Agenda item no 14

Committee report

Audit Scotland report: Local government in Scotland financial overview 2015/16

Committee Audit and Standards

Date of meeting 17 March 2017 **Date of report** 6 March 2017

Report by Assistant Chief Executive (Business Support)

1. Object of report

To advise the committee on the issue of an Audit Scotland report titled *'Local government in Scotland financial overview 2015/16'.*

2. Background

Audit Scotland report

In November 2016, Audit Scotland published a report titled *'Local government in Scotland financial overview 2015/16'.*

The report says that councils have managed their finances well but significant challenges lie ahead.

The report adds that councils had remained within their overall budgets, increased their reserves slightly and reduced their debt in 2015/16. Each council has its own particular challenges but all councils face financial shortfalls requiring further savings or using reserves. Councils need to change the way they work if they are to make the savings needed.

The Scottish Government provides around 60 per cent of councils' total income. Over the past six years, up to and including 2016/17, Scottish Government funding (revenue and capital) for councils fell by 8.4 per cent in real terms.

The report warns that further reductions are expected while demand on key services, particularly social care, continues to rise. Councils also face increased cost pressures in areas such as pension provision.

The report and supplements can be found at:

http://www.audit-scotland.gov.uk/uploads/docs/report/2016/nr_161129_local_government_finance.pdf http://www.audit-scotland.gov.uk/uploads/docs/report/2016/nr_161129_local_government_finance_supp1.pdf

http://www.audit-scotland.gov.uk/uploads/docs/report/2016/nr_161129_local_government_finance_supp2.pdf

3. Outline of findings

The key messages outlined in the Audit Scotland report are:

'The overall financial health of local government was generally good in 2015/16 and there was a slight increase in overall reserves and a reduction in overall debt. Auditors did not raise concerns about the immediate financial position of Scotland's councils and, for the fifth year in a row, issued unqualified opinions on councils' accounts.

Councils' budgets are under increasing pressure from a long-term decline in funding, rising demand for services and increasing costs, such as pensions. There is variation in how these pressures are affecting individual councils, with some overspending their total budgets or budgets for individual services such as social care. It is important that councils have effective budgetary control arrangements in place to minimise unplanned budget variances that can affect their financial position.

All councils face future funding gaps that require further savings or a greater use of their reserves. There is variation in how well placed councils are to address these gaps.

Long-term financial strategies must be in place to ensure council spending is aligned with priorities, and supported by medium-term financial plans and budget forecasts. Even where the Scottish Government only provides councils with one-year financial settlements, this does not diminish the importance of medium and longer-term financial planning. This is necessary to allow councillors and officers to assess and scrutinise the impact of approved spending on future budgets and the sustainability of their council's financial position'.

The supplements to this report provide a self-assessment tool for members on the areas highlighted in the Audit Scotland report and summary of local government pension schemes 2015/16.

4. Conclusions

Audit Scotland published a report titled *'Local government in Scotland financial overview 2015/16'* in November 2016.

5. Committee action

The committee is asked to note the contents of this report and the Audit Scotland report titled *'Local government in Scotland financial overview 2015/16'.*

6. Consequences

Policy consequences	*None*
Legal consequences	*None*
Financial consequences	*None*
Personnel consequences	*None*
Social Inclusion consequences	*None*
Risk consequences	*As detailed in the report.*

Name	Valerie Davidson	**Name**	Gordon Maclennan
Title	**Assistant Chief Executive (Business Support)**	**Title**	**Chief Executive**

For further information, please contact Iain McNicol, Audit and Assurance Manager on 0141 333 3195.

Local government in Scotland

Financial overview 2015/16

ACCOUNTS COMMISSION

Prepared by Audit Scotland
November 2016

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/ac

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.

Contents

Links

PDF download

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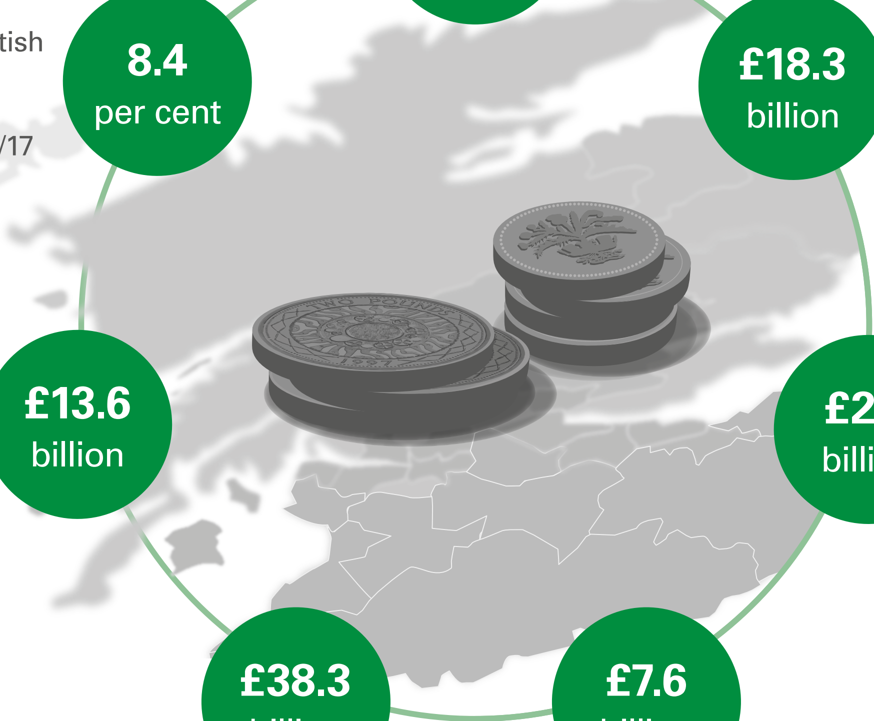
Exhibit data

When viewing this report online, you can access background data by clicking on the graph icon. The data file will open in a new window.

These question mark icons appear throughout this report and represent questions for councillors.

Key facts



£18.9 billion — Council income in 2015/16

£18.3 billion — Spending on day-to-day services in 2015/16

£2.5 billion — Councils' usable reserves at 31 March 2016

£7.6 billion — Councils' share of the Local Government Pension Scheme deficit at 31 March 2016

£38.3 billion — The value of councils' physical assets, including buildings, schools and equipment

£13.6 billion — Councils' net debt at 31 March 2016

8.4 per cent — Real-terms reduction in Scottish Government funding between 2010/11 and 2016/17

Chair's introduction

This financial report is the first of our new overview outputs. It tells the strategic financial story for local government in Scotland in 2015/16, another challenging year for councils. Overall, councils responded well by controlling their spending and have also increased reserves and reduced debt. Scottish Government funding has fallen in real terms in recent years and, although there was a small annual real-terms increase in 2015/16, it fell again in 2016/17. Councils also continue to face cost pressures, including increasing pension costs and wage inflation. We recognise councils have been making difficult decisions when setting their budgets and that this has required a disciplined approach to delivering savings. This disciplined approach must continue when we move into the 2017 election year, as significant challenges lie ahead and councils need to be well placed to meet them.

In anticipation of reductions in future Scottish Government funding, most councils have continued to increase their reserves. Councils must consider how and when reserves are used to support services, in line with their financial plans and reserves policies, as they can only be used once and relying on them is not sustainable. All councils have identified future funding gaps that will need to be addressed through making savings or using reserves. How well placed individual councils are to address these funding gaps is a combination of the relative size of the funding gap, the reserves they hold, and their ability to identify and make savings and to service debt.

Financial scrutiny and transparency in financial reporting are themes that recur throughout this report. Under the new *Code of Audit Practice 2016*, auditors will comment on the financial sustainability of councils. It is important that all councils have long-term financial strategies in place that support their strategic priorities, underpinned by more detailed financial plans and indicative budgets that cover the next three to five years. These will help councillors and officers assess the impact of approved spending on their current and future financial position.

Our new approach to overview reporting

This year, we have developed our approach to overview reporting for local government into a series of outputs throughout the year. We will examine the performance of council services and the challenges facing councils in our upcoming overview report in March 2017, but hope that the links between good financial and service performance remain clear.

We are publishing this analysis of the 2015/16 accounts and audit findings a few months earlier than usual, so that they can be considered by councils and councillors when setting their 2017/18 budgets. In addition to this report and the accompanying supplements, an interactive exhibit and additional financial information are available on our website. These will allow council officers and councillors to look at areas that may be of particular interest to them and to compare their council with others.

I hope this report and the supplementary information prove to be informative and help shed light on the complex nature of local government finances. We welcome feedback and will use this to inform our approach to overview reporting in future years.

Douglas Sinclair
Chair of Accounts Commission

Summary

Key messages

1 The overall financial health of local government was generally good in 2015/16 and there was a slight increase in overall reserves and a reduction in overall debt. Auditors did not raise concerns about the immediate financial position of Scotland's councils and, for the fifth year in a row, issued unqualified opinions on councils' accounts.

2 Significant challenges for local government finance lie ahead. Councils' budgets are under increasing pressure from a long-term decline in funding, rising demand for services and increasing costs, such as pensions. There is variation in how these pressures are affecting individual councils, with some overspending their total budgets or budgets for individual services such as social care. It is important that councils have effective budgetary control arrangements in place to minimise unplanned budget variances that can affect their financial position.

3 Councils need to change the way they work to deal with the financial challenges they face. All councils face future funding gaps that require further savings or a greater use of their reserves. There is variation in how well placed councils are to address these gaps.

4 Long-term financial strategies must be in place to ensure council spending is aligned with priorities, and supported by medium-term financial plans and budget forecasts. Even where the Scottish Government only provides councils with one-year financial settlements, this does not diminish the importance of medium and longer-term financial planning. This is necessary to allow councillors and officers to assess and scrutinise the impact of approved spending on future budgets and the sustainability of their council's financial position.

councils have managed their finances well but significant challenges lie ahead

About this report

1. This report provides a high-level, independent view of councils' financial performance and position in 2015/16. It is aimed primarily at councillors and senior council officers as a source of information and to support them in their complex and demanding roles. It is in two parts:

- Part 1 (page 9) focuses on the councils' income and expenditure in 2015/16 and trends over time.
- Part 2 (page 19) comments on the financial outlook of councils at the end of 2015/16 and outlines important factors to be considered in assessing future spending plans.

2. Throughout this report we present a detailed analysis of councils' finances in 2015/16 and, where appropriate, comparisons over a five-year period (2011/12 to 2015/16). Our primary sources of information are councils' audited accounts and their 2015/16 annual audit reports. We have supplemented this with other information supplied by auditors and councils. This includes budget information collected by auditors shortly after councils approved their 2016/17 budgets and which informed our analysis of councils' projected funding gaps up to 2018/19.

3. Where we refer to councils' funding in 2016/17, we use information from the Scottish Government's 2016/17 Local Government financial settlement. Although we do not audit this information, we feel it is important to make appropriate references to funding in the current financial year. Where we have done this, we have analysed trends since 2010/11 when Scottish Government funding peaked.

4. We refer to real-terms changes in this report where we are showing financial information from past and future years in 2015/16 prices, adjusted for inflation, so that they are comparable to information from councils' 2015/16 accounts. In general we compare income and expenditure items in Part 1 in real-terms but do not adjust items in Part 2 as they are adjusted in their preparation.

5. Throughout the report, we identify 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 in Supplement 1: Self-assessment tool for councillors on our website.

6. We recognise that complex financial information is often presented differently for different purposes. For example, local finance returns (LFRs), which councils submit to the Scottish Government, present spending information for councils on a different basis from the spending information that councils record in their annual accounts. There are also differences in how funding is recorded in different sources. Alongside this report, we have published a short supplement to explain the main differences in the way financial information is reported. This is included in the self-assessment tool for councillors.

7. 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.

Part 1

Income and spending

Key messages

1 The overall financial health of local government was generally good in 2015/16 and there was a slight increase in overall reserves and a reduction in overall debt. Auditors did not raise concerns about the immediate financial position of Scotland's councils and, for the fifth year in a row, issued unqualified opinions on councils' accounts.

2 More than half of councils' income comes from the Scottish Government. Councils have experienced a long-term decline in their grant funding from the Scottish Government. This is expected to continue to fall in future, putting greater pressure on budgets.

3 Councils have managed their finances well so far in responding to the pressures they face. In 2015/16, 15 councils planned to use some of their reserves to support spending and, across local government, revenue reserves were forecast to decrease. However, only seven councils drew on their reserves and, overall, revenue reserves increased in 2015/16.

4 Councils spent £19.5 billion in 2015/16. Spending on providing services remains lower than in 2011/12, but is increasing in key services, most noticeably in social care because of rising demand from an ageing population. Many councils overspent their social care budgets and this poses a risk to their longer-term financial position. Councils need to ensure budgets reflect true spending patterns so that the impact of current spending on their financial position is clearly understood.

5 Over and above growing demands on services, councils need to manage other financial pressures such as increasing pension costs and wage inflation. It is essential that councils have long-term financial strategies and plans in place that align with their priorities and are supported by medium-term financial plans and budget forecasts.

there has been a long-term decline in grant funding to councils, this is to continue

All councils received an unqualified audit opinion on their 2015/16 accounts but they can better use their accounts to explain financial performance

8. The overall financial health of local government was generally good in 2015/16. All accounts were received on time and, for the fifth consecutive year, auditors issued all of Scotland's 32 councils with a true and fair unqualified audit opinion on their 2015/16 accounts.

9. Over two-thirds of councils operated within their budgets and there was a slight increase in overall reserves and a reduction in overall debt. Auditors did not raise concerns about the short-term financial position of Scotland's councils, but raised a number of concerns about individual councils facing significant funding gaps over the next two to three years.

10. For the last two years, councils have produced a management commentary to accompany their annual accounts. These commentaries play an important role in helping readers to better understand the accounts and a council's financial performance. 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.

11. The 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.

12. Analysis of the management commentaries shows variation in how clearly councils explain their financial and general performance. However, there is a general improvement from last year. It is the Commission's view that councillors have an important role in ensuring that the management commentary effectively tells the story of the council's financial performance and can be understood and scrutinised by a wide audience.

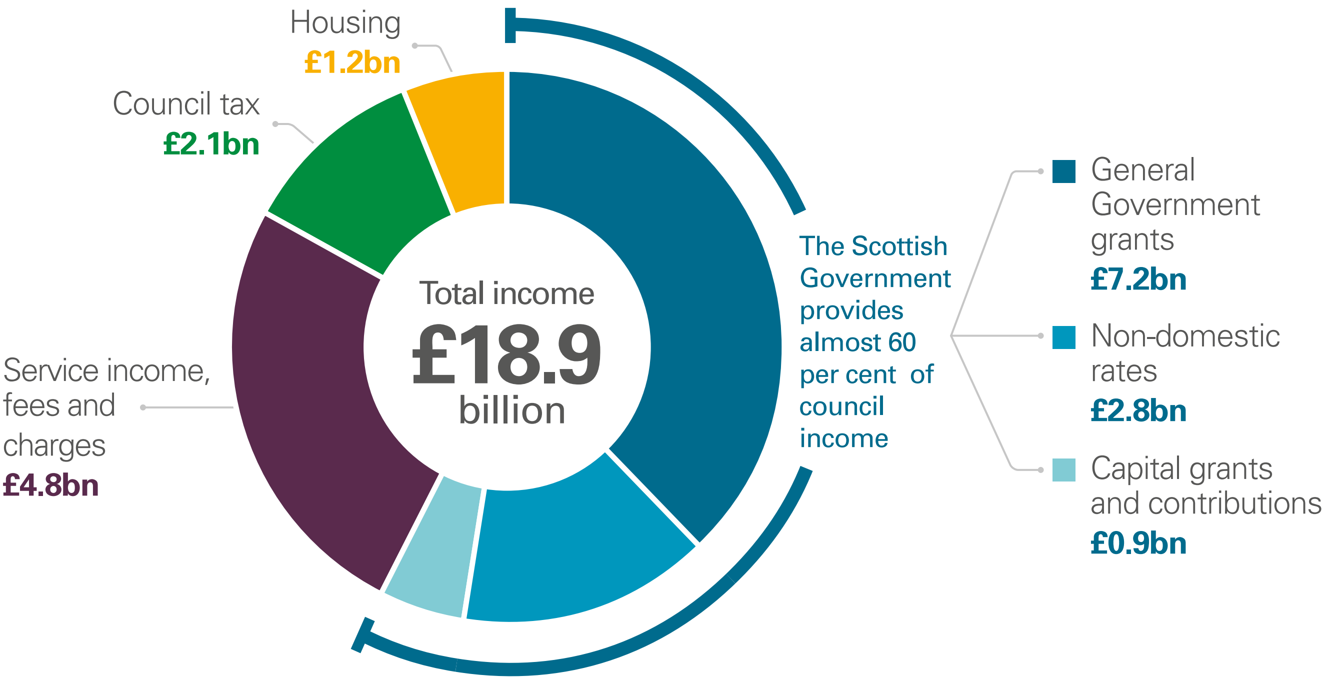
Does the management commentary section of the annual accounts provide a clear and easily understandable account of the council's finances?

