Local Authority Financial Sustainability and the Section 114 Regime

Housing, Communities and Local Government Committee. November 2020

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This submission relates to the following key issues outlined in the terms of reference

The Committee is inviting submissions on the scale and depth of financial sustainability issues within local authorities with the potential to lead to the issuing of S114 notices, including the effect of commercial investments and the impact of Covid-19, and the role of central government in helping councils avoid this outcome. In considering this question, submitters may wish to address:

- Those issues likely to cause impact the financial sustainability of local authorities, specifically structural funding issues (including grant funding), commercial investment decisions and the impact of Covid-19;
- The scale of the problem, including assessment of CIPFA's resilience index;
- The role of MHCLG, including oversight of the Prudential Framework, capitalisation and reform of the Public Works Loan Board (PWLB);
- What measures could help to stop, or reduce the number of, further S114 notices being issued.

Summary

This submission provides evidence on all of the key issues outlined in the terms of reference. It exceeds 3000 words and is summarised as follows.

There are increasing numbers of long-term and complex financial challenges besetting local government, that if not addressed, will continue to make an increasing number of authorities financially unsustainable. Under current financial reporting arrangements this will lead to the issuing of more Section 114 Notices.

The scale of the problem is significant, and the long-term unsustainability of local authority finances is fundamentally due to underlying structural issues in the collection, allocation and distribution of revenue raised to support local public service provision.

Continuing to provide short term and piecemeal financial support on the basis of the system last revised in 2013 is increasingly inefficient and sub-optimal in terms of distribution, with all parts of the current model becoming demonstrably more regressive in terms of their impact.

COVID-19 impacts and authorities' involvement in risky commercial investments exacerbate and intensify this long-term problem and have accelerated the process, but neither are they the fundamental causes of these problems.

There is a long-term need to re-establish a new regime for local authority financing that is fair and sustainable; that reflects the levels of need for local services and the ability of individual local areas to generate revenue.

The implementation of the Redmond proposals for local audit, the adoption of CIPFA's financial resilience index and the provisions of the Fair Funding Review will not resolve these fundamental issues on their own. A new local audit regime and a fairer distribution mechanism are both necessary, but not sufficient to generate long-term stability and a robust new regime.

A new regime will require significantly improved data and information, not least for the assessment of need, as the basis of calculating the future property tax component, and for the economic and efficient operation of the re-distributional mechanism.

An improved and updated Resilience Index; changes to the oversight of the Prudential Framework, capitalisation and reform of the Public Works Loan Board are necessary in themselves and as part of a new local government financial regime.

The submission that follows provides analysis and recommendations on each of these issues.

1. Introduction

In our evidence to the Committee in November following the announcement of the Spending Review for 2021/22, we submitted the view that whilst the reliance on annual budgeting was understandable given the dynamic crisis caused by COVID-19, the government needs to introduce a longer-term, more fundamental change to local government finance arrangements for the post pandemic and post Brexit era (Murphy & Eckersley, 2020). This should move central-local relations onto a more stable and long-term statutory footing, make the system more robust and transparent (including improving the data and information upon which decisions are based), and hence improve accountability. The new system should also incorporate periodic reviews of the key elements as part of its basic design.

This evidence draws on our earlier submissions to the committee that identified the structural funding issues facing local authorities (Eckersley, Murphy & Ferry 2019) and discussed some authority's commercial investment decisions (Murphy 2019a). In addition, it builds on our evidence to the Redmond Review on the inadequacy of local audit arrangements and the need for financial sustainability and financial resilience to replace the 'going concern' judgement which has been rendered "meaningless" in the local authority context (Redmond 2020, p. 50). It also includes consideration of the use of Section 114 notices and Public Interest Reports (Murphy & Lakoma 2020). Finally, it uses insights from interviews that we conducted with 11 councils between November 2020 and January 2021 to gather their perceptions on financial resilience and sustainability. We stress that a Section 114 notice should be viewed as a (very) late distress signal that highlights financial problems within a local council, and the key issue to address revolves around the ability of an authority to set a sustainable (and therefore legal) budget in the first place, not the issuing of the Section 114 notice in and of itself. In this vein, we concur with the evidence that Sir Amyas Morse gave to the 2019 Spending Review inquiry, namely that "a combination of reduced funding and higher demand has meant that a growing number of single-tier and county authorities have not managed within their service budgets and have relied on reserves to balance their books. These trends are not financially sustainable over the medium term". This was later confirmed in the NAO's Departmental Overview for local authorities (NAO 2020b).

