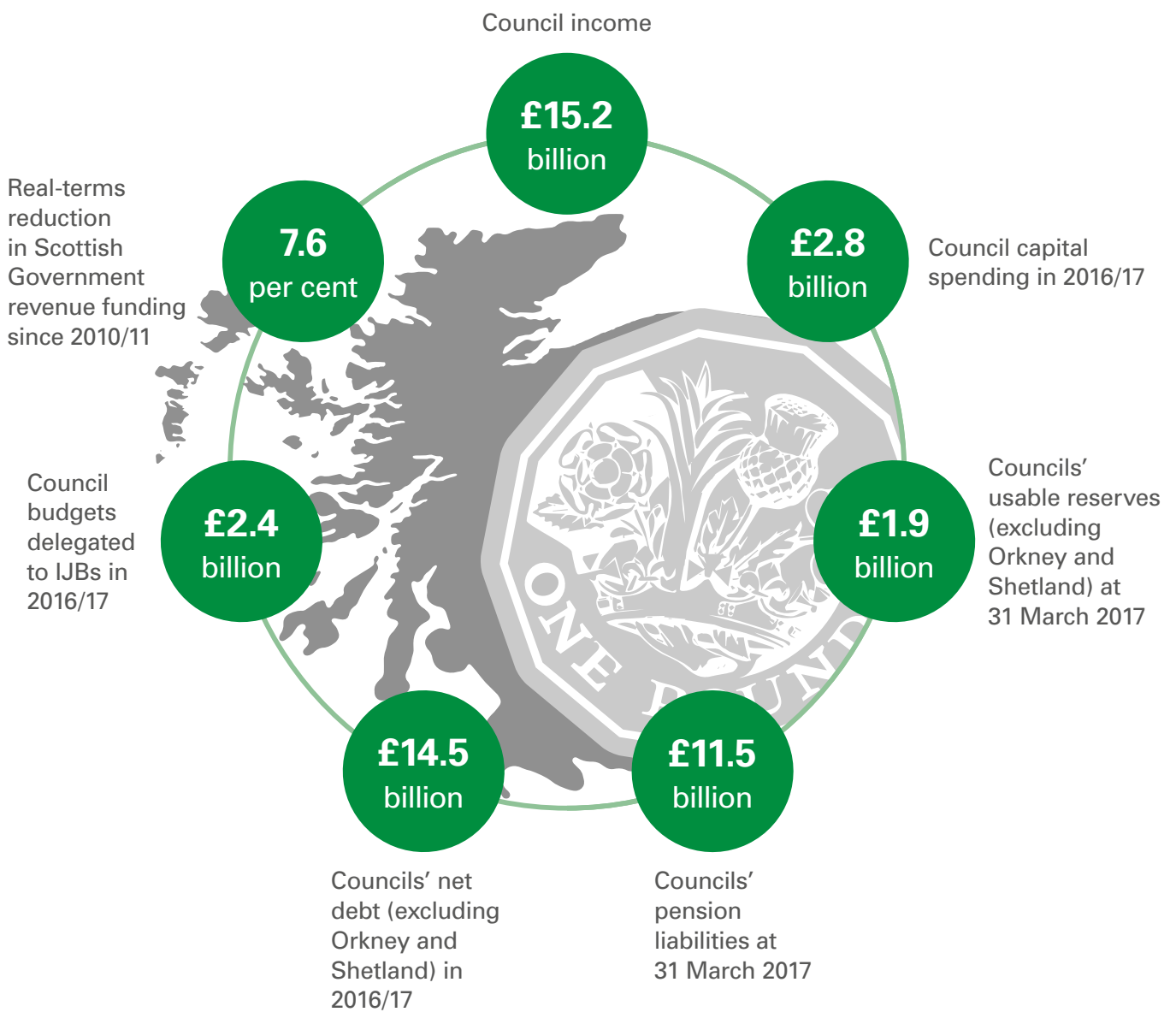
-  PDF download
-  Web link



These question mark icons appear throughout this report and represent sample questions for councillors ([paragraph 7](#)).

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# Key facts



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# Chair's introduction

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Welcome to the Accounts Commission's 2017 financial overview report for local government.

Last year was the first time that we published a separate financial overview report. In view of the very positive feedback we received from our stakeholders, we have decided to continue publishing two overview reports each year: this one focuses on financial matters, and the other on councils' performance and outcomes, which we plan to publish in April 2018.

Generally, councils face increasing challenges which require flexible responses that balance immediate needs, sound long term planning and limited financial resources. This task is a demanding one for elected members – not least for newly elected members – and I would hope that this overview report and its associated material, including the examples of questions we provide to support scrutiny by councillors, is a useful source of information and guidance.

We live in a rapidly changing public sector landscape, where external issues such as the transfer of further powers to Scotland and the decision to withdraw from the European Union add to an already complex domestic environment. Against this general backdrop the Commission is very aware of the importance of understanding the individual context faced by each council in terms of demand for services and resources available to sustain or develop them.

A major element of this operating environment for councils is the continuing pressure on finances. There was a real terms reduction in councils' main source of funding from the Scottish Government for 2016/17. This year has seen a further real terms funding reduction, with that trend forecast to continue into future years.

Councils tell us that they are finding the situation more serious than ever, with savings becoming increasingly difficult to identify and achieve. The Commission recognises this, but also recognises that some councils are in a better position to respond than others.

Effective leadership and financial management is becoming increasingly critical and medium-term financial strategies and well thought out savings plans are key to financial resilience and sustainability.

Elected members need to be clear about the potential impact of planned savings on achieving corporate objectives and the subsequent outcomes for citizens. The implications of community empowerment legislation heighten the importance of engaging effectively with communities around local priorities, and working together on options for the best future use of resources in service provision.

The Commission continues to emphasise the importance of Best Value as a comprehensive framework, based on the principle of continuous improvement that encompasses the key features of a high performing and effective council. It is especially relevant in times of tight finances, and we welcome the work being carried out by the Scottish Government, CoSLA, Solace and others, to refresh the Best Value statutory guidance so that it better reflects the current context for local government.

Finally, we welcome that once again the audits of annual accounts from all 32 councils were signed off with no qualifications. This is testament to the hard work amongst council staff, especially those within the finance function, and the good relationships developed by our auditors. There is of course, always room for improvement in financial management, such as in monitoring and reporting of financial matters to both councillors and the wider public. We will continue our interest in this.

**Graham Sharp**

Chair of Accounts Commission

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# Summary



## Key messages

- 1** Councils' financial challenges continue to grow. Funding reductions are compounded by increasing costs and demands on services. In response, councils have needed to achieve ambitious savings plans, including around £524 million of savings for 2016/17.
- 2** Councils are showing signs of increasing financial stress. They are finding it increasingly difficult to identify and deliver savings and more have drawn on reserves than in previous years to fund change programmes and routine service delivery. Some councils risk running out of General Fund reserves within two to three years if they continue to use them at levels planned for 2017/18.
- 3** Debt increased by £836 million in 2016/17 as councils took advantage of low interest rates to borrow more to invest in larger capital programmes. Councils' debt levels are not currently problematic, but some are becoming concerned about affordability of costs associated with debt within future budgets.
- 4** Councils' budget-setting processes for 2016/17 were complicated by late confirmation of funding from the Scottish Government and the funding arrangements for integrating health and social care. Councils' expenditure and use of reserves often differed noticeably from that originally planned, indicating the need for budget-setting to become more robust and reliable.
- 5** All councils received an unqualified audit opinion on their 2016/17 accounts but auditors found that in several councils financial management could be improved. Councils can use their accounts to more clearly explain their financial performance over the whole year to support better scrutiny.
- 6** The financial outlook for councils continues to be challenging, with the need to deliver savings being increasingly critical to their financial sustainability. As such, robust medium-term financial strategies and effective leadership to deliver them are of increasing importance.

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**councils are showing signs of increasing financial stress**

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## About this report

**1.** This report provides a high-level independent analysis of the financial performance of councils during, and their financial position at the end of, 2016/17. It also looks ahead and comments on the financial outlook for councils. It is one of two overview reports that the Accounts Commission publishes each year, complementing a report on councils' performance and outcomes that will be published at the start of the next financial year in April 2018.

**2.** The report is intended to inform the public and its representatives. It is particularly aimed at councillors and senior council officers, and will be of significant interest to elected members who joined councils for the first time following the May 2017 elections. While the focus of the report is on councils, we also provide some early information about Integration Joint Boards (IJBs), which are also local government bodies, following their first full year of operation in supporting health and social integration. A programme of audit work looking in more detail at health and social care integration and IJBs is under way.<sup>1</sup>


**3.** The report is in three parts:



- **Part 1 (page 10)** comments on councils' income and budgets for 2016/17.
- **Part 2 (page 20)** looks at councils' financial performance during, and position at the end of, 2016/17.
- **Part 3 (page 33)** looks at councils' 2017/18 finances and the challenges faced going forward.

**4.** Our primary sources of information are councils' 2016/17 audited accounts (including management commentaries) and their 2016/17 external annual audit reports. We have supplemented this with data submitted by councils to the Scottish Government through local finance returns (LFRs) and Provisional Outturn and Budget Estimates (POBE). LFRs present spending information for councils on a different basis from the spending information that councils record in their annual accounts. We do not audit data contained in LFRs.

**5.** UK-wide changes to the format of council financial statements in 2016/17 mean that we are no longer able to compare spending on services across councils using the annual accounts. This includes changes that make it difficult to establish the true service income and expenditure totals. We will include further analysis of these areas in our local government overview report in April 2018, using Scottish Government LFR data.

**6.** We refer to 'real-terms' changes in this report. This means we are showing financial information from past and future years at 2016/17 prices, adjusted for inflation, so that they are comparable to information from councils' 2016/17 accounts. We also refer to figures in 'cash terms'. This means we are showing the actual cash or money paid or received.

**7.** Throughout the report, we identify examples of questions that councillors may wish to consider to help them better understand their council's financial position and to scrutinise financial performance. The questions are also available on our website in [Supplement 1: Scrutiny tool for councillors](#) .

**8.** Accompanying this report, and to facilitate insight and comparisons across the sector, we have provided additional financial information on our website. The information is based on councils' audited accounts. We hope this will be useful for senior council finance officers, their staff and other interested stakeholders. We have also produced a separate supplement on councils' [Housing Revenue Account \(HRA\)](#)  and the [Local Government Pension Scheme \(LGPS\)](#) .

**9.** Throughout this report Orkney and Shetland have been excluded from exhibits that show usable reserves and debt. This is because the levels they hold mean inclusion would make it difficult to see relative positions of other councils. Most councils hold usable reserves of between five and 35 per cent of their annual income, whereas Shetland's reserves were 250 per cent of its annual income and Orkney's 300 per cent of its annual income. These large reserves relate to oil, gas and harbour related activities. As a result, both Orkney and Shetland also have more investments than borrowing unlike other councils.

# Part 1

## Councils' income and budgets for 2016/17



### Key messages

- 1** 2016/17 was a challenging year for councils with a real-terms reduction in revenue funding, a continuation of the council tax freeze, inflationary pressures and the cost of new UK and Scottish Government policy commitments.
- 2** Councils depend on Scottish Government funding for the majority of their income. The largest element of Scottish Government funding, relating to Grant Aided Expenditure, has remained largely unchanged since 2008/09, with additional funding linked to supporting national policies. The Scottish Government and COSLA should assure themselves that the funding formula remains fit for purpose in a changing landscape for local government. It is important that it is suited to improving outcomes for local communities and sensitive to priorities such as reducing inequality within and across council areas.
- 3** In response to funding reductions, councils approved about £524 million of savings and the use of £79 million of their reserves when setting budgets for 2016/17. Councils' savings plans have focused on reducing staff numbers, rationalising surplus property and improving procurement of goods and services. Councils were not always clear in their budget-setting reports about the risks associated with savings and their potential impact on levels of service.
- 4** Councils' budget-setting processes for 2016/17 were complicated by later confirmation of funding from the Scottish Government and the funding arrangements for integrating health and social care.
- 5** Councils set larger capital budgets in 2016/17 than in 2015/16. The Scottish Government capital grant fell and councils planned to fund expenditure through increased borrowing.

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**2016/17 was  
a challenging  
year for  
councils**

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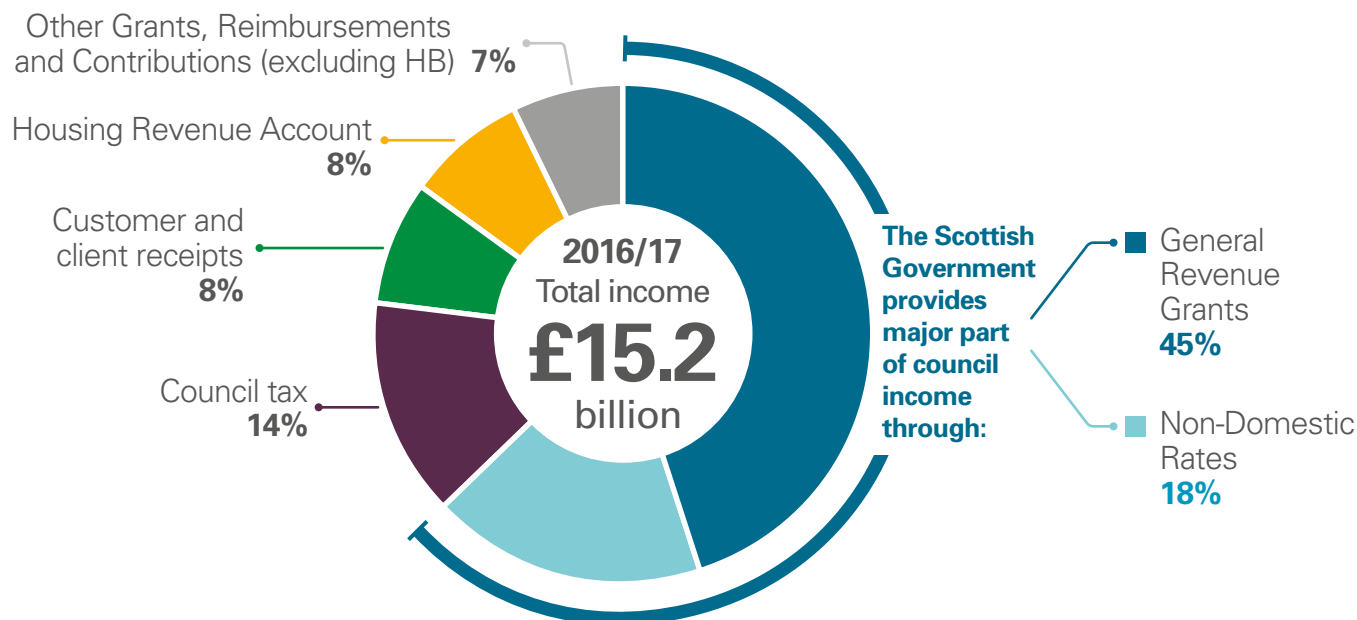
### Councils faced a major challenge from the significant fall in revenue funding for 2016/17

**10.** The Scottish Government provides almost two-thirds of councils' income through general revenue grant, non-domestic rates (NDR) and specific grants for things like community justice ([Exhibit 1, page 11](#)). In comparison, council tax accounts for 14 per cent of councils' income, and fees and charges about eight per cent of their income.<sup>2</sup>

## Exhibit 1

### Sources of council revenue income, 2016/17

Councils are dependent on the Scottish Government for the majority of their income.



