The Chartered Institute of
Public Finance & Accountancy

CIPFA

# CIPFA Financial Resilience Index

Financial resilience is the ability, from a financial perspective, to respond to changes in delivery or demand without placing the organisation at risk of financial failure. Without resilience, the essential public services that our communities depend upon would be at risk.

For this reason, it is important that the sector strengthens its financial resilience where it can, and the Index is just one tool designed to support that ambition.

CIPFA's Financial Resilience Index[1] is a comparative analytical tool that supports good financial management and provides a high-level common understanding within a council of their financial position based on a range of measures associated with financial risk.

We hope to encourage discussion and debate about public finances to improve understanding and appreciation. This 2022 Resilience Index looks at data from 2020/21 and has been influenced by the pandemic.

## Overview of the financial context for local authorities in England

It remains difficult to assess and predict the uncertain nature of how COVID-19 and its legacy will impact local government. The pandemic has caused extraordinary financial costs to local government, and the effects of COVID-19 on council budgets and cost pressures have continued to be felt into 2021/22 and will be felt for some time to come.

Some service demands were suppressed during the lockdowns, with pent-up demand now surfacing, particularly in adult and children's services. This demand and the expenditure needed to meet it has, in many cases, been merely delayed, not removed from the system.

Councils continue to lead their local communities through the pandemic. The extra government funding and support provided to date has been crucial, but it has been short term in nature.

Recent analysis estimates that the average increase in annual cost pressures facing councils is £2.6bn per year.[2] This is to maintain services at the current level of access and quality, suggesting funding of £1.1bn for adult social care, £0.6bn for children's social care and £0.9bn for other council services. This position and these services are not sustainable without significant additional sources of income for local authorities.

While the short-term picture based on the increases in reserves may appear to suggest that local government finances are sustainable, we remain concerned with the medium-term and long-term outlook, which largely remains unsettled and uncertain.

The government should continue to monitor the situation, both in the short and long term, providing vital support to councils when needed.

## Key messages from the Resilience Index

- It represents a transitional year for local authorities.
- It shows an increase in the reserves held by local authorities at 31 March 2021.
- Reserve picture for the majority, both a temporary and transitional position.
- Focus is needed on the longer-term financial health of local authorities.

1 The 2022 Index uses figures from the 2020/21 DLUHC revenue and expenditure outturn data return (RO).

2 Local Government Association (LGA).

## How has COVID-19 impacted the Index data?

The 2019/20 financial year was not materially affected by the pandemic with the data cut off at 31 March 2020, before the impact of government interventions. Therefore, it provided a useful baseline showing the resilience of councils as they entered the pandemic.

The data for 2020/21, however, has been significantly impacted by the pandemic, as there have been additional payments made to local authorities in relation to COVID-19, and this has particularly affected reserves. The local context is important to understanding the position for each local authority.

## Challenges of audit

For the 2020/21 financial year, there has been a change in the external auditor's judgement from a simple qualified (negative) or unqualified (positive) opinion on a local authority's arrangements for delivering value for money (VFM), to a narrative-based judgement.

In addition, due to COVID-19 and other resourcing pressures in both audit firms and within councils, there have been significant delays in the completion and publication of local authority external audits, with 91% of audits missing the statutory deadline for 2020/21 compared to 55% in 2019/20.

Therefore, the Resilience Index 2022 signposts readers to the local authority website to locate the most up to date position and judgement from their external auditor.

## Headline indicators

While all the indicators within the Resilience Index are measures of financial risk, we would consider that three are particularly relevant in the context of the transitional COVID year.

## Reserves

CIPFA has always been very clear on the importance of reserves, and it is vital that any discussion is based on a true understanding of the nature of those reserves.

The Resilience Index uses three different indicators to look at reserves. These are:

- the reserves sustainability measure
- the level of reserves
- the change in reserves.

The reserves sustainability measure provides a measure of how long in years it will take for a council to run out of their reserves if they continue to use them as they are and is represented as a yearly figure.

The level of reserves is perhaps the simplest reserves indicator and compares the current level of reserves to the council's net revenue expenditure.

Finally, the change in reserves identifies the change over a three-year period using figures from the current year and those from the previous three years.

This year's analysis of the data from the Resilience Index has shown that reserves have grown between 2019/20 and 2021/22; however, this hides a very complicated picture where short-term concerns must not deflect attention from medium-term and longer-term concerns.

Funding from central government for COVID-related expenditure was made late in the 2020/21 financial year, and there was insufficient time for local authorities to utilise the funds for their intended COVID-related purpose before the end-of-year accounts had to be finalised. Therefore, local authorities placed funds into earmarked reserves reflecting the specific purpose to which they would be applied. Identifying and managing funding in this way is good financial management.