In December 2020, the Institute for Fiscal Studies (Ogden & Phillips 2020) brought the analysis fully up to date when they assessed the 2021/22 Local Government Finance Statement (LGFS) plans for both core funding and top-ups for ongoing COVID-19 related costs. In simple terms, these sources all indicate that the scale of the problem is significant, will continue to increase and the number of councils under financial stress will almost inevitably rise.

Commercial investment has become a controversial feature of local government finance in recent years, in particular the extent to which these investments are funded by borrowing. This has stimulated debate around the extent to which local authorities should be undertaking this type of activity to generate income in response to increasing service demand, reductions in government grants and restrictions on traditional sources of revenue.

Low interest borrowing has led to a sharp increase in acquisitions of land and buildings using capital finance. Although relatively stable at between £800m and £1.1bn from 2012 to 2016, there has been a sharp rise since 2016/17, and this trend has continued. MHCLG's statutory guidance and CIPFA's recently updated Prudential Code are clear that authorities need to consider the long-term sustainability risk implicit in becoming too dependent on commercial income, or in taking out too much debt relative to net service expenditure. Issues arising from increased debt levels and the activities of wholly owned commercial enterprises have also featured prominently in the Public Interest Reports in Nottingham and Croydon (Grant Thornton 2020a, 2020b).

Central government has encouraged councils to be innovative and become more entrepreneurial but borrowing in advance of need purely for commercial purposes is not consistent with the Code or with the guidance, and CIPFA have continually reiterated the need to ensure that such acquisitions are affordable, prudent and sustainable (CIPFA 2019).

2. Issues affecting the financial sustainability of local authorities, specifically structural funding issues, commercial investment decisions and the impact of Covid-19;

The main structural issues with the financial sustainability of local authorities have revolved around the following

a. **Revenue Collection**: the form, nature and amount and level of certainty of revenue collection both national and local. Should revenue for local government be collected via taxes on income; or property (whether collected from owners or occupiers,) or local sales or tourism tax or a combination thereof?

The fact that local government in the UK is not funded from the plurality of taxes is very unusual, particularly compared to other Western European countries (Kuhlmann and Bouckaert 2016). Tax raising to support local government spending in the UK is also exceptionally centralised (Ferry et al 2015). The two major reviews of local government finance since 1914 (Layfield 1976, Lyons 2007) both took the view that the design of a system of local finance must depend on the nature of the relationship between central and local government and what local government is expected or empowered to provide. They then considered the fundamental options referred to above. We would very much wish to contribute to such a fundamental debate (and believe one is necessary), but we are assuming the committee's intention is to adopt a narrower focus relating to the current structure and forms of revenue available for local government services.

The current structure and forms of revenue for local government services are central government support to local authorities both capital and revenue (in the form of council government grant and borrowing allowances); the collection and redistribution of revenue from business rates; the levying of council tax and the ability to levy various fees and charges. The UK is also unusual in that a large share of this revenue comes from recurrent taxes on buildings (council tax and business rates).

It is widely reported and accepted that since 2011 (and prior to COVID-19 expenditure), the real level and proportion of central government grant that supports local government expenditure has significantly declined (National Audit Office 2018). In effect, central government has been collecting more money that it distributes, and it has significantly reduced funding for local government. Although there were large increases in local authority grant funding between 2000/2001 – 2010/2011, these have been wiped out over the last decade and there has been a fall in the funding that local government receives as a percentage of national income, by approximately 8% between 2000/2001 and 2018/19 (Institute of Fiscal Studies 2019). Between 2010 and 2019, more money was being collected by HMG than redistributed because of the government's policy aimed at national debt reduction. This policy reversed in 2020 in response to the COVID-19 pandemic emergency.

