Learning lessons: what Section 114 can teach us

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Executive summary

This insight re-examines evidence from three authorities that have issued Section 114 notices in recent years to identify and highlight recurring themes.

While at the time there was intense focus on the reasons behind the notices in these authorities, CIPFA's current advisory work across the UK suggests that there are an increasing number of authorities that are exhibiting some of the same symptoms.

The three local authorities (which will be familiar to the sector) examined in this report are very different. Northamptonshire was a county council in the south Midlands, Croydon a London borough and Slough a unitary council in the home counties. Looking at them side by side reveals some common themes.

CIPFA has a crucial role to play in strengthening public sector financial management across the UK and internationally. Supporting our members and the wider sector community by sharing learnt experiences is an important part of achieving that goal. This insight is the first of a series of documents that covers some of that learning based on our experience and sector understanding.

Summary of the common symptoms

Over-ambitious savings – we continue to see evidence of over-ambitious savings targets that are not well evidenced. This is particularly concerning when historically records show savings have not been achieved.

Lack of a medium-term financial plan – even with the current fluid financial landscape, medium-term planning indicates an understanding and assurance that support financial sustainability.

Leadership – as financial sustainability becomes increasingly challenging it is essential for the leadership team to work together. Increasingly organisations that have been subject to intervention have experienced change at senior level.

Inadequate governance – the depth of financial problems indicates a serious lack of oversight, with audit and governance committees not exercising their function and roles not understood.

Weak financial management – the importance of good financial management in relation to reporting and monitoring provides assurance and evidence for effective budgetary decision making.

Lack of reserves – while the economic climate continues to be difficult, organisations that have little to no reserves face significantly higher risks.

Insight from our experience

As evidenced in the case studies, it is often the situation that there are underlying issues beyond what is cited in a Section 114 notice. Focusing only on the immediate problem risks a superficial approach that will not prevent further financial instability in future. Instead, a thorough investigation should be undertaken to look deeper into the situation and ensure the authority's true financial position is uncovered. CIPFA has been working closely with authorities to ensure investigations like this look at all relevant processes, from procurement and service contracts to fundamental accounting practices.

Where these underlying issues are unaddressed, it can take time to first recognise the problem and then take action to change. As external partners we can help identify changes and advise on how they can be implemented, but there needs to be an accompanying cultural shift to lay a solid foundation for the recovery work to take place. Leadership is key in overcoming any reluctance to change how things are done, alongside an acknowledgement that culture will take time to transform. Paying attention to the culture of your organisation and ensuring it reflects the key principles of clear leadership, accountability and transparency will enable problems to be identified and resolved before they deteriorate.

02

Introduction

Section 114 notices are the last resort for local authorities in financial trouble. Once rare, there have been several high-profile examples since 2018, with councils of different sizes and located across the country sending out a distress signal over their financial position. Although each situation is unique, there are some common trends and themes around financial management and governance issues, which will be explored in this report. By looking at what went wrong, we can identify preventative actions that will help improve and maintain resilience across the sector.

The term 'Section 114' refers to this section of the **Local Government Finance Act 1988**, part (3) of which sets out the duty of the chief finance officer (CFO) to "*make a report under this section if it appears to him that the expenditure of the authority incurred (including expenses it proposes to occur) in a financial year is likely to exceed the resources (including sums borrowed) available to it to meet that expenditure*". Issuing the notice under Section 114(3) immediately suspends all financial activity apart from that which is necessary to maintain statutory duties; it also initiates a 21-day period for full council to consider the report and agree urgent action to start to remedy the situation. The authority's external auditors and the Department for Levelling Up, Housing and Communities (DLUHC) will also be notified and can step in to provide advice and support.

It is unlikely that a Section 114 notice would be issued out of the blue – warnings may have been raised by the CFO, auditors or others before the point at which a notice becomes unavoidable. To issue a notice is a public admission that the authority cannot balance the books, and therefore indicates that warnings regarding the seriousness of the financial situation have been ignored. The severity of the position may not have been appreciated by those in leadership until it is too late, while the problems only become more severe the longer they are neglected.