The table below shows that at a national level across England, earmarked reserves rose significantly more steeply than unallocated reserves.

| Reserves (£000) | 2017/18 | 2018/19 | 2019/20 | 2020/21 |
|---|---|---|---|---|
| **Earmarked** | 12,849.12 | 13,989.12 | 16,007.49 | 25,133.62 |
| **Unallocated** | 3,173.24 | 3,231.31 | 3,334.20 | 4,127.09 |
| **Total** | 6,022.36 | 7,220.42 | 9,341.69 | 9,260.71 |

The reasons behind the increases will vary at an individual local authority level, but central to the increases will be that many local authorities will have received a Section 31 payment for business rates relief before 31 March. As noted above, timing differences meant that the income (grant) was received and allocated to an earmarked reserve pending distribution early in the 2021/22 financial year.

The national picture is distorted further, as the amount of grant paid to authorities varies. For example, councils in London will have received significantly higher business rates grants than smaller districts, and this will be reflected in the increase in their reserves.

This means that although reserves are an important element of financial resilience, reserve figures for the 2022 Resilience Index cannot be taken at face value in the same way they might have been in the past. This set of indicators based on the revenue outturn (RO) form for 2020/21 must be interpreted through a COVID-related lens with an understanding that the increases in reserves are temporary in nature, reflecting the fact that the sector has not seen the full impact of COVID-19 funding.

While reserves are higher than previous years, providing financial sustainability for the majority in the short term, the issue is the medium and longer term. Services where demand due to COVID-19 has been surpressed may see an increase, and overall demand in areas such as adult and children's social care is expected to increase. When planning over a longer period, it is necessary to recognise that demand will alter.

## Reserves figures and COVID-19 amendments

According to the RO form 'updated provisional', at 31 March 2021 local authorities (counties, unitaries, metropolitan districts, London boroughs and non-metropolitan districts) held £4.1bn in general reserves and balances (unallocated), representing 4.9% of local government revenue expenditure and 10% of net revenue expenditure (NRE). In addition, they held £25bn in earmarked reserves and £2bn in schools reserves

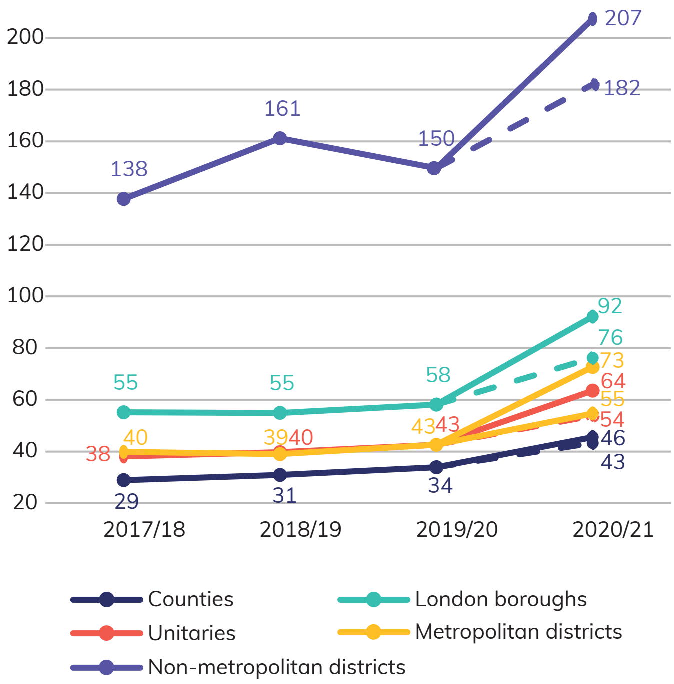
The RO form allowed authorities to record some of their earmarked reserves (915) in the following subcategories (921–925).[3]

| | |
|---|---|
| **915** | Estimated other earmarked financial reserves level at 31 March |
| | **... of which exceptional sub-components of other earmarked reserves (31 March 2021)** |
| **921** | COVID general funding grant tranche 1 (March 2020) carried forward at 31 March |
| **922** | Section 31 business rates grants paid in March 2020 carried forward at 31 March |
| **923** | Relating to Section 31 business rates relief grants at 31 March |
| **924** | Other 1 at 31 March |
| **925** | Other 2 at 31 March |

With these subcomponents subtracted, local authorities' earmarked reserves reduced from £25.1bn to £20.7bn. This increased to £24.9bn if then combined with the unallocated reserves. This represents 29.6% of local revenue expenditure and 59.8% of NRE.

We recognise that this is not a complete picture but is a-19 reflection and interpretation of the available data.