The amount of local government expenditure derived from locally raised revenue (council tax and business rates) has also reduced in real terms, although the more substantial fall in central grant funding means that this revenue now accounts for a greater proportion of overall income. The amount and the proportion of revenue raised from fees charges and other sources (including commercial operations) has also increased in both real terms and proportionately. The analysis from the Institute of Fiscal Studies of the 2020 single year Spending Review (Ogden & Phillips 2020) indicates that all these trends are set to continue. All of these changes have had a regressive effect on local taxation.

Multi-year Spending Reviews and indicative medium-term financial settlements were introduced to the UK in 1997 to facilitate more effective service and activity planning, for local authorities. However, the last two settlements (including that for 2021/22) have been single year settlements. In addition, the way in which spending reviews are conducted in the UK disadvantages local authorities, which are dependent on multiple central government departments.

It should be noted that since the announcement of the closure of the Audit Commission in 2010, knowledge and understanding about local authority performance and value for money has significantly deteriorated, as has the assurance to be taken from the local audit process since 2013. The Redmond Review demonstrates, and the government accepts, that local audit is no longer fit for purpose (Redmond 2020, HMCLG 2020a).

b. **Revenue distribution**: As well as being exceptionally centralised in terms of collection, central government exerts significant control over the amount of locally generated revenue (including VAT) and controls the re-distributive mechanism (usually referred to as 'needs equalization process'). The latter is required to ensure the resources available to different local authorities is adjusted to avoid major inequalities in local service provision between communities.

The basis of the redistributive mechanism has historically varied over time and for many years was reassessed annually. Since the 1970's, it was to a degree based on the Index of Multiple Deprivation. However, since 2011, needs and resource equalisation has effectively been frozen, and significant changes to the needs and demands of local communities since that time have not been taken into account. The basis for collecting council tax is even more variable and inequitable, since collection is based on valuation bands established in 1993, which have never been comprehensively reviewed or extended, but merely adjusted when individual properties are sold and a new valuation is applied.

Since 2011 there have been substantial demographic changes – the population has been growing and, more importantly, the parts of the population that rely on the services or have demand for the services that local government provides have been growing more quickly than the population as a whole.

(Murphy 2019). This has most obviously been seen in social services. Over the same period , the reductions in central government grant have fallen disproportionately heavily on higher spending authorities, because central government grant is based on needs, resources and equalization, and ring-fenced grants that funded specific initiatives or services (such as Sure Start centres or neighbourhood renewal) were either subsumed into the Revenue Support Grant or abolished altogether.

The Committee will be aware that the ongoing 'Fair Funding Review' (Sandford 2020) that both central and local government are committed to progressing, has agreed that population, deprivation, sparsity and special considerations will be reintroduced as the basic pillars of future needs assessment. This needs to be accompanied by significant improvements in the data and information on which decisions are taken. If a property tax is retained, then contemporary values of domestic properties should be used, and council tax bands extended. If business rates are retained (these are currently calculated on the basis of square footage of business floorspace), this should be recalculated on the basis or added value or alternatives that better reflect the contemporary nature and pattern of business and wealth accumulation.

Another issue is that LG Financial Settlements do not attempt to identify how much funding councils need to provide a given level of services at a certain quality and at what efficiency they should be able to do that. They look at needs in an area relative to other areas. The key elements underlying the proposed new funding formula are:

- A relative needs formula, including an area cost adjustment (relative needs will be measured via a 'foundation formula' plus a number of additional formulae that are service-specific);
- A relative resources formula (using the council tax base and a single notional level of council tax, rather than actual local rates);
- Transitional arrangements known as 'damping' to ensure individual authorities do not experience very significant changes at the date of transition, which would cause them to be unable to manage their budgets in the short term.