Scottish Government funding increased in 2015/16 but has reduced significantly over the longer term

13. In 2015/16, councils' total revenue and capital income was £18.9 billion, a real-terms increase of 2.9 per cent since 2014/15. £10.9 billion (57 per cent) of this came from the Scottish Government (Exhibit 1, page 11). The share of council income coming from the Scottish Government has reduced slightly from 2014/15 (58 per cent), mainly because of a large increase in income from service fees and charges.[1]

14. Scottish Government grants are councils' major source of income. Between 2010/11 and 2015/16, Scottish Government funding (combined revenue and capital) for councils reduced in real terms by around £186 million (1.7 per cent) to £10.9 billion.[2] Taking into account 2016/17 funding, councils have experienced a real-terms reduction in funding of 8.4 per cent since 2010/11. This is approximately the same as the reduction in the Scottish Government's total budget over the same period.

Exhibit 1
Sources of councils' income in 2015/16
Councils' total income in 2015/16 was £18.9 billion and almost 60 per cent (£10.9 billion) of this came from the Scottish Government.



Notes: 1. Figures have been rounded to one decimal place so the sum of the categories does not exactly match total income. 2. Service income, fees and charges may include specific service-related grants and income such as payments from the Scottish Government, NHS or other councils. It also includes funds returned to councils from Integration Joint Boards. 3. Capital grants and contributions include income from the Scottish Government and others such as central government bodies, National Lottery and the European Union. As the majority is in the form of Scottish Government capital grants, we have included this within income provided by the Scottish Government.

Source: Councils' audited annual accounts, 2015/16

In 2015/16, councils received a slight increase in revenue funding from the Scottish Government to support the implementation of national policies

15. The Scottish Government allocates councils a set amount of revenue funding from both grants and non-domestic rates (NDR). In 2015/16, this amounted to £10.0 billion. This represents a real-terms annual increase of 1.1 per cent but a 2.1 per cent reduction since 2010/11.

16. Revenue grants totalled £7.25 billion in 2015/16 and included: £560 million for continuing to freeze council tax at 2007/08 levels; around £350 million to replace council tax benefit previously provided by the UK Government; and additional funding for implementing other Scottish Government policies, such as maintaining teacher numbers and pupil to teacher ratios. In their accounts, councils record income from Scottish Government funding differently from how it is allocated (Supplement 1: Self-assessment tool for councillors). As a result, councils' accounts show income from Scottish Government general revenue grants of £7.2 billion in 2015/16. This represents a real-terms reduction in councils' income of £38.0 million since 2014/15.

17. An increasing proportion of revenue funding is coming from NDR (29 per cent in 2015/16 compared to 22 per cent in 2010/11). The increase in NDR income in recent years has not fully offset reductions in revenue grant funding.

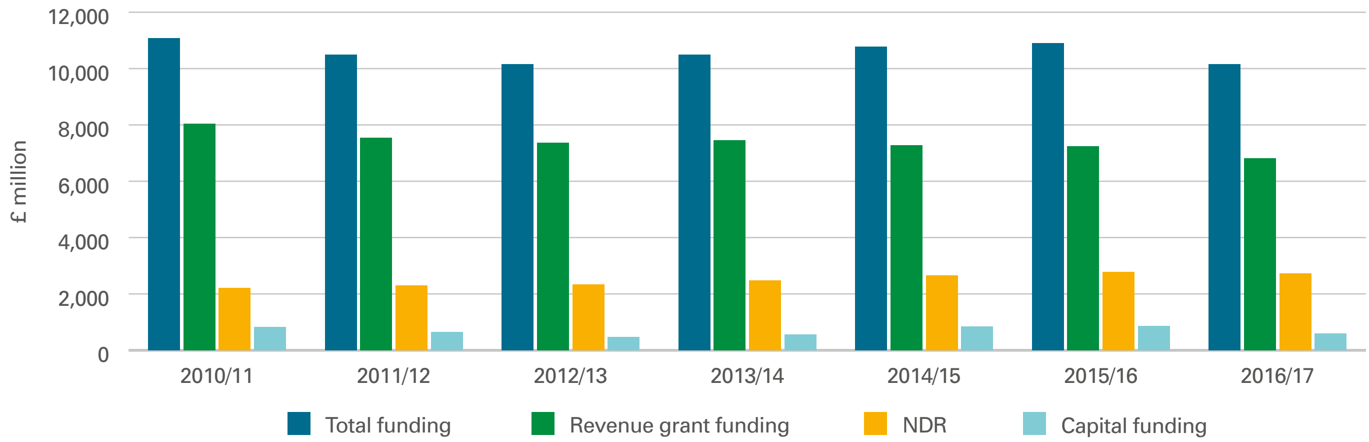
Scottish Government revenue funding fell by almost seven per cent between 2010/11 and 2016/17, and further reductions are expected

18. In 2016/17, Scottish Government grant funding has fallen by £489 million to £9.6 billion. This is a greater reduction than in previous years and represents a real-terms annual reduction in revenue grant of 5.9 per cent and NDR of 2.2 per cent. Since 2010/11, combined revenue funding has fallen by 6.8 per cent (Exhibit 2).

Exhibit 2

Scottish Government funding to councils from 2010/11 to 2016/17, at 2015/16 prices

Councils are experiencing a long-term reduction in revenue funding.



Notes:

1. Funding allocations up to 2012/13 have been adjusted to remove funding for police and fire. Responsibility for these services transferred from local to central government in April 2013. From 2013/14, revenue funding includes payments for council tax reduction, replacing council tax benefit previously coming from the UK Government. We have also adjusted these figures for specific elements of the local government settlement relating to adjustments for police and fire pensions.
2. Since 2013/14, Scottish Government revenue funding has included payments of around £350 million per year to fund council tax reductions, replacing council tax benefit which previously came from the UK Government.
3. The 2016/17 figures do not include £250 million the Scottish Government allocated to health and social care integration authorities specifically for social care. This is an allocation from the Scottish Government health budget to NHS boards, rather than councils. The NHS boards will allocate this funding to the integration authorities.

Source: Local Government Finance Circulars 2011-16, Scottish Government

19. Councils expect revenue funding to decrease in future years, although the extent of this is not clear as, the Scottish Government has provided councils with one-year funding settlements in 2015/16 and 2016/17. Councils contend that this constrains their ability to develop meaningful long-term financial strategies and medium-term financial plans. However, the challenging financial environment further strengthens the case for councils taking a long-term view of their finances Part 2 (page 19). There should be clear links between financial strategies and plans and councils' strategic priorities to provide a basis for decision-making.

How do you consider potential changes to income streams and their impact on spending and services as part of medium and long-term planning?

Income from NDR and council tax increased in some councils in 2015/16

20. In 2015/16, councils received £2.79 billion in NDR income, a real-terms annual increase of £134.3 million (5.1 per cent). Twenty-six councils saw an increase in their NDR income in 2015/16. This ranged from a £12.1 million (16.0 per cent) reduction in Falkirk Council to an increase of £26.5 million (7.3 per cent) in City of Edinburgh Council.

21. Council tax income was £2.1 billion in 2015/16, a real-terms annual increase of £32.3 million (1.6 per cent). With council tax levels being frozen nationally (paragraph 16), real terms increases and decreases will come about through changes in council tax relief and collection rates, as well as changes in the number of households paying council tax through new housebuilding, empty homes and/or depopulation. Council tax income increased in 29 councils but decreased in real terms in three (Aberdeenshire 1.4 per cent, Argyll and Bute 0.1 per cent and East Lothian 1.7 per cent.)

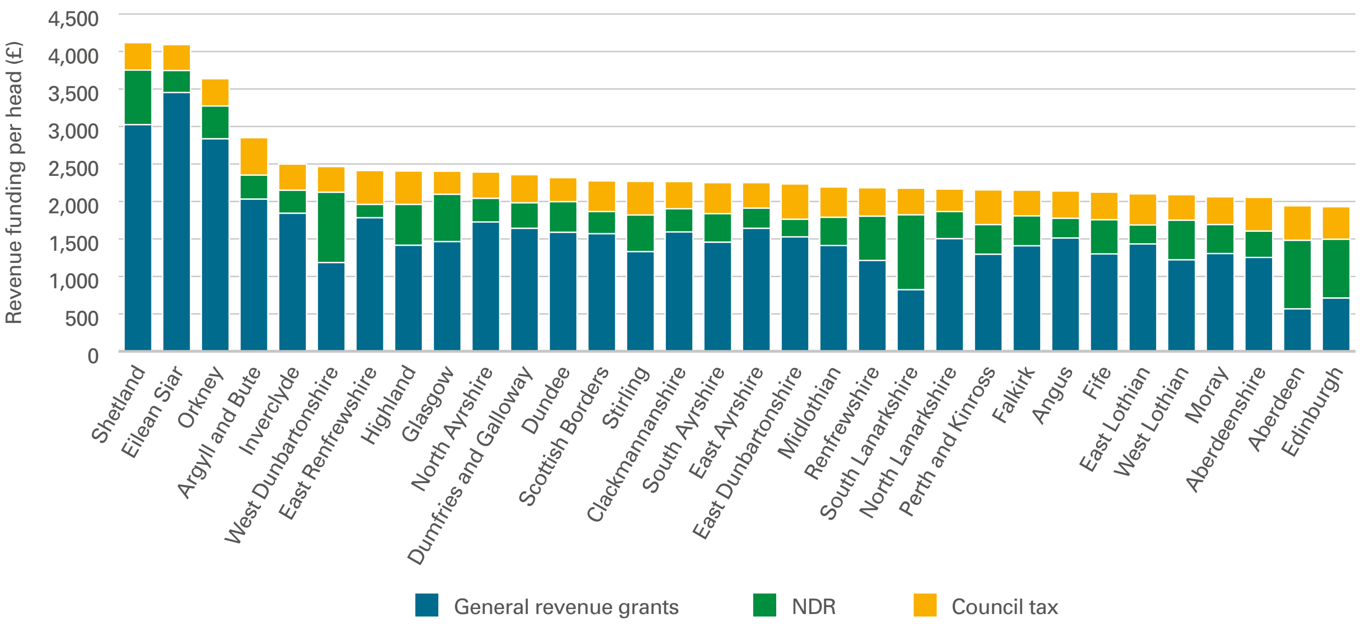
22. Councils collected 95.7 per cent of council tax in 2015/16. This was up from 95.3 per cent in 2014/15. Collection rates ranged from 93.6 per cent in Dundee City Council to 98.5 per cent in Perth and Kinross Council. We will look in more detail at councils' performance in collecting council tax and the associated costs in our March 2017 report.

23. The funding available to councils from Scottish Government general revenue grants, NDR and council tax varies widely. For Scotland, this equated to £2,232 per person in 2015/16. This is around £14 (0.6 per cent) higher in real terms than in 2014/15 and around £214 (8.8 per cent) lower than in 2011/12. The highest revenue funding per person was in Shetland Islands Council, around £4,118; and the lowest was around £1,928 in City of Edinburgh Council (Exhibit 3). The variation in funding per head between councils can impact upon both their financial performance and financial position.

Exhibit 3

Revenue funding from general grants and taxation, 2015/16

Revenue funding per head varies significantly by council.



Note: General revenue grant funding allocations for individual councils are decided by a needs-based formula that takes into account a variety of factors including rurality (including an allowance for island authorities) and levels of deprivation.

Source: Councils' audited accounts for 2015/16; and General Registrar of Scotland mid-year population estimate for 2015

Councils are raising an increasing proportion of their income through fees, charges and specific grants

24. Councils' 2015/16 accounts show income from fees and charges and other specific grants income totalled £4.8 billion. In real terms, this was £324.0 million (7.2 per cent) more than in 2014/15 and represents the largest growth area in council income. Service income increased in a number of areas, including education, roads and transport. The most significant increase was within social work and social care services, reflecting how councils have accounted for funds provided by Integration Authorities for delivering services.[3] Service income from other areas, including environmental and planning and development services, fell in real terms.

25. Councils' accounts do not show how much of their income is specifically from service charges. In 2013, the Accounts Commission highlighted that councils need to be clear about how their charging policies affect local citizens.[4] Charges should not be set in isolation. Any decision to vary or introduce charges to generate income should take account of the council's priorities. We will be looking at this again in our future work programme.

Capital income increased in 2015/16, reflecting earlier Scottish Government decisions about capital funding

26. In 2015/16, councils' total capital income was £0.9 billion. This represented a real-terms annual increase of £50.4 million (5.8 per cent). £856.3 million of this capital income came from Scottish Government grant funding. Between 2010/11 and 2015/16, capital funding from the Scottish Government increased by three per cent in real terms.

27. As part of its 2011/12 Spending Review, the Scottish Government rescheduled some of councils' planned capital grant funding for 2012/13 and 2013/14 by two years. As a result, capital allocations in 2014/15 and 2015/16 were around 50 per cent more than originally planned. Scottish Government capital funding in 2016/17 has fallen to £597.9 million owing to the Scottish Government again rescheduling capital funding (£150 million) to later years.

28. When councils borrow, it is mainly to finance assets such as buildings, schools and houses. Councils' current and planned capital expenditure therefore impacts upon what they borrow, their total levels of debt and the level of reserves they hold. In Part 2 (page 19), we examine the financial position of councils and how debt and reserves directly affect this.

Councils' spending on services increased in 2015/16 but is lower than five years ago

29. In 2015/16, councils spent £19.5 billion (revenue and capital). This real-terms increase of £708.9 million on 2014/15 was driven by increased spending in 22 councils. Although councils spent £0.6 billion more than their income, this can be attributed in part to accounting adjustments that councils must make in their annual accounts.

30. Councils' spending included pensions and interest on borrowing, but the vast majority (94.2 per cent) was spent on providing services to their communities. At £18.3 billion, this was a real-terms increase of £756.6 million (4.3 per cent) on 2014/15.

Is income from fees and charges clearly reported?

What increases in fees and charges are planned and how will these affect your citizens? Do you consider local economic impacts?

How do your fees and charges compare to other councils?

Is your capital investment programme appropriately funded?

31. Twenty-six councils own council houses. In 2015/16, these 26 councils spent £1.3 billion on council housing, around 6.5 per cent of total local government spending. This ranged from three per cent of total spending in Shetland Islands Council to 19.2 per cent of spending in Aberdeen City Council.