Average level of reserves as proportion of NRE (dotted line): reserves minus COVID reserve lines



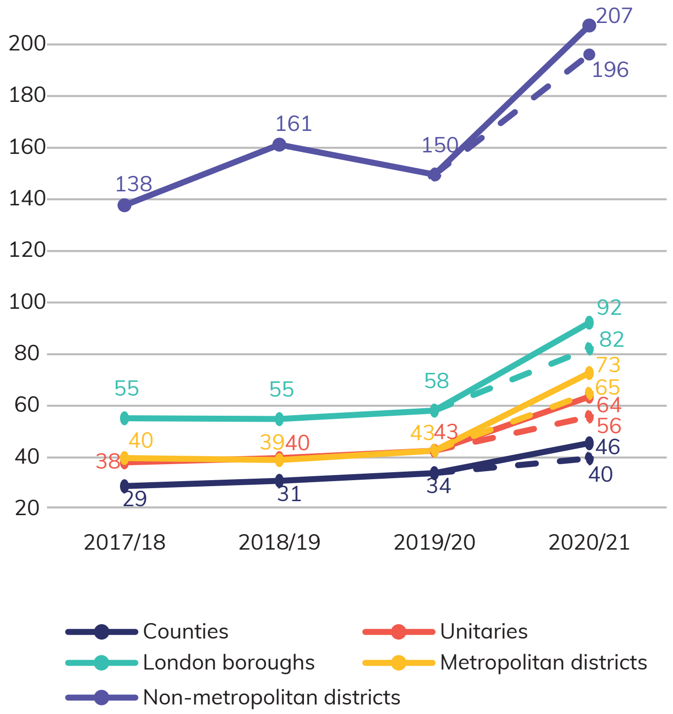

## Minus COVID-19 funding

Another way to look at reserves is to consider the additional funding provided as a result of the pandemic. COVID-19 funding was received in four tranches by local authorities and was recorded in line 852: COVID-19 2020/21 emergency unringfenced funding tranches 1–4. It amounted to £3.27bn.

While we recognise that it does not represent a complete picture, we can identify this tranche of funding, and if this is subtracted from the unallocated and earmarked reserves, the total becomes £26bn, which represents 31% of local revenue expenditure and 62.6% of NRE.

3 Authorities did not apply a consistent approach to these allocations; therefore, our analysis has used the published figures in the RO form.

Average level of reserves as proportion of NRE (dotted line): reserves minus COVID funding (line 852) (%)




Neither method is perfect for understanding the underlying reserves position for local authorities, but it does illustrate the significant impact that COVID-related funds have had on local authorities in 2020/21.

CIPFA continues to consider that reserves are essential to a local authority's financial resilience, as unlike central government, they cannot borrow money over the medium term, other than for specific functions, and they are required to balance their budgets on an annual basis.

Local authorities generally hold reserves for three purposes:

- as a working balance to help cushion the impact of uneven cash flows
- as a contingency to cushion the impact of unexpected events or emergencies
- for building up funds to meet known or predicted requirements – often referred to as earmarked reserves.

With continuing funding pressures and uncertainty as a result of the pandemic, it is essential that local authorities manage unexpected in-year expenditure. It may be counter-intuitive, but at a time of increased uncertainty, the role of reserves becomes more important and the need for adequate levels of reserves has increased.

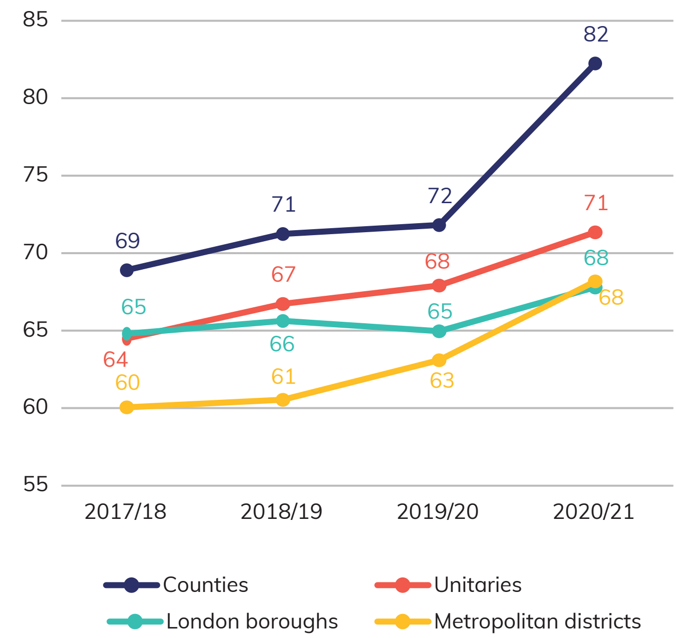
While reserves are an essential marker of resilience, they are not the only one. Resilience also includes indicators of financial standing; the predictability, buoyancy and diversity of income streams; cost and demand pressures; and management and governance judgements of auditors and regulators.