Local authorities are legally required to set a 'balanced' budget, yet are facing increasing pressures on funding amid rising demand for services, particularly around social care. Central government funds reduced by 49% in real terms between 2010 and 2018 according to **figures from the Public Accounts Committee**, leading authorities to seek alternative sources of income. For many authorities, this has presented an opportunity to innovate and bring benefits to their local area, and there are many success stories; at the same time, if new projects are not well managed and governed they can expose the authority to a significant amount of risk and compound difficulties around budget setting.

The wider economic outlook is also a source of concern for financial resilience in local government. The COVID-19 pandemic was a once-in-a-generation shock that required an immediate response, and despite government support many authorities found themselves in financial difficulty as a result: in August 2020 it was reported *in the Local Government Chronicle* that **as many as one in 20 local authorities** were at high risk of issuing a Section 114 notice due to pandemic pressures. While recovery from the pandemic has been ongoing, with its impact still being felt across the country, 2022 has brought new economic challenges including rising inflation, increased interest rates and an energy crisis. In an atmosphere of political and international uncertainty, and with other significant threats on the horizon such as the climate crisis, these issues look set to persist over the medium to long term. In this context, making sure authorities are in a resilient and sustainable position to weather any shocks becomes ever more important.

This report contains case studies on three authorities that have issued Section 114 notices within the last five years: Northamptonshire County Council, London Borough of Croydon and Slough Borough Council. The aim is not to castigate where there have been failures, but look at common issues that contributed to the decision to issue a notice, and how each authority has recovered and rebuilt, even if this is still ongoing. This report also takes into account higher-level conversations about the Section 114 regime, following the **Housing, Communities and Local Government Select Committee report** on this issue in July 2021 and the government response in October 2021. It is right and commendable that section 151 officers exercise their legal duty to issue a notice when the situation demands it; it is also essential that robust financial management processes are in place to identify and resolve issues long before a notice becomes necessary.

03

Case study: Northamptonshire

In February 2018, Northamptonshire County Council was the first local authority in nearly 20 years to issue a Section 114 notice. At the time this was a dramatic development, though several other authorities have reached this point or come close to it in subsequent years. Investigations demonstrated that issues at Northamptonshire dated back to 2013/14, if not before, and following the work carried out by commissioners it was decided that the county council should be part of a reorganised structure that created two unitary authorities. So far, it is the only authority to be dissolved following a Section 114 notice.

Warning signs were on the horizon before February 2018, with external auditors KPMG issuing adverse audit opinions in relation to value for money in 2015/16 and 2016/17; a September 2017 Local Government Association (LGA) peer review also raised concerns about the authority's compliance with their best value duty. In response to this, the Secretary of State for Housing, Communities and Local Government commissioned an independent inspection in early January 2018 with a specific focus on best value. The county council had also raised ongoing issues with the government including high demand for services and demographic pressures, and a separate exploration into re-organisation had commenced, with the seven district councils in Northamptonshire resisting proposals for a county-wide unitary authority.

While the best value inspection was in progress, the section 151 officer issued the Section 114 notice on 2 February. Then on 20 February, KPMG issued their advisory notice that the budget about to be set for 2018/19 was likely to be unlawful. A revised budget was issued on 1 March that reduced spending by £10m, thereby meeting the legal duty to set a balanced budget, though concerns remained about the overall financial position.

The **best value report** conducted by Max Caller was published two weeks later on 15 March, and found that "*Northamptonshire County Council (NCC) has failed to comply with its duty under the Local Government Act 1999 (as amended) to provide best value in the delivery of its services.*" A lack of budgetary control was traced back to 2013, and of particular concern was the reduction in the authority's reserves, from £57.7m in 2013/14 to £8.8m by 1 April 2017. Capital receipts had been used to compensate for an overspend in revenue and to fund unsubstantiated 'transformation' initiatives, likely in breach of statutory guidance, and decisions were not adequately challenged or scrutinised when passing through approval. The report also highlighted pervasive cultural issues at the authority including deficiencies in leadership, cross-organisational working, budgetary oversight and accountability, with high turnover at the top of the organisation and structures that prevented co-ordination in working practices. The Section 114 notice and the auditors' advisory notice were cited as indicators of "systemic failure", and final recommendations included replacing the county and district councils with two new unitary authorities, to enable a clean start.