As Sandford states "neither the Fair Funding Review nor business rate retention address the issue of how much funding should be made available to local authorities, nor do they address how this question should be answered…. There is no automatic link between the statutory duties faced by local authorities and the funding made available by the Government to enable them to carry out their duties" (Sandford 2020 pp. 23-24).

A long-term fundamental review of local government finance and spending should address these broader issues, namely how much funding should be made available. This should be related to statutory duties, informed by an assessment of absolute, rather than relative need. It should utilize data and information that is collected together in a publicly accessible repository sufficient to measure individual authorities' performance and spending against the needs of the authority's area.

Commercial investments

Low interest borrowing has led to a sharp increase in councils' acquisition of land and buildings using capital finance. Although relatively stable at between £800m and £1.1bn from 2012 to 2016, there has been a sharp rise since 2016/17, and this trend continues. In 2018 the NAO were sufficiently concerned to examine whether MCHLG's framework on investment in commercial property was sufficient to ensure the financial sustainability of local authorities. In October, Plymouth City Council agreed the first interest rate swap deal in almost 30 years (Rudgewick, 2020), after a High Court ruled that the 2011 Localism Act overrides a previous court decision that banned the practice. It allows the council to convert a proportion of its short-dated variable rate loans into fixed borrowing.

MHCLG issues statutory guidance and CIPFA recently updated the Prudential Code, which makes it clear that authorities need to consider the long-term sustainability risk implicit in becoming too dependent on commercial income, or in taking out too much debt relative to net service expenditure. However, in July 2020 the Public Accounts Committee issued a report that accused MHCLG of being too complacent about local authority's risky commercial property investments and extreme levels of debt**:** "The actions taken by the Department to address risky and non-compliant behaviour have been too little and too late….and … demonstrate that the 'soft' approach of guidance changes has failed" (PAC 2020).

The Public Accounts Committee would like to see the development and rapid deployment of 'interventions that target extreme risk taking'. While the Redmond review of local audit might include helpful recommendations it also called for "a wider package of changes, rather than relying primarily on (post-Redmond) external audit to address failings in the local governance of commercial investment activities" (PAC 2020). The government subsequently agreed with the committee's recommendation (HM Treasury Minutes 2020).

There are two main categories of local authority commercialisation:

- Investment in commercial property, usually through the general fund; and
- Investment in wholly owned companies set up using the "general power of competence".

Although the NAO and PAC reports relate to investments in commercial property, their concerns about increased risks are equally applicable to both categories.

Redmond noted that neither CIPFA's Pillars of Financial Resilience nor the Financial Management Code explicitly cover the impact of commercial activity on a local authority's financial resilience. General fund investments should be considered as part of the audit of financial accounts but wholly owned companies would only be considered if material enough to be consolidated into the accounts. He noted an additional risk from a potential lack of transparency in the governance of wholly owned companies.

Redmond recommended that the scope of audit should include a substantive test of a local authority's financial resilience and sustainability. This clearly must include wholly owned companies and investments in commercial property. Issues arising from the activities of wholly owned commercial enterprises featured prominently in the Public Interest Reports issued to Nottingham City Council and to the London Borough of Croydon.

MHCLG's response to Redmond (MHCLG 2020a) grouped its response into five areas, two of which are relevant to this review. In relation to the recommendations for:

- enhancing the functioning of local audit, and the governance for responding to its finding, and
- improving transparency of local authorities' accounts to the public,

the department agreed with the recommendations and agreed to work with the LGA, the NAO and CIPFA to deliver the recommendations. Thus, the reporting of both commercial investment and the accounts of wholly or substantially owned companies should form parts of the publicly reported accounts of local authorities. This does not however obviate the need for the development and rapid deployment of proactive 'interventions that target extreme risk taking' as recommended by the Public Accounts Committee, which we support.