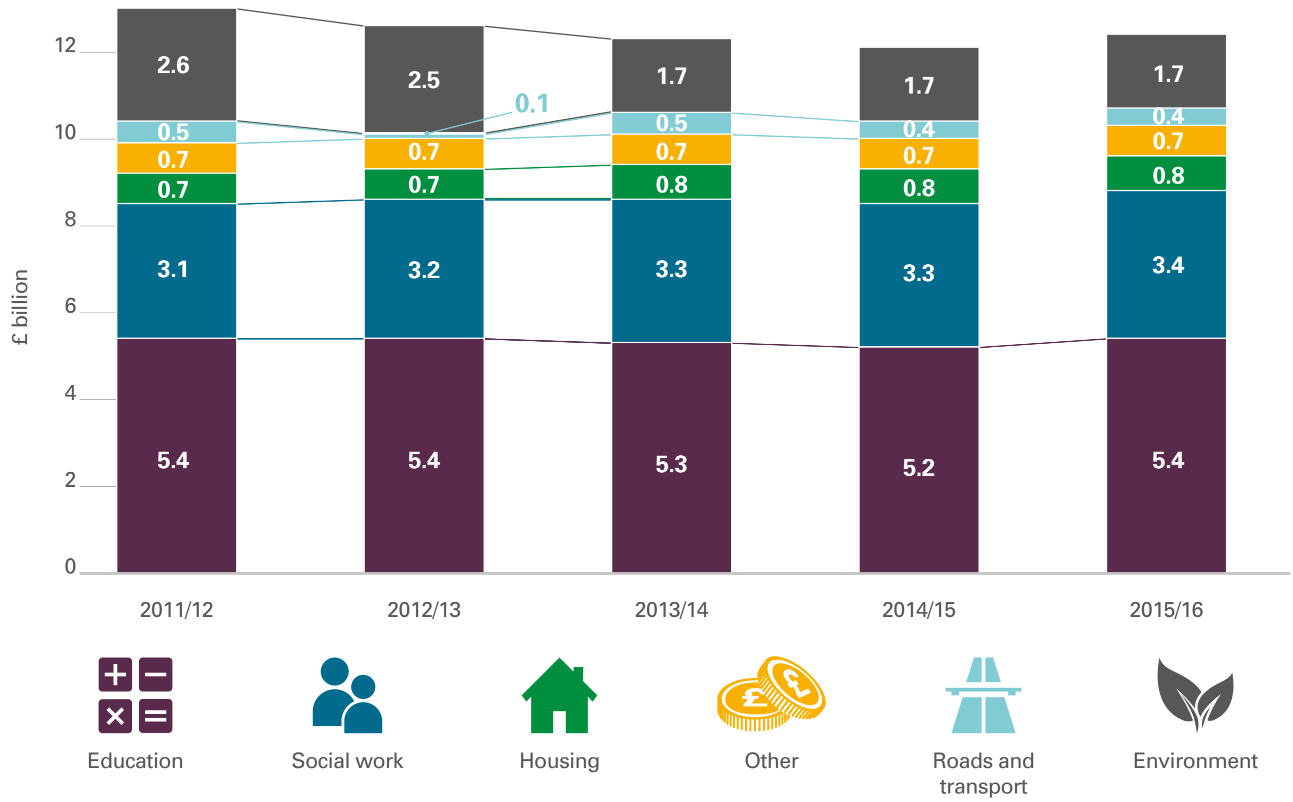
32. Overall, council expenditure remains 1.4 per cent lower than in 2011/12. Councils have managed financial pressures by controlling net spending (spending minus service income) over time. However, net service spending in 2015/16 was higher than in 2014/15, at £12.4 billion. The increase in 2015/16 included a real-terms increase of £217.3 million in net spending on education, driven by additional funding from the Scottish Government to support national educational priorities.

33. Real-terms spending on other services, such as roads and housing, has been maintained or reduced over time. The exception to this is social work and social care, where net spending has increased by £268 million (8.6 per cent) since 2011/12 (Exhibit 4). This reflects the increasing demand from a growing elderly population, which presents a huge challenge for both health and social care.[5]

Exhibit 4

Council spending on main services, 2011/12 to 2015/16 (at 2015/16 prices)

Councils have reduced or maintained real-terms net spending in a number of service areas, but there have been annual increases within social work.



Notes:
1. The figures show net spending, which is the total amount spent less any income from fees, charges or other service income.
2. Housing figures include spending from the General Fund (GF) and Housing Revenue Account (HRA).

Source: Councils' audited annual accounts, 2011/12-2015/16

Councils spent around £2.4 billion on capital projects in 2015/16, with around a quarter of this spent on council housing projects

34. Of the £19.5 billion that councils spent in 2015/16, £2.4 billion (12 per cent) was on investing in capital projects such as buildings, roads and equipment. Just over a quarter of this capital spending (£632 million, 27 per cent) was on council housing projects. Capital spending ranged from £13.8 million in Shetland Islands Council to £191.9 million in City of Edinburgh Council.

35. There is a wide range in the scale of councils' capital investment programmes relative to their other expenditure. For example, less than seven per cent of total spending in East Ayrshire Council was on capital projects, while it was over 20 per cent of total spending in Highland Council. Capital investment will be driven largely by the condition of councils' current estate and their local priorities. Capital investment can reduce ongoing revenue expenditure and generate income, but it also incurs long-term costs that impact on councils' revenue budgets.

36. The majority of councils (28) underspent significantly against their combined General Fund and Housing Revenue Accounts (HRA) capital budgets in 2015/16. Common reasons for this were project delays and project slippage where spending did not progress as expected. Where possible, councils attempted to offset this by bringing projects scheduled for later years forward into 2015/16. For example, Angus Council spent £48.3 million on its General Fund capital programme in 2015/16, £4.0 million (eight per cent) less than budgeted. This was after the council offset some of the forecast shortfall by bringing forward two education projects and beginning them in 2015/16 rather than in 2016/17.

Do you know what slippage there has been in capital projects and why? Are you assured that appropriate action is being taken?

Over two-thirds of councils remained within their overall budgets in 2015/16 but there were variations within individual services

37. Councils are required to submit their annual budget and expected expenditure (provisional outturn) to the Scottish Government. Like the budgets presented to councillors, these are prepared on a funding basis and this differs from the figures in the annual accounts (Supplement 1 outlines the differences).

38. Throughout the year councils will revise their initial budget estimates to take into account factors such as extra funding. Our analysis of annual accounts and the information councils provide to the Scottish Government indicates that provisional outturns were relatively accurate when compared to actual spending, with actual expenditure being within two per cent in most cases. (Exhibit 5, page 17).

39. While over two-thirds of councils have remained in line with their overall budgets in 2015/16, there are significant variations in how different services have performed within councils. Where some services are significantly overspending, this may be offset by underspends elsewhere and result in a council remaining within their overall budget.

Do service budgets reflect your priorities?

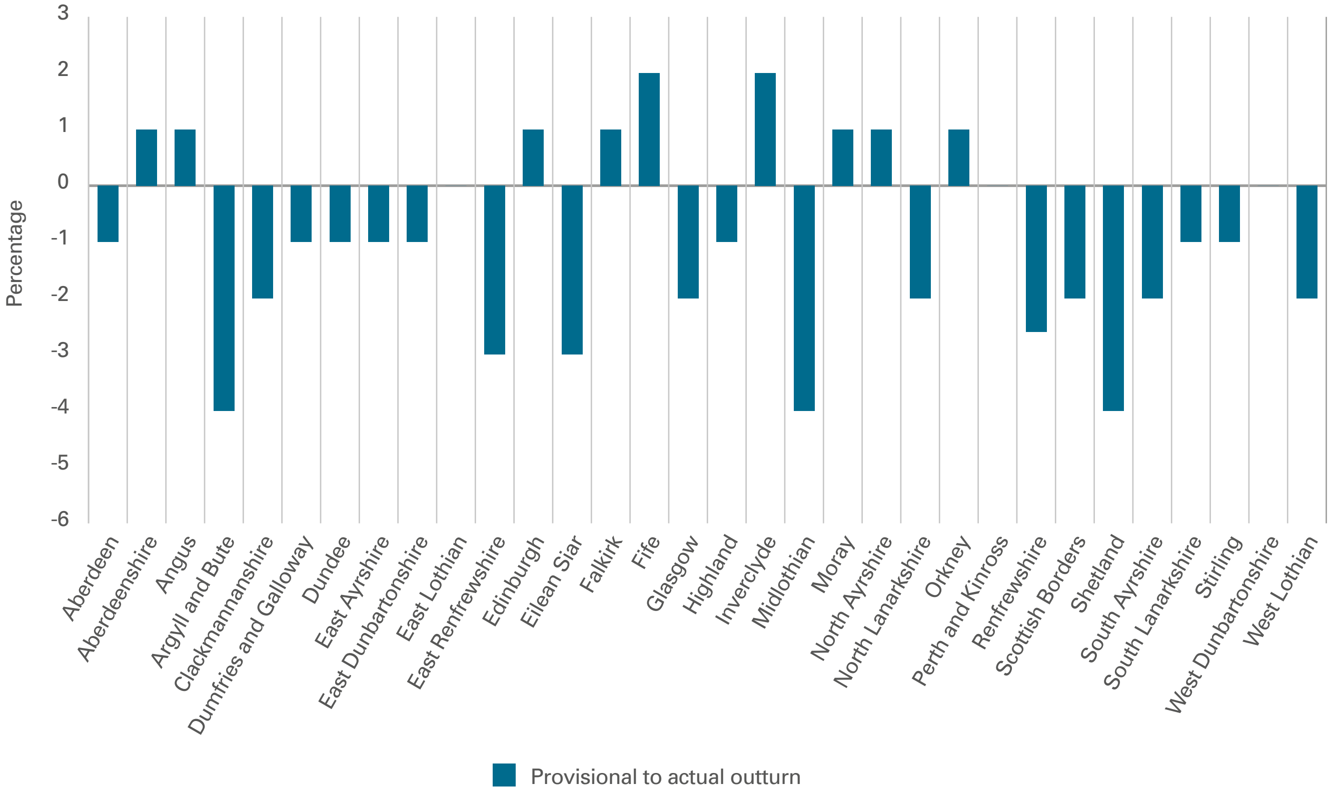
Are potential overspends highlighted to you as they occur and before year-end?

40. Our review of councils' annual audit reports has highlighted a number of service areas where councils commonly over-or underspent against their budgets. Around a third of the reports highlighted overspending in social work or elements of social work services. Aberdeenshire Council, for example, overspent against its adult social work budget by £2.0 million, with a £2.7 million overspend on care packages being the main contributor to this. A number of councils, including Clackmannanshire, Dundee and Falkirk, reported overspending relating to fostering services and residential school placements.

Exhibit 5

Councils' provisional and actual net service expenditure, 2015/16

Only a few councils spent significantly more or less than they estimated near the end of the year.



Note: Budget figures that councils submit to the Scottish Government are prepared on a funding basis (Supplement 2). While there is no corresponding figure in the annual accounts, we are able to adjust the figures from the accounts to allow final service spending from the accounts to be compared to councils' provisional outturns.

Source: Councils' audited accounts 2015/16; and Provisional Outturn and Budget Estimate Statistics 2015/16, Scottish Government

41. Conversely, around a third of councils reported underspending against their education budgets or elements of these, and several councils underspent against their social work budgets. Last year, we reported that City of Edinburgh Council overspent its health and social care service budget by £5.9 million owing to demand pressures. In 2015/16, the service received additional funding of £9.8 million to provide additional short-term support and underspent its total budget by £3.4 million.

42. The need for budgets and forecasts to reflect actual spending becomes increasingly important for councils with decreasing or low levels of usable reserves to draw on. Councils cannot continue to rely on underspends in certain services offsetting overspending elsewhere. Where services have been found to consistently overspend, budgets should be revised to reflect true spending levels and patterns. This requires good financial management to ensure spending is accurately forecast and monitored within the year. The impact of current spending approved by councillors on the financial position can only be accurately assessed if budgets are robust.

Are there services where you are consistently over or under spending against your budget? Are such variances adequately explained?

Councils continue to generate savings through reducing their workforce

43. Councils have continued to reduce their workforces to make recurring savings. In doing so, they incur significant initial costs, typically lump sum payments for redundancy or early retirement, and additional payments to pension schemes if employees are offered enhanced benefits or early access to their pension. Councils' decisions on reducing their workforce numbers through exit packages are supported by business cases which set out the associated costs and potential savings. Councils will typically expect to recoup the costs and start making savings within a few years.[6]

44. In 2015/16, 2,246 staff left councils through exit packages at a total cost of £79.7 million. This represents an average cost of around £35,500 per package. In the last five years, just over 13,000 staff have left councils through exit packages at a cost of £518.5 million (at 2015/16 prices) (Exhibit 6). We will consider how councils are managing their workforces in more detail in our March 2017 report.

Are exit packages supported by business cases setting out the total estimated costs and savings?

Exhibit 6

Number and cost of staff exit packages, 2011/12 to 2015/16

Over 13,000 staff have left via exit packages since 2011/12 at a cost of £518.5 million at 2015/16 prices. The average cost per package has been reducing since 2012/13 and is less than £40,000 over the period.

2015/16 prices	2011/12	2012/13	2013/14	2014/15	2015/16	Total
Number of packages	4,070	2,407	2,373	1,933	2,246	**13,029**
Cost of packages (£m)	156.9	112.7	94.2	75.0	79.7	**518.5**
Cost per package (£)	£38,555	£46,818	£39,681	£38,798	£35,504	**£39,797**

Source: Councils' audited accounts 2011/12-2015/16

Equal pay claims impact on councils' financial position

45. Equal pay remains a substantial issue for local government and continues to be of public interest. Settling claims may require councils to use a significant amount of their usable reserves, influencing their financial position. The Accounts Commission is currently carrying out a performance audit on equal pay and will publish our findings in 2017.

Part 2

Financial outlook

Key messages

1 By the end of 2015/16, usable reserves had risen by five per cent across local government and net debt decreased slightly for the second year in a row. Some councils are building up reserves and reducing borrowing in anticipation of further funding reductions.

2 Councils' net debt currently stands at £13.72 billion. Councils currently spend around £1.5 billion a year on the associated interest and repayments. The proportion of their income that councils spend on servicing debt varies and this has direct implications for the amount available to spend on services.

3 Local Government Pension Scheme (LGPS) deficits decreased from £10.0 billion to £7.6 billion in 2015/16. Despite this, councils and pension funds continue to face challenges from below-target or negative returns on investments and increasing administration costs.

4 All councils face future funding gaps and there is significant variation in how well placed individual councils are to address them. Councils will need to make further savings and/or generate additional income as relying on reserves is not sustainable. Opportunities to make savings are partly affected by national policy commitments and the costs of servicing debt. Councils' ability to make savings will also be influenced by the level of savings they have already made and the extent of their plans for transforming how services are delivered. It is therefore important that councils' savings plans are achievable within the timescales required.