Northamptonshire County Council had previously claimed that they were disadvantaged by higher than average population growth, resulting in both increased demand for services and insufficient funding from central government. The best value report refutes this by benchmarking against other similarly sized counties to find no overall disadvantage, while noting that such pressures should not prevent an authority from meeting the duty to set a balanced budget. Overspends against the budget were recorded every year between 2013/14 and 2016/17 and were largely in the area of children's and adult social care; these were funded via the use of reserves and one-off resources. Planned savings were also not achieved, and so the amount of savings required grew year-on-year. A Section 114 notice was even considered in October 2015 but ultimately not issued – doing so would potentially have averted the much more serious position the authority found itself in by early 2018. The LGA peer review in 2017 was explicit in its assessment of Northamptonshire's financial position, but as with the adverse audit opinions it did not provoke an urgent response. In light of these developments it is clear that a Section 114 notice retains its impact as a severe wake-up call where other measures have lacked teeth.

The best value report concluded that the time and investment required to rectify these deep-seated issues at Northamptonshire would be too vast to be worth it – anything less than a fresh start would be a disservice to the people of the county. The proposal to set up two new authorities, West Northamptonshire and North Northamptonshire, was accepted on 16 March 2018, and the government appointed two commissioners to guide the county council through to March 2021. One of their first steps upon arrival at the authority was to bring in CIPFA to uncover the true financial position: rather than the reported £8m financial pressures for 2018/19, CIPFA's work revealed a significant unfunded deficit for 2017/18 alongside £30m pressures in 2018/19 and a projected shortfall of £60m for 2019/20. The **commissioners' final report** is clear about the extent of the problems, but they are positive about the improvements achieved during their tenure, and praise the efforts of staff to make the necessary changes.

Northamptonshire's recovery by March 2021 has provided a positive lesson: the commissioners' work to prevent overspending and implement financial controls meant that by the end of 2019/20 the authority was generating an operating surplus, with an improved reserve position by the end of 2020/21. Some of these reserves were found through savings and efficiencies rather than through extraordinary measures such as raising additional council tax. Strengthened leadership and good management, financial and otherwise, benefitted the whole organisation, raising both employee morale and salaries and allowing the restoration of local services that had been neglected. The commissioners also noted that although there were many challenges around children's social care, adult social care had maintained consistently high performance at a below-average cost. Even with the pandemic to potentially disrupt the transformation programme, Northamptonshire reached March 2021 with renewed decision-making capacity, financial integrity, operational capability and trust – both within the organisation and with external stakeholders. The commissioners' intervention aimed to rebuild governance capacity via culture change to enable scrutiny and challenge, and to secure financial management and compliance with the best value duty; their report concludes that these objectives have been achieved, and the authority was ready for the transition into two new entities.

04

Case study: Croydon

Though many authorities experienced financial challenges during the onset of the pandemic, the London Borough of Croydon was the first to issue a Section 114 notice, in November 2020. Despite this timing, the problems that Croydon faced dated back several years, and although they were exacerbated by the economic impact of COVID-19 and government lockdowns, their causes lay elsewhere.

Croydon had engaged in informal discussions with the then Ministry of Housing, Communities and Local Government (MHCLG) during summer 2020 about its financial position. **Guidance around Section 114** had been modified by CIPFA and MHCLG to allow such discussions to take place, due to the extraordinary circumstances of 2020. However, Croydon's position was still of significant concern, and by September the CFO issued a draft Section 114 notice to the council leader and deputy leader, interim chief executive and monitoring officer. This did not constitute a formal notice, but it was copied to MHCLG, the LGA and their external auditors (Grant Thornton). The auditors then also sounded the alarm by issuing a report in the public interest on 23 October; this prompted a government rapid review, announced on 29 October. On 6 November, CIPFA CEO Rob Whiteman wrote to Croydon to clarify that the modified Section 114 guidance only applied to financial pressures and incurred costs caused by the pandemic, which was not the case in this situation.