COVID-19

In November 2020, prior to the LGFS announcing plans for council funding that included the top-ups for ongoing COVID-19 related costs, the professional accounting press reported that around 100 councils were in confidential discussions with the government, as COVID related expenditure and loss of income (from rents, council tax and commercial operations) threatened the statutory requirement of local authorities to set a balanced budget (AAT 2020). It was at this time that the possibility of numerous Section 114 notices became apparent. CIPFA identified three groups of councils most at risk:

- those dependant on significant commercial income including airports, such as Luton and Manchester
- Councils with low reserves
- Councils most reliant on sales, fees and charges (e.g. Coastal councils and districts)

MHCLG is carrying out a data collection to gather information on the impact COVID-19 is having on local authority finances. Information has been collected from local authorities in 8 rounds in April, May, June, July, August, September, October and it was last updated in December. The collection is being run on a regular basis while the government's response to the pandemic is ongoing. This data shows councils' COVID-19-related additional expenditure, income loss and allocation of the government emergency funding, as well as estimations of the full year impact. The Institute for Fiscal Studies in its analysis of the LGFS suggests

> "The extra COVID-19 funding being provided for next year does not look unreasonable if the impacts of the pandemic largely recede by summer as the vaccination programme rolls out and warm weather returns. If impacts persist though, additional funding may be needed, and in this case, the government could call on its £21 billion COVID-19 reserve"
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> (Ogden & Phillips 2020, p.1).

However, they warn that there is potential for longer-run and indirect impacts, which in addition to pre-existing demand and cost pressures will further widen the funding gap for local councils "unless there are continued large increases in council tax and/or additional funding is allocated or devolved to councils".

The case for sufficient and sustainable funding for local services was clear prior to COVID-19, but the pandemic heightened the need for long term stability and certainty in core funding and the need for greater in-year flexibility. Councils have to respond rapidly and "denying them funding certainty undermines their capacity to respond to fast-moving events." It also results in sub-optimal decision making, because they have fewer resources to gather and make sense of the multiple sources of information that could help them to identify and implement effective responses (Eckersley and Tobin 2019).

3. The scale of the problem, including assessment of CIPFA's resilience index

The scale of the potential problems is shown by the increasing numbers of councils having difficulty closing their accounts and the numbers who were in confidential discussions with the government about the potential challenges to setting a legal budget for 2021/22. However, the form of current local government accounts does not allow us to make an accurate assessment of the overall scale of the problem with any confidence. We do however know that the scale of the problem will increase (see section 1 above) unless there is a radical change in the system for funding local government and that will require legislation as well as resources.

The financial resilience of local governments is also linked to their level of perceived vulnerability. Perceived vulnerability is the extent to which an organisation considers itself susceptible to shocks and uncertain events, to which it is expected to cope, adapt, or recover from using a bouncing back, bouncing forward, or a combination of both approaches. The perceived vulnerability of an organisation is controlled using the financial resilience dimensions as stipulated by Steccolini et al. (2015). Some academic commentators (Barbera et al. 2017, 2019) have found that organisations with high perceived vulnerability levels are more likely to adopt coping capacities, while those with lower vulnerability levels would apply more anticipatory capacities. On this note, we know this suggests one reason why local government organisations often adopt coping capacities, by using short-term resources to address long term financial and service pressures.

Financial Resilience and CIPFA's resilience index

In Building Financial Resilience, CIPFA (2017) identified four 'pillars' or foundations of sound financial management and five indicators of financial stress. It then developed its Local Government Financial Resilience Index, which was launched in December 2019, although it continues to refine the tool. This is a comparative analytical tool that locates a council's position against a range of measures associated with financial risk. It is intended to provide a clear understanding of possible areas of financial risk and allows comparisons with various groups of analysis. It is currently based on data from 2015/16 – 2018/19 and can therefore help to identify trends.