#### Notes:

- Does not include all income collected for services delivered through council arm's-length external organisations (ALEOs) and Integration Joint Boards (IJBs).
- Income excludes housing benefit.
- Customer and client receipts are 2015/16 totals at 2016/17 prices.

Source: Annual accounts 2016/17 and Scottish Local Government Finance Statistics 2015-16

**11.** Scottish Government revenue funding for councils in 2016/17 fell by 5.2 per cent in real terms ([Exhibit 2](#)). Councils' revenue funding from the Scottish Government has fallen in real terms by 7.6 per cent since 2010/11. The size of the reduction in 2016/17 presented councils with a major challenge in delivering services and required most to identify significant savings.

## Exhibit 2

### Scottish Government revenue funding to councils

Revenue funding fell both in cash and real terms in 2016/17 compared to 2015/16.

	2016/17 £'000	Change on 2015/16	
		Cash %	Real %
NDR	2,769	-0.7 ▼	-2.7 ▼
Revenue Grant	6,939	-4.3 ▼	-6.2 ▼
<b>Total revenue funding</b>	<b>9,708</b>	<b>-3.3 ▼</b>	<b>-5.2 ▼</b>
Additional resource via IJBs	250		
	<b>9,958</b>	<b>-0.8 ▼</b>	<b>-2.8 ▼</b>

Source: Local Government Finance Circular 1/2017, Scottish Government

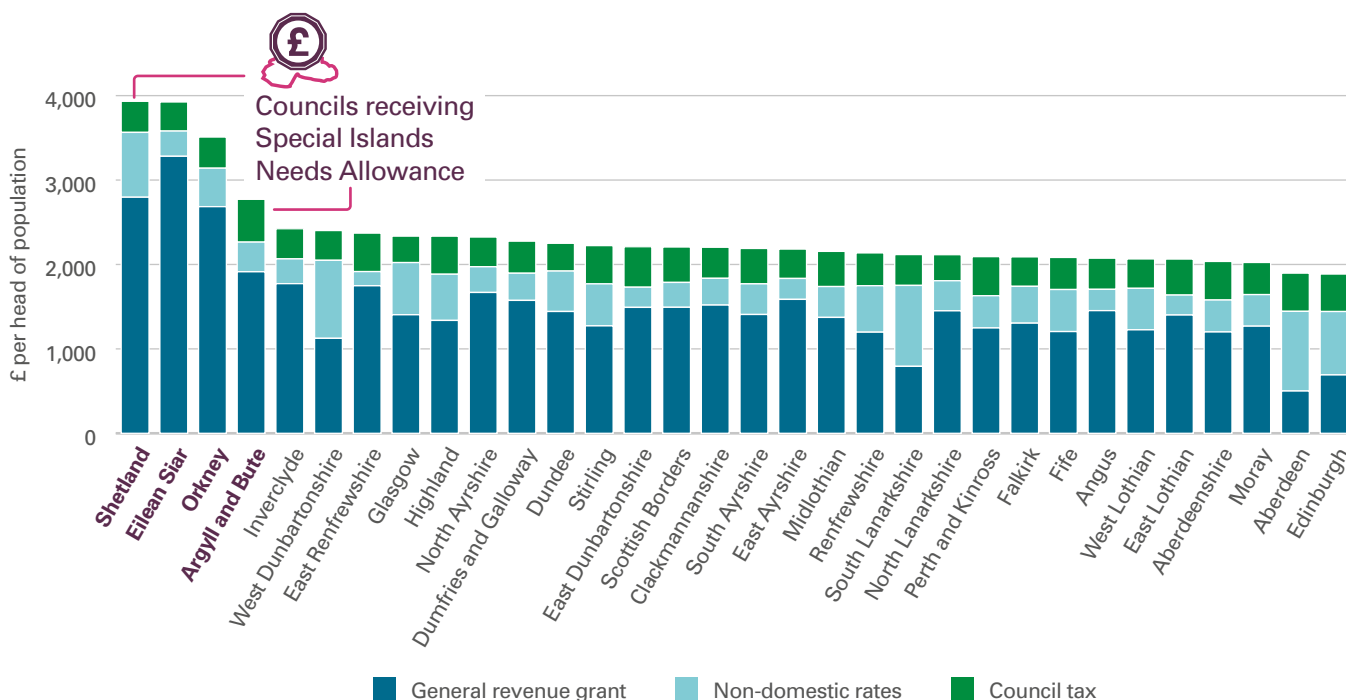
**12.** In 2016/17, the Scottish Government transferred an additional £250 million from the health budget to support health and social care integration. Even taking this into account, total revenue funding for councils fell in 2016/17.

**13.** Council tax is a key source of income for local government. Councils have typically set council tax rates to reflect local policy choices. Between 2008/09 and 2016/17, councils agreed with the Scottish Government to freeze council tax rates. To compensate them, the Scottish Government provided local government with an additional £70 million in each year of the freeze. In 2008/09, £70 million represented just over three per cent of council tax income and councils each received a share in line with their tax base. Councils that may not have increased their council tax by this amount each year will have benefited from additional funding as a result of the freeze. Councils did, however, lose the option of raising council tax to generate additional revenue. Although the council tax freeze was lifted in 2017/18, councils were constrained to increases of three per cent.

**14.** The revenue funding that councils received from the Scottish Government and council tax income varied between £2,000 and £2,400 per head of population for most councils in 2016/17 ([Exhibit 3](#)). This impacts on the income they have available and on the decisions they need to make about delivering services. The income per head of population in Argyll and Bute, Eilean Siar, Orkney and Shetland is higher than in other councils because they receive extra funding for their island populations, in recognition of the additional costs they face when providing services.

### Exhibit 3

**Income from General Revenue Grant, Non-Domestic Rates and council tax per head of population, 2016/17**  
 Most councils received between £2,000 and £2,400 per head of population.



Source: Annual accounts 2016/17; and National Records of Scotland mid-year population estimate for 2015

### Additional Scottish Government funding has been linked to supporting national policies

**15.** The Scottish Government funding mechanism is the main determinant of a council's overall funding. It is designed to reflect differences between councils in terms of population and other factors, such as geography and deprivation. The funding mechanism is based on a large number of elements as illustrated in [Exhibit 4 \(page 14\)](#). The Fraser of Allander Institute has provided a useful outline summary of how funds are allocated:

'The Scottish Government allocates grants to local authorities taking into account both the relative spending need of each authority, and the revenues raised from council tax and non-domestic rates income.

The grant allocation system first calculates the 'total estimated expenditure' (TEE) that each local authority is likely to need to meet its various commitments. The elements of TEE are:

- an assessment of spending needs, based on the Grant Aided Expenditure (GAE) assessments combined with a Special Islands Needs Allowance (SINA)
- a series of additional revenue grants – such as the funding used in the past to support the council tax freeze – the allocation of which is determined on a case-by-case basis
- a series of further non-specific changes to grant allocations, the allocation of which is based on local authorities' shares of GAE + SINA
- local authorities' commitments in respect of certain historic loan charges
- the sum of these elements is then adjusted by a 'floor' to ensure that no local authority experiences particularly large swings in support from one year to the next.

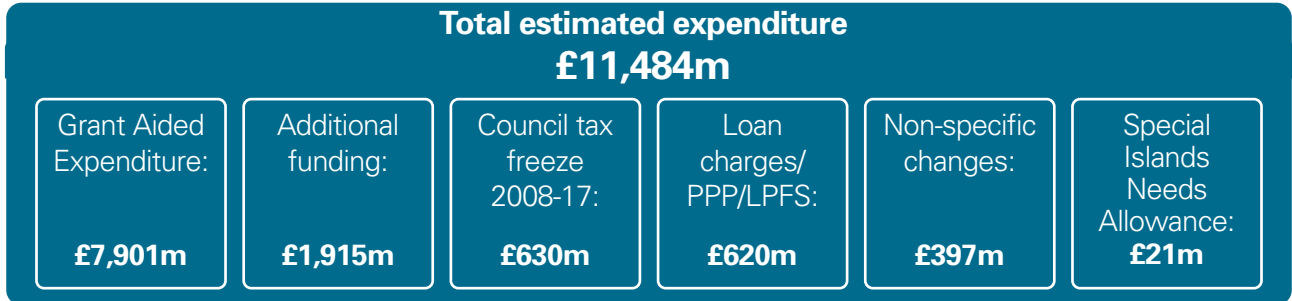
Having calculated TEE, an adjustment is then made based upon an estimate of what each local authority is expected to raise from council tax, the revenues that each local authority is forecast to raise from non-domestic rates, and their allocation of ring-fenced Gaelic funding. A further 'floor' calculation is applied to ensure that no local authority receives less than 85 per cent of the Scottish average on a per capita basis.<sup>13</sup>

**16.** Within the Scottish Government's estimate of councils' TEE in any year, the largest element is Grant Aided Expenditure (GAE). GAE totals have remained broadly the same since 2008/09, with the exception of funding for police, fire and district courts having been removed. In 2016/17, GAE was £7.9 billion of a total estimated expenditure of £11.5 billion. GAE is distributed between councils based on an estimate of their relative spending needs across 89 elements, with reference to one or more indicators. For example, the GAE for primary education is allocated with reference to its share of primary school aged pupils. A small adjustment is made based on a secondary indicator of the percentage of pupils in small schools. The variations between councils in each of the elements are mostly determined by population profiles, although other factors to reflect rurality and deprivation are also used when appropriate.

### Exhibit 4

#### Local Government funding mechanism, 2016/17

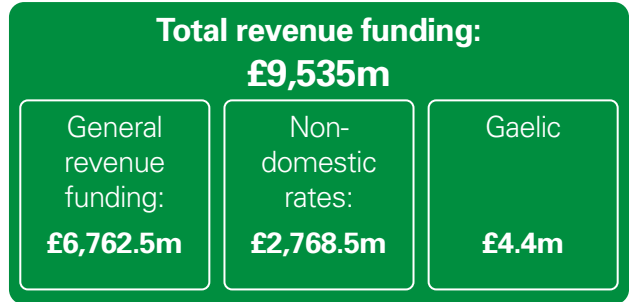
The formula contains many elements.



**Main Floor:** Redistributes so **no council loses more than 4.5%** a year



Assumed council tax contribution:  
**£1,949m**



**85% Floor:** Ensures Scottish Government funding 85% to all councils: **£25m**



**Distributable revenue funding:  
£9,560.4m**

Notes: On top of distributable revenue funding, councils also received £133 million from other grants and payments such as the Teacher Induction Scheme and Discretionary Housing Payments.

In 2016/17, the 85 per cent floor was applied to funding for Aberdeen City and City of Edinburgh Councils.

Source: Audit Scotland and Fraser of Allander Institute

**17.** New funding for councils since 2008/09, for example funding to expand early years' childcare, has come as 'additional funding' and 'non-specific changes' and is funding specifically directed at delivering particular national policies. The proportion of council funding directed towards national policies is increasing, a trend that will continue with Scottish Government proposals for fairer funding for equity and excellence in education. This shift increasingly restricts the flexibility councils have in managing their budgets across their full range of services. The Scottish Government and COSLA should assure themselves that the funding

formula remains fit for purpose in a changing landscape for local government. It is important that it is suited to improving outcomes for local communities and sensitive to priorities such as reducing inequality within and across council areas.

## Councils faced increased budgetary pressures in 2016/17

**18.** Councils faced a growing range of budgetary pressures in 2016/17 from the real-terms reduction in Scottish Government funding, the continuation of the council tax freeze and cost inflation. They also faced additional pressures in meeting new UK and Scottish Government policy commitments. Many of the budgetary pressures that councils faced were associated with staff. As councils' largest area of expenditure, additional staff-related costs have a very significant impact on their budgets ([Exhibit 5](#)).

### Exhibit 5

#### Significant budgetary pressures on councils in 2016/17

UK and Scottish Government policy commitments had sizeable cost implications for councils.



The **move to the single state pension at UK level**. This ended the employer NI rebate in relation to staff in contracted-out pension schemes (such as the LGPS and Teachers schemes).

**3.4 per cent increase in NI costs affected employees from 1 April 2016.**



The cost of introducing the **living wage for social care workers** from 1 October 2016.

**Estimated cost of £100 million.**



The undertaking to **maintain teacher numbers in Scotland** and the **Teacher Induction Scheme**.

**Councils spend around £2.4 billion on teachers. By not cutting teacher numbers they receive a share of £88 million extra funding.**



**Annual increases in staff costs.**

**Estimated cost of one per cent pay rise about £70 million. Costs also increase as staff move up pay scales.**




The **full year effect of increased pension contributions for teachers** (increased from 14.9 per cent to 17.2 per cent from September 2015).

**The estimated impact was around £20 million in 2016/17.**



**19.** In addition to the costs of meeting government policies and inflationary pressures, councils also had to deal with ongoing demand pressures. Some demand pressures such as those associated with an ageing population and placements for looked-after children, are often not easy to forecast and budget for. This highlights the need for adequate budget contingency and robust arrangements for identifying and responding to changes in demand for services.