## Social care ratio

Even before the pandemic, the pressures on social care were considerable, and the long-awaited social care White Paper, while providing additional funding, has not been a panacea for the sector. This indicator reflects the fact that the greater the proportion of the local authority budget that is used for social care, the less funding there is for other services. Increased demand will therefore reduce the flexibility of the council's budget, making it more vulnerable to financial challenge

The 2022 Resilience Index shows the local authorities with the highest level of spending as a percentage of their NRE. During the pandemic, additional funding has been provided for this sector, but the underlying principle that the higher the spend in this area, the less flexibility a council has to spend on other services remains true.

Average social care expenditure as proportion of NRE (%)




| Authority class | 2017/18 | 2018/19 | 2019/20 | 2020/21 |
|---|---|---|---|---|
| **Counties** | 69% | 71% | 72% | 82% |
| **Unitaries** | 64% | 67% | 68% | 71% |
| **London boroughs** | 65% | 66% | 65% | 68% |
| **Metropolitan districts** | 60% | 61% | 63% | 68% |

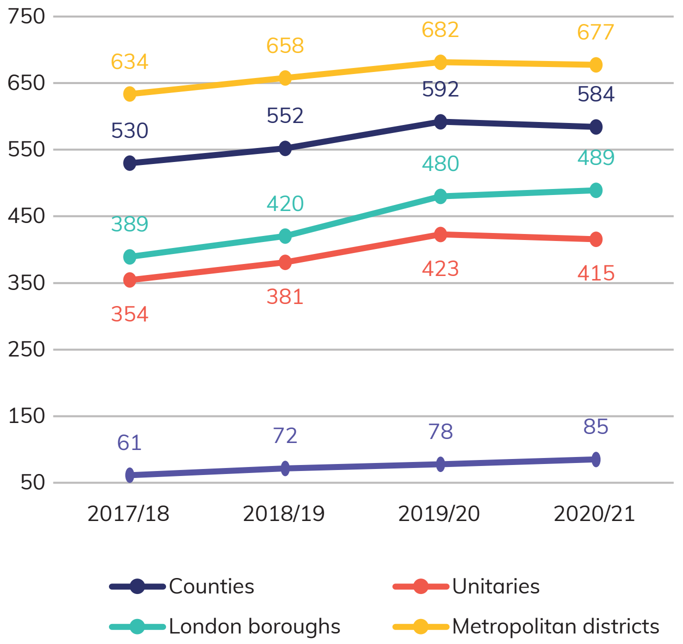
## Gross external debt

The **Prudential Code** is clear that local authorities should borrow within their means, and minimum revenue provision ensures that there is suitable debt cover. This indicator does not show how an authority will repay the debt but shows the gross external debt level and compares to other similar authorities.

While the level of debt itself does not indicate immediate risk, it is an area that may limit a local authority's ability to remain financially resilient. Substantial debt must be monitored, and effective risk management must be evident as part of good governance.

The table below indicates that the average gross external debt has reduced for the majority of councils, indicating that fewer councils were borrowing in 2020/21, which may reflect changes in guidance but also the fact that COVID-focused capacity impacted other programmes.

Average gross external debt (millions)




| Authority class | 2017/18 | 2018/19 | 2019/20 | 2020/21 |
|---|---|---|---|---|
| **Counties** | 530 | 552 | 592 | 584 |
| **Unitaries** | 354 | 381 | 423 | 415 |
| **London boroughs** | 389 | 420 | 480 | 489 |
| **Metropolitan districts** | 634 | 658 | 682 | 677 |
| **Non-metropolitan districts** | 61 | 72 | 78 | 85 |

## Conclusion

The picture for local authority finances remains very unclear. Levels of reserves have risen; however, there is an explanation for this, and one that also underlines the short-term nature of the change. Social care expenditure remains a dominating factor for many authorities, limiting the flexibility of an authority to deliver other non-statutory services.

CIPFA would argue that for authorities to remain financially stable, it is important for them to be able to plan in the medium and longer term with sufficient funding. One of the challenges is the continuing debate surrounding local authority funding and the recent spending review not providing adequate support for the pressures local authorities face. In this period of uncertainty, reserves will play an important role in dealing with unexpected shocks. While the Financial Resilience Index can shine a light on areas of possible risk and generate local discussion, it is essential that a national conversation on funding remains a priority and that local authorities continue to focus on medium-term and longer-term planning.

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