5 Councils face tough decisions around their finances that require strong leadership and sound financial management. Long-term financial strategies must be in place to ensure council spending is aligned with priorities. Decisions need to be informed by well-developed medium-term financial plans and budget forecasts that allow councillors and officers to assess the impact of approved spending on their longer-term financial position.

all councils should have long-term financial strategies supported by more detailed financial plans

Councils continued to increase their usable reserves and reduced their net external debt in 2015/16

Usable reserves reached £2.5 billion in 2015/16

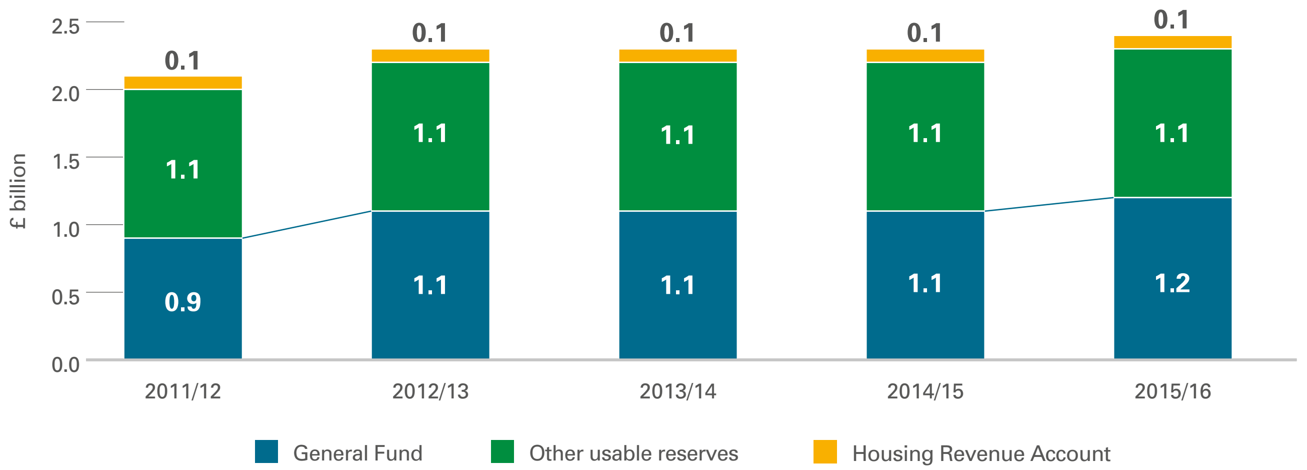
46. Councils' reserves at 31 March 2016 were £18.9 billion. Of these, £2.5 billion (13 per cent) were usable reserves that can be used to support services (these are often referred to as cash-backed reserves). The remainder were unusable reserves (£16.4 billion), which represent accounting adjustments to reflect things such as an increase in the value of council-owned buildings. Continuing the trend in recent years, councils increased both their usable and unusable reserves during 2015/16.

47. Usable reserves comprised £1.9 billion of revenue and £0.6 billion of capital reserves. The General Fund, which can be used to support a wide variety of services, is the largest usable reserve. Together with the Housing Revenue Account (HRA) reserve, these represent over half of usable reserves (Exhibit 7).

Exhibit 7

Councils' usable reserves, 2011/12 to 2015/16

Usable reserves have increased since 2011/12.



The level of General Fund reserves as a proportion of income from general revenue grants, NDR and council tax income has increased slightly since 2011/12.

2011/12	2012/13	2013/14	2014/15	2015/16
7.6%	8.8%	9.2%	9.4%	9.8%

Note: Other usable reserves are primarily attributable to Orkney and Shetland Islands holding large reserves relating to oil, gas and harbour related activities.

Source: Councils' audited accounts 2011/12-2015/16

48. Twenty-three councils increased their General Fund reserves in 2015/16, resulting in an overall increase of £58.0 million (5.2 per cent) to £1.2 billion. This is equivalent to about nine per cent of councils' available revenue income from

Scottish Government grants, NDR, council tax and council house rents. Half of the 26 councils with council houses increased their HRA reserves. This resulted in HRA reserves increasing by £11.9 million (9.2 per cent) overall to £141.8 million.

49. While usable reserves can be used to support services, councillors must consider how and when these are used as they can only be used once. Use of reserves must comply with the council's annually reviewed reserves policy. This should be clearly linked to financial plans and consideration must be given to the impact on future financial position. Using reserves to support services in the short term is not sustainable unless they are used to support service transformation and generate future savings. A significant proportion of usable reserves held by councils have already been allocated for specific purposes and so will not be available for other uses.

Do you know what levels of reserves are needed and why?

Do you think reserves are being used effectively?

Net debt decreased again in 2015/16, but is set to rise as councils use their reserves to fund services

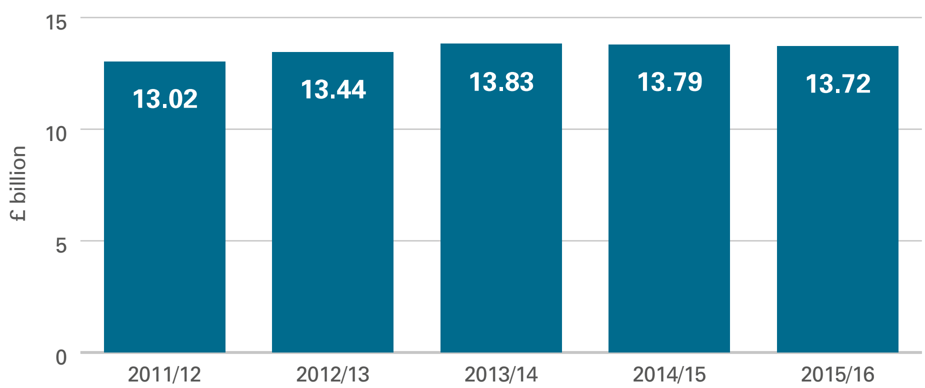
50. In 2015/16, Scotland's councils owned physical assets worth £38.3 billion. Councils can borrow from both external and internal sources to fund capital investment in new assets, such as building a school. Councils' assess the affordability of borrowing decisions under CIPFA's Prudential Code and it is up to individual councils as to what they borrow to invest in assets. External borrowing involves a council borrowing from another public sector body, from the financial markets or entering into a public-private partnership. Internal borrowing is when a council temporarily borrows from funds it has available, such as its reserves. This can delay it having to borrow externally. By doing this, a council will avoid paying costs to a lender but will also forego interest it could receive by investing its reserves.

51. For the second year in a row, councils' net debt (total external debt minus investments) decreased in 2015/16. The fall in net debt is largely a result of councils having higher levels of usable cash reserves that they can either invest or use to finance the capital expenditure for which they would otherwise have to borrow. Councils now have debt of around £15.2 billion and investments of around £1.5 billion. This means net debt is £13.72 billion, a reduction of £69 million (0.5 per cent) since 2014/15 (Exhibit 8).

Exhibit 8

Councils' net external debt, 2011/12 to 2015/16

Councils' net external debt has been falling but remains higher than in 2011/12.



Note: Orkney and Shetland Islands councils hold large reserves and investments related to oil, gas and harbour activity so are excluded from this analysis of net debt.

Source: Councils' audited accounts 2011/12-2015/16

52. We estimate value of internal borrowing across councils is about £0.9 billion. Interest payable on external debt is higher than the interest a council can receive on investments and so councils are utilising more internal borrowing to save money.

53. A key treasury management decision for councils will be when to borrow rather than use their cash reserves to fund projects. This will be influenced by councils' capital investment plans, the extent to which reserves are needed to support service spending as cost pressures increase (which means councils will need to borrow externally to replace the reserves used for internal borrowing) and whether any forecast change in interest rates makes external borrowing more attractive. The link between capital plans and debt is important and councillors must have a clear understanding of how changes in capital programmes will affect their council's debt position. Our report *Borrowing and treasury management in councils* outlines this in more detail.[7]

Are there clear links between the capital programme and treasury management strategy?

Councils spend around £1.5 billion on servicing debt each year

54. Councils' external debt comprises borrowing from a variety of sources:

- the Public Works Loan Board (PWLB), which is a UK Government agency
- long-term liabilities from assets acquired under public/private partnerships, including the Public Finance Initiative (PFI), Public/Private Partnerships (PPP) or the Scottish Government's newer Non-Profit Distributing (NPD) model (paragraphs 58 and 59)
- lender option/borrower option loans (LOBOs) (paragraph 60)
- other market loans.

Do you know the implications that different types of borrowing options have on future revenue budgets?

55. Within councils' accounts, debt is categorised by when it has to be repaid and not by source. It is also discounted to take into account factors such as when it has to be paid and interest payments. The source and value of councils' external debt in 2015/16 is shown in Exhibit 9 (page 23).

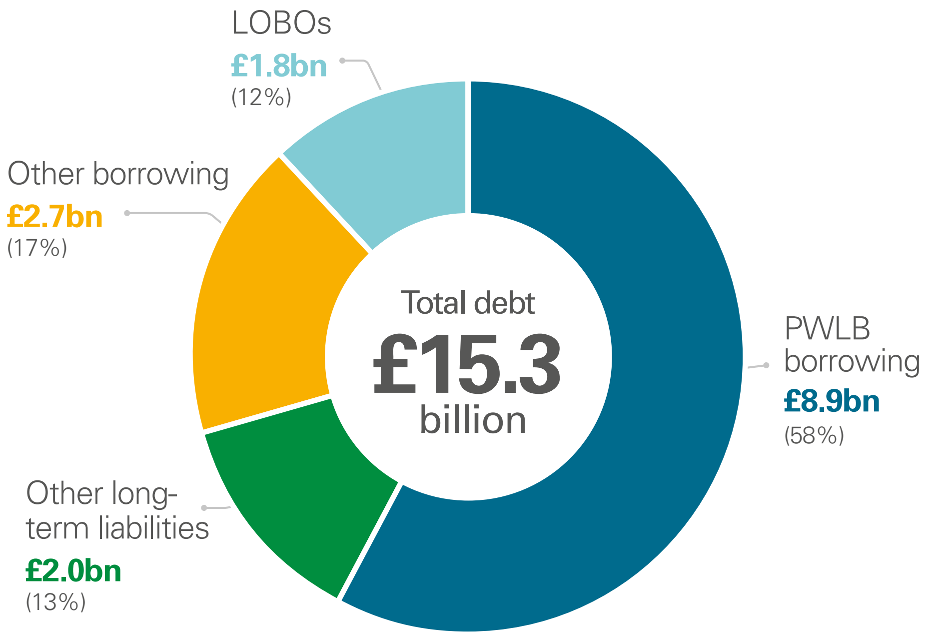
56. The presentation of local government accounts mean that it is not always possible to identify whether a council's debt is related to its HRA or its General Fund. This is an important distinction, as the cost of servicing HRA debt will affect council house rents, whereas the cost of servicing General Fund debt will need to be met from general revenue grants, NDR and council tax that are typically used to fund services.

Do you know the split in debt between General Fund and HRA (where applicable)? Is this reported within your management commentary?

57. The capital finance requirement included in councils' accounts, a measure of what council debt still needs to be financed, can be split between the HRA and General Fund. Using this split, we have apportioned debt to both the HRA and General Fund Exhibit 10 (page 23). This shows considerable variation.

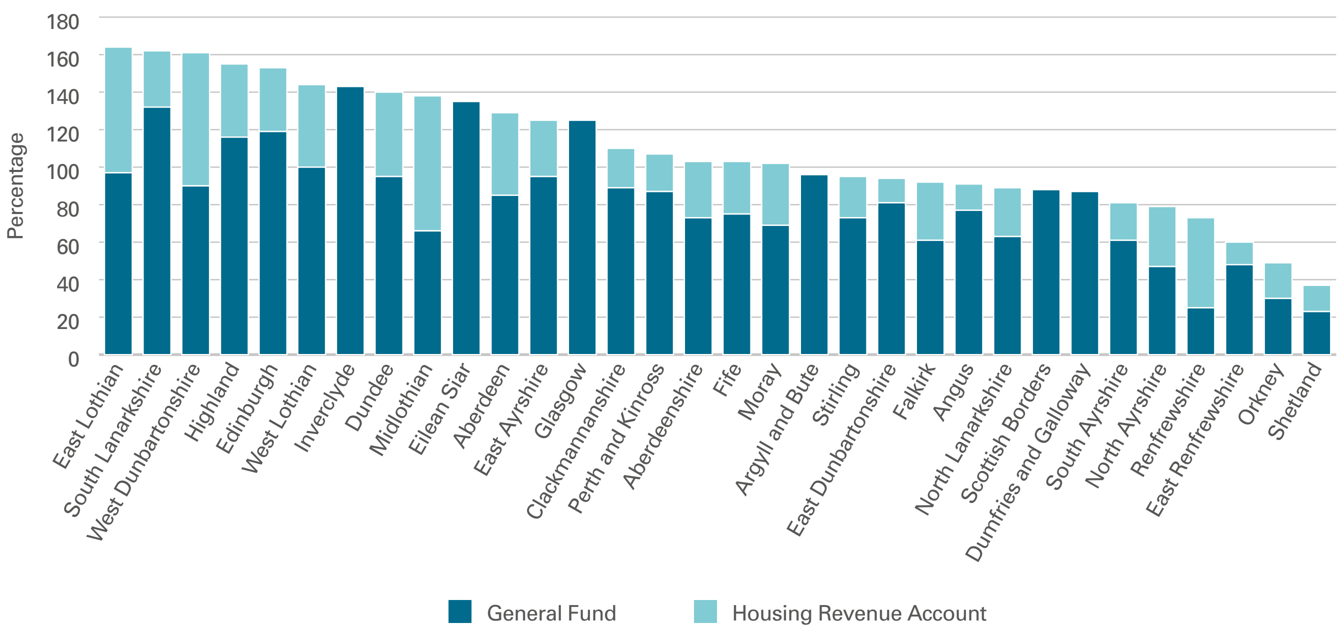
58. Most council debt takes the form of traditional fixed interest rate loans, providing certainty over future interest payments. The exception to this is PFI/PPP/NPD debt and LOBOs. The cost of PFI/PPP/NPD debt is generally acknowledged to be more expensive than traditional borrowing, as repayments are usually inflation-linked. Councils should have considered this in their value for money assessments. Councils with a high proportion of PFI/PPP/NPD debt will have to make more complex affordability assessments for future borrowing. Exhibit 11 (page 24) shows levels of General Fund debt relative to the size of council, with the debt split between borrowing and other long-term liabilities (PFI/PPP/NPD and finance leases).

Exhibit 9
Sources of councils' debt, 2015/16
Over half of council debt is borrowing from the PWLB.



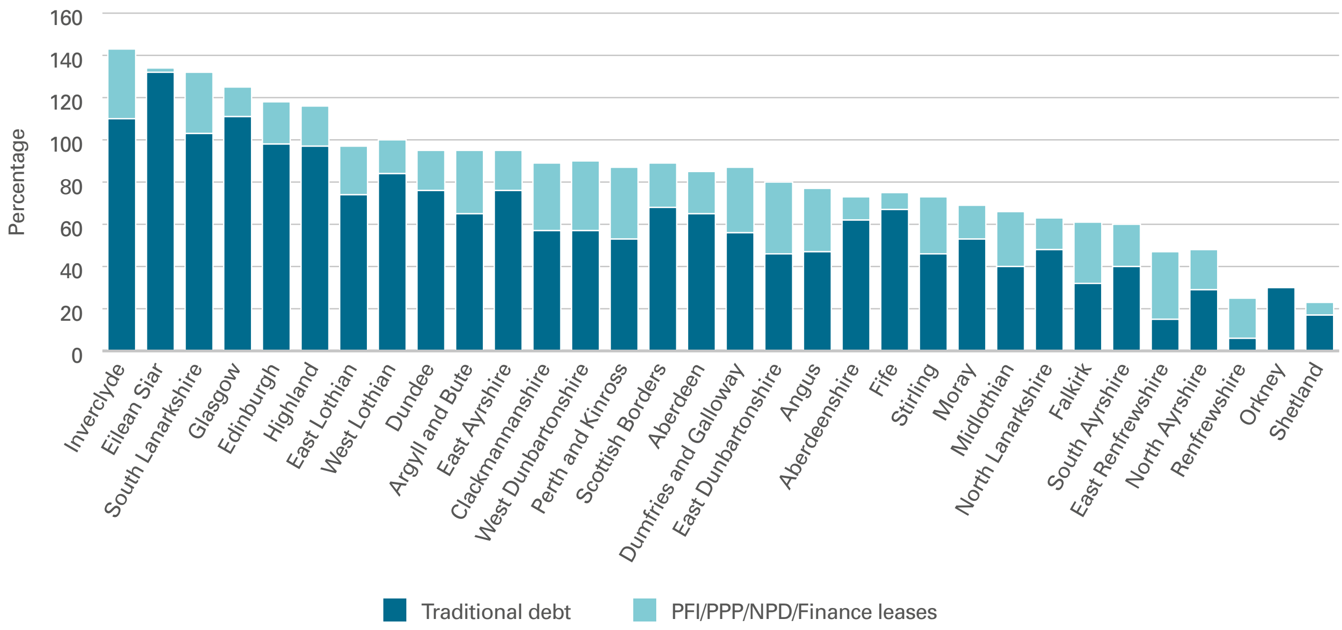
Note: Total figure subjects to rounding.
Source: Councils' audited accounts 2015/16 and auditor returns

Exhibit 10
Councils' total debt as a proportion of their annual income, 2015/16
Councils' debt varies from less than half to more than one and a half times their annual income.