**20.** Rent arrears can also create budgetary pressures for councils' Housing Revenue Accounts. The Department for Work and Pensions (DWP) began a roll-out of Universal Credit (UC) in Scotland in March 2016. By March 2017, UC had rolled out across five councils.<sup>4</sup> Rent arrears across these councils increased in 2016/17 by an average of 14 per cent, compared with an average of 4 per cent across the remaining councils. Our [Housing Benefit Performance Audit: Annual update 2016/17](#)  highlighted that councils are finding that the roll-out of UC is having a detrimental effect on their collection of housing rental income.

### Some service areas saw larger reductions to budgets in 2016/17

**21.** In responding to the range of pressures they face, councils approved about £524 million of savings and budgeted to use about £79 million of reserves in their budgets for 2016/17. Savings plans continued to focus on their main areas of spend, reducing staff numbers, rationalising surplus property and improving procurement of goods and services. It was not always clear from budget-setting reports how savings aligned with the council's corporate and financial plans or how they would impact on service delivery.

**22.** In 2016/17, budgets for education increased, mainly as a result of the policy commitment to maintain teacher numbers and the inflationary pressures around pay and pension costs. Despite demand pressures in social work, overall budgets reduced – but not by as much in percentage terms as in other areas of service. Remaining service areas have seen larger reductions to their budgets. In some cases, increases in fees and charges may have reduced the amount of budgeted expenditure. This pattern of larger reductions to relatively smaller service areas has been recurrent in recent years and is something that has continued into 2017/18. While it is right that resources should be aligned with policy priorities, the impact on other services and their outcomes should be carefully assessed ([Exhibit 6, page 17](#)).

### Councils have been seeking to maximise the income available to them from charging for services

**23.** Councils generate about eight per cent of their total income from charging for services (excluding housing rents). This includes income from charges to service users, rental income (excluding council houses) as well as 'other' charges. It is difficult to establish from the data available the full extent of income councils receive. Some income from services provided via arm's-length external organisations (ALEOs) and IJBs is not shown in council totals.<sup>5</sup>

**24.** Councils have been seeking to maximise their income through increasing charges and by introducing new charges for services, for example introducing charges for garden waste. Councils have also sought to collect more of the income that is due to them. Charges for social care which are subject to regulation, represented the largest area of income from charging services in 2015/16 ([Exhibit 7, page 18](#)).






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Does your council have a charging policy? Is this in line with corporate plans and objectives? When was this last reviewed?

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What information do you need to be able to explain increases in fees and charges to your constituents?

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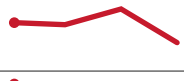






25. The Scottish Parliament's Information Centre (SPICe) has published a [detailed briefing on some fees and charges](#) . The Accounts Commission also considered fees and charges for services in its 2013 report, [Charging for services: are you getting it right?](#) 

26. Although councils generate a relatively small proportion of their overall income from fees and charges, increases can make a difference to council finances over time. However, councils face difficult decisions in balancing their need to maximise income while also ensuring their charging policy is consistent with corporate objectives, such as providing access to services and addressing inequality. Increasing prices can be unpopular with the public, but effective leadership, sensitive management, good communications and community engagement can assist with this.

## Exhibit 6

### Trend in council expenditure on main services, in real terms

There was significant variation in budget changes across council services.

	2013/14 £million	2014/15 £million	2015/16 £million	16/17 Budget £million	Change over period
 Education	4,771	4,736	4,830	4,826	1% 
 Cultural and related services	639	661	610	560	-12% 
 Social work	3,158	3,194	3,233	3,086	-2% 
 Roads and transport	454	431	427	419	-8% 
 Environmental services	686	684	698	668	-3% 
 Planning and development services	291	286	248	251	-14% 
 Other services	839	802	778	687	-18% 
 <b>Total</b> (excludes trading services and interest payments)	<b>10,840</b>	<b>10,793</b>	<b>10,823</b>	<b>10,496</b>	<b>-3%</b> 

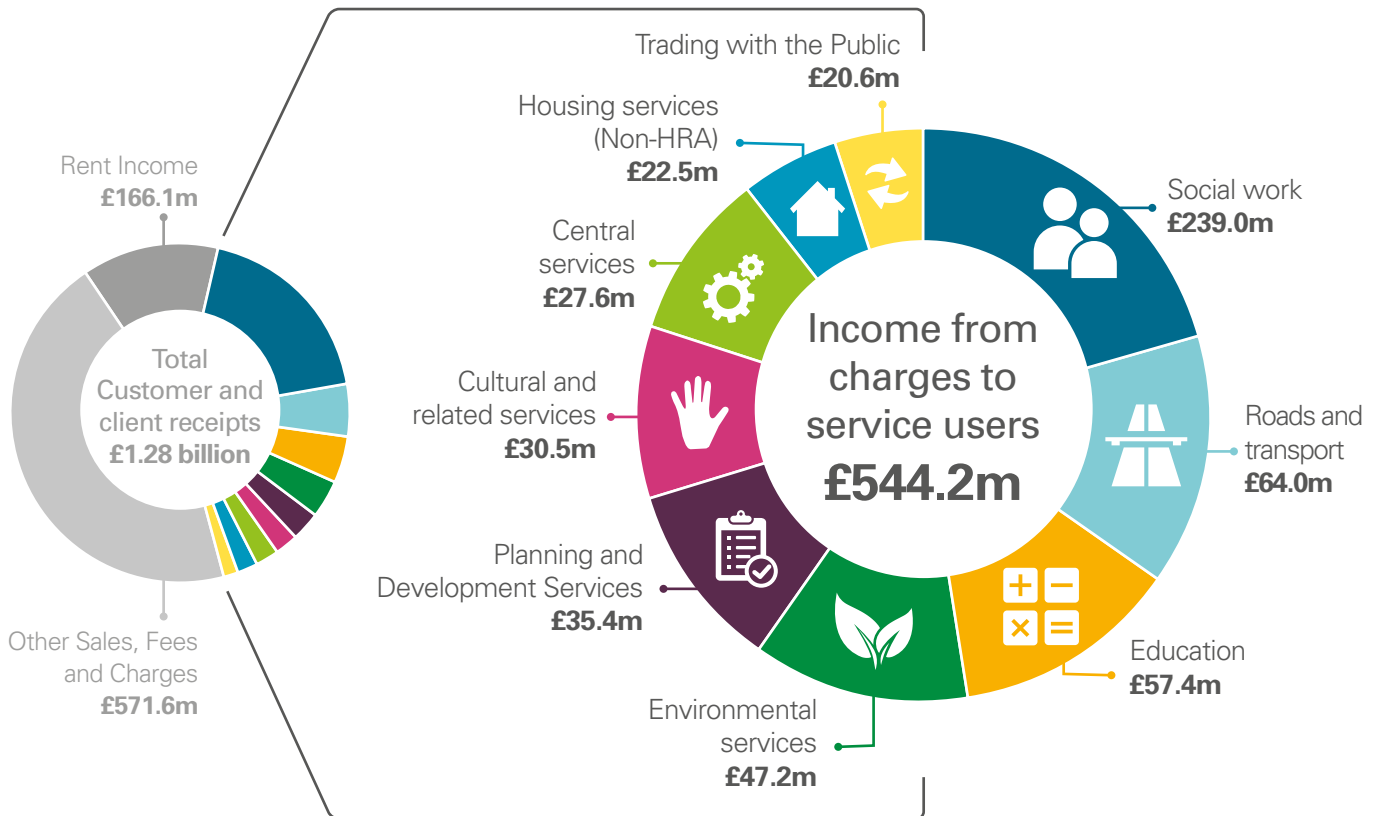
Note: 'Other services' combines Central Services and non-HRA housing.

Source: Scottish Local Government Finance Statistics 2015-16; and Scottish Government Provisional Outturn Budget Estimate returns 2016

## Exhibit 7

### Charges to service users

Charges to service users account for over £500 million of councils income.



Note: Does not include all income collected for services delivered through council ALEOs and IJBs.

Source: Scottish Local Government Finance Statistics 2015-16

## Integration Joint Boards added further complexity to budget setting

**27.** For the majority of councils, 2016/17 was the first operational year for Integration Joint Boards (IJBs). IJBs were established as a result of the Public Bodies (Joint Working) (Scotland) Act 2014. They are partnerships between NHS boards and councils and are responsible for the delivery of adult health and social care, and in some council areas, for other services, such as children's services. The partnerships are the subject of 'integration schemes' which are written agreements about how they will operate, including responsibilities for any budget underspends and overspends.

**28.** Councils delegated £2.4 billion of social care expenditure to IJB budgets for 2016/17 and NHS boards contributed £5.6 billion. The introduction of IJBs has complicated budget-setting, due to differences in both the approach and timing of budget-setting between councils and NHS boards. The establishment and development of IJBs has been a complex exercise and will take time to mature. Their operation will be the focus of further performance audit work we have planned in 2018.

## Councils set larger capital programmes for 2016/17, with plans to increase borrowing

**29.** In addition to their day-to-day revenue spending on goods and services, councils also incur capital expenditure on the assets that support those services, including schools, houses and equipment such as vehicles. In 2015/16, councils spent about £2.4 billion on capital projects. Budgets for 2016/17 were much higher at over £3.3 billion.

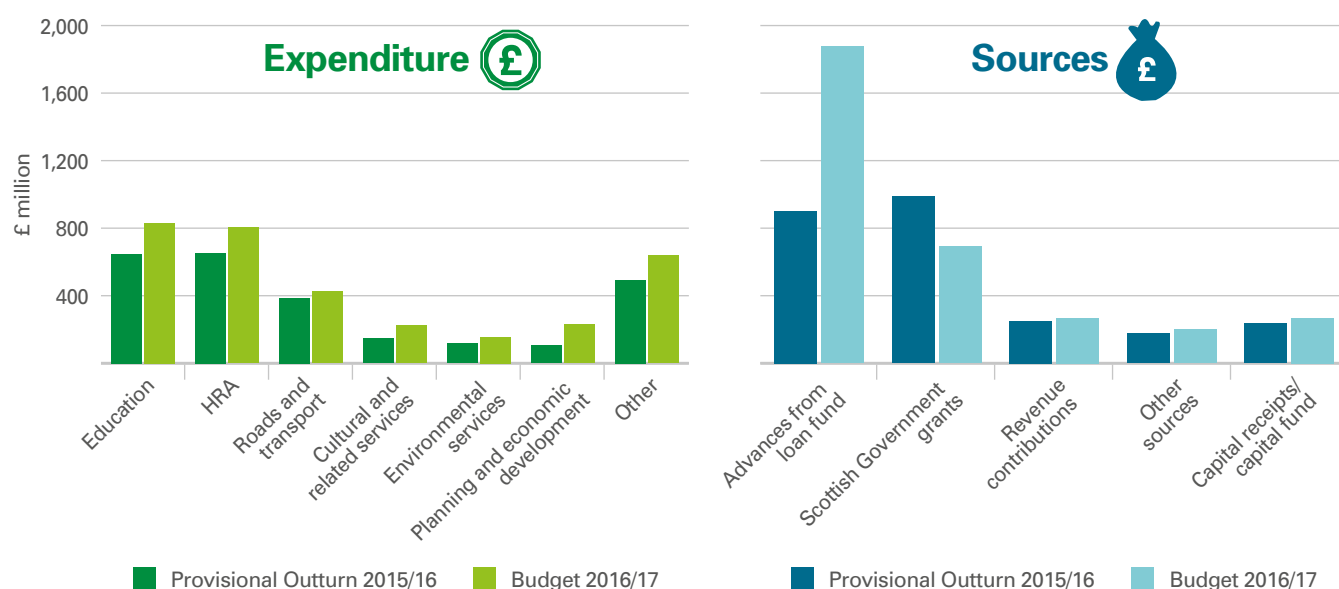
**30.** Councils finance their capital expenditure from a number of sources, including Scottish Government capital grants and borrowing. Scottish Government grants fell from £834 million in 2015/16 to £591 million in 2016/17, returning to a more usual level following re-profiling in earlier years. [Exhibit 8](#) shows where councils were planning to spend their capital and how they planned to finance it.

**31.** Councils are required to consider the affordability of their capital programmes. This includes the cost of any borrowing along with the impact on day-to-day running costs. However, they are free to determine what they consider prudent and with interest rates remaining low in 2016/17, councils assessed increased borrowing to be affordable. The delivery of capital programmes and the affordability of debt are considered further in [Part 2](#) and [Part 3](#).

### Exhibit 8

#### Capital programmes and sources of finance, 2015/16 and 2016/17

Councils planned to borrow more in 2016/17 to meet the cost of larger capital programmes.



#### Notes:

1. Excludes regional transport partnerships and Joint Valuation Boards.
2. Other budgeted use of capital includes Social Work, Central Services, Trading Services, etc.
3. Other sources of capital finance for the General Fund are grants (excluding those received from the Scottish Government).
4. For HRA this includes capital from other sources, such as developer contributions.

Source: Scottish Government Capital Provisional Outturn Budget Estimate 2015-16

# Part 2

## 2016/17 financial performance



### Key messages

- 1** All councils received an unqualified audit opinion on their 2016/17 accounts but the accounts could more clearly explain their financial performance.
- 2** Councils are showing signs of increasing financial stress with 20 councils drawing on their usable reserves in 2016/17.
- 3** Councils' actual use of reserves was often quite different from that originally planned. The reasons why are not always clear.
- 4** Auditors found that budget-setting needed to be more robust and that financial management could be improved in several councils.
- 5** Levels of net debt increased by £836 million in 2016/17. On average councils spent almost ten per cent of their revenue budgets servicing this debt. Some councils are concerned about the ongoing affordability of servicing their debt as resources decrease.
- 6** Councils that have been proactive in making difficult decisions will be better placed to deal with future financial pressures.

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**Twenty councils drew on reserves in 2016/17 – actual use of reserves was often quite different from original plans**

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### **All councils received an unqualified audit opinion on their 2016/17 accounts but the accounts could more clearly explain their financial performance to readers**

**32.** In 2016/17, for the sixth consecutive year, auditors issued a 'true and fair' unqualified audit opinion on the accounts of all 32 councils. An unqualified opinion means auditors have judged that all council's financial records and statements are fairly and appropriately presented, that the council's financial statements are sound and free from material misstatements or errors.