Redmond (2020) considers the pillars of financial resilience related to process and governance matters, so could be part of the auditor's Value for Money opinion while the indicators of financial stress should be part of the risk assessment Redmond notes that while CIPFA members must follow the code, neither the pillars nor the code have a statutory basis to ensure compliance. Neither do they cover the impact of commercial activities on an authority's finances. General fund investments should be considered as part of the audit of financial accounts but wholly owned companies would only be considered "if material enough to be consolidated into the accounts".

Notwithstanding the fact that it does not include commercial exposure in non-consolidated accounts, we have retrospectively applied the index *inter alia* to Nottingham and Croydon and compared them to their nearest neighbour authorities. Within its group of 16 authorities, Croydon has the highest risk in either three or four of the nine factors for each year between 2015/15 and 2018/19. Nottingham is placed first or second in three categories in its group in every year bar 2016/17, with a pronounced deterioration in the subsequent two years.

Assuming practice develops, as the new NAO Audit Code intends (2020a), we agree with CIPFA and the department

- that the scope of local audit should include a substantive test of a local authority's financial resilience and sustainability to test whether the body is planning effectively to continue to deliver its services or the way in which they would be delivered over the medium or longer time horizon (as in Scotland).
- Auditors (internal and external) should use the CIPFA indicators of financial stress as a key element of the risk assessment.

In addition, if it is not already doing so, CIPFA should be requested to extend their financial resilience index to include all appropriate commercial investments and wholly owned companies. All Section 151 offices should also be required to report on an authority's compliance with the CIPFA Financial Management Code and report on it in the Annual Governance Statement. Auditors should be required to report on any material breaches.

We also agree with Redmond's suggestion that the auditor should be required to critically assess and, in cases where significant risks are identified or emerging, test the CFO's Section 25 report along with any other statutory reports or management estimates that have an impact on medium- or long-term financial resilience. This testing could include an assessment of whether there are clear plans for delivering savings, the usage rate for non-ringfenced revenue reserves and whether the local authority benchmarks its costs against nearest neighbours and takes appropriate action in response to variances, as set out in accordance with CIPFA's Pillars of Financial Resilience".

CIPFAs Resilience Index is a relative comparative tool which ideally in the long-term should be supplemented by some absolute service benchmarks and costs. In our interviews with local authority finance managers, we found that some do use the tool and find it useful, although others prefer to rely on other internal tools to measure their financial sustainability and organisational resilience. Some local authorities also use the CIPFA resilience index as a tool to check the effectiveness of their locally generated tool. We would suggest that the CIPFA Resilience Index be modified to suit the needs of all local authorities in England and Wales. The tool needs to be reviewed to ensure more clarity to users, as the current guide looks brief and does not seem to capture a variety of functions within the dashboard. We believe that the tool will be much useful and useable if adjustments are made based on these recommendations.

4. The role of MHCLG, including oversight of the Prudential Framework, capitalisation and reform of the Public Works Loan Board (PWLB).

The terms and arrangements for borrowing are determined by HM Treasury and set out in the Lending Arrangements for PWLB loans. Interest rates for PWLB loans are also determined by HM Treasury in accordance with section 5 of the National Loans Act 1968. The interest rates are calculated and published by the Debt Management Office (DMO) on HM Treasury's behalf in accordance with agreed procedures and methodologies set out in in a DMO Technical Note.

Major local authorities may take out PWLB loans. Since 2004, under the prudential regime, major local authorities are responsible for their own financial decision making. They are free to finance capital projects by borrowing, provided they can afford to service their debts out of their revenues. In deciding how much debt is affordable, authorities are required by law to "have regard" to the Prudential Code, published by CIPFA, but have discretion to decide how to fulfil this statutory requirement.

