Financial crisis at Birmingham City Council: Part 1 – understanding the section 114

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Introduction

In September of this year Birmingham City Council, Europe's largest local authority issued a section 114 notice, essentially declaring itself bankrupt. The accepted view is that this collapse was due to a poorly managed £760m equal pay bill. Whilst that was important, there are deeper causes that underlie the financial situation at Birmingham City Council which provide a salutary warning of the crisis unfolding across the local government sector. At the heart of this, and other, crises are less well documented accounting, auditing, and governance issues which are sector wide and follow from a decade of austerity and the systematic failure of the external audit system.

The root causes of the impending crisis are related to the arcane financial tests that a Council must pass to avoid a section 114 notice. These tests are based on two elements: first, a short term budgetary goal and second, a General Fund position goal; where both are open to manipulation and tell only a partial story about a Council's financial position. The management of these two metrics have gone hand in hand with missed in-year savings targets for long periods and encouraged a growing reliance on debt finance. External auditors, the council and government have failed to identify the build-up of budgetary pressures from overstretched statutory services as potential Going Concern issues in a timely fashion.

This failure means that adjustments are less achievable without significant disruptions. It has implications for the upcoming budget consultation at Birmingham City Council and provides a warning to other councils about to commit to 'hard' (as opposed to 'soft') budgetary cuts. The consequences for residents, the delivery of statutory services, and longer-term financial viability, are likely to be profound. Many authorities face a situation where they are effectively unviable – faced with either breaking the laws that mandate the setting of balanced budgets or failing to maintain the crucial public services that they are obliged by law to deliver.

We will now outline in more detail what a section 114 notice means, outlining some of the accounting games played at BCC and the extent of audit failure there; before noting the difficulty and counterproductive outcomes of hard budgetary cuts.

A lay summary of section 114 notices

A section 114 (s114) notice under the Local Government Finance Act 1988 is issued when the Finance Director (referred to as the section 151 officer) of the Council adjudges that one of two somewhat esoteric financial tests set out in law cannot be met. These tests amount to: first, can the council balance its budget in year; and, second, does the council have sufficient reserves in their General Fund to cover future costs[1]. Failure of the first test leads to a s114(2) notice, while failure of the second test leads to a s114(3) notice. Such a notice is widely referred to as being an 'effective bankruptcy'.

In the case of Birmingham City Council a s114(3) notice was issued on 5th September 2023. However, in practice such a notice bears little resemblance to a technical corporate bankruptcy – it does not, for example, arise due to any inability to pay creditors, nor does it provide the council with any road map out of trouble, such as a debt consolidation or access to new long-term funding.

Once the s114 notice is submitted, the Council is then restricted such that they cannot approve any new non-statutory expenditure and must meet to formulate a plan to address the issues raised by the s151 officer. In the case of Birmingham, the s114 notice was then followed by the appointment of commissioners by the Department for Levelling Up, Housing and Communities to oversee governance, financial planning, and senior appointments, and the commissioning of a local inquiry into the causes of the financial breach.

However, in any s114, the council must continue to honour existing contracts and debt commitments as well as staff wages and salaries, which, together, amount to the vast majority of expenditure. And, just as importantly, the council must continue to provide the wide range of statutory services that they are also obliged by law to deliver. These demands conflict, pulling councils in different directions at the same time. And outcomes are thus often unchanged even after an s114 issuance.

The s114 situation at BCC

BCC's financial position was fragile even before the unequal pay claim liabilities were recognised. Indeed, it is arguable that the s151 officer would have been within their rights to issue a s114(2) notice over the summer of 2023 as significant budget overspends were declared: July 2023 Cabinet papers show that there was an £87.4m in-year overspend against the 2023/24 budget before the pay claims, rising to £177m by 2025/26. When the additional £650m to £760m equal pay liabilities were recognised, this pushed the council unambiguously into a negative reserves position, triggering a s114(3) notice. But these historic overspends

[1] For the full wording in statute, see: https://www.legislation.gov.uk/ukpga/1988/41/section/114

had already hollowed out a lot of the useable reserves, leaving little or no buffer for a claim of this magnitude (table 1).

By December 2023, Cabinet papers showed that little had changed, and had in fact worsened: deficits were predicted to increase to £300m in 2025/26. The Council therefore has an in-year budget deficit of around 9.5% of total income for this year (2023/24), an even larger budget deficit looming, *and* a negative General Fund position. In other words, even prior to the equal pay claims, the city was very nearly in negative reserves territory, such that a new equal pay liability of as little as £30m would have triggered the s114(3) notice. Similarly, of the £300m budgetary deficit, only a small amount related to the cost of settling new equal pay claims – the vast majority simply being an overspend against existing services.

Equal pay may have been the headline issue, but Birmingham Council, like many other councils across the country, was practically on the brink of, and had quite likely already passed the point at which, they were no longer able to set a short-term balanced budget. BCC did not reach this position overnight; it came after many years of cutting services without accounting for the knock on costs of these cuts, as we cover in Part 2 of this blog in relation to statutory services.

Table 1: BCC's General Fund Position

Useable Reserves	Value (£m)
Balance at 31st March 2022	**£596.8m**
Reserves used in 2022/23	(£336.2m)
Latest forecast 31st March 2023	**£260.6m**
Estimated reserves usage in 2023/24	(£25.6m)
Latest forecast 31st March 2024	**£235.0m**

Of the £235.02m, £172.2m is available for use.

*There are **additional draw-downs** which need to be addressed.*

Reserves available for Overspend and Other Items	£172.2m
Overspend for 2023/24	(£87.4m)
Oracle Costs (multi-year)	(£46.5m)
Extra Pay Award Costs 23/24 (assuming 6.5%)	(£11.2m)
Equal Pay Liability, midpoint £650m-£760m future yr	(£705.0m)
Negative Reserves	**(£677.9m)**

- Useable reserves is currently defined as the sum of the Delivery Plan Reserves, Financial Resilience Reserve, Other Corporate Reserves, and Earmarked Reserves;
- Our expected 2023/24 reserves position forecasts that we could have up to £172.2m of usable reserves to