**33.** For the last three years, councils have had to produce a management commentary to accompany their annual accounts. These commentaries play an important role in public accountability and helping interested parties to better understand the accounts of each council and its financial performance and position. As such, they should include explanations of amounts included in the accounts as well as:

- a description of the council's strategy and business model
- a review of the council's business
- a review of principal risks and uncertainties facing the council
- an outline of the main trends and factors likely to affect the future development, financial performance and financial position of the council.

**34.** Each management commentary should concisely present the financial 'story' of a council in an understandable format for a wide audience. Auditors express an opinion on whether the management commentary is consistent with the audited financial statements and is in line with Scottish Government guidance.

**35.** Management commentaries for 2016/17 vary in how clearly councils and IJBs explain their financial and general performance. Overall there remains scope for improvement. It is the Accounts Commission's view that councillors have an important role in ensuring that the management commentary effectively tells a clear story of financial performance and can be understood and scrutinised by a wide audience. The story at the end of the year should be produced from regular reports provided to councillors throughout the year.

## Councils are showing increasing signs of financial stress

### Twenty councils drew on their usable reserves in 2016/17

**36.** In 2016/17, 20 councils drew on their usable revenue and capital reserves. Nineteen councils drew on their revenue reserves in 2016/17, an increase from the eight councils that did so in 2015/16. Council revenue reserves fell by £32 million in 2016/17. ([Exhibit 9, page 22](#)). Overall council usable reserves (capital and revenue) fell by about £33 million.

**37.** The Chartered Institute of Public Finance and Accountancy (CIPFA) has identified the rapid decline of usable reserves as one of the symptoms exhibited by councils under financial stress.<sup>6</sup> Councils with good financial management demonstrate well-planned and managed use of reserves, in accordance with carefully thought out council policies.

**38.** In some cases, councils have used reserves to support service delivery. Councils have used reserves to invest in their change programmes, such as meeting the additional costs of staff severance. In 2016/17, councils continued to focus on reducing staffing levels. They reduced their workforces by almost 2,200 staff (almost one per cent of the total workforce), at a cost of £78 million ([Exhibit 10, page 23](#)). Councils' policies around voluntary severance and redundancy typically require payback of the costs over two to three years.

**39.** In future, severance schemes could become less attractive for staff under Scottish Government proposals to limit payments. Conversely, severance packages for staff with retirement dates after April 2020 will become more expensive for councils following changes to pension protection.




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**Do management commentaries clearly explain council performance and any changes to plans?**

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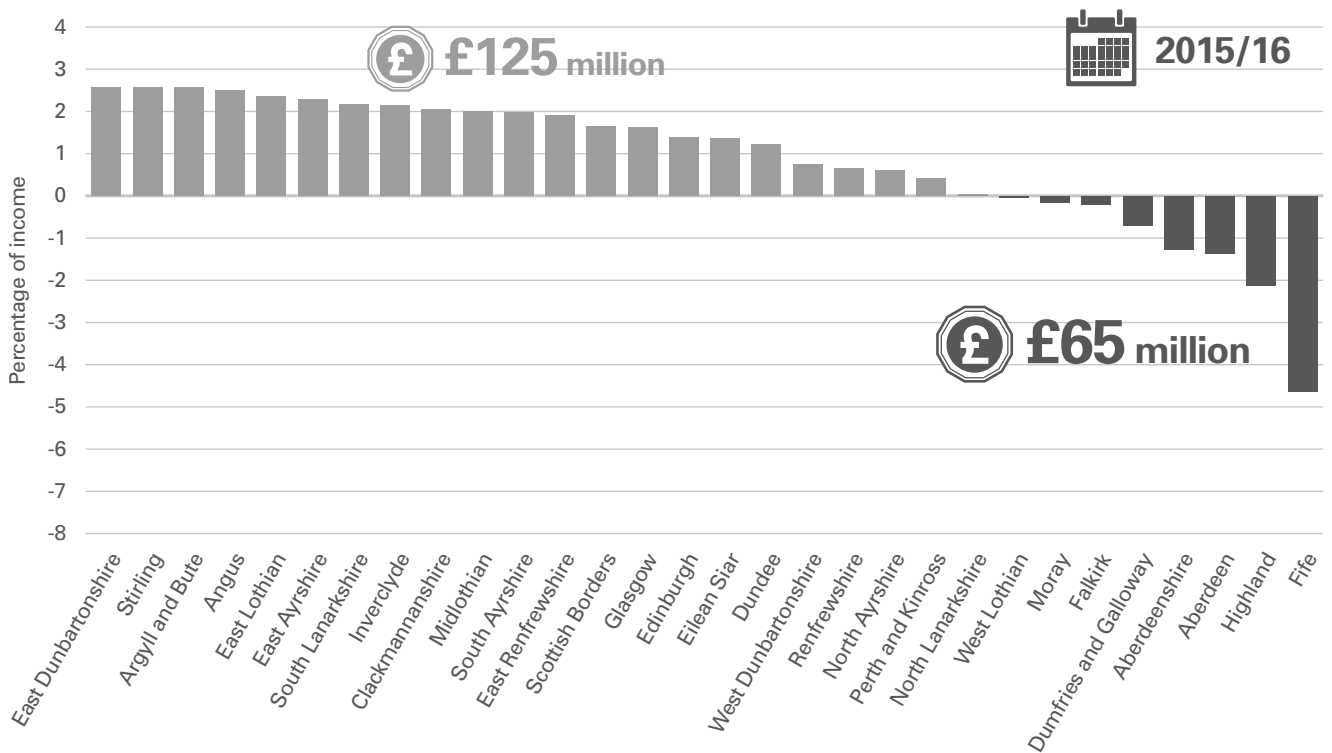
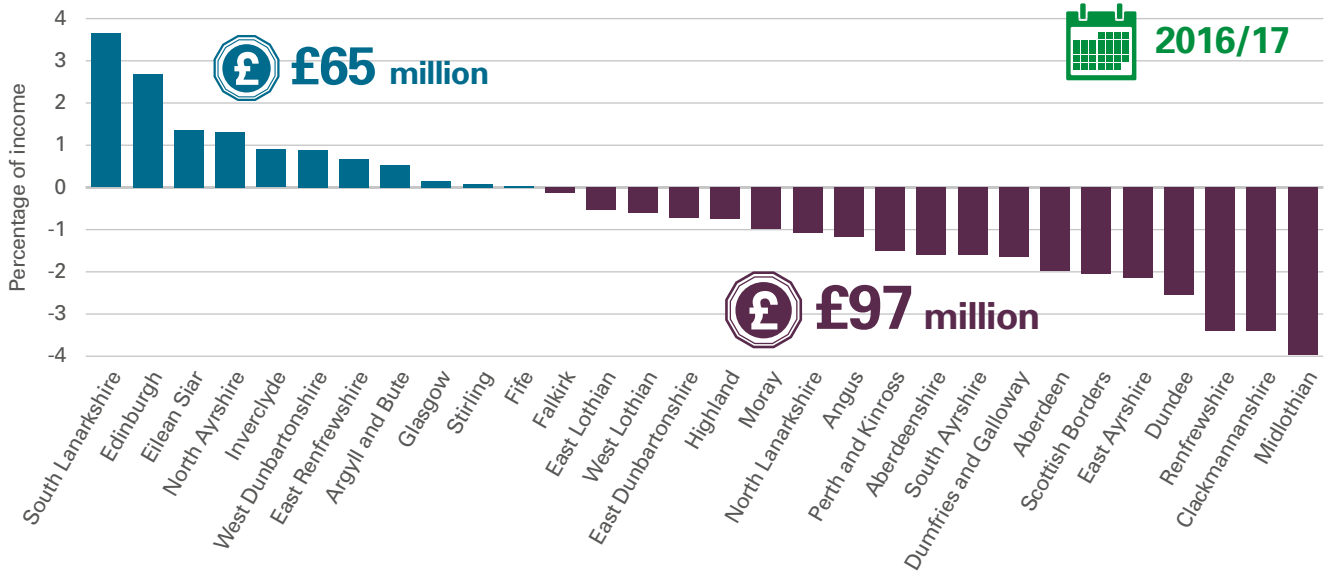
**Are staff severances in line with the council's workforce plan?**

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### Exhibit 9

#### Changes in revenue reserves (excluding HRA), 2015/16 and 2016/17

Many more councils drew on revenue reserves in 2016/17 compared with 2015/16.



Notes:

- 1. Due to issues with the scale on this exhibit Orkney and Shetland are excluded (paragraph 9).
- 2. In 2016/17, Renfrewshire moved money from revenue to capital reserves.

Source: Audited accounts 2015/16 and 2016/17

## Exhibit 10

### Exit packages, 2011/12 to 2016/17

The number and average cost of exit packages both fell in 2016/17.

	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	Total
Total number of packages	4,070	2,407	2,373	1,933	2,660	2,195	<b>15,642</b>
Total cost of packages Cash terms £000	148,750	109,068	92,640	74,935	97,231	78,125	<b>600,750</b>
Total cost of packages Real terms £000	160,868	115,528	96,535	76,955	99,172	78,125	<b>627,184</b>
Average cost per package Real terms £	39,525	47,997	40,681	39,811	37,227	35,592	<b>40,096</b>

Note: Real terms comparisons are based on 2016/17 prices.

Source: Annual accounts 2016/17

### Councils use of reserves and service expenditure was often quite different from that originally planned

**40.** In 2016/17, as many councils used more reserves than they had originally planned as used less ([Exhibit 11, page 24](#)). It is not always clear from management commentaries why the actual use of reserves differed from that planned.

**41.** There can be a range of reasons why councils need to draw more heavily on their reserves than planned. It can be the result of poor budget-setting and/or budgetary control. For example, councils may need to use reserves to balance budgets where savings have not been achieved. The failure to deliver savings might be due to councils underestimating the time required for change programmes to deliver benefits. As budgets come under greater pressure from funding reductions, cost pressures and increasing demand, it is critical that councils understand the risks of using reserves in an unplanned way in relation to future savings and long-term financial sustainability.

**42.** Auditors identified that some councils failed to deliver their savings plans in 2016/17. Auditors also highlighted that some budgets did not properly reflect patterns of previous actual expenditure and that councils should consider rebasing their budgets where they consistently underspend. One such area is underspending on financing costs, where slippage on capital programmes leads to less borrowing and lower interest payments. Built-in budget contingencies partly explain budget underspends but councils need to explain this more clearly.



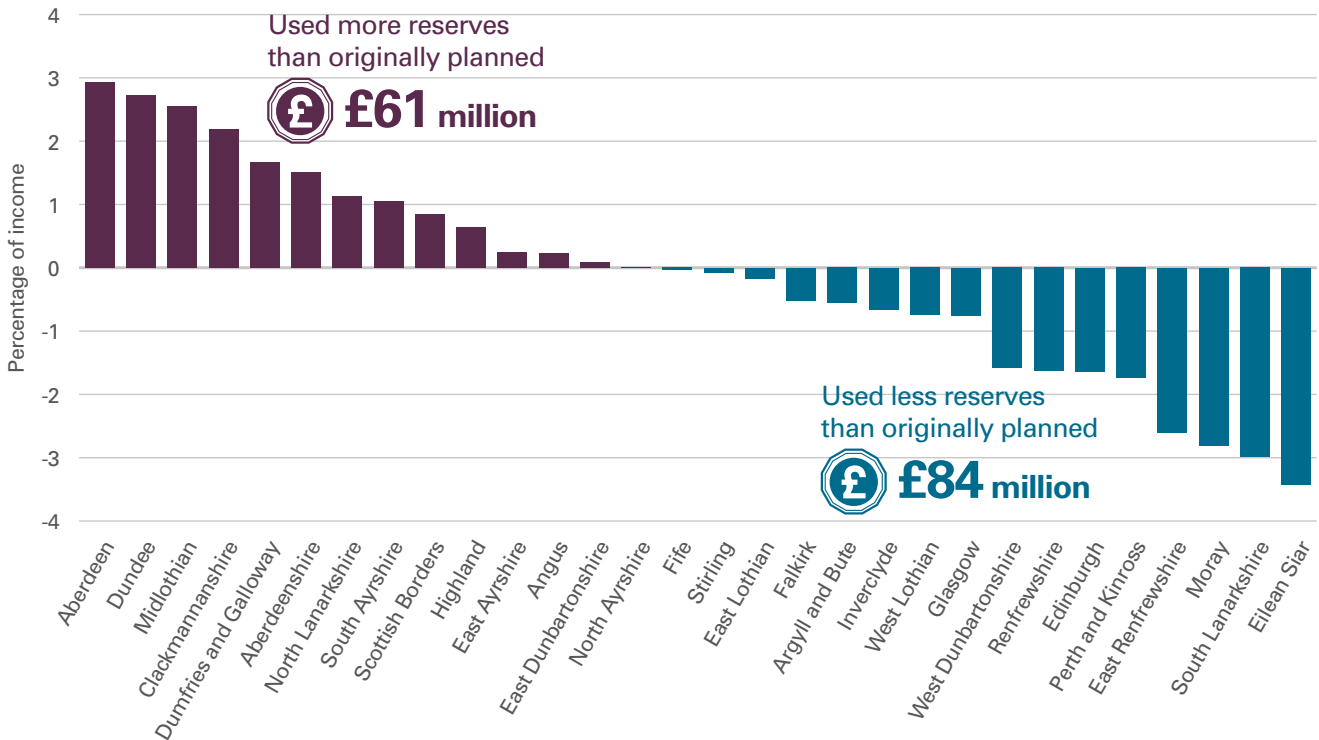
**How does the council ensure that council staff have the capacity to delivery transformational change?**

**What have reserves been used for in recent years? Supporting services and bridging the funding gap or transforming services?**



### Exhibit 11

Difference between planned and actual use of General Fund reserves as a proportion of income, 2016/17  
 The difference between planned and actual use of reserves for some councils was more than two per cent of their total income from general revenue grants and taxation.