Source: Audit Scotland's analysis of councils' audited accounts 2015/16

Exhibit 11
Councils' General Fund debt, 2015/16
Councils with more debt relating to PFI/PPP/NPD projects and finance leases may face higher costs.



Source: Audit Scotland's analysis of councils' audited accounts 2015/16

59. As well as the debt and debt repayments associated with public/private partnerships, there are also significant revenue costs associated with these projects. Under the terms of the contracts, councils make annual repayments (unitary charges). Around 90 per cent of annual unitary charges relate to schools projects. The charges are made up of three elements: debt repayment, interest costs (both of which are included in debt servicing costs) and an annual service charge (included within the relevant service revenue spending). Councils' annual unitary charge payments are around £500 million per year. As councils' revenue budgets decrease, and the repayments increase in line with inflation, the proportion of revenue budgets being used to service the revenue elements of these contracts will increase.

60. LOBOs offered councils borrowing at lower interest rates than were available for fixed or variable interest loans but, at fixed intervals, a lender can decide to change the interest rate. As such, the long-term cost of servicing LOBOs is uncertain. While councils benefited from lower interest rates offered by LOBOs, their use has attracted public interest owing to the financial risk to which councils are exposed from the potential change in the interest rate.

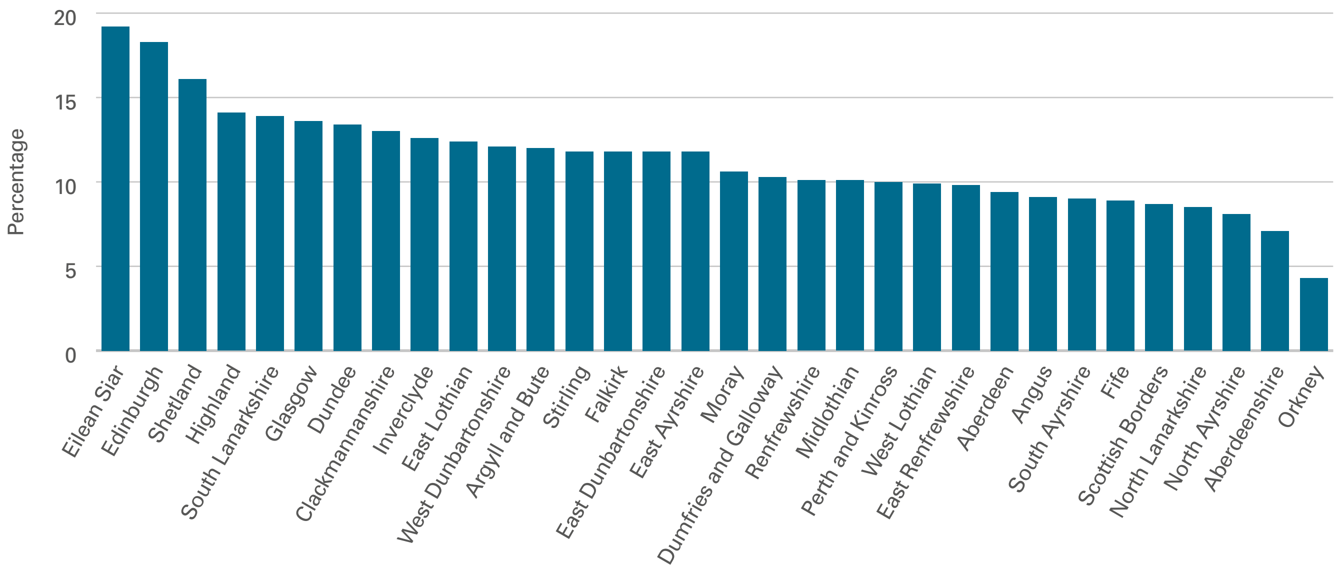
61. The cost of servicing debt (repaying debt and interest costs) will depend on the mix of borrowing a council has, the interest rates secured at the time loans were taken out and the amounts it requires to set aside to repay debt. In 2015/16, this cost councils around £1.5 billion, equivalent to 12 per cent of their available funding from general government revenue grants, NDR, council tax and council housing rents. The percentage of this funding that councils use to service debt varies significantly, from 19.2 per cent in Comhairle nan Eilean Siar to 4.3 per cent in Orkney Islands Council. Aberdeenshire Council, with 7.1 per cent, is the council with the next smallest percentage of income used to service debt (Exhibit 12, page 25).

Do you know how debt repayments affect what money is available to spend on services?

Exhibit 12

The percentage of income used to service debt, 2015/16

Twenty-two councils spend ten per cent or more of their revenue income on servicing their debt.



Source: Councils' audited accounts 2015/16

62. The cost of servicing debt directly impacts upon council spending on services. However, councils can elect to reduce their debt by making extra repayments or by repaying loans early. Councillors must satisfy themselves that any accelerated debt repayment represents an appropriate use of funds, balancing the future savings against the current impact on council services.

Local government pension deficits decreased in 2015/16, mainly owing to estimated changes in long-term liabilities

63. Councils have long-term commitments regarding pensions. They are required to include a pension liability on their balance sheets for the Local Government Pension Scheme (LGPS) but not for the Scottish Teachers Superannuation Scheme (STSS).

64. The size of council pension liabilities varies significantly and depends on factors including:

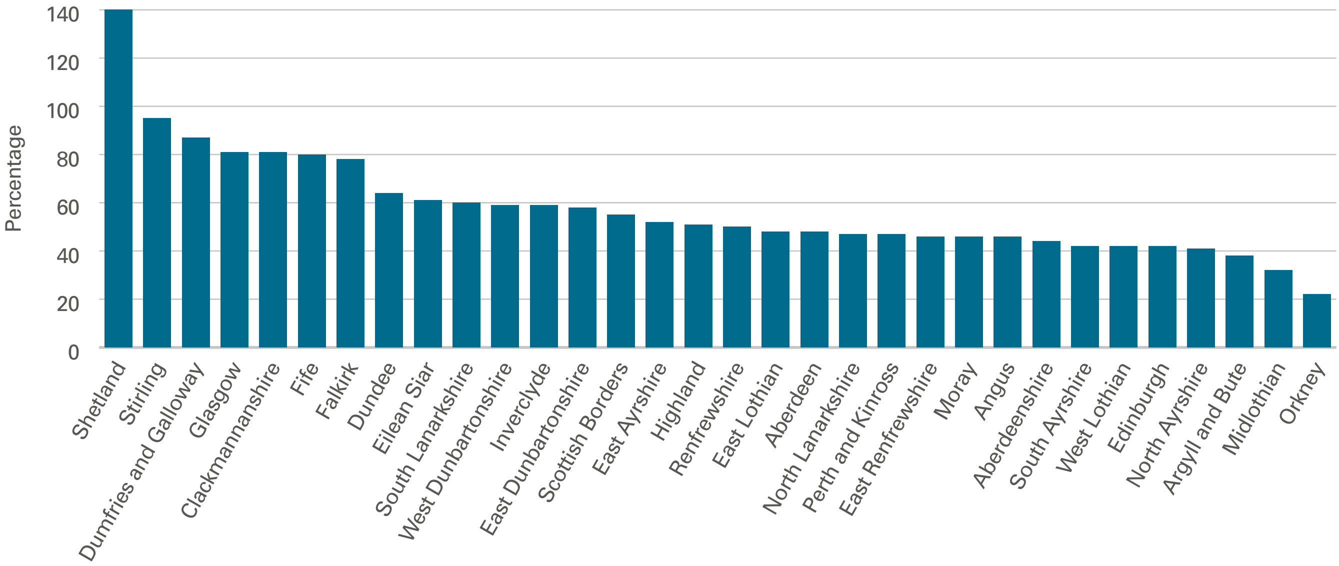
- performance of the pension funds of which they are members
- assumptions made by actuaries of the various funds
- the maturity of the council's membership (average age of pension scheme members)
- decisions made by councils to award discretionary benefits to staff retiring early.

65. Councils with larger pension liabilities will tend to have higher annual costs. The scale of the challenge for each council in meeting these costs can be illustrated by considering their pension liability in relation to their annual income (Exhibit 13, page 26).

Exhibit 13

Council pension liabilities (LGPS and discretionary benefits awarded), 2015/16

Councils' pension liabilities range from around 1.4 to 0.2 times their annual revenue incomes.



Source: Councils' audited accounts 2015/16

66. The LGPS is a funded pension scheme, where employers' and employees' contributions are invested to meet the cost of future benefits. For most councils, the estimated value of employees' benefits exceeds the current value of investments, leading to a net pension deficit. Councils' pension deficits reduced from £10.0 billion to around £7.6 billion during 2015/16 (Exhibit 14, page 27). This reduction is primarily due to actuarial calculations discounting the current value of what the funds will need to pay in the future. The factors contributing to this decrease include assumptions around inflation and salary increases decreasing and the discount rate increasing significantly.

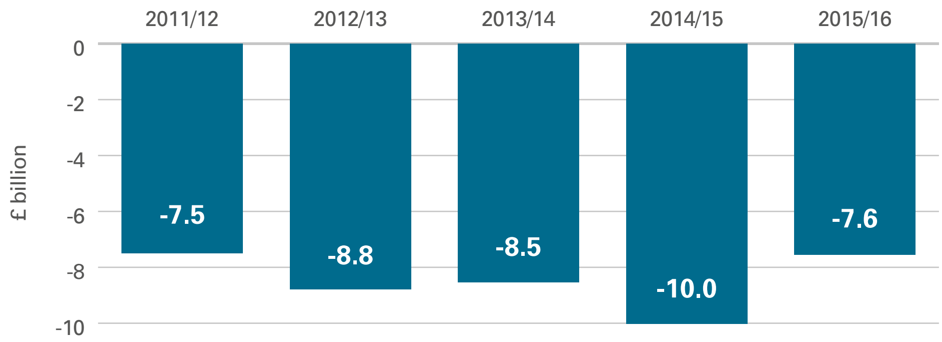
67. With increasing life expectancy, pension contributions have risen to help meet the increased cost of providing pension benefits. Employer contributions in respect of teachers increased by two per cent to 17.2 per cent in October 2016. Councils' contributions to the LGPS are reviewed every three years and will next be reviewed in 2017.

68. In 2015/16, the new 2015 LGPS was introduced. This sees pensions based on average career earnings and the pension retirement age linked to the state retirement age. The scheme includes a cost-sharing mechanism that limits employer costs to ensure it remains affordable. This cap is set by considering the cost associated with active members and will come into force when these reach a maximum of 17.5 per cent for the whole of the scheme (rather than for individual employers).

Exhibit 14

Pension deficits on councils' balance sheets, 2011/12 to 2015/16

Councils' pension deficits decreased in 2015/16, mainly owing to actuarial calculations discounting the value of future commitments.



Source: Councils' audited accounts 2011/12-2015/16

69. Alongside changes to the LGPS, pension auto-enrolment for existing and new employees is now in place. Traditionally there is high pension scheme membership among council staff but there will be additional costs associated with existing and new staff joining the pension scheme.

70. The councils that administer the 11 LGPS funds in Scotland have coped well with these changes. However, the scheme changes, combined with workloads associated with councils reducing their staffing costs through voluntary severance and having to administer added year payments, means there are ongoing administrative pressures.

71. We comment on the 11 LGPS funds, their accounts, governance and performance in a supplement to this report (Supplement 2: Local Government Pension Funds 2015/16).

Good financial planning and management are required to ensure the impact of spending decisions is fully understood

72. Councils are developing their financial strategies and plans in an increasingly complex environment. It is imperative that long-term financial strategies (covering five to ten years) link spending to councils' strategic priorities and that spending plans are considered in this context.

73. The Commission recognises that the Scottish Government providing funding settlement figures for a single year (as in 2016/17 and 2017/18) presents challenges to councils updating medium-term financial plans and ensuring they have long-term financial strategies in place. Although we recognise changes in Scottish Government funding may alter assumptions in both the long and medium terms, the absence of indicative funding should not prevent councils projecting future income and spending, and planning accordingly.

74. Fourteen councils currently have long-term financial strategies in place while 15 others have at least a medium-term financial strategy (three to five years) linking their spending plans to their wider strategic priorities. Three councils (East Renfrewshire, Glasgow City and Highland) do not have a financial strategy covering the medium or long term.

Do you have a long-term financial strategy covering five to ten years?

Are there clear links between the financial strategy and the vision for the future?

Is the long-term financial strategy supported by detailed plans covering a minimum of three years?

75. Twenty-nine councils have either medium-or long-term financial plans that set out planned spending, the savings required and how they intend to use reserves to support spending. Two councils have financial plans covering less than three years (Falkirk and Glasgow City). Orkney Islands Council does not have a financial plan but has a medium term financial strategy and a change programme is in place to deliver the medium-term savings identified.

76. There should be very clear links between a council's medium-term financial plan and the annual budgets that councillors approve. Although councillors approve only the budget for a single year, this should be supported by indicative future spending plans that forecast the impact of relevant pressures for councils. Presenting a budget for a single year in isolation does not allow councillors to fully scrutinise the implications of spending decisions.

77. There is variation across councils in how they presented indicative future budgets to councillors alongside their 2016/17 budget. Twenty-three councils presented budgets up to 2018/19; four (Glasgow City, North Ayrshire, South Ayrshire and West Lothian) presented budgets up to 2017/18; and five (Aberdeen City, Angus, Dundee City, Orkney Islands and Renfrewshire) presented budget figures for 2016/17 only.

Councils face significant funding gaps over the next three years

78. We asked auditors to provide information about budgets for 2016/17 and indicative plans for 2017/18 and 2018/19 that were presented to councillors when the 2016/17 budget was being approved (Appendix (page 34). We focused on the largest elements of councils' budgets: the General Fund revenue budget; the level of approved savings within this budget; and the potential impact of this upon councils' General Fund reserves.

79. Within our analysis we have made several simplifying assumptions. We have only adjusted for savings approved in 2016/17 and further savings will have been identified. When approved these savings will offset future funding gaps. We have also assumed that any identified funding gaps will be met from General Fund reserves when councils' can also use other usable reserves to support spending. Finally, we have assumed that all General Fund reserves are available to close identified funding gaps when a significant proportion of these reserves may have already been allocated.

80. Where councils did not provide information to their auditors about their forecast General Fund budgets in 2017/18 and 2018/19, we made some assumptions from available information. Most councils that provided information up to 2018/19 are forecasting a continued reduction in revenue funding from the Scottish Government but with increases in council tax receipts. They are also forecasting that spending will increase. In particular, they anticipate rising demand on key services through demographic changes and generally assume wage inflation of between 1.0 and 1.5 per cent in both 2017/18 and 2018/19.