By 11 November 2020, Croydon's CFO judged that there was not enough time left in the financial year to rectify their position and deliver the necessary savings against the budget, and so issued the Section 114 notice. At the time of issuance, the forecast overspend was £30m, with a further £36m at risk. This was taking place amid the ongoing uncertainty of the pandemic – the notice was issued around a week into England's second national lockdown – it was likely to be especially challenging to find enough savings, and a requested emergency capitalisation direction that could have provided additional financial capacity was not guaranteed.

The **auditors' public interest report** identifies several issues behind Croydon's inability to balance their budget. Spending pressures related to social care, with an overspend of £39m in this area, combined with worryingly low levels of reserves, which were flagged in the auditors' report for 2018/19 and also highlighted in the CIPFA Resilience Index and by the Institute for Fiscal Studies, as the public interest report notes. Grant Thornton had raised concerns about financial sustainability in the 2017/18 accounts in relation to value for money, but recommendations in that year and the following year were not followed and the position deteriorated. The flexible use of capital receipts was maximised to fund 'transformation' efforts, though the auditors did not see clear evidence of transformation being achieved. The authority's focus in the years preceding the Section 114 notice included:

- improving service delivery, but without monitoring overspends against budget
- investing in commercial opportunities, but without addressing their delivery against expectations
- asking for additional funding from central government, but without controlling their spending.

An additional layer of complexity came from Croydon's investment strategy, which had resulted in borrowing of £545m in a three year span; any significant return on investment had not yet materialised by the time the Section 114 notice was issued. Per the auditors' report, the asset investment strategy was approved in October 2018 without substantial challenge, and included two purchases in 2018/19 of a shopping centre (The Colonnades) and a hotel (Croydon Park Hotel). The council also invested around £200m in Brick by Brick, a housing development company designed to address housing shortages in the local area, of which the borough was the sole shareholder. In the case of each of these companies, there was a serious lack of oversight and governance, and therefore a very high level of risk exposure to the authority that was not managed. Grant Thornton's report notes that "*the investments in The Colonnades and Croydon Park Hotel were not grounded in sufficient understanding of the retail and leisure market and have again illustrated that the council's strategy to invest its way out of financial challenge rather than pay attention to controlling expenditure on core services was inherently flawed.*" Both establishments were immediately impacted by the COVID-19 lockdown in spring 2020; the shopping centre closed permanently, while the hotel operators went into administration. Despite the quantity of investment in Brick by Brick, it was slow to build and sell houses and so did not deliver any of the expected dividends for Croydon – or the much-needed housing for local residents.

With hindsight, Croydon's problems were not caused by the pandemic, but they were exposed by it. Events in 2020 threw the authority's financial instability into sharp relief, and resulted in a situation that required urgent remedy. The Section 114 notice was the legislation process that enabled the borough to stop and review its direction of travel.

05

Case study: Slough

Slough Borough Council was one of eight local authorities under MHCLG-commissioned review during the summer of 2021; before the review commenced, Slough's CFO issued a Section 114 notice, on 2 July 2021. The notice drew members' urgent attention to the authority's financial forecast and severe deficit, citing specific problems with the miscalculation of the minimum revenue position (MRP, ie the annual charge to the revenue account for the repayment of debt incurred to fund capital expenditure) since 2016/17. Other issues included the overstatement of various assets, the incorrect use of capital receipts and a fall in reserves. In-year projected spending for 2021/22 was far above budget, with a negative General Fund balance of £56m and a deficit of £40m within the year. To make matters worse, the council was awaiting the outcome of a £15m capitalisation direction, which was contingent on the outcome of the financial review undertaken by CIPFA Solutions. In all, this was undoubtedly a very difficult budget position.