The Public Accounts Committee argued that these arrangements are far too lax, and that the prudential framework has been impaired by the emergence of new initiatives in the sector, and now requires fundamental review (PAC 2016). In a subsequent report, it considered that MHCLG took “modest steps to improve data and strengthen its guidance after realising that there is an issue with the borrowing and investment behaviour in parts of the sector” (PAC 2020). Since 2016 these investments have increased 14-fold and the recent NAO report (2020b) showed 179 authorities purchased commercial property in the 3 years to 2018-19, with 49 authorities accounting for 80% of the investments. The NAO found significant numbers of acquisitions were for yield rather than service provision: £2.5 billion was for property outside of authorities’ own areas and up to £6 billion was financed by borrowing. The NAO also found instances where local authorities were not making Minimum Revenue Provision on their commercial property acquisitions. This borrowing should properly be reflected in current spending so that the costs of borrowing do not fall wholly on future council taxpayers.

Local governance arrangements were not considered robust enough to monitor these investments with some authorities’ commercial investments not being properly transparent or subject to adequate scrutiny and challenge (NAO 2020). The Centre for Public Scrutiny told the committee that, in some councils, member governance has not caught up with commercial activity and a change in culture is required (PAC 2020). This view is highly resonant with the Public Interest Reports into Croydon and Nottingham. The Public Accounts Committee recommended that MHCLG should be more active in its oversight of the prudential framework and strike a better balance between supporting localism and ensuring that local authorities act within the frameworks that underpin local freedoms.

The PAC recommended that MHCLG should work with CIPFA and sector stakeholder bodies, to undertake a thorough review of the prudential framework. This review should incorporate provisions to challenge behaviour in the sector, design effective interventions and improving the data held by the MHCLG. We support these recommendations.

5. What measures could help to stop, or reduce the number of, further S114 notices being issued.

A local authority’s Section 151 Officer (normally the Chief Finance Officer) has the personal power (and duty) to issue a Section 114 notice if they believe the authority is unable to set and implement a balanced budget. A section 114 notice effectively freezes spending other than statutory obligations, and the local authority may not incur new expenditure commitments. The Full Council must meet within 21 days to discuss the report although there is no provision for any action they must take.

As Redmond succinctly put it

> “If a local authority mismanages its budgets over a number of years so that it is unable to recover its financial position, then central government has the choice of:
>
> - intervening under its “best value” powers,

- providing exceptional financial support,
- facilitating an offer of leadership and governance support from elsewhere in the sector, or
- using a mixture of these options."

Contrary to the implication in the committee's terms of reference, the issuing of Section 114 is rare, as is the use of statutory intervention purely on the grounds of financial non-sustainability. Northamptonshire County Council in 2018 was the first statutory intervention primarily due to financial resilience issues, and the first issuing of two Section 114 notices, since Hackney in 2000. KPMG, the external auditor had provided earlier warnings about the issues that could trigger financial pressures, but these were not adequately considered in the councils decision-making process.

> "Even following the issue of the Section 114 notice in February 2018 and the KPMG Advisory Notice on the Budget also in February 2018, the Council still appears to struggle to take the necessary decisions at both member and officer level to control and restrain expenditure to remain within budget constraints." (Caller 2018 p. 1).

In 2018, KPMG (2018) warned NCC of potential "fraudulent revenue recognition" and identified a significant risk in the calculation of the Council's Minimum Revenue Provision (MRP).

> "Since the audit plan was published, we have now identified the calculation of Minimum Revenue Provision (MRP) as a significant audit risk. The Authority is proposing to recalculate MRP to achieve a saving of £8 million in 2017/18." (KPMG 2020 p. 7)

In summary the two Section 114 issues at NCC were due to financial failures, poor financial management, poor leadership styles (skills), and corporate negligence.