81. At the time of setting the 2016/17 budgets, councils anticipated an £87 million in-year shortfall between General Fund revenue income (excluding any use of reserves) and expenditure (after approving savings of £524 million). They planned to bridge the gap by using seven per cent of existing General Fund reserves, reducing them from £1.2 billion to around £1.1 billion by the end of 2016/17.

82. All councils have adequate reserve cover in 2016/17, meaning at the end of the year they will still have General Fund reserves they can use in future. The

Is the long-term financial strategy supported by detailed plans covering a minimum of three years?

Do financial plans set out the implications of different levels of income, spending and activity?

Is there a clear link between the council's revenue plans and the budget information you are asked to approve?

Do financial plans identify the differences between income and expenditure for the next three years?

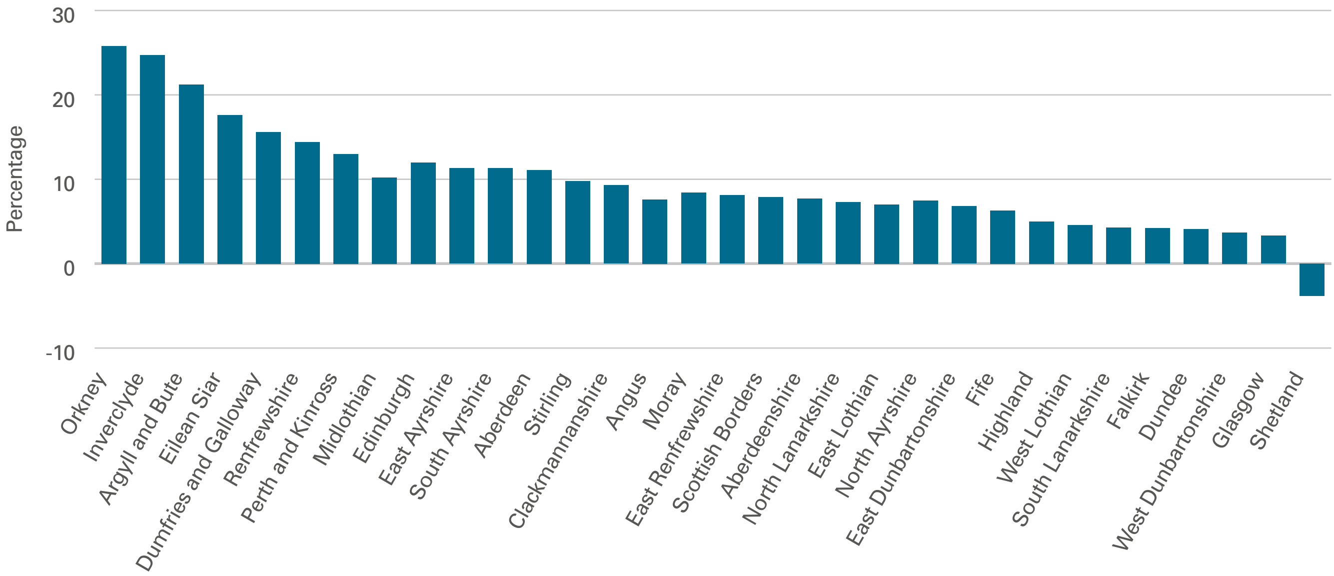
Do you know the actions being taken to close the funding gap?

exception is Shetland Islands Council, but only because of the way it classifies its sizeable reserves as opposed to any financial difficulties or it approving an unbalanced budget. General Fund reserves at the end of 2015/16 were equivalent to nine per cent of councils' overall income from the Scottish Government, NDR, council tax and council housing rents (paragraph 48). Adjusting for reserves that councils planned to use in 2016/17 reduces this to just over eight per cent (Exhibit 15). Councils will also have already allocated a proportion of their available reserves for specific purposes, and therefore what remains available as a contingency to support services will be significantly less.

Exhibit 15

2015/16 General Fund reserves as a percentage of councils' income, adjusted for planned reserve use in 2016/17

The level of reserves held as a percentage of income varies widely among councils.



Note: Shetland Islands Council classifies its reserves differently. This is not an indication of financial difficulties or an unbalanced budget.

Source: Councils' audited accounts 2015/16 and auditor returns

83. Seventeen councils planned to use reserves to balance their budget in 2016/17. This ranged from Angus Council planning to use 23 per cent of reserves to Dumfries and Galloway Council intending to use less than one per cent.

84. Excluding Shetland Islands Council, two councils (Falkirk and South Lanarkshire) forecasted a funding gap in excess of their General Fund reserves in 2017/18. A further 11 councils currently forecast a funding gap in excess of their General Fund reserves in 2018/19. Our analysis therefore indicates that by 2018/19, over a third of councils will face a funding gap that exceeds their General Fund reserves. We recognise that since setting their 2016/17 budgets this position will have changed as councils have continued to identify other savings to address funding gaps.

Exhibit 16

Council budget information for 2016/17, 2017/18 and 2018/19

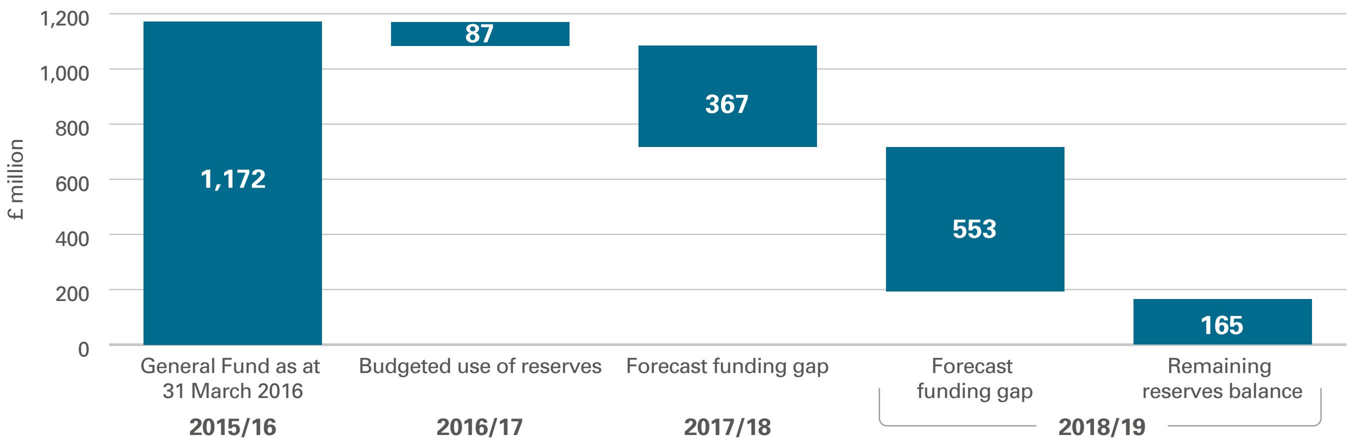
Councils planned to use £87 million of reserves in 2016/17 and forecast significant funding gaps in the following two years. There were significant forecasted funding gaps across the 23 councils that approved their 2016/17 budgets accompanied by indicative plans for the next two years.

	2016/17 (32 councils)	2017/18 (27 councils)	2018/19 (22 councils)
	Budget	**Forecast funding position**	**Forecast funding position**
Income	£11.94 billion	£10.32 billion	£7.85 billion
Expenditure	£12.02 billion	£10.65 billion	£8.25 billion
Budgeted use of reserves/ Forecast funding gap	£87 million	£323 million	£402 million

After applying assumptions derived from completed returns to estimate the position for councils that did not provide information for all three years, we estimated the following position:

	2016/17	2017/18	2018/19
	Budget	**Forecast funding position**	**Forecast funding position**
Income	£11.94 billion	£11.82 billion	£11.72 billion
Expenditure	£12.02 billion	£12.18 billion	£12.27 billion
Budgeted use of reserves/ Forecast funding gap	£87 million	£367 million	£553 million

The potential impact on General Fund reserve balances is illustrated below, assuming that further savings are not approved and funding gaps are met from General Fund reserves. A proportion of these reserves, however, will have already been allocated for other purposes.



Source: Councils' audited accounts 2015/16 and auditor returns

85. The level of General Fund reserves as a percentage of General Fund revenue expenditure would fall from 9.1 per cent at the end of 2016/17 to 1.2 per cent at the end of 2018/19 if all funding gaps had to be met from General Fund reserves. This reflects the need for councils to draw on a significant proportion of reserves if further savings are not identified and approved (Exhibit 16, page 30).

Councils need to appraise all possible options to address forecasted funding gaps

86. Councils need to make significant savings to address forecasted funding gaps without significantly reducing reserves in the next three years to support recurring spending. Councils' ability to make savings will be influenced by a range of factors, including:

- the level of savings they have already made and the extent of their plans for transforming how services are delivered
- national policy commitments for example, around education
- demographic changes increasing demand for services such as social care
- the costs of servicing debt, such as PPP/PFI/NPD revenue payments relating to school buildings.

87. In total, net spending on education, social work and interest payments on external debt equates on average to almost 75 per cent of local government income from general revenue grants, NDR, council tax and council housing rents. The variation across councils is shown in (Exhibit 17, page 32). Councils with a higher proportion of spending on education, social work and debt repayment may face greater challenges in generating their required savings, and potentially face making more significant savings in other areas. This highlights the importance of councils appraising all possible options for delivering their broad range of services. Recent Best Value audits have shown councils relying on incremental savings rather than considering service redesign options. The Commission is of the view that this is neither sufficient nor sustainable given the scale of the challenge facing councils.

Do you know what plans there are to redesign services and deliver savings?

Are savings plans realistic within agreed timescales?

Are all savings clearly identified and categorised as recurring or non-recurring (i.e. one off) savings?

Is the council reliant on non-recurring savings?

Do you know what will happen to the reserves if savings are not made?

Councillors should understand how the plans and budgets they are approving will affect the financial position of their council

88. Throughout this report, we ask councillors and officers to be clear about how their financial strategies, plans and agreed budgets affect their council's financial position. We would expect the following to form part of an assessment of the short and medium-term financial sustainability:

- confirmed and indicative changes in Scottish Government funding to councils
- how to avoid any short-term budget pressures, such as significant overspending in services that could result in the financial position of councils deteriorating
- whether future financial plans provide sufficient spending information to be considered when approving budgets.

Do you feel you have the knowledge and expertise to scrutinise your finances effectively?

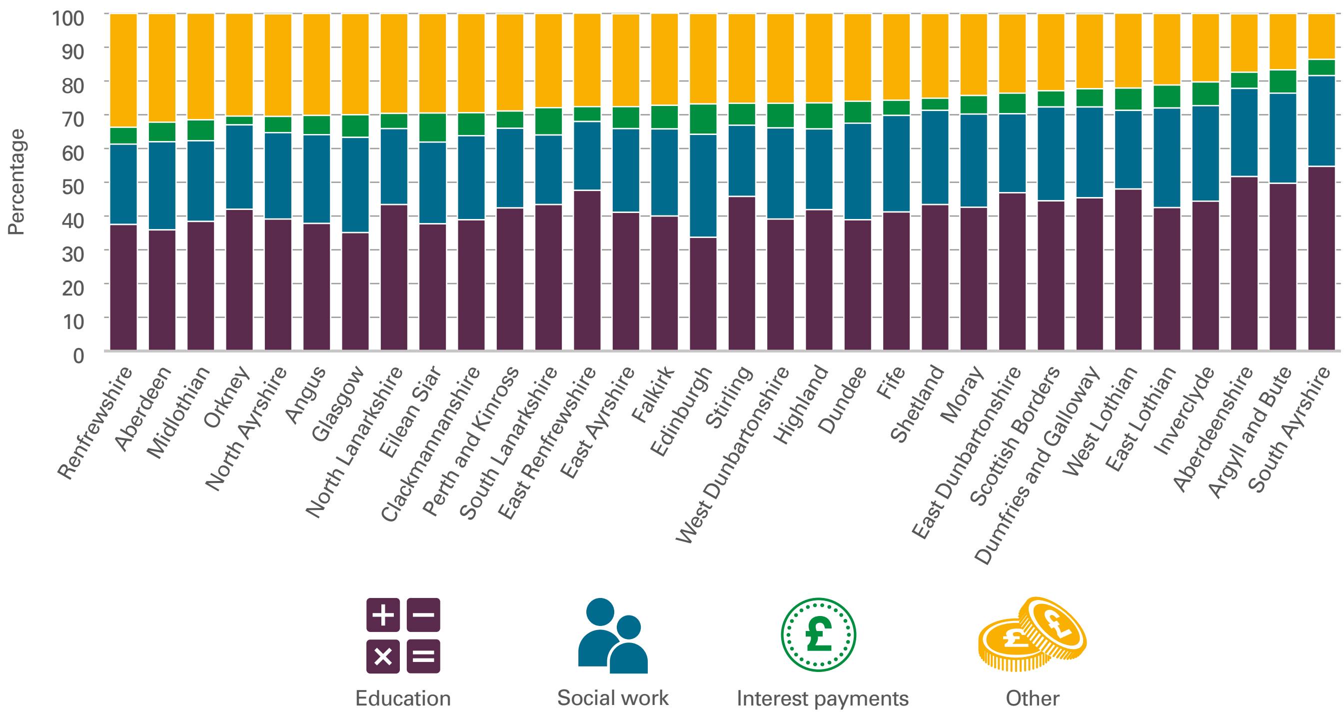
89. In the medium to long term, we would also expect the presence of long-term financial plans, and the assumptions these make, to be taken into account alongside the following factors:

- current reserve levels and how these will be used to support service transformation and delivery while continuing to provide a suitable level of contingency
- expected demand and ongoing cost pressures, including councils' pension obligations, and how these are likely to impact on the services councils need to deliver
- the impact options for investing in assets (such as buildings) will have on both councils' debt and available income, taking into account ongoing servicing costs.

Exhibit 17

Percentage of councils' income spent on education, social work and interest payments, 2015/16

Savings may be more difficult to identify where councils devote more spending to education, social work and paying interest on their external debt.



Notes: 1. Figures are from councils' accounts and include interest payments totalling £814 million, including annual interest costs associated with PFI/PPP/NPD projects. 2. The £1.5 billion debt servicing costs quoted elsewhere are on a funding basis and are not directly comparable for the purposes of this analysis and includes the annual repayments of debt related to PFI/PPP/NPD projects. 3. For the purposes of this analysis net spending on social work services includes money directed to and from Integration Authorities.

Source: Councils' audited accounts 2015/16

Endnotes

1 Most of the increase in service income is due to a £371 million increase in social work and social care income because of how councils have accounted for money being returned to councils from the new Integration Joint Boards (IJBs) which are now responsible for local health and social care.

2 Funding allocations up to 2012/13 have been adjusted to remove funding for police and fire. Responsibility for these services transferred from local to central government in April 2013. From 2013/14, revenue funding includes payments for council tax reduction, replacing council tax benefit previously coming from the UK Government.

3 Councils contribute to Integration Authorities (IAs), and receive money back to provide services on behalf of the IA. Social Work income in the accounts may be inflated depending on how councils have recorded this income received from the IA.

4 *How councils work: an improvement series for councillors and officers – Charging for services: are you getting it right?*, Audit Scotland, October 2013.

5 *Health and social care integration*, Audit Scotland, December 2015; and *Social work in Scotland*, Audit Scotland, September 2016.

6 *Managing early departures from the Scottish public sector*, Audit Scotland, May 2013.

7 *Borrowing and treasury management in councils*, Audit Scotland, March 2015.

Appendix

Methodology of funding gaps analysis

There are challenges in analysing budget information for individual councils to provide a comparative picture across local government. This is mainly due to variations in the way councils prepare and present budget information and the terminology used to define funding gaps. In discussions with local auditors and wider stakeholders we have designed our approach to try and address these challenges.