The **Section 114 notice** confirms that dialogue with MHCLG had been ongoing since December 2020, and significant issues such as the extent of the deficit had only been uncovered in April 2021, after the 2021/22 budget had been approved. This was an indication of weak financial management. By July 2021, the 2018/19 accounts had not yet been signed off by external audit, and the 2019/20 and 2020/21 audits remained incomplete. The incorrect calculation of MRP was a significant concern due to the fact that this was potentially a breach of statutory duty.

Other issues raised by the CFO in the Section 114 notice were governance arrangements around wholly or partly owned companies, with weak financial management practices creating risk exposure for Slough. The departure of experienced finance staff over recent years had caused a loss of organisational knowledge that was hard to replace. Council tax income estimates were found to be inaccurate, and the insurance reserve and PFI sinking fund had been used up in previous years to cover shortfalls and balance budgets. Overall, there was a lack of long-term planning and financial strategy, with successive budgets focused on the short-term, year-to-year view rather than looking to the medium term. This led Slough to a position where there were no straightforward solutions, but the Section 114 notice was a crucial first step in drawing attention to the urgency of the problem.

The **CIPFA report**, on behalf of what was by then the Department for Levelling Up, Housing and Communities (DLUHC), identified the need for significant government support while the council sold off its assets to cover the budget shortfall. A significant level of savings would need to be identified and achieved to complement this work, even as investigations were ongoing as to the true financial position of the authority and the quantity of its liabilities. The report recommended an immediate capitalisation direction for £112m to cover previous years as well as the 2022/23 budget, while noting: *"At this stage, we cannot provide assurance that the Council will be able to balance its budget in the medium to long term."* Other recommendations included the urgent preparation of a high-level risk register and the annual governance statement for 2020/21, which was still outstanding, as well as setting limits on future borrowing and capital spending. The council's financial capacity also needed to be reinforced, particularly by moving staff from interim to permanent or longer contracts and hiring a deputy section 151 officer and any additional resource required. Overall, the CIPFA report confirmed the scale of the challenges faced by Slough and recognised that this was not something that would be remedied in the short term.

To complement the CIPFA investigation into financial management at Slough, a review was also undertaken on **governance arrangements**; Jim Taylor reported back to DLUHC in September 2021 that Slough had failed in its best value duty and its governance processes were not fit for purpose. Issues dated back ten years, with Ofsted rating the council's children's services as 'inadequate' in 2011 and then again in 2016, with improvements only seen by 2019. The length of time it took to address problems in such a crucial service was noted by Taylor, who also remarked that the Section 114 notice and Section 24 statutory recommendations from external audit are "*signals of systemic failure [...] they develop over years of inadequate corporate governance and action.*" LGA reviews in May 2018 and February 2019 highlighted major risks and should have prompted an immediate response from the authority, but no action seems to have been taken at the time. The report's recommendations confirmed those made by CIPFA and included a complete cessation of the capital programme, flagging the risk that Slough would not be able to fulfil its statutory functions such as social care if the challenges were not addressed.

Following these reports, DLUHC appointed commissioners to Slough on 1 December 2021, including Max Caller, who had previous experience at Northamptonshire. The appointment was for three years, with reports to the secretary of state every six months on Slough's progress. A lawful, balanced budget was approved on 10 March 2022, following approval for capitalisation directions to cover the years between 2018/19 and 2022/23 – which would only be issued on an iterative basis once the previous year's accounts have been finalised, approved and certified by the auditors. In **their initial report in June 2022** the commissioners confirmed that Slough would need capitalisation support of at least £670m over subsequent years, alongside asset disposal of £600m over three years and revenue savings of £20m per year.

Through the first half of 2022 Slough started to make the necessary changes to address the severity of its position, including some internal restructuring to improve capacity. However, the commissioners' view echoes the concerns expressed in the antecedent reviews and reports about the scale and pervasive quality of the problems. Recovery will take at least six years and is likely to require extraordinary council tax increases as well as continuing government support, on top of the asset disposal and savings plans already being pursued. At the time of writing, the outlook for Slough remains uncertain.