Note: Due to issues with the scale on this exhibit Orkney and Shetland are excluded (paragraph 9).  
 Source: Audited accounts 2016/17 and auditor returns

43. Reasons often cited by councils for under and overspends against final budgets are included in [Exhibit 12 \(page 25\)](#).

44. Management commentaries in councils’ accounts tend to only identify the main reasons for over or underspends against final budgets and not why plans or budgets changed during the year. This represents an area of weakness in financial reporting that councils need to address to support more effective financial scrutiny. If significant changes are made to original budgets the reasons should be clearly reported to councillors throughout the year, as well as featuring in the management commentary accompanying the accounts at the end of the year.

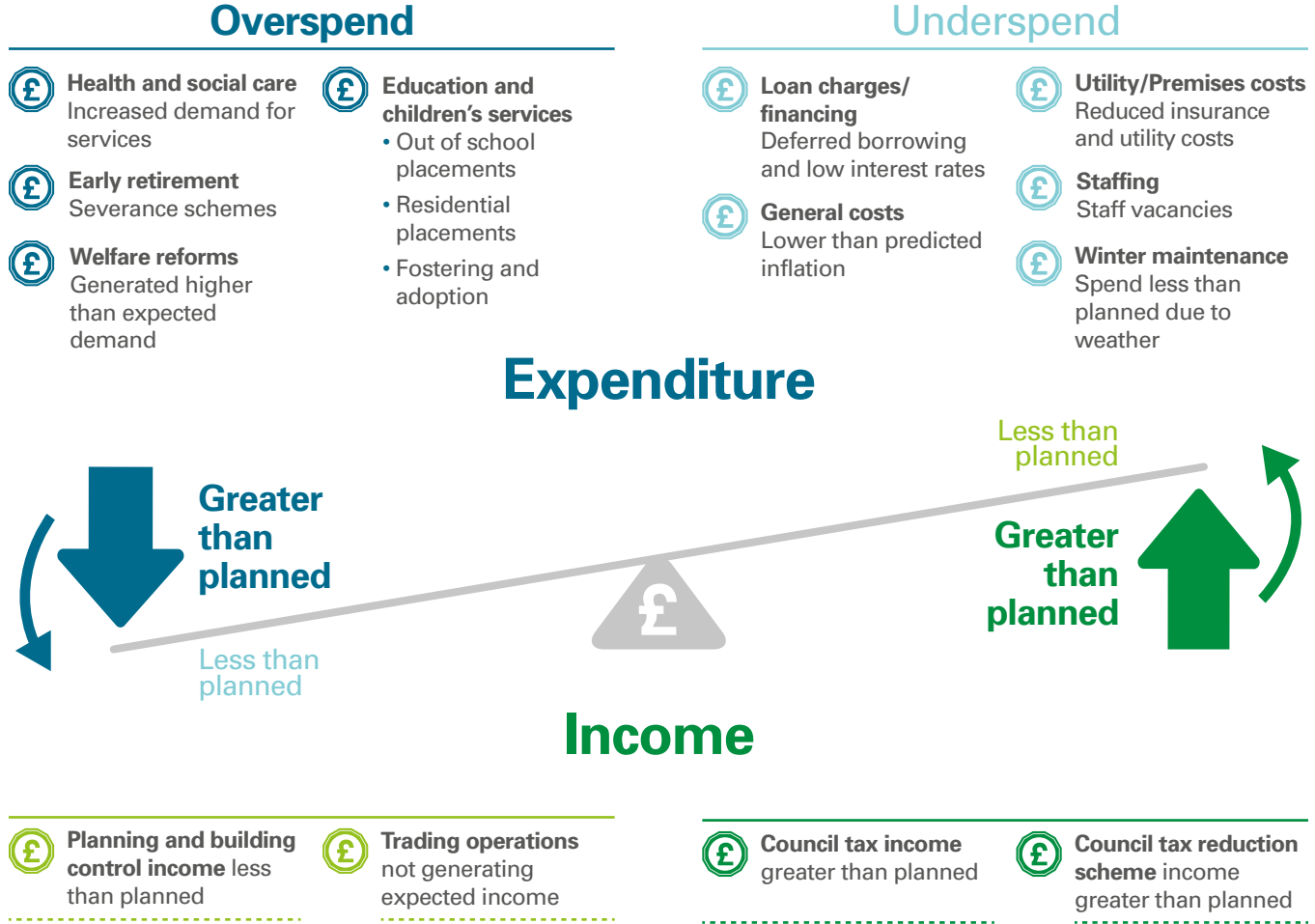


**Do budget monitoring reports clearly explain performance against plans and any changes to plans?**

**Exhibit 12**

**Commonly reported reasons for budget variances, 2016/17**

Demand pressures primarily drove overspends – with financing costs a key driver of underspends.



Source: Audit Scotland review of management commentaries

**Levels of usable reserves vary widely and it is important that councils have clear reserves policies**

**45.** The levels of usable reserves held by councils vary widely, as do policies on the minimum level of reserves they should hold. The General Fund reserve is the main revenue reserve available to support general council services. By the end of 2016/17, General Fund reserves, excluding Orkney and Shetland, totaled £1.1 billion. However, councils hold a number of other reserves and total usable reserves held amounted to £1.9 billion (excluding Orkney and Shetland, [paragraph 9](#)), ([Exhibit 13, page 26](#)).



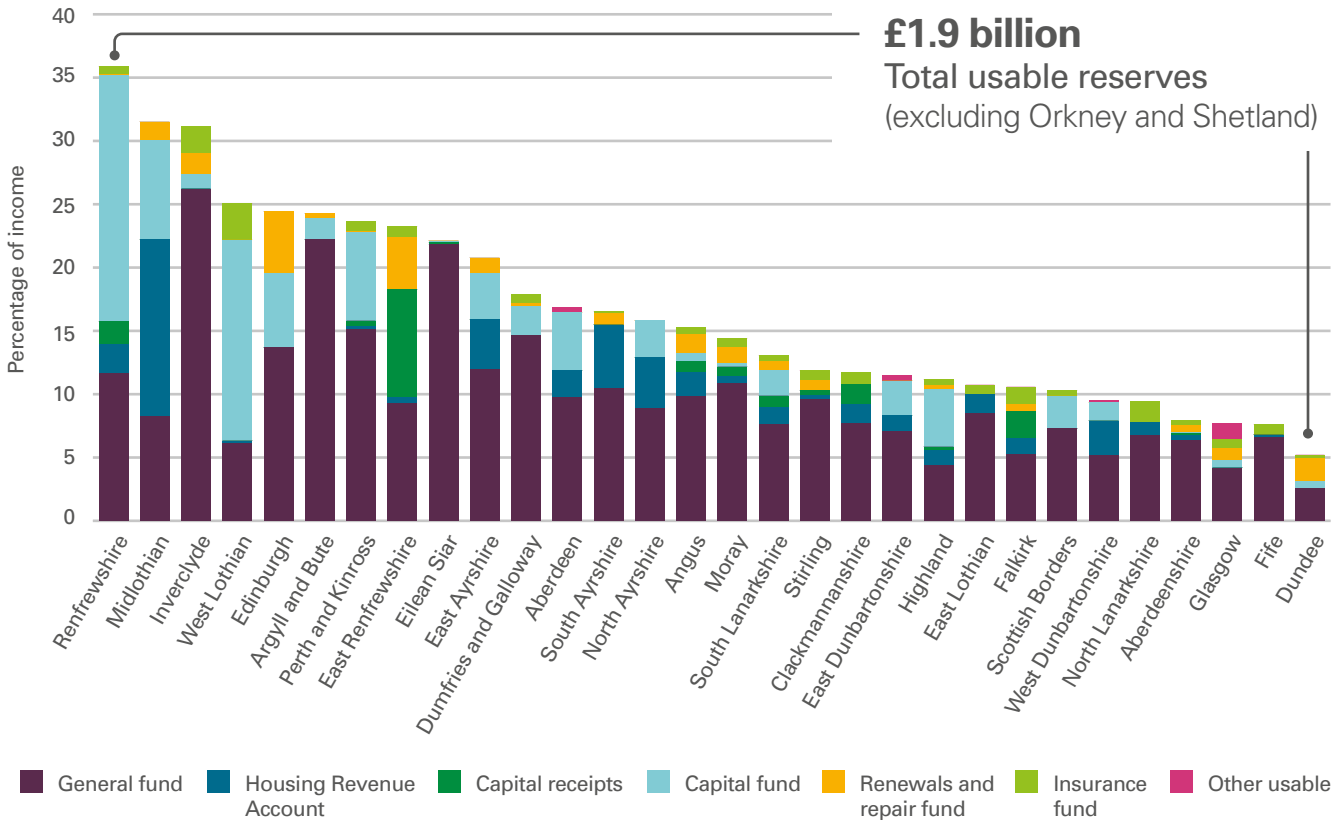
**What is your councils reserves policy?**

**46.** There is no prescribed minimal level of usable reserves. Typically councils' policies are to have a minimum uncommitted General Fund balance of between two and four per cent. Councils need to be clear about the reasons for the levels of reserves they hold to mitigate risks and support medium-term financial plans.

### Exhibit 13

#### Council usable reserves at 31 March 2017

There are wide variations in the level of reserves as a proportion of income from general revenue grant, taxation and housing rents.



Note: Orkney and Shetland councils have reserves far in excess of those held by other councils and are excluded. We explain why this is the case in [paragraph 9](#).

Source: Annual accounts 2016/17

**47.** At the end of their first full operational year, IJBs held usable reserves of £96 million, representing about 1.2 per cent of their total income of £8 billion in 2016/17. Reserves vary across IJBs. Not all integration schemes permit IJBs to hold reserves. Only North Ayrshire Council recorded an overspend. This was largely due to spending on social care services ([Exhibit 14, page 27](#)).

**48.** It is not clear from the accounts of IJBs to what extent reserves have been built up in a planned way, have arisen as a result of underspends on IJB activities or have been earmarked for transformation activity. There is a lot of pressure on the budgets of IJBs and reserves at the end of 2016/17 are not forecast to continue in future years. Further analysis of IJB accounts will help inform specific audit work on IJBs being carried out in 2018.

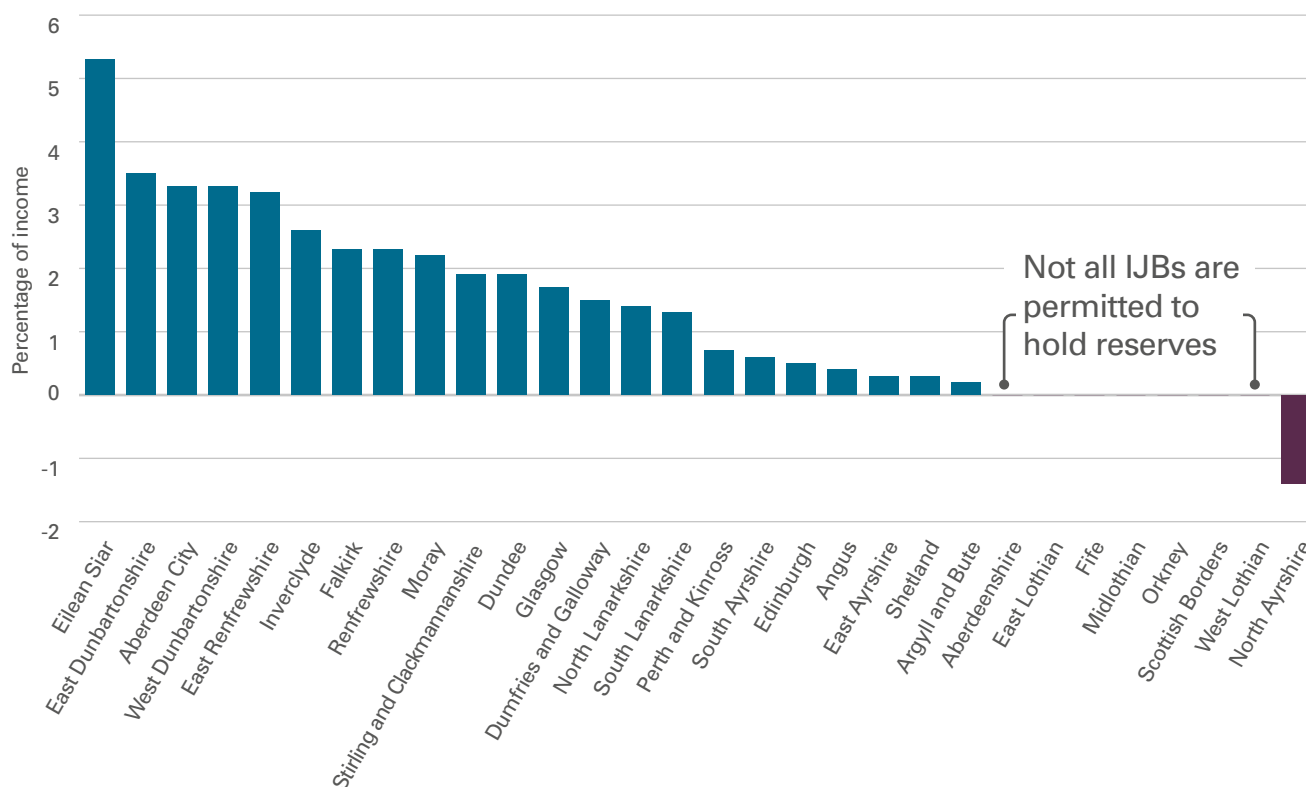


**What are the different types of reserves your council holds? Do you know what these can be spent on?**

## Exhibit 14

### IJB usable reserves as a proportion of 2016/17 income

Reserves vary across IJBs.



Note: Stirling Council and Clackmannanshire Council are members of the same IJB.

Source: Annual accounts 2016/17

## Levels of debt have increased and some councils are concerned about future affordability

**49.** Following two years of reducing debt, councils' net debt increased in 2016/17 from £13.7 billion to £14.5 billion (excluding Orkney and Shetland). The increase in borrowing was lower than that originally planned when capital programmes were approved. This was primarily due to slippage in delivering capital programmes.