To allow a more consistent comparison among councils, we have revised how we define a funding gap. Previously the Commission identified a budget shortfall as the difference between income and expenditure, and a funding gap to be any remaining difference once savings approved by councillors have been taken into account (for example, service redesign, approved savings or use of reserves). Feedback from auditors and wider stakeholders suggested these definitions did not accurately reflect how councils refer to a funding gap.

As part of our 2015/16 audit work, we issued an information request to auditors. This focused on councils' General Fund revenue budgets for 2016/17, their budgeted use of reserves and forecasted differences between income and expenditure. We also requested information about approved savings and the main assumptions in respect of the forecasted figures.

In this analysis, we have focused on councils' General Fund budgets and the difference between income (excluding income drawn from reserves) and expenditure (reduced only for approved savings). This allows us to report on the budgeted use of reserves in 2016/17. Forecasted differences between income and expenditure in 2017/18 and 2018/19 then represent the forecasted funding gap, better reflecting the feedback we received about how this term is generally used.

The revised approach provides greater clarity about each council's plans and of the current position of the sector. We asked auditors to provide the level of savings formally approved by councils as part of the 2016/17 budget-setting process. This will include specific savings as well as general efficiencies. While it is expected that councils will continue to identify and approve further savings, the forecast funding gaps for 2017/18 and 2018/19 represent what councils currently forecast they will need to reduce expenditure by or finance from their reserves, ahead of formally approving further savings for these years.

We have applied common assumptions to allow the position of all 32 councils to be reported for years where individual councils did not supply information. Using information supplied by the other councils, we derived and applied:

- a reduction in income of 1.10 per cent and an expenditure increase of 1.16 per cent in 2017/18
- a reduction in income of 0.89 per cent and an expenditure increase of 0.66 per cent in 2018/19.

Local government in Scotland

Financial overview 2015/16

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ACCOUNTS COMMISSION

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• Do financial plans set out the implications of different levels of income, spending and activity?		
• Is there a clear link between the council's revenue plans and the budget information you are asked to approve?		
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• Do you know the actions being taken to close the funding gap?		
• Do you know what plans there are to redesign services and deliver savings?		

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4. From 2016/17, councils will be required to include an expenditure funding analysis showing more clearly the differences between the figures in the accounts and those that officers and members will be more familiar with from budget reports. The Commission welcomes this development as it is hoped this will present figures councillors are more familiar with and therefore make the accounts more useful at a local level and improve scrutiny of the accounts.

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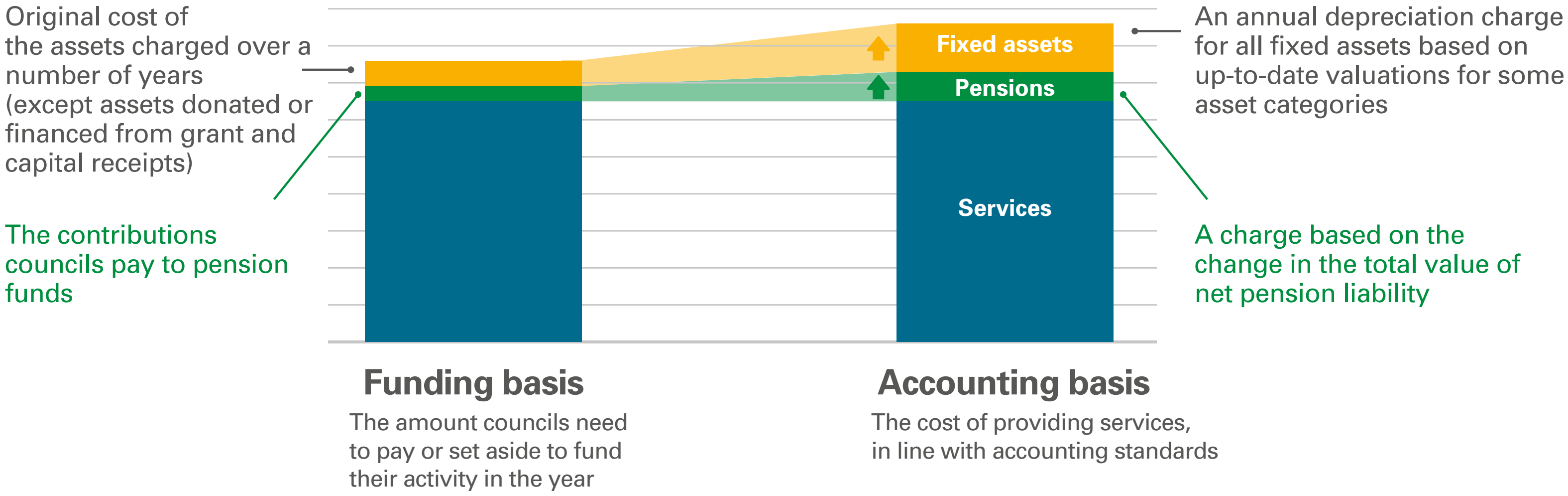
The main differences are in respect of pensions and fixed assets.



Source: Audit Scotland

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SUPPLEMENT 2

Prepared by Audit Scotland | November 2016

Local Government Pension Scheme 2015/16

ACCOUNTS COMMISSION

1. This supplement accompanies our Financial Overview of Local Government in Scotland 2015/16.

2. There are 11 council administered Local Government Pension Scheme (LGPS) pension funds in Scotland. They range from one of the biggest pension funds in the UK (Strathclyde) to one of the smallest (Orkney). Key LGPS facts are shown in Exhibit 1.

Exhibit 1

Scottish Local Government Pension Scheme–key numbers

Membership

Active **226,000**

Deferred[1] **126,000**

Pensioner **169,000**

Assets and liabilities

Position

£34.5 billion assets

£41.8 billion liabilities (estimate)

Transactions

£1.1 billion benefits paid

£0.94 billion employer contributions

£0.27 billion employee contributions

£0.68 billion return on investments

Note: 1 Deferred pensioners are members who have left the scheme but will be eligible for benefits upon reaching retirement age

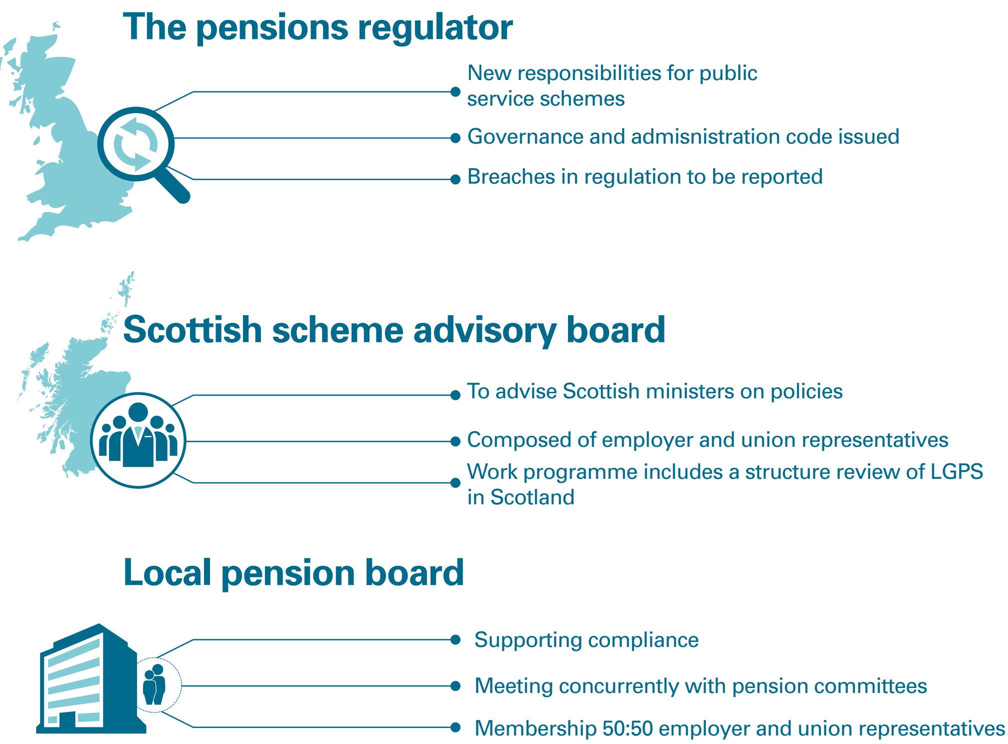
3. It has been a challenging year for the LGPS in Scotland with the introduction of the new career average revalued earnings (CARE) scheme from 1 Aril 2005, new governance arrangements at UK, Scotland and local levels and uncertainty in investment markets affecting invest returns.

4. Pension funds are required by regulation to produce an annual report and accounts and these are audited separately from the accounts of the administering council. Auditors' deemed the 2015/16 annual accounts of all 11 pensions funds to be true and fair.

Governance arrangements

5. The Public Service Pensions Act 2013 introduced significant changes to the governance framework for public service pension schemes and for the LGPS in Scotland. Exhibit 2 sets out the key changes to governance in 2015.

Exhibit 2
New LGPS governance arrangements in Scotland 2015



6. The Pensions Regulator has issued a code of practice for public sector schemes and pension funds in Scotland continue to monitor compliance with the new code assisted by local pension boards. Fund managers and advisors have a statutory responsibility to report significant breaches to the Pensions Regulator. We have not been made aware of any reports in respect of breaches in 2015/16.

7. The Scheme Advisory Board has a comprehensive programme of work and is planning to review of the LGPS structure in Scotland during 2016-17. Its review will include consideration of collective investment vehicles and the asset pooling model adopted in England and Wales.

8. At a local level all funds introduced pension boards. The role of pension boards is to support pension committees on compliance with regulations and codes. The role pension boards can play is developing, but it is clear they can also provide a useful scrutiny function. Auditors will be expected to monitor the operation of pension boards.

The new Career Average Revalued Earnings LGPS 2015

9. A new Scottish Local Government Pension Scheme was introduced on 1 April 2015. The key changes include:

- a move to benefits being worked out using career average (CARE) rather than final salary
- pension is built up at a rate of 1/49th of annual pensionable pay
- member's normal retirement age being linked to their own State Pension Age.
- A cost-control mechanism will be implemented to make sure the Scheme remains affordable and sustainable in the future.

10. Pension funds have coped well with the introduction of the new CARE LGPS with only minor teething issues reported by auditors. However, there are ongoing challenges in relation to the new scheme as record keeping is more complex than for final salary schemes and there is greater dependency on employers for complete and accurate information. Pension calculations for existing older members will be complex as many will have benefits accrued under the new 2015 scheme (based on CARE and 1/49ths) the previous 2009 scheme (based on final salary and 1/60ths) and the 1998 scheme (based on final salary and 1/80ths).

Cost control under the LGPS 2015

11. The new LGPS 2015 includes a cost control mechanism designed to ensure that the LGPS remains affordable for employers. Under this arrangement, the Government's Actuary Department (GAD) has established a Scottish LGPS cost cap of 15.5 per cent for employers (on a whole scheme basis). If the cost of providing benefits to members increases by more than two per cent above the employer cost cap, then employee contributions and /or benefits will be reviewed. We understand that employer cost cap costs will next be appraised by GAD following the 2017 triennial valuation and that the earliest cost sharing could start would be 2019.

Investment returns and expenses 2015/16

12. A number of LGPS funds saw negative investment returns on their assets in 2015/16, as shown in Exhibit 3 (page 4). This was influenced by increased uncertainty in global investment markets, low inflation and low growth. The outlook for investment management remains challenging with ongoing volatility and uncertainty in global markets following important events such as Brexit and the US presidential election.

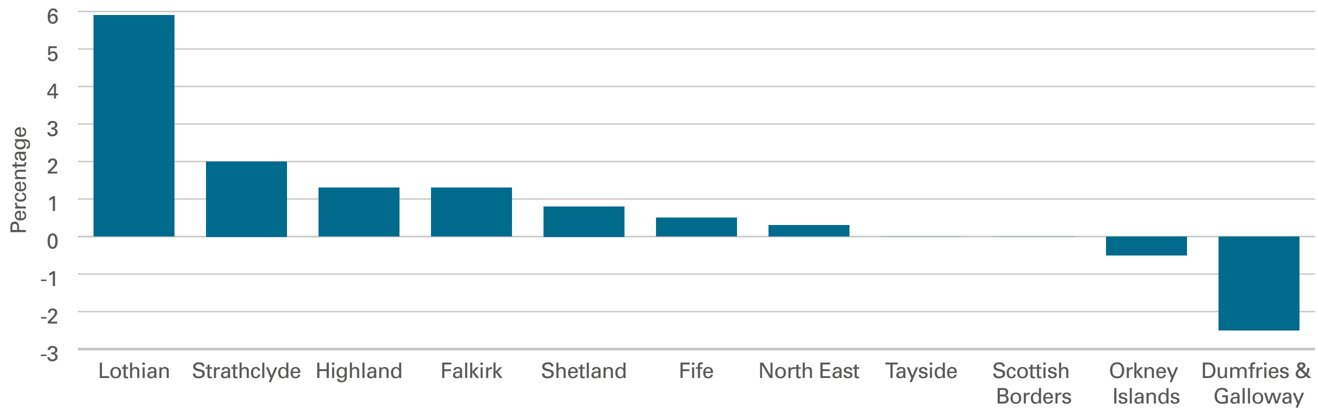
13. Although pension funds manage their investments in line with the same regulatory and governance regimes they have differing strategies and arrangements. Investment management is a complex area and funds make use of external advisers and managers. The full costs of investment management are not always fully transparent and there has been increased scrutiny and changes to guidance around accounting for these costs in recent years.

14. In 2015/16 we saw a divergence in approach by pension funds to the inclusion of investment management expenses in their annual accounts. Revised accounting guidance for 2016/17 emphasises that pension funds' financial statements should only include costs for which they are directly liable, or are within their control. The Accounts Commission is encouraged by the commitment of Scottish funds to full transparency around investment management costs charged and supports indirect expenses being reported in the wider annual report.

Exhibit 3

LGPS pension funds – Net return on investment 2015/16

In 2015/16, four funds saw negative returns on investments.



Source: Pension Fund accounts 2015/16

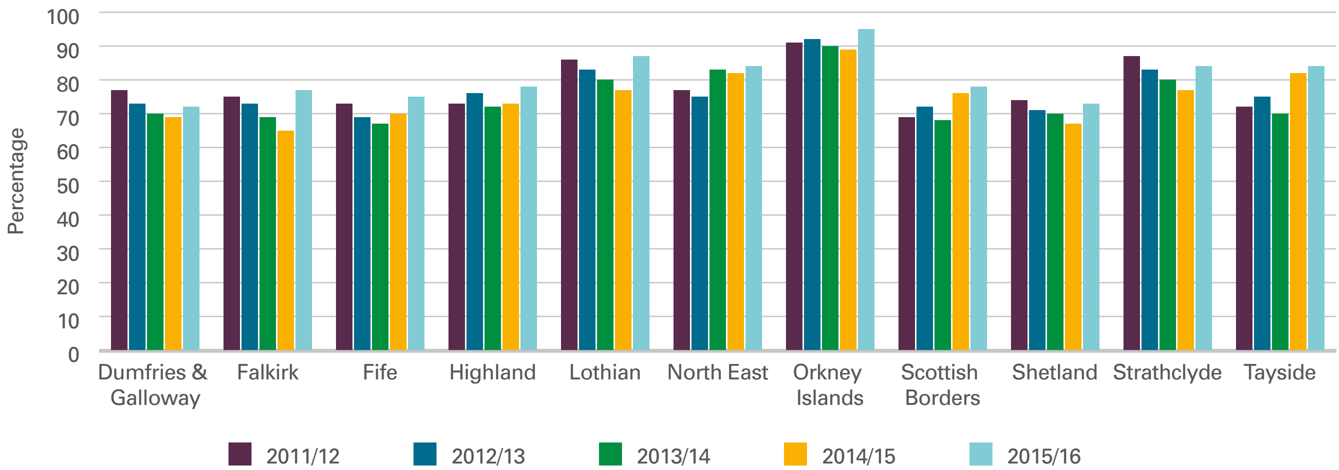
Present value of promised retirement benefits

15. Pension fund accounts include a disclosure of the present value of promised retirement benefits. This value of this liability is an estimate made by actuaries based on a number of assumptions about the future and the figure is quite sensitive to changes to those assumptions. The Liability can be compared with the assets of the pension fund at a point in time and Exhibit 4 shows the valuation of pension fund assets as a proportion of liabilities for each of the last five years.

