State of Local Government Finance – Update January 2018

CIPFA Essentials Briefing
Cliff Dalton and David Ellis
CIPFA Networks

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Overview of the half day

- The state of public finances
  - Pressures
  - Future funding
- Can local government support itself financially?
  - Business rates
  - Financial resilience
- Responding to sectoral challenge
  - Social care
  - Housing
  - Education
  - Faster closedown
- The role of local government 2018 and beyond
  - Combined authorities
  - Income generation

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The State of Public Finance

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Key issues are:

- Sustainable finance
- Fairness
- Incentives

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BREXIT?

Austerity

Ageing Population

New burdens?

Children Service - Service pressures

Social Care

Funding cuts

Mental Health

New Legislation

Community based support

Staff training

Homelessness

Tax base / BP assumptions - Optimism bias

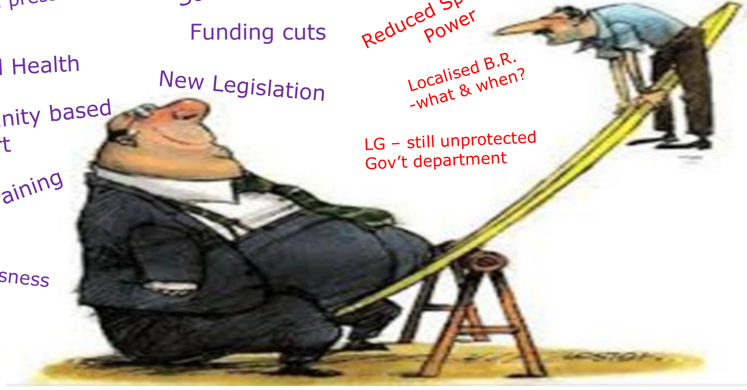
Risk of another Economic downturn

OBR Growth assumptions

Reduced Spending Power

Localised B.R. -what & when?

LG – still unprotected Gov't department



Balancing the budget

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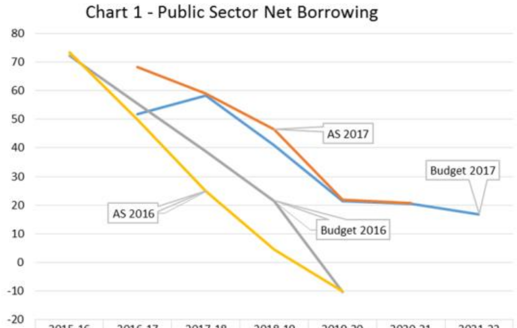
Chart 1 - Public Sector Net Borrowing



	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22
Budget 2017		51.7	58.3	40.8	21.4	20.6	16.8
AS 2016		68.2	59	46.5	21.9	20.7	
Budget 2016	72.2	55.5	38.8	21.4	-10.4		
AS 2015	73.5	49.9	24.8	4.6	-10.1		

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Pressures on the public sector

- Austerity and financial resilience
- Devolution/’Fragmentation’/’Place’ building
- Integration agendas
- Business Retention (75%?)/ Growth splits…
- Fair Funding Review
- Demand Mgt. – (Adults / Children’s & Housing)
- Major IT/ Digital transformation / Predictive Data
- Brexit?
- Financial Compliance: The Accounts…

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IFRS 9 *Financial Instruments* – financial asset classification changes

- **Classification and measurement**
- **Impairment**
- Hedge accounting
- New disclosure requirements – apply materiality

  - All financial assets reclassified/classified

Amortised cost (AC)

Fair value (FV) →
- Through profit and loss (FVPL)
- Through Other Comprehensive Income (FVOCI) (for debt instruments)
- Designated FVOCI for equity instruments (additional disclosures)

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IFRS 9 – Expected credit losses impairment

- Three stage approach

Stage 1

12 month expected credit losses

- Portion of lifetime expected credit losses that represent the expected credit losses from default events possible within 12 months of reporting date
- Impairment allowance

Significant increase in credit risk?

Stage 2

Lifetime expected credit losses

- Expected credit losses from all possible default event over asset's life

Objective evidence of impairment?

Stage 3

Lifetime expected credit losses

- Impair asset

NB Does not apply to equity instruments or financial instruments @ FVPL

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2017/18 Accounting Code Changes

- Narrative reporting – principles based
- Accounting policies
  - Avoid boilerplate – list of policies removed
  - Reflect authority's individual circumstances
- Going concern reporting
  - Remains right basis for local authority reporting
  - Reinforced in Code – adequate disclosure of any issues
- Pension investment transactions disclosures
- Regulatory changes
  - The Cities and Local Government Devolution Act 2016
  - Housing Revenue Account (Accounting Practices) Directions 2016
- ALATS

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IFRS 15 *Revenue from Contracts with Customers*

Core principle: recognise revenue to depict transfer of goods/services

Step 5 — Recognise revenue

Step 4 — Allocate transaction price

Step 3 — Determine transaction price

Step 2 — Identify performance obligations in contract

Step 1 — Identify contract with service recipient

Over time or at a point in time

Contract: agreement between two or more parties that creates enforceable rights and obligations

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IFRS 16 *Leases* – new leasing standard

- Definition of a lease similar to IAS 17
- Lessors – no substantial change (some additional disclosures)
- Eliminates operating or finance lease classification for lessees
- Lessee – all leases on balance sheet but optional exemptions for:
  - leases of 12 months or less (short-term leases), and
  - leases of low value assets (eg laptops and office furniture)
- Summary – leasing standard will require a lessee to:
  - recognise lease assets and liabilities on the balance sheet (initially measured at the present value of unavoidable lease payments)
  - recognise depreciating of lease assets and interest on lease liabilities over the lease term
  - separate the total amount of cash paid into a principal portion and interest for cash flow statement

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Future funding projections

- Local government still 'unprotected'
  - Grants/austerity expectations
  - Public sector pay
  - Demand led and integration
- 'Fair' funding review – *Or 'right' funding?*
  - Size of quantum currently challenged (new burdens)
  - Localism and outcome re. retention levels (B/R)
  - Reset percentage and frequency?
  - Tariffs and top-up arrangements?
  - Simple, transparent, projections and honesty/consistency from government

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Austerity in numbers…

- Between 2010/11 and 2017/8 spending power fell by 28.6%
- A real-terms decline in government funding of 49%
- The rate of funding (drop) has slowed recently, but largely due to extra for social care (precept)
- Councils now spend less on services overall (20%)
  - What is spent, focuses on statutory services
  - Discretionary services now (typically) severely hit
- NAO criticism – delivery at local area not consistent with government policy announcements

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OBR’s view of local government

- Acknowledges that local authorities remain under severe pressure, particularly in adult social care
- Focus on changing use of reserves by local government
  - Between 2010/11 and 2014/15, local authorities increased their reserves (by about £2bn per year according to the OBR)
  - By 2015/16 to 2016/17, the trend reversed and English local authorities have drawn down £0.4bn and £1.5bn respectively
- Increasing pressure on adult social care has forced local authorities to use reserves?

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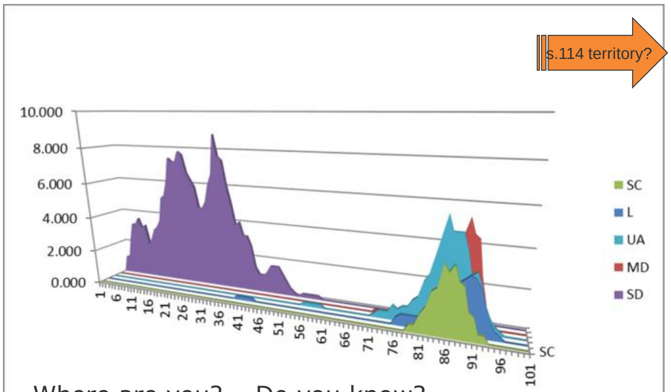
Sector impact – where are you?



Where are you? – Do you know?
(Source: CIPFA FAS)

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Can local government support itself financially ?

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Budget pressures and strategy in local government – IFS and NAO

- Service quality sustained or improved since 2010, as has satisfaction rates
- Majority of councils with social care responsibilities report that quality has been sustained or improved
- Qualifying criteria change, to help manage demand
- 88% of authorities "believed that some local authorities will get into serious trouble in the next five years" – *crying wolf?*
- Confidence in ability to make savings declines the further into the future one looks (now about innovation)
- Pessimism about adult/children social care; district councils more optimistic
- FFR – biggest obstacle will be from within!

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Future of business rate retention

- Government still committed to increased rate retention and control over local tax receipts
- Not necessarily 100% retention – possibly via extension of pilots or transfer of funding (latest pilot uptake from April 2018)
- Pilots to drive design of changes to future rate retention system
- 75% retention from 2020/21
- Growth not necessarily 80:20 to districts!
- Model is under review (simple v complicated etc…)
  - Relative need consultation runs for 12 weeks to 12 March 2018
  - Changes ongoing (VOA corrections have led to revised settlement figures from last month already)

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Rates retention – knowns and unknowns

Knowns

- Phasing out RSG and other grants… by end of this SR period
- Redistribution mechanism coming (detail to be agreed)
- 11 new pilots for 2017/18 confirmed – further round in 2018/19
- Fair funding review continues (including baseline assessment of need)
- Government confirmed intention for new funding baseline in 2020/21

Unknowns

- Extra powers for elected mayors – only?
- Pooling (how will they work?)
- Full or partial resets?
- Compensation for appeal losses/new burdens
- Tier splits – pilot?
- Incentives to work more collaboratively and with LEPs?

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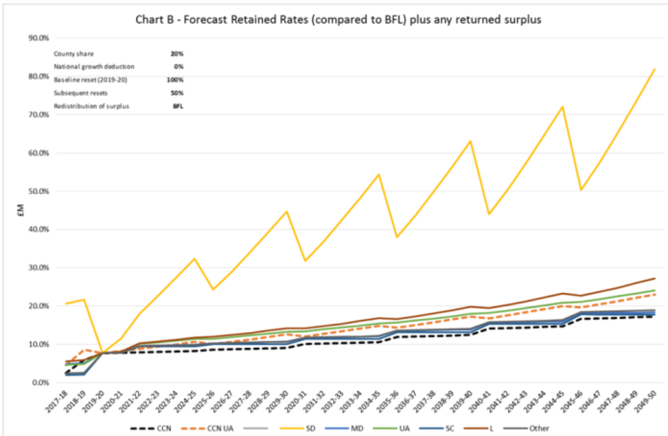
Baseline reset – what will this mean for you?

- Baseline reset expected in 2020/21 alongside implementation of FFR
- Assuming full baseline reset in 2020/21 (partial 50% reset every five years thereafter)
- Calculation possibly based on average of 2017/18 and 2018/19?
- For authorities above baseline (esp. districts), this is the most significant variable in future funding
- Financial modelling and sensitivity analysis/scenario planning, just got real!

Modelling 100% retention

20% county council share, 5 yearly 50% partial reset, redistribution by BFL, no levy



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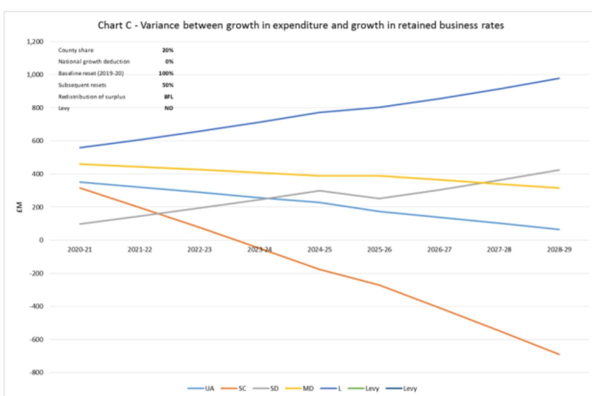
Divergence between rates and need

20% county council share, 5 yearly 50% partial reset, redistribution by BFL, no levy



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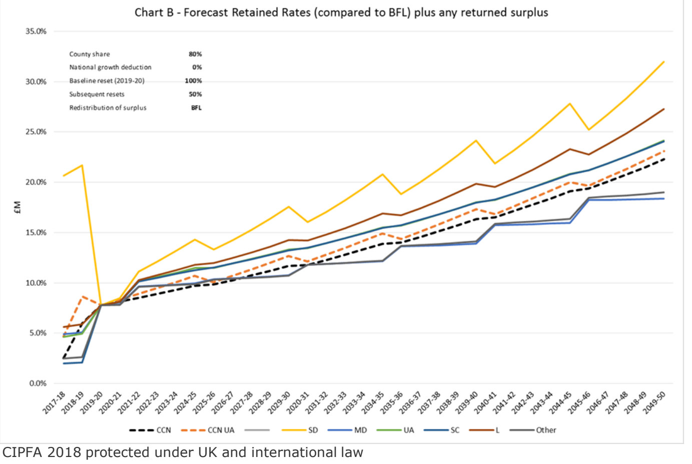
Tier splits