**50.** As with reserves, levels of debt vary widely across councils ([Exhibit 15, page 28](#)). 2016/17 saw an increase in the HRA borrowing requirement of about £140 million, with the 26 councils who provide social housing being actively involved in new council housing development. Collectively they plan to deliver about 13,000 homes by 2020/21. The cost of servicing additional HRA debt will be met from rental income.

**51.** The ongoing costs associated with debt reduces the amount councils have available for day-to-day service expenditure. It is therefore important that assets are effectively supporting service delivery and strategic priorities. Higher levels of debt often result in higher costs for councils but actual interest and repayment costs will depend on the type of debt councils hold and the period over which it has to be repaid.

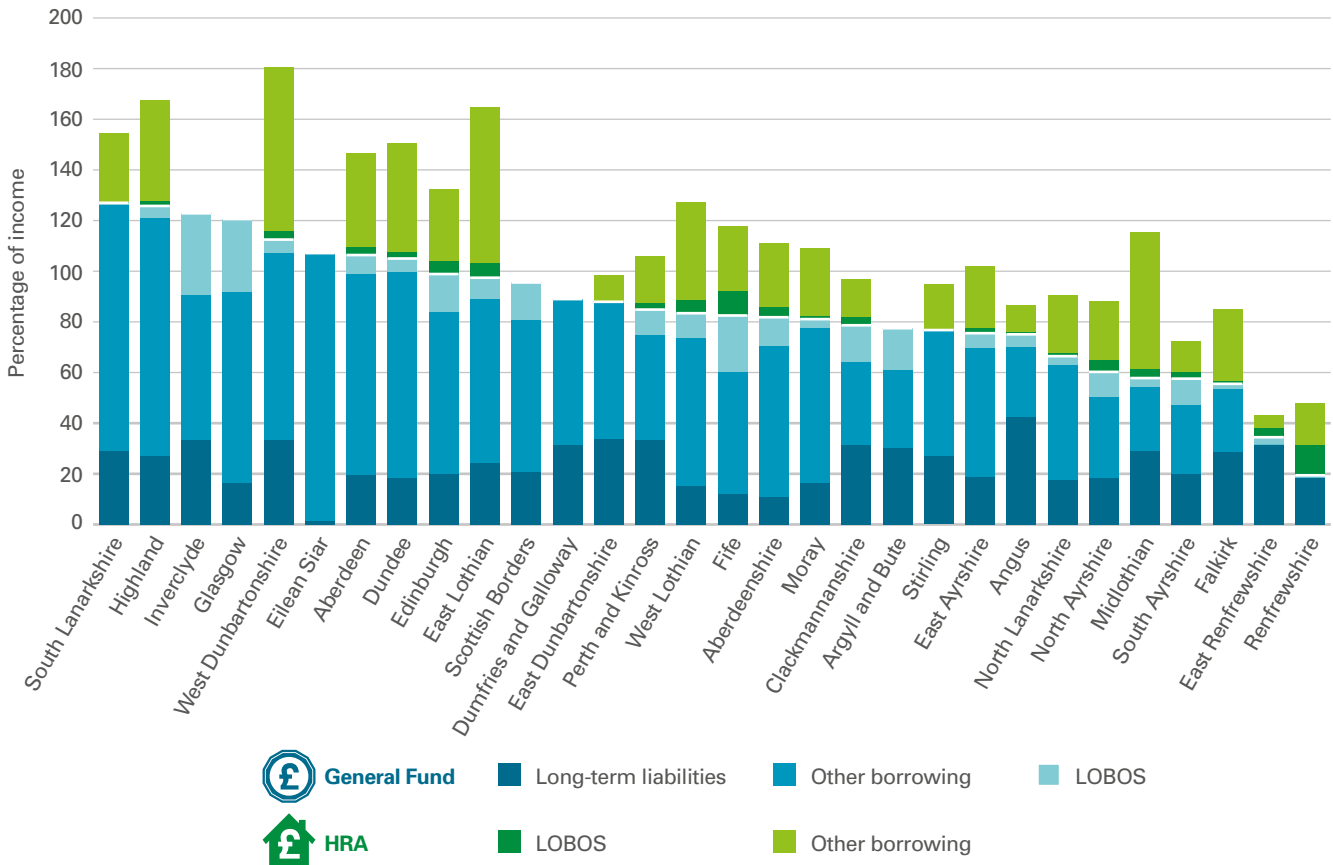


**What are the levels of reserves held by your council's IJB? Are these in line with the IJB's reserve policy?**

## Exhibit 15

### Council net external debt at 31 March 2017

Levels of debt held vary across councils as a proportion of income from general revenue grant, taxation and housing rents.



Note: Council debt has been allocated to General Fund and HRA in proportion to capital financing requirements.

Source: Annual accounts 2016/17

**52.** Despite debt increasing, the ongoing cost of servicing it, through the interest and repayment costs, reduced slightly in 2016/17. This in part reflects the lower interest rates available on new borrowing. It also reflects councils choosing to make lower voluntary debt repayments. On average, councils spent almost ten per cent of their income on interest and debt repayment ([Exhibit 16, page 29](#)).

**53.** Councils are required by regulation to consider the revenue impact of borrowing, ie its ongoing affordability. A large part of council debt has fixed interest rates which gives councils certainty about costs. However, this type of debt makes councils' assessment of longer term affordability more complex, requiring more detailed assumptions of future inflation and interest rates:



**What share of your council's budget is taken up with interest payments and debt repayment?**

- ‘Lender option borrower option’ loans (LOBOs) include options for the lender to increase interest rates. LOBOs account for about 11 per cent of council debt.
- PPP/PFI and indexed linked bonds include charges that increase with inflation. Projects financed using the Scottish Government’s Non-Profit Distributing (NPD) programme (which replaced the previous long standing PPP/PFI programmes) also include an element of indexation but typically at lower levels. The value for money of newer NPD projects will be examined in detail in a joint report by the Auditor General and the Accounts Commission in 2019/20.

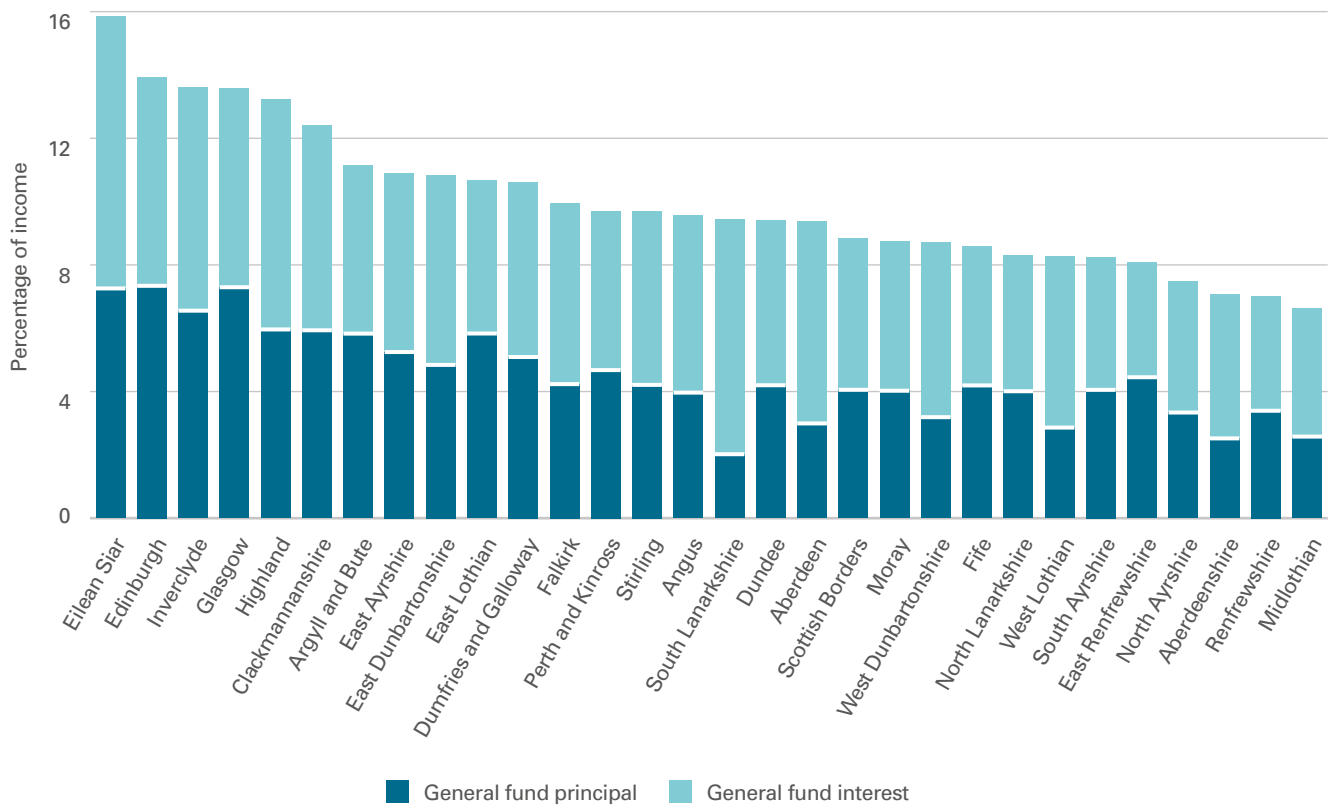


**What proportion of your council's debt is linked to inflation (ie, subject to indexation)? What does that mean for longer term affordability?**

## Exhibit 16

### Revenue cost of General Fund borrowing, 2016/17

Costs associated with debt vary across councils as a proportion of income from general revenue grants and taxation.




Source: Annual accounts 2016/17

**54.** Levels of debt and associated costs are set to rise in future. This is because councils have invested usable reserves in their capital programmes, something referred to as 'internal borrowing'. At the end of 2016/17 the amount of 'internal borrowing' was about £0.5 billion. Internal borrowing is usual treasury management practice for councils during periods when they would make a lower return from investing their usable reserves than it would cost them to borrow money. However, as councils increasingly rely on reserves to fund services they will need to replace internal borrowing with external borrowing, increasing their costs.

### Councils continue to report significant slippage in delivering capital programmes

**55.** Councils spent £2.8 billion on capital projects in 2016/17, 84 per cent of their planned expenditure of £3.3 billion. Twenty-four out of 32 councils underspent against their capital budgets in both 2015/16 and 2016/17.


**56.** The reasons for slippage in delivering capital programmes are unclear. Management commentaries for the councils recording the largest slippage give reasons such as changes to project start dates, and one council identified weaknesses in the forward planning process. However, the consistent levels of capital slippage across the country suggest that councils are setting unrealistic budgets.

**57.** In our 2013 report [Major capital investments in councils](#)  we noted 'that for most major projects completed within the previous three years, councils' early estimates of the expected costs and timetable were inaccurate, and recommended that better information was made publicly available'.<sup>7</sup> Our [follow-up report](#)  in 2016 suggested councils had made limited progress on this recommendation.<sup>8</sup> Data for 2016/17 shows that councils still need to improve in this area.

### Net pension liabilities increased for councils despite large increases in pension fund assets

**58.** Overall, net pension liabilities on council balance sheets were approximately £11.5 billion at the end of 2016/17, an increase of 51 per cent on the previous year. This increase was mainly due to a change in actuarial assumptions used to value future liabilities. It was a good year for Local Government Pension Scheme (LGPS) investments, which increased by almost 22 per cent.

**59.** Not all council pension liabilities are the responsibility of the LGPS fund. Where councils have awarded added-year pension benefits as part of severance arrangements, for both teachers and other staff, they have to meet the ongoing cost of pensions themselves. This also helps explain why the increase in council liabilities outstripped investment returns. These liabilities are not matched with any pension fund assets.

**60.** Public service pension scheme benefits have been reduced on a number of occasions to make the schemes more affordable. However, pension contributions have been a significant cost pressure for councils in recent years. The need for any increase in employer contributions will be determined through the results of the 2017 triennial funding valuation. The LGPS 2015 includes a cost-sharing mechanism that will limit any future increase for employers. A supplement on the [Local Government Pension Scheme](#)  is available on our website.




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**Has non delivery of the capital programme (ie, slippage) been significant at your council in recent years? Why?**

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**Do you know the implications of your council's pension liabilities of staff retiring early?**

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## **Provisions and contingent liabilities can be difficult to quantify and should be kept under review**

**61.** Where councils have a known obligation and they can quantify the cost, they are required to make a provision in their accounts. Councils held provisions of £132 million at the end of 2016/17 covering areas such as equal pay compensation claims, teachers' maternity pay, holiday pay, insurance claims and landfill site reinstatement.<sup>9</sup>

**62.** Councils are also required to disclose potential liabilities that are still contingent on future events or which cannot be quantified reliably. Fourteen councils are disclosing contingent liabilities for equal pay claims that they are defending. Other contingent liabilities identified by a number of councils include those relating to holiday pay claims and potential claims arising as a result of changes to the legislation around historic child abuse.

## **Councils that have been proactive in making difficult decisions will be better placed to deal with future financial pressures**

**63.** Councils have had to make difficult decisions in recent years in the light of falling resources and increasing demand for services. Councils that have a track record of effective leadership, self-evaluation, robustly addressing the financial challenges, and are implementing effective medium to long-term strategies and plans, will be in a better place than those that have avoided difficult decisions or not applied sufficient pace to making changes. That is not to say that the challenges faced by councils have necessarily been uniform. Differences in the resources available to them, the demand for services and the costs councils face as a result of their size and remoteness can also impact on their financial position ([Exhibit 17, page 32](#)).

**64.** The effectiveness of council leadership will be tested further in the years ahead given the increasing demand for services and likely funding scenarios that the public sector faces. Decisions made as part of budget-setting for 2017/18 together with the financial outlook are considered in [Part 1 \(page 10\)](#).



**Exhibit 17****Main determinants of a council's financial position**

There are number of factors that affect a councils financial position.