As we state in section 1 above, it was the possibility of numerous Section 114 notices that caused concern in 2020, not the actual number of notices issued. Croydon issued two notices in December 2020 following the receipt of a Public Interest Report by their external auditors (Grant Thornton) in October and a further report from PricewaterhouseCoopers into Brick by Brick Croydon Ltd, (a wholly owned subsidiary); the local Growth Zone; Croydon Affordable Homes LLP, the Revolving Investment Fund and the Asset Investment Fund in November (PwC 2020). The PIR revealed that

> "Croydon (the Council) has experienced deteriorating financial resilience for a number of years with spending pressures within both children's and adult social care and low levels of reserves which created a significant financial challenge in 2020/21, made worse by the additional financial pressures as a result of the pandemic." (Grant Thornton 2020, p.2)

On 16th December Croydon submitted a Renewal Plan to HMCLG and requested £150m of capitalisation loans, acknowledging that they will not be able to resolve the budget crisis without substantial support from the Government.

Nottingham City's expenditure has exceeded its budget since 2016/17, but despite regular warnings from the Section 151 Officer, it introduced short-term mitigation initiatives and a 'high risk' strategy of commercialisation rather than trying to reduce core expenditure and/or transform of service delivery. In August 2020, the External Auditors (Grant Thornton) issued a Public Interest Report ostensibly into Robin Hood Energy Ltd, a wholly owned company of the council, but the report also indicated wider financial issues in the portfolio of commercial companies and in the council's underlying financial health.

In October 2020, MHCLG instigated a 'rapid, non-statutory independent review' (akin to a Best Value Review) which concluded that "Nottingham City Council is not in a position to prepare and approve the legally required balanced budget for 2021/2022 without significant external support or the imposition of spending reductions, which would not be likely to deliver services that meet their statutory duties" (Caller 2020, p 2). Nottingham was at risk of issuing a Section 114 notice but never actually issued one. It did however formally agree with the conclusion of the review that it could not balance its budget without significant external support. In the circumstances the Secretary of State decided

> "I am minded to agree that, on balance, Nottingham City Council should be able to respond to their challenges… This reflects the Leader and Chief Executive's commitment to change and the fact that the necessary budget management work is now underway. However, it is clear that the Council will require significant and ongoing support."
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> (MHCLG 2020 p.1)

The Secretary of State announced that he would appoint an external Improvement and Assurance Board and require a recovery plan to be submitted by January 2021, upon receipt of which he will consider the form and nature of future support necessary to balance the authority's budget for 2021/2022.

It is the inability of an authority to set a sustainable (and therefore legal) budget that is the problem, not the issuing of the Section 114 notice. Section 114 notices can be considered as akin to a (very) late distress signal. At any stage during the audit, auditors can communicate on specific elements of the auditor's work on the audited body, report in the public interest, or make written recommendations. However, evidence shows that they have been used relatively infrequently (PSAA 2019). As the NAO recommends,

> "the auditor should maintain regular communication with the audited body to ensure that emerging findings are raised on a timely basis in the form, and at the level within the audited body, that the auditor judges appropriate".
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> (National Audit Office 2020a, p. 21)

Like Public Interest Reports and auditor's statutory recommendations, Section 114 notices are useful parts of the public assurance and financial investigation portfolio, as are statutory interventions based on part 3 of the Local Government Act 1999 (Best Value inspections). However, there are circumstances where some could be effective, but none are sufficient on their own to cover all relevant circumstances (Murphy 2019b). The NAO have given a great deal more prominence to most of them in their latest Code of Audit Practice (NAO 2020a) but, given past experience and the proliferation of commercial involvements and hybridized governance arrangements involving local authorities, we think they need revitalizing and a more fundamental review.

If new sustainable funding arrangements are established for local authorities in a multi-year spending review and Redmond's recommendations in relation to enhancing the functioning of local audit, and the governance for responding to its finding, are implemented, then the circumstances which require a Section 114 notice to be issued will decelerate rather than accelerate as they currently have the potential to do.

In the absence of a general requirement, and where material risks (to financial resilience or value for money concerns) have been identified by external audit or the Section 151 officer, whichever body assumes responsibility for the overview of Local Audit should have the power to require a specific investigation and a more detailed report to identify specific Value for Money or financial resilience issues. Similarly, the power and duty of Section 151 officers to issue Section 114 notices should be retained.

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