Exhibit 4

Pension fund assets as a proportion of the present value of promised retirement benefits

The position of all funds improved in 2015/16.



Note: The Scottish weighted average is close to that for Strathclyde which is by far the biggest pension fund in Scotland and one of the biggest in the UK.

Source: Pension Fund accounts 2011/12–2015/16

16. The percentages shown in Exhibit 4 will typically be lower than those calculated by actuaries for the triennial funding valuations which are then used to set employer contributions. This is because the assumptions that can be used for accounting purposes are more tightly prescribed.

17. The overall Scottish LGPS net pension deficit at 31 March 2016 was £7.3 billion. Pension fund deficits are included in employers' accounts. Pension funds have arrangements to recover deficits over periods of up to 20 years in some cases, depending on the risk status associated with individual employers.

18. Pension deficits and employer contributions are complex areas and it can be difficult to establish differences between pension funds from their annual reports. Greater transparency and consistency of reporting in this an area would be beneficial to an understanding of the LGPS in Scotland.

Outlook

19. At a time when councils are under increasing financial pressure, administrative workloads will remain high as councils: continue to reduce their workforces and deal with auto enrolment; refine how they administer the new LGPS; embrace new online technologies to improve information flows with employers and members; deal with recent changes to pension scheme governance; and changes to the UK state pension arrangements.

20. The low inflation and low growth economic outlook together with uncertainty on the financial markets means that investment management will remain challenging at a time when investment performance is key.

21. The new cost control mechanism should help ensure that the LGPS remains affordable for employers in respect of active members although it does nothing to reduce the costs of pensions in payment and the associated deficits.

22. The Scottish Scheme Advisory Board is currently undertaking a structural review of the LGPS in Scotland. The outcome of this review is clearly of pivotal importance to the shape of the scheme and to administration costs going forward.

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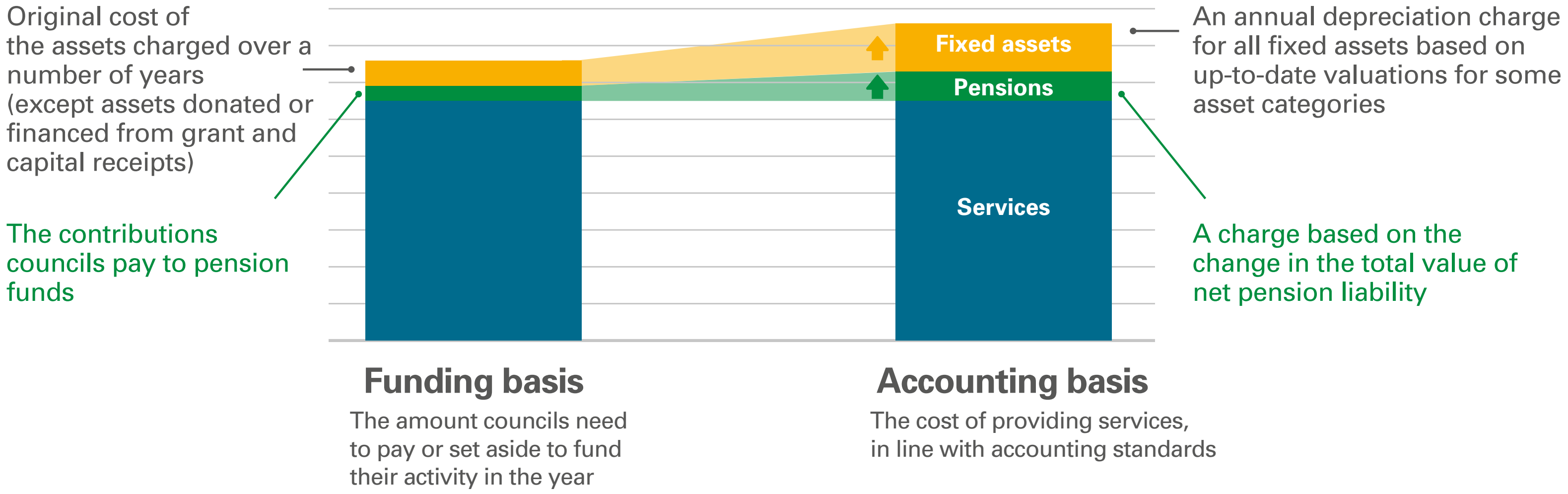

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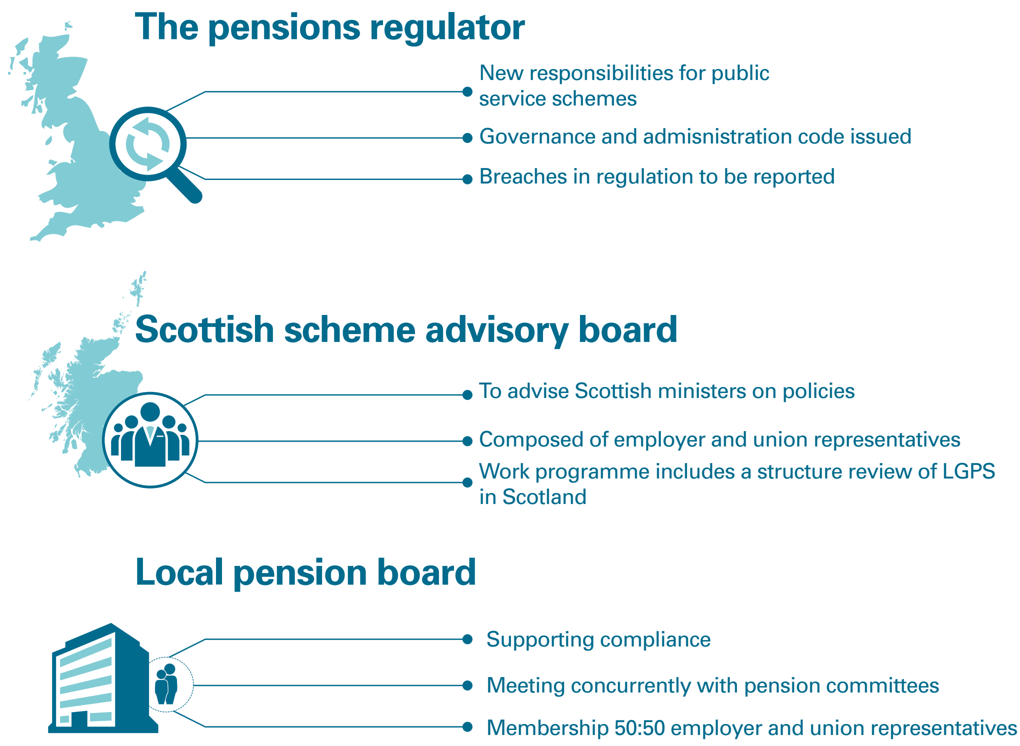

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10. Pension funds have coped well with the introduction of the new CARE LGPS with only minor teething issues reported by auditors. However, there are ongoing challenges in relation to the new scheme as record keeping is more complex than for final salary schemes and there is greater dependency on employers for complete and accurate information. Pension calculations for existing older members will be complex as many will have benefits accrued under the new 2015 scheme (based on CARE and 1/49ths) the previous 2009 scheme (based on final salary and 1/60ths) and the 1998 scheme (based on final salary and 1/80ths).

Cost control under the LGPS 2015

11. The new LGPS 2015 includes a cost control mechanism designed to ensure that the LGPS remains affordable for employers. Under this arrangement, the Government's Actuary Department (GAD) has established a Scottish LGPS cost cap of 15.5 per cent for employers (on a whole scheme basis). If the cost of providing benefits to members increases by more than two per cent above the employer cost cap, then employee contributions and /or benefits will be reviewed. We understand that employer cost cap costs will next be appraised by GAD following the 2017 triennial valuation and that the earliest cost sharing could start would be 2019.

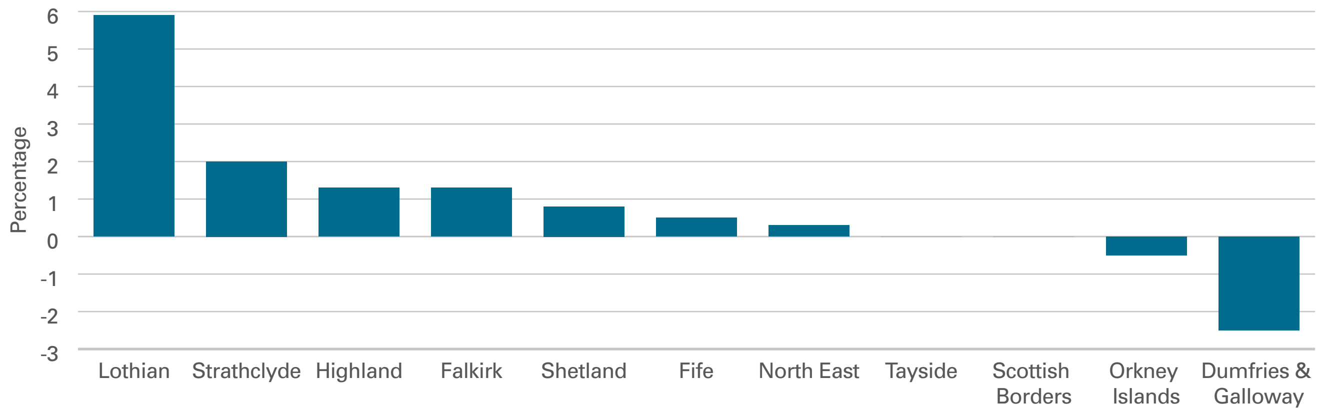
Investment returns and expenses 2015/16

12. A number of LGPS funds saw negative investment returns on their assets in 2015/16, as shown in Exhibit 3 (page 4). This was influenced by increased uncertainty in global investment markets, low inflation and low growth. The outlook for investment management remains challenging with ongoing volatility and uncertainty in global markets following important events such as Brexit and the US presidential election.

13. Although pension funds manage their investments in line with the same regulatory and governance regimes they have differing strategies and arrangements. Investment management is a complex area and funds make use of external advisers and managers. The full costs of investment management are not always fully transparent and there has been increased scrutiny and changes to guidance around accounting for these costs in recent years.

14. In 2015/16 we saw a divergence in approach by pension funds to the inclusion of investment management expenses in their annual accounts. Revised accounting guidance for 2016/17 emphasises that pension funds' financial statements should only include costs for which they are directly liable, or are within their control. The Accounts Commission is encouraged by the commitment of Scottish funds to full transparency around investment management costs charged and supports indirect expenses being reported in the wider annual report.

Exhibit 3
LGPS pension funds – Net return on investment 2015/16
In 2015/16, four funds saw negative returns on investments.

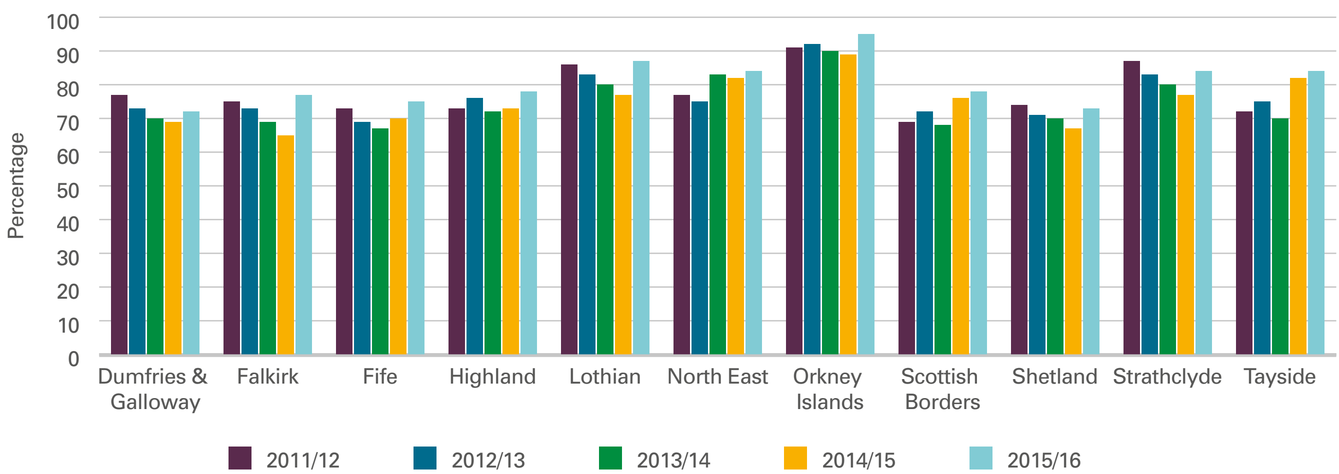


Source: Pension Fund accounts 2015/16

Present value of promised retirement benefits

15. Pension fund accounts include a disclosure of the present value of promised retirement benefits. This value of this liability is an estimate made by actuaries based on a number of assumptions about the future and the figure is quite sensitive to changes to those assumptions. The Liability can be compared with the assets of the pension fund at a point in time and Exhibit 4 shows the valuation of pension fund assets as a proportion of liabilities for each of the last five years.

Exhibit 4
Pension fund assets as a proportion of the present value of promised retirement benefits
The position of all funds improved in 2015/16.



Note: The Scottish weighted average is close to that for Strathclyde which is by far the biggest pension fund in Scotland and one of the biggest in the UK.

Source: Pension Fund accounts 2011/12–2015/16

16. The percentages shown in Exhibit 4 will typically be lower than those calculated by actuaries for the triennial funding valuations which are then used to set employer contributions. This is because the assumptions that can be used for accounting purposes are more tightly prescribed.

17. The overall Scottish LGPS net pension deficit at 31 March 2016 was £7.3 billion. Pension fund deficits are included in employers' accounts. Pension funds have arrangements to recover deficits over periods of up to 20 years in some cases, depending on the risk status associated with individual employers.

18. Pension deficits and employer contributions are complex areas and it can be difficult to establish differences between pension funds from their annual reports. Greater transparency and consistency of reporting in this an area would be beneficial to an understanding of the LGPS in Scotland.

Outlook

19. At a time when councils are under increasing financial pressure, administrative workloads will remain high as councils: continue to reduce their workforces and deal with auto enrolment; refine how they administer the new LGPS; embrace new online technologies to improve information flows with employers and members; deal with recent changes to pension scheme governance; and changes to the UK state pension arrangements.

20. The low inflation and low growth economic outlook together with uncertainty on the financial markets means that investment management will remain challenging at a time when investment performance is key.

21. The new cost control mechanism should help ensure that the LGPS remains affordable for employers in respect of active members although it does nothing to reduce the costs of pensions in payment and the associated deficits.

22. The Scottish Scheme Advisory Board is currently undertaking a structural review of the LGPS in Scotland. The outcome of this review is clearly of pivotal importance to the shape of the scheme and to administration costs going forward.

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