Source: Audit Scotland

# Part 3

## Financial outlook



### Key messages

- 1** The financial outlook for councils remains challenging with further real-terms reductions in funding and a range of cost and demand pressures on budgets.
- 2** In total councils approved £317 million of savings and the use of £105 million of reserves when setting budgets for 2017/18.
- 3** Some councils relying heavily on the use of reserves to fund services will need to take remedial action or they will run out of General Fund reserves within two to three years.
- 4** Robust medium-term financial strategies and savings plans are increasingly critical to the financial sustainability of councils.
- 5** Strong leadership is increasingly important and it is essential that councillors work effectively with officers, their partners and other stakeholders to identify and deliver necessary savings. It is important that councils engage with local communities when planning and delivering services and identifying savings.

the financial outlook for councils remains challenging

### Council funding continues to fall as cost pressures increase

#### Scottish Government funding fell again in real terms for 2017/18

**65.** Councils received a further real-terms reduction of 2.3 per cent in their funding from the Scottish Government for 2017/18, reflecting the overall trend and direction of travel ([Exhibit 18, page 34](#)).

**66.** Councils' funding continues to include money targeted at delivering national policy commitments that restricts the overall flexibility in their budget setting. In 2017/18, this included £120 million provided for the school attainment fund and £88 million for maintaining pupil teacher ratios and for the teachers' induction scheme.



How is your council preparing for any further real terms reduction in Scottish Government funding?

## Exhibit 18

### Scottish Government revenue funding to councils

Local government funding fell in real terms in 2017/18 compared to 2016/17.

	2017-18 £000	Change on 2016-17 %
<b>Cash terms</b>		
NDR	2,666	-3.7 ▼
Revenue Grant	6,974	0.5
<b>Total revenue funding</b>	<b>9,639</b>	<b>-0.7 ▼</b>
Additional resource via IJBs	357	
	<b>9,996</b>	<b>0.4 ▼</b>
<b>Real terms – 2016/17 prices</b>		
NDR	2,623	-5.3 ▼
Revenue Grant	6,862	-1.1 ▼
<b>Total revenue funding</b>	<b>9,485</b>	<b>-2.3 ▼</b>
Additional resource via IJBs	351	
	<b>9,836</b>	<b>-1.2 ▼</b>

Source: Scottish Government Finance Circular 1/2017

### Reductions in Scottish Government funding were only partly offset by the end of the council tax freeze

**67.** The council tax freeze ended in 2017/18. Twenty-four councils chose to increase council tax, with 21 approving the maximum three per cent permitted. Fourteen councils chose to remove the ten per cent discount on second homes, another option for increasing revenue. For some councils, additional income from second homes is not significant.

**68.** There were reforms to council tax banding multipliers for 2017/18 that resulted in a further £110 million of council tax due across the 32 councils. This will be available in full as additional income to be spent in the local authority area it is collected. [Exhibit 19 \(page 35\)](#) shows the additional income councils are due from council tax in 2017/18.

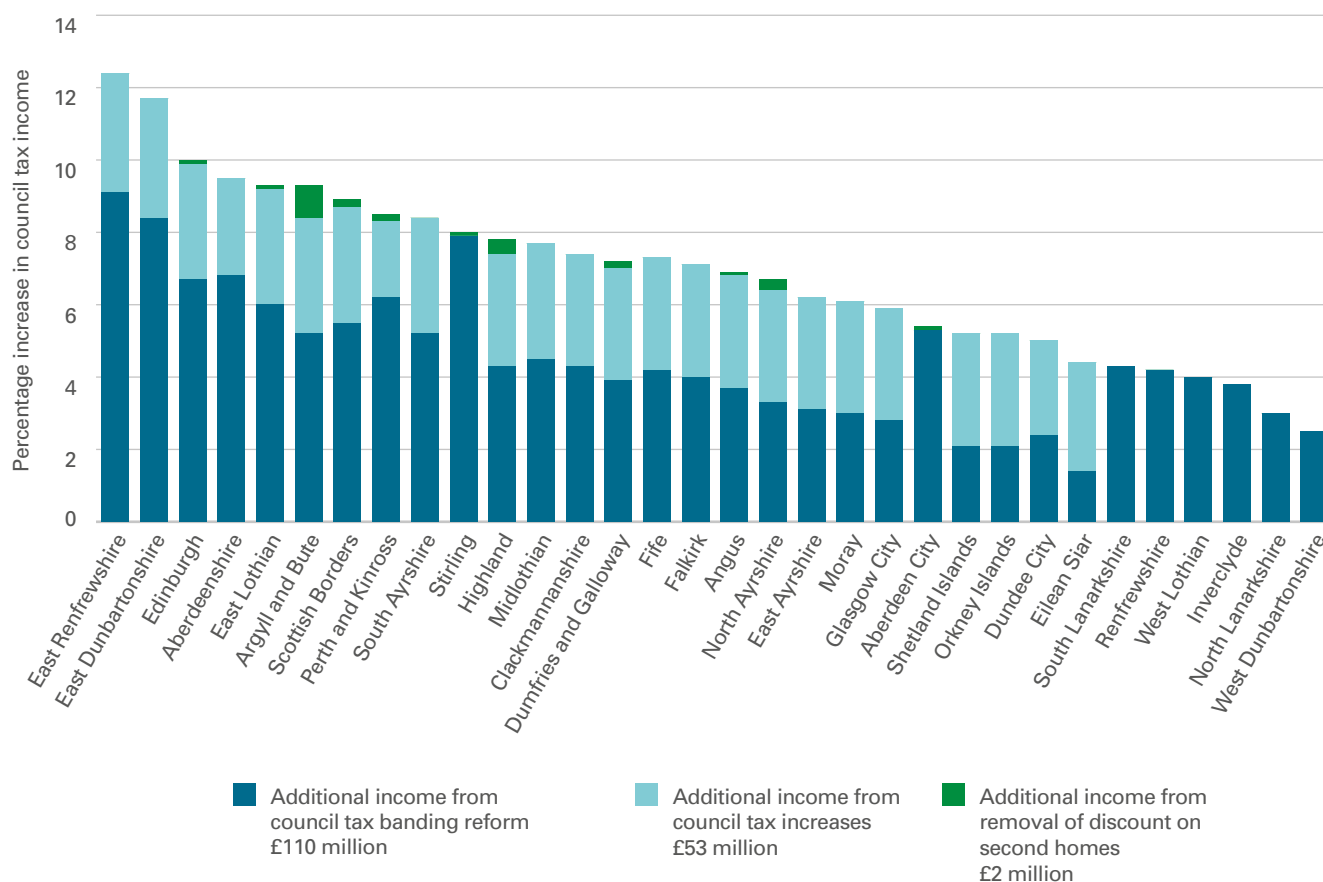


**If your council plans to raise council tax, do you know how much it will raise? How will you communicate and explain the reasons for the rise to constituents?**

## Exhibit 19

### Increase in council tax by council, 2017/18

Council tax in 2017/18 has risen as a result of reforms and the end of the council tax freeze.



Note: Council tax due before any discounts are applied.

Source: Scottish Government Finance Circular 1/2017, Council tax banding information and SPICe

## Delivering savings is critical for councils' financial sustainability

Councils approved savings of £317 million and the use of £105 million of reserves when setting budgets for 2017/18

69. When setting budgets for 2017/18, councils had to take into account a number of new cost pressures, including:

- the introduction of the apprenticeship levy of 0.5 per cent of pay bills above £3 million
- the requirement to meet the first full year effect of the living wage
- meeting HMRC guidelines on paying the national minimum wage for care workers when sleeping over
- non-domestic rates (NDR) revaluation.

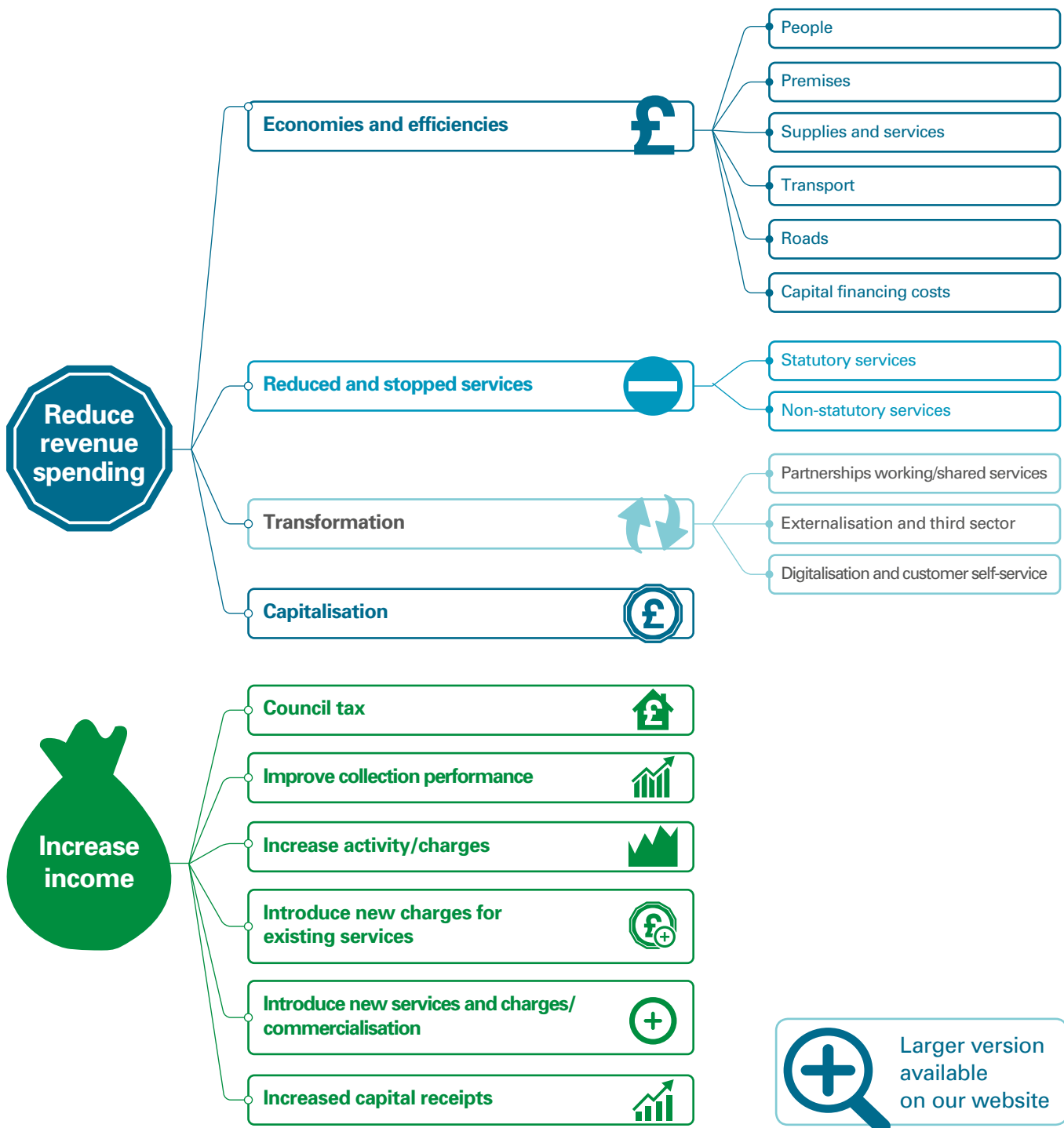


**70.** In balancing funding reductions and cost pressures, councils' 2017/18 budgets included approved savings of £317 million and the use of £105 million of General Fund reserves. Common measures taken by councils to close their funding gaps in 2017/18 are set out in [Exhibit 20](#). Not all initiatives to reduce expenditure are savings, some simply deferred expenditure by moving it from revenue to capital.

**Does your council have a savings plan? What are the options to close future funding gaps?**

## Exhibit 20

Measures taken by councils to close their funding gaps in 2017/18





### Some councils will need to take remedial action or they will run out of General Fund reserves within two to three years

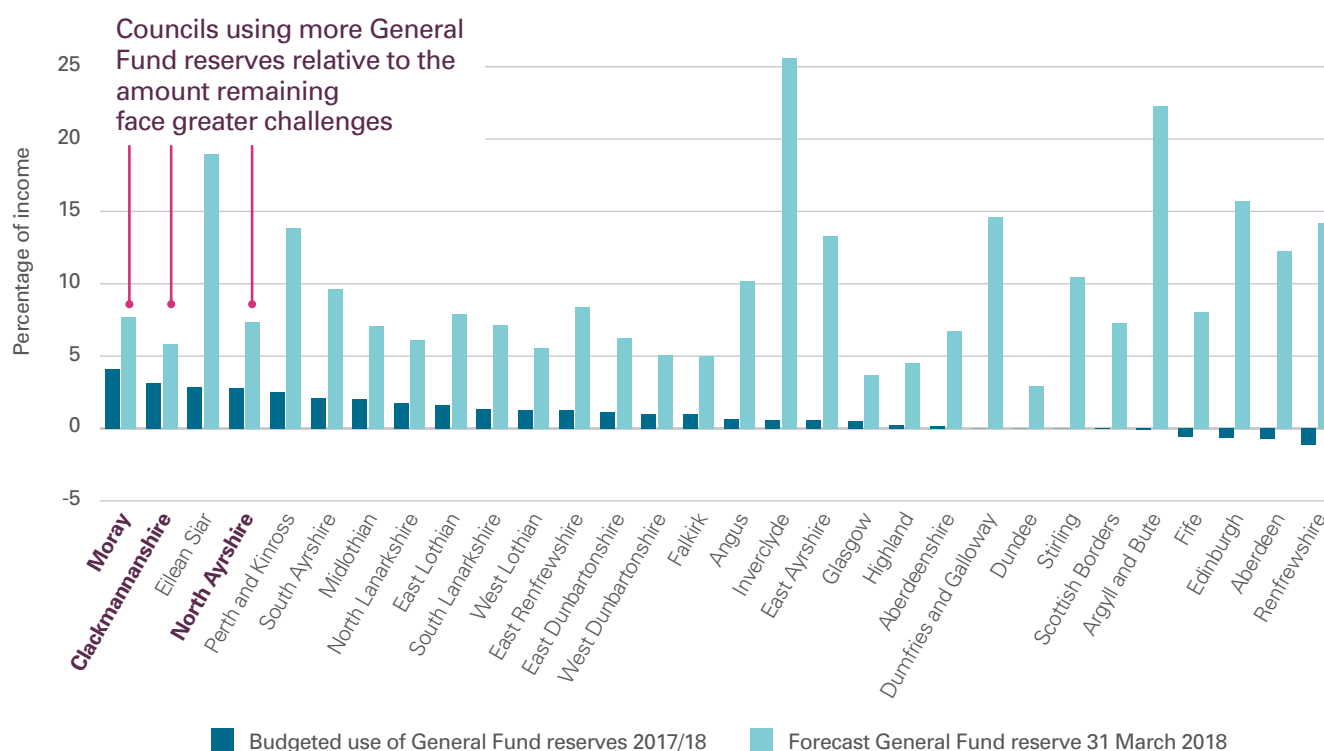
**71.** Some councils' plans for 2017/18 have relied more heavily than others on using reserves to bridge funding gaps. A number of these councils could have relatively low levels of General Fund reserves remaining at the end of the year ([Exhibit 21](#)).

**What is the likely use of reserves for 2017/18? How does this compare to forecast funding gaps?**

## Exhibit 21

### Budgeted use and remaining levels of General Fund reserves, 2017/18

Two-thirds of councils budgeted to use reserves in 2017/18.



Source: Annual accounts and auditor funding gap returns 2017

**72.** Councils using reserves to support services in 2017/18 will be faced with having to identify larger savings in 2018/19 or again using reserves. However, using General Fund reserves at the current rate is not an option for some councils – Clackmannanshire, Moray and North Ayrshire councils would run out of General Fund reserves within two to three years if they continued to use them at the level planned for 2017/18.

**73.** Forecasts made by councils when setting their budgets for 2017/18 indicated the overall local government funding gap would increase to about £350 million in 2018/19 and to about £650 million in 2019/20.<sup>10</sup>

**74.** Since setting 2017/18 budgets, councils will have changed their plans for the current year and updated their forecast funding gaps for 2018/19 and beyond. A number of factors have created further potential pressures and uncertainties, for example:

- ongoing demand pressures from people living longer and population growth
- ongoing cost pressures from general inflation



**What is your council's financial position? What particular challenges does it face?**

- increased staffing costs from staff moving up pay scales, proposals to end the public sector pay cap and potential increases in employers' pension contributions following the LGPS triennial funding valuation
- income and rent collection potentially becoming more difficult and costly as a result of increased charges and the continued roll-out of Universal Credit
- interest rate rises
- the potential impact from changes to NDR (as outlined in [Exhibit 22](#))
- potential impacts from the process of withdrawal from the European Union.

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## Exhibit 22

### Barclay review of non-domestic rates (NDR) 2017

The Barclay review recommended removing NDR relief for councils' ALEOs.

**Councils collect NDR and pay this into a central pool, which is redistributed back to councils by the Scottish Government.**

The Government established the Barclay review group in 2016 to make recommendations that would 'enhance and reform' NDR in Scotland. The review aimed to:

- better support business growth and long-term investment
- reflect changing marketplaces
- retain the same level of income (recommendations would be 'revenue neutral').

The review concluded that some form of NDR was still appropriate. The recommendations in the report focused on measures to support economic growth, improve how the system is administered and increase fairness in the system.

In seeking increased fairness, the review recommended that councils' NDR relief for ALEOs should be removed. The review recommended that legislation be changed to remove relief for ALEOs and, in the interim, that the Scottish Government should adjust its funding to recoup an estimated £45 million of ALEO funding from councils. The review recommended this is applied from April 2018.

The Scottish Government has accepted many of the points of the Barclay review, but the recommendation around ALEOs is still being considered. The Accounts Commission will examine ALEOs in more detail in a report to be published in May 2018.

Source: Report of the Barclay Review of Non-Domestic Rates, August 2017

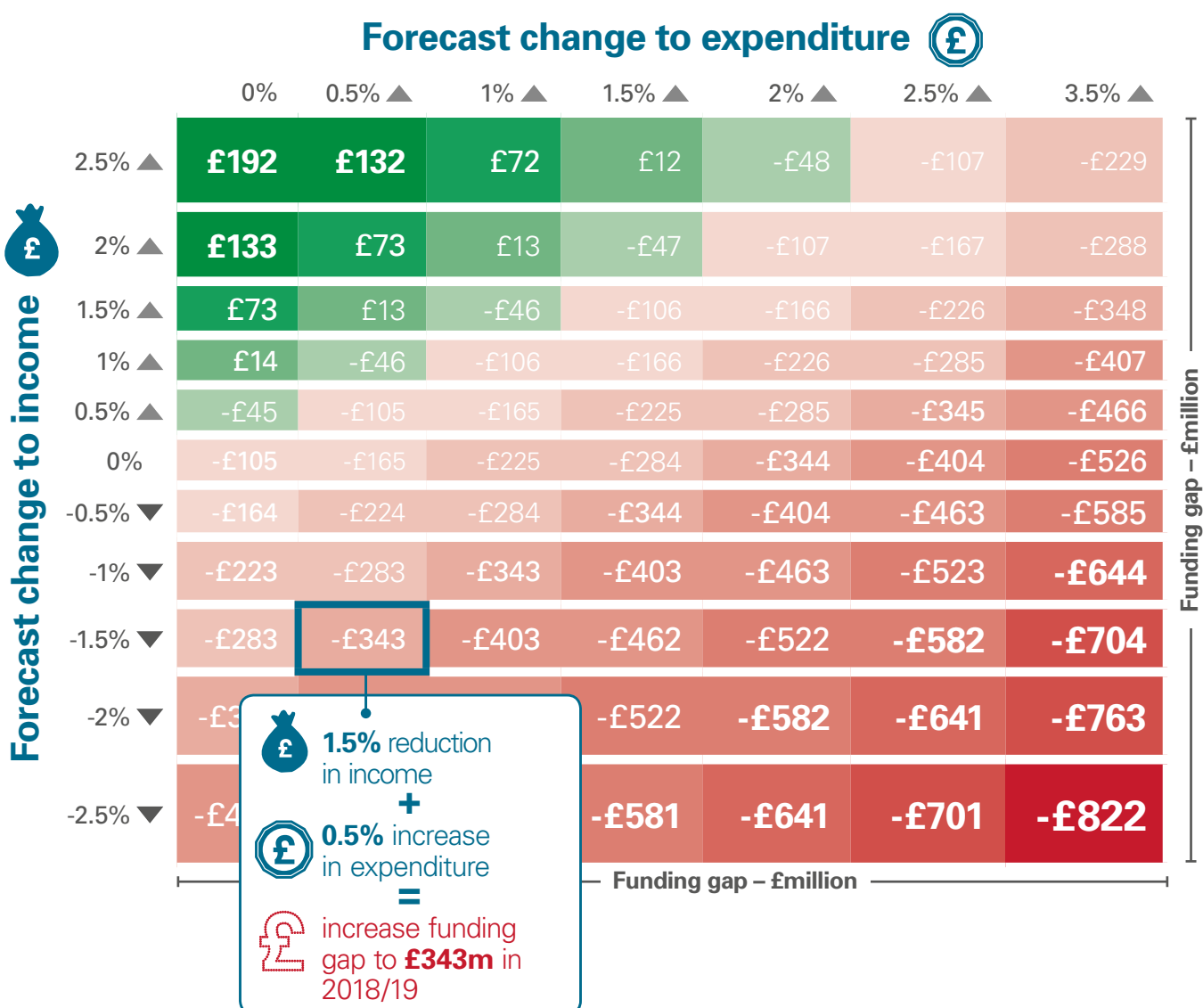
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75. Uncertainty means that councils need to prepare for a range of possible scenarios both in terms of costs and funding and different savings options available to them. For example, if councils were to apply a further three per cent increase in council tax in 2018/19 this would raise about £68 million in additional income. In contrast, applying a one per cent increase to staff salaries would cost about £70 million. Even a small proportional increase above this as a result of lifting the public sector pay cap would have further significant costs. [Exhibit 23](#) shows the overall impact of various income and expenditure scenarios on the size of the total funding gap across councils for 2018/19.

### Exhibit 23

#### Council funding gaps scenarios, 2018/19

In the absence of further savings, councils would use around £343 million in 2018/19 if expenditure were to increase by 0.5 per cent and income decrease by 1.5 per cent.



Source: Audit Scotland funding gap returns



### Savings plans should be scrutinised and the impact assessed

**76.** CIPFA's report on building financial resilience and managing financial stress in local authorities highlighted the importance of planning for savings over at least a three-year period, and the need for robust challenging of plans as part of the scrutiny process.<sup>11</sup> In previous reports, the Accounts Commission has highlighted the need for councils to adopt this practice.

**77.** Regular updates on forecasts of funding gaps as savings are approved enable councillors to better understand the impact of the savings decisions they are making. However, currently only about half of councils routinely update their three-year financial forecasts as part of their annual budget-setting process.

**78.** To achieve effective financial management, long-term planning is essential. It is important that councils continue to consider likely funding scenarios and what this means for council services in the longer term as well as the medium term. For councils with lower levels of reserves, financial plans need to be increasingly detailed and robust. This will mean more work for officers and members in clearly identifying savings and assuring themselves that they have the capacity to deliver their intended plans.

**79.** It is important that savings plans are clear and that the impact on services is understood. Savings should be realistic and achievable. Where funding reductions are passed on to other bodies, such as ALEOs and IJBs, by reducing council contributions to them, it is equally important to assess the impact on service users and communities. Risks associated with income generation initiatives or arising from cuts to services should be explicit and considered by councillors as part of their scrutiny role.

**80.** Medium-term financial strategies should ensure that both revenue and capital budgets are aligned with corporate plans and that the revenue impact of capital expenditure is understood. Savings from service redesign and other initiatives need to be monitored effectively to ensure that plans and strategies continue to be relevant and accurate.

### Longer-term affordability of capital programmes should be kept under review

**81.** Council capital programmes for 2017/18 are broadly in line with those for 2016/17, with General Fund budgets at about £2.6 billion and HRA budgets at about £800 million.

**82.** Councils are required to consider the affordability of their capital programmes and any new borrowing before approving them each year. Assessments will include consideration of:

- existing debt levels and servicing costs and how these may increase
- capital reserves available
- impact on running costs, eg reduced overall running costs arising from invest to save initiatives
- additional income streams that can be used to service borrowing




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**Does your council have a medium term financial strategy aligned with corporate objectives?**

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**How does annual budget setting link to medium term financial planning?**

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**What impact will savings have on the delivery of services? What are the potential risks?**

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**How clearly does the council's capital programme link with the asset management plan and corporate objectives?**

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- additional funding available, eg Scottish Government funding for NPD projects, additional capital grants in respect of the City Deals (a recent initiative backed by UK and Scottish governments).

**83.** As revenue resources reduce, and the cost of some debt increases, it is becoming increasingly important for councils to keep the longer-term affordability of their borrowing under review. The need for robust business cases setting out how new capital expenditure will support corporate objectives is key. Capital finance and treasury management are areas covered by regulation and where councils also take professional advice. A key treasury management issue facing councils is the risk around interest rate rises, which makes decisions about the timing of borrowing important. If councils borrow in advance of their need they will incur additional interest costs in the short term. However, if the interest rates go up before councils borrow then they will be faced with paying higher interest rates for the term of any new borrowing. Recently a number of councils have been turning to short-term borrowing to keep their interest costs down but this strategy is not without risk and it is important that councils are clear about these in their plans and reports.

### Effective leadership is increasingly important in maintaining financial sustainability

**84.** The Accounts Commission recognises that the financial challenges facing councils will inevitably mean councillors need to make difficult choices and take decisions that may not sit neatly with the manifestos they were elected on in May 2017. This requires effective political leadership and effective communications. It is essential that councillors work effectively with officers, council partners and other stakeholders to identify and deliver necessary savings. It is important that councils engage with local communities when planning and delivering services and identifying savings. We published a report [\*Roles and working relationships in councils – Are you still getting it right?\*](#)  (November 2016) to support councillors in their difficult and challenging role.

### Addressing the underlying demand for services through transformation is key to longer-term sustainability

**85.** Given the scale of the challenge facing councils, we are of the view that the sustainability of some services will be increasingly dependent on the ability of councils and their partners to address the underlying demand for them. With health and social care integration, for example, much depends on the extent to which resources can be switched from treatment to prevention. Council transformation programmes need to identify and deliver changes of this nature over the longer term. It is important that councils give careful consideration to their capacity to support such change when making savings as part of budget setting.

**86.** The extent to which council transformation plans are delivering real changes to the way services are being delivered will be explored further in the second of our local government overview reports planned for publication in April 2018.




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**What additional training would you like to receive to develop your knowledge and skills in financial scrutiny?**

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**What measures in the council's corporate and transformational plans are aimed at addressing the underlying demand for services?**

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# Endnotes




- ◀ 1 We published the first of three planned audits on health and social care integration in 2015: [Health and social care integration](#) , December 2015. Our next national audit in this area will be carried out in 2018/19. Annual audit plans and reports for each IJB are also published on [Audit Scotland's website](#) .
- ◀ 2 This excludes income received from arm's-length external organisation (ALEOs) providing services such as leisure services on behalf of the council.
- ◀ 3 *Fiscal issues facing Local Government in Scotland*, Fraser of Allander Institute, March 2017.
- ◀ 4 East Lothian Council, Highland Council (Inverness Jobcentre only), East Dunbartonshire, Midlothian Council and Inverclyde Council (no council stock – therefore no arrears).
- ◀ 5 ALEOs are separate bodies councils create to deliver services that they previously delivered in house.
- ◀ 6 *Building financial resilience: managing financial stress in local authorities*, CIPFA, June 2017.
- ◀ 7 [Major capital investment in councils](#) , Accounts Commission, March 2013.
- ◀ 8 [Major capital investment in councils: follow-up](#) , Accounts Commission, January 2016.
- ◀ 9 For more detail on councils' implementation of equal pay, see the Accounts Commission's [Equal pay in Scottish councils](#)  report.
- ◀ 10 This forecast is based on the average of available forecasts.
- ◀ 11 *Building financial resilience: managing financial stress in local authorities*, CIPFA, June 2017.

# Local government in Scotland Financial overview 2016/17



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Audit Scotland, 4th Floor, 102 West Port, Edinburgh EH3 9DN  
T: 0131 625 1500 E: [info@audit-scotland.gov.uk](mailto:info@audit-scotland.gov.uk)   
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