80% county council share, 5 yearly 50% partial reset, redistribution by BFL, no levy



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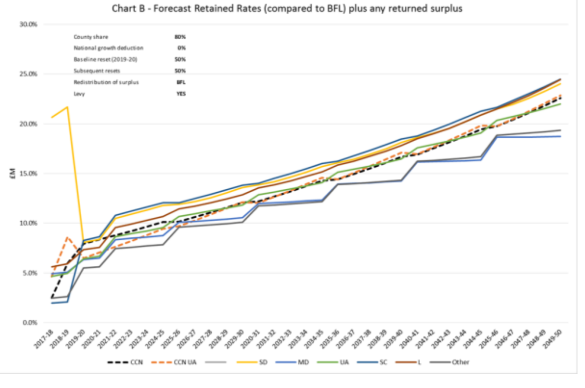
The levy on growth

Retain levy, 80% county council share, 5 yearly 50% partial reset, redistribution by BFL



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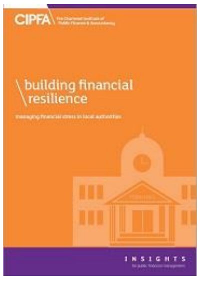
Building Financial Resilience – onsite support

- Essential for good financial management
- Key message from the institute and why CIPFA has conducted a number of resilience reviews
- Seeking to help councils spot the warning signs of financial stress and take the right steps towards resilience

CIPFA approach:
- Report
- Diagnostic
- Onsite review



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Road to recovery

- Getting routine financial management right
  - Clear understanding of current position
  - Compare with others
  - Understanding of long term financial strategy
  - Responsibility

- Cost and service comparisons
  - Should be routine
  - Clear understanding
  - Involve members

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Symptoms of stress (NAO – 2017 report)

- **A rapid decline in reserves** – using reserves to avoid cuts will only provide temporary relief
- **A failure to plan and deliver savings in service provision**, so that councils are not living within their resources
- **Shortening of medium-term financial planning** – a failure to plan ahead could indicate a lack of strategic thinking and an unwillingness to confront tough decisions
- **Firm objectives missing from savings plan**, such as a saving plan with 'still to be found' gaps or consisting of targets rather than robust plans; this may also include a tendency for over optimism in timing and scale of savings
- **Tendency for unplanned overspends** – carrying forward undelivered savings into the following year only creates the need for greater cuts in subsequent years

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Recovery

- Clear plans for delivering savings
- Single consolidated living document
- Linked with budget and medium term financial plan
- Distinguish between the different types of savings
    - Clear delivery
    - In principle
    - Proposed
    - Thoughts
- Managing reserves
    - Use

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Responding to sectoral challenges

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Social care funding challenges

- For all councils (with these services) ASC & children's now accounts for majority of non-schools expenditure
- It is the area subject to the most demographic pressures and to the most volatility of demand.
- They are also the main sources of budgetary pressures and in year overspends.
- STP (CIPFA response to Commons Select Inquiry)
  - A positive initiative, but with problems
  - Should drive efficiencies, but inadequate involvement from local government currently
  - Too much short term focus 'firefighting' not enough longer term demand management initiatives

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Over spend

- The latest ADASS budget survey indicated overspent by £366m 2016/17, more than double the overspend in preceding year (£168m)
- 75% of councils overspent on children's services (circa £605m)
- Total overspending across adult and children's in region of £1bn for 2016/17 – an average of over £7m per council.

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Adults – focus alone,

- About 100 councils completed the ADASS snap survey
- More than 50% already forecasting overspend for 2017/18
- Level of spending (as percentage of GDP) put us below the average for rich nations with developed economies
- We currently spend less than a third of what they do in the Netherlands

Service pressures

- Greater expectation and need to understand future demographic change
- More social housing, support/prevention – homeless, will bring rewards downstream, but not joined up (NAO)
- Affordable housing is key – *CIPFA Counter Fraud Centre indicators*
- Invest in prevention, to reduce the cost of cure
- Typical pressures identified in research:
  - More children coming into care
  - Increased domestic abuse
  - Asylum seekers
- Councils need to understand this narrative when considering policy

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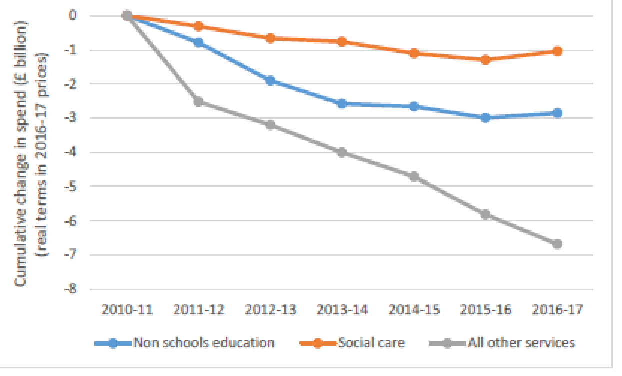
Service pressures

Cumulative change in spend by service: all local authorities



Source: NAO analysis of departmental data. See standalone methodology.

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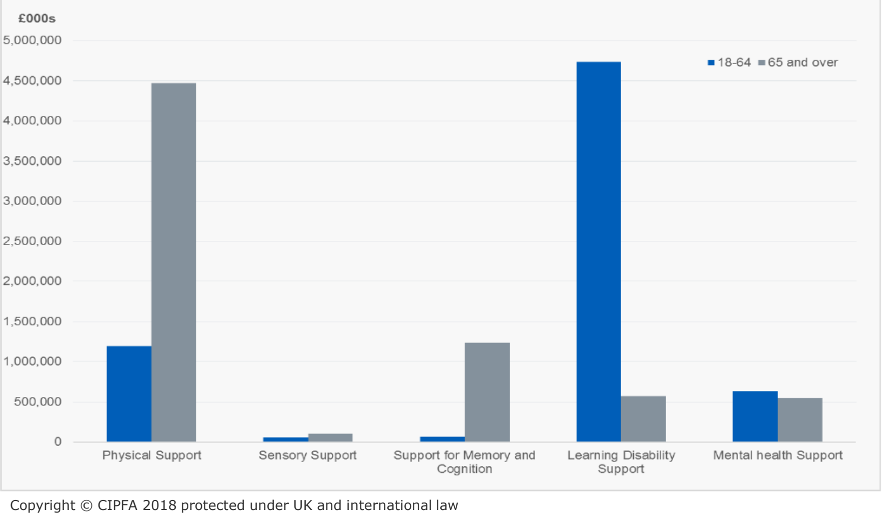
Understanding your demographic and demand led pressures – based on 2016/17 expenditure



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Adult social care funding future?

- Green Paper is not now expected until summer 2018
- It might propose some reorganisation so that local authorities can manage 'markets' better (what is the optimum size?)
- Expected that STPs will play an increasing role, with more funding through this route with health
- Continuing problem: cost of social care is increasing, and who pays?

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Deprivation – a modelling example

- Deprivation influences the number of people receiving long term support
- Given that support is means tested – then areas of greater financial deprivation will have more people eligible for support
- As deprivation changes there may be subtle changes in the numbers of people eligible for support
- Part of CIPFA's pilot work with a council to match service/budget demands with influencers such as this
  - Watch for more on this at our spring events and publications

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White Paper: Fixing Our Broken Housing Market (February 2017)

- Political support from the top changes, but now new minister Dominic Raab
- Housing is increasingly unaffordable to many and lack of housing often linked with other social issues
- Housing closely linked to economic activity and regeneration
- White Paper – seeks to tackle housing shortage and clear barriers to increase supply, a theme taken to the November 2017 budget
- Tension still exists between the need to build and the current incentives to do so (see examples and authority approaches)

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White Paper (Headliners)

- Local plans – more formalised and a clear strategy
- Five-year land supply and 'objectively assessed need'
- Housing delivery test – need in line with supply
- Green belt (more wanted by many)
- Brownfield development (still favoured)
- Strategic planning/joint plans
- Engage with smaller house builders?

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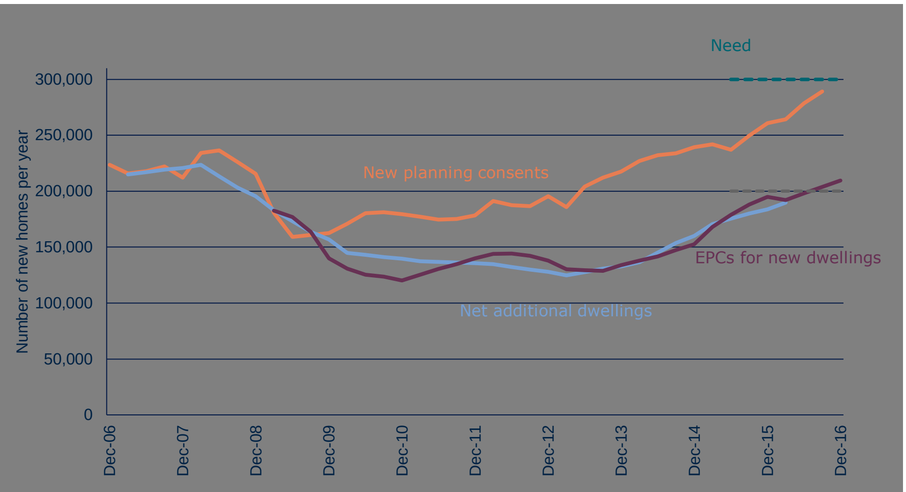
Housing supply increasing but more needed

Source: DCLG, Glenigan, Savills

Gov. target (1m by 2020)



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CIPFA Housing Round Table (since June 2017)

- Council housing is part of the solution. Strategy needed.
- Should involve all with a stake (social landlords and benefit)
- Barriers shared include:
  - HRA borrowing challenges (increased @ Nov 2017 Budget)
  - Rent cap levels has taken millions away in supplier revenue
  - Policy uncertainty curbs appetite in s-housing investment
  - RTB rules and high value asset policy – little incentive & impacts on sustainability concerns (further high value pilot scheduled in 2018)
- Every housing authority is unique
- It is the business of all councils (social cohesion & growth)

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What councils are doing now

- Nottingham: Regeneration, bit by bit.
- South Cambs: Housing purchased specifically for the homeless. More to be built as part of City Deal initiative. www.scambs.gov.uk/content/affordable-housing-development
- Croydon: In-house team carries out work for others on a commercial basis
- Luton: Uses a hedge fund for social housing
- Birmingham: Work with a mix of partners who all have a stake. New build also seen as a pump primes apprentice training
- Brighton: Joint venture with developers. Linked with local neighbourhood improvement: www.brighton-hove.gov.uk/content/housing/council-housing/new-homes-neighbourhoods
- Other councils have taken sites used for fly tipping and built houses there. Stops tipping, gives homes
- The Smith Institute '150 Local Housing Companies' most <5 years old.

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Children's services

- Children's social care overspends
  - £605m 2015/16, £1bn in last three years
  - £2bn 'black hole'
- Putting finance before support – MP inquiry
- £1.3bn additional funding for schools 2018/19 and 2019/20
- Only modest link between school funding and attainment
- Costs and pupil numbers rising – additional funding required
- Uncertainty in education policy
- National funding formula

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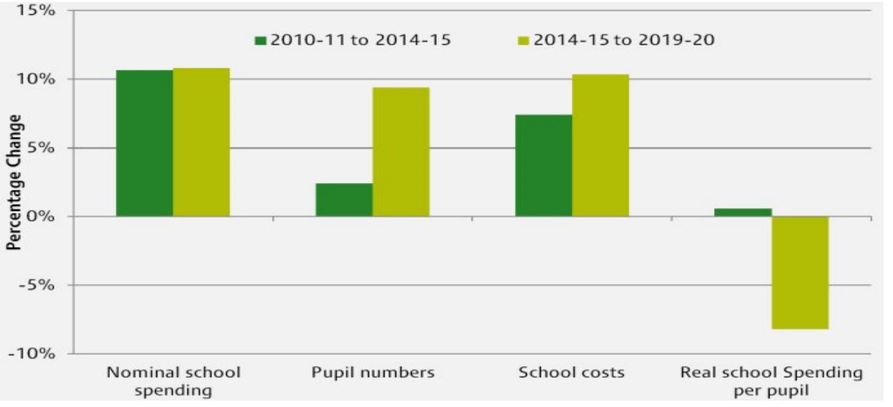
IFS predictions – percentage changes in school spending and cost factors, 2010/11 to 2019/20



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New national funding formula from 2018/19

- 'Soft' formula 2018/19 and 2019/20
  - 'hard' national funding formula to determine local authority schools block allocations
  - local formula for school allocations
- 'Hard' national funding formula from 2020/21
- Ringfence schools block from 2018/19 – but 0.5% for transfers between blocks ie high needs if schools forum agrees
- Re-base DSG from 2017/18
- New DSG 'central schools block' and high needs formula

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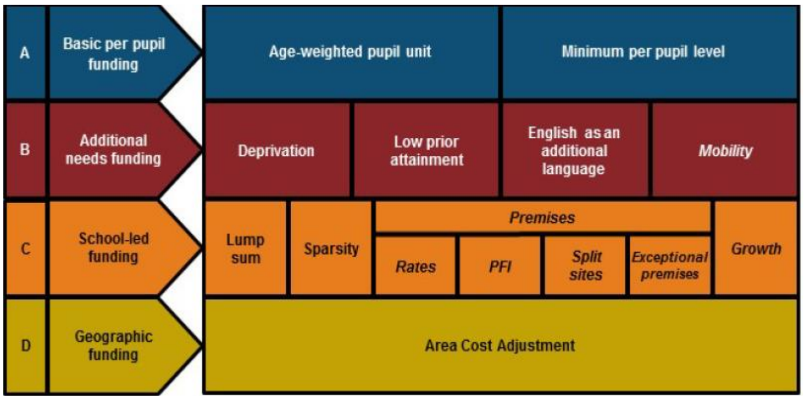
Schools National Funding Formula Stage 1 – the building blocks and factors (schools block)



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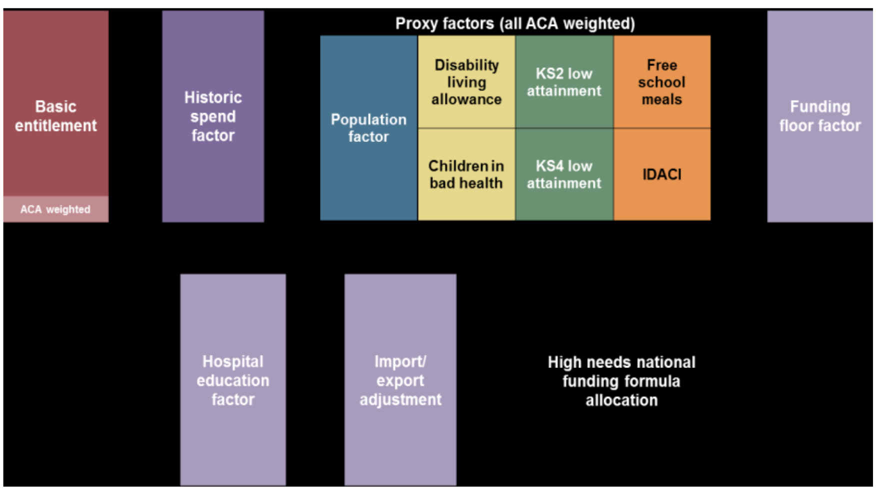
High needs funding formula



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Key issues in education

- Funding quantum – many unions and others argue it is not enough
- Recruitment and retention issues around teachers – notably leadership roles
- Local authority 'tipping point' when X no. of schools become academies
- Local authority still has statutory duties but has limited power over academies' decision making
- Does giving academies greater autonomy mean greater accountability!

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Faster Closedown – Statutory Changes

- Accounts and Audit Regulations 2015 (England)
- Draft accounts deadline 31 May (was 30 June)
- Audited accounts published by 31 July (was 30 September)
- Auditors discussing plans with client authorities to meet new deadlines
- Where are you on that journey?
- What are your challenges?
- What support do you need?

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Faster Closedown – Other Factors

- Frees up limited resources to support priorities
- Better decisions from earlier confirmation of results
- In-year reviews lead to fewer errors / corrections at year-end
- Top level commitment key to deliver successful outcomes…finance cannot work in isolation

- What lessons can be learned from others?

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Faster Closedown – Ten Key Tips (1)

- Ensure finance staff suitably trained
  - Changes in Code, rotation of duties
- Start early
  - Template, policies, disclosures, use of estimates
- Dry-run closedown tasks
  - Address problems early, in-year reconciliations
- Review processes and learn from problems
  - How did last year go? Work with auditors
- Focus on the bottlenecks
  - Capital, Collection Fund, Valuations, etc

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Faster Closedown – Ten Key Tips (2)

- Project planning is key
  - Key tasks, dependencies, 3rd party data
- Look to automate repeated tasks
  - CIPFA Closedown can help
- Challenge and question closedown tasks
  - Necessary and material? – Risk based approach
- Document learning and processes for future use
  - Avoid past mistakes, continuity planning
- Maintain good housekeeping
  - Chart of accounts, holding/suspense, QA reviews

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CIPFA Closedown Support

- Assured Managed Service (with EY)
  - Three strands - Consultancy support, fully-managed closedown service, software solution
  - CIPFA Closedown (Big Red Button) – automated code-compliant accounts, disclosures and working papers, ingrates with your existing ledger
  - Frees up skilled resource to add greater value
- Network support
  - Closedown events, subscriber technical support, solutions-based support
  - http://www.cipfa.org/training/essentials

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The role of local government 2018 and beyond

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Role of local government

- Local authorities – increasingly 'individual'
- Change being driven by (nobody mention Brexit)
  - Financial need
  - Legislation
  - Leadership
- Devolution and combined authorities (stalled?)
  - Greater ability to effect change on a regional scale
  - Aligning local public services (ALPs)
  - Working with LEPs
- Greater commercial activity
  - Risk and rewards
  - Growing concern from DCLG (MHCLG) & PAC

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A changing investment landscape

Councils embracing commercialisation, says survey

Commercialisation has become the most talked about topic in councils this year, with some seeing turnover equivalent to a FTSE 250 company, according to research gathered by Zurich Municipal.

NEWS

Public Finance – 2 November 2017

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National Audit Office Report(s)

- Tried to protect front line, but local authorities now spend less on services
- Statutory ones preserved but not untouched
- Concern over the changing profile of spend (higher capital long term investment to ease short term revenue costs) – how sustainable?
- Loss of focus on what councils should be doing?
- Criticism from PAC principally aimed at DCLG

"Authorities face a growing challenge to continue long-term investment in their existing assets. Capital strategies have begun to shift from focusing on managing assets, to generating revenue savings and commercial income."

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Prudential Code update 2017

- Published December 2017 – effective 2018/19
- Transitional changes may require longer lead-in – encouraged to adopt at earliest opportunity
- Confirms underlying principles apply to mayors, combined authorities and group entities
- Encouragement of local indicators
- Requirement to consider explicitly separate ringfenced funding streams
- Deletion of council tax indicator
- Development of a capital strategy

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Capital strategy – overview

- Requirement for full council to approve annual capital strategy
- Sets out long term context in which capital expenditure and investment decisions are made
- Consideration given to risk and reward and impact on achievement of priority outcomes
- Links should be made where appropriate to treasury management strategy
- CFO to report explicitly on deliverability, affordability and risk associated with capital strategy

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Treasury Management Code update 2017

- Published December 2017 – effective 2018/19
- Some changes may require longer lead-in
- Minor tidying of TM indicators
- Code principles cover non-TM investments – but they are not responsibility of treasury teams
- Recognition that for non-TM investments the principles of placing security and liquidity above yield (SLY) may not be appropriate in all cases but decision should be explicit
- Clarity over delegation to avoid duplication
- Organisations designations under MIFID II included
- Additional areas identified for local authority sectoral guidance

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Linked to higher risk perception for treasury management – implications of MiFID II on local authorities

- Local authorities will lose '*professional*' status for '*retail*'
- Some authorities may wish to remain retail
- Otherwise, must demonstrate appropriate level knowledge, skills and expertise, to make and own investment decisions
- Must pass quantitative and qualitative tests
- Re-testing assessment will follow
- Real challenge is managing the process of 'electing up' and ongoing obligations to maintain status

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Quantitative and qualitative tests – MiFID II

Quantitative test

- Satisfy criteria a) as well as either b) or c):
  a) The size of the clients financial instrument portfolio, defined as including cash deposits and financial instruments exceeds £10,000,000
  b) Carried out transactions, in significant size, on the relevant market at an average frequency of ten per quarter over the preceding four quarters
  c) The client works or has worked in the financial sector for at least one year in a professional position, which required knowledge of the transactions or services envisaged

Qualitative test

"An adequate assessment of the **expertise**, **experience** and **knowledge** of the client that gives reasonable assurance, in light of the nature of the transactions or services envisaged, that the client is capable of **making its own investment decisions** and **understanding the risks involved**."

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Summary

- Reduced funding is creating a new financial landscape for local authorities
- Shorter term thinking must not be at the expense of investment
- Political uncertainties
- Greater diversity in service delivery
- Greater expectation from the public
- Demographic change

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