06

Conclusion

The three local authorities examined in this report are very different to each other. Northamptonshire was a county council in the south Midlands; Croydon is a London borough; Slough is a unitary council in the home counties and the third smallest unitary in England. Though they are situated in different contexts, these three case studies show how the authorities found themselves in a similar position. Looking at them side by side reveals some common themes, which can be drawn on as ways to avoid reaching the point where a Section 114 notice becomes a possibility.

An unwillingness to see the reality of the situation

Across the three case studies there are various points at which warnings about the financial position of the authority were ignored or not acted on. This took the form of auditor reports, section 151 officer notices, peer reviews or other external partners voicing concerns. When investigations began into what went wrong, it was clear in each case that opportunities had been missed in the preceding years to take preventative action. Northamptonshire focused on lobbying for more central government funding, Croydon kept pursuing their investment strategy and Slough continued borrowing large sums for further capital expenditure. The first step in each case would have been to recognise that the current plan was not working and clearly assess the risks and budget pressures in front of them. This might have involved taking very difficult decisions, but would have prevented the situation deteriorating to the same extent.

An absence of leadership

The inability to make those difficult decisions comes from a lack of leadership at the top of the organisation, constraining lower-level employees from being able to address problems. This also frequently manifested as a lack of proper scrutiny and challenge in relation to budgets, financial reports and capital and investment strategies. At Slough, the commissioners reported on a sense of 'passivity' from senior leadership that resulted in corporate inertia rather than seizing hold of the situation. At Croydon, the CFO noted in the Section 114 notice that there was a lack of urgency or appetite for the radical decisions needed to turn the situation around. By contrast, the decision to issue a Section 114 notice displays the kind of leadership needed to start to improve the authority's position, by publicly calling attention to the problem and putting a halt to spending in the short term.

Inadequate governance processes

Governance processes in these three authorities have also been revealed as not fit for purpose. The depth of their financial problems indicates a serious lack of oversight, with audit and governance committees not exercising their function as they should have been. At Slough and Croydon, this was a particular issue around their council-owned companies, which were under-performing and not delivering the expected results. In each case, senior officers and members needed the skills to appropriately govern and scrutinise the authority's operations, and manage the risks so as not to put taxpayers' money and local services in jeopardy.

Weak financial management

Financial management processes were often weak and insufficient for the tasks at hand. Key principles of good financial management such as accountability, sustainability and transparency were absent, and this allowed issues to flourish. A substantial reduction in reserves was a concern for each authority, and left them without the funds to hand to solve problems when they appeared. **The CIPFA Financial Management Code** sets out best practice in this area and was published in 2019 – too late for Northamptonshire, but in sufficient time for Croydon and Slough to have regard to its guidance. As stated in the best value report on Northamptonshire, "*In local government there is no substitute for doing boring really well. Only when you have a solid foundation can you innovate.*"

CIPFA promotes best practice in financial management to support the local government sector's sustainability and resilience, and help avoid the rare circumstances where a Section 114 notice becomes necessary. We have a variety of services and resources to further this aim, including training and continuing professional development, technical publications and networks maintained by our in-house experts. CIPFA Solutions, our consultancy and advisory team, have experience in conducting reviews and providing direct support to local authorities in financial difficulty.

Section 114 notices are rare, but not as rare as they used to be. The long-term reduction in central government funding and the rising demand for services are pressures that will not go away any time soon, and the sudden shock of the pandemic laid bare any underlying weaknesses in authorities' financial positions. With an increasingly uncertain economic outlook, local government resilience faces another severe challenge, and therefore the time is ripe to learn from these case studies. Strong financial management and governance will put local authorities in the best position to weather any storms to come.

Further information

CIPFA's *Financial Management Code* provides guidance for good and sustainable financial management in local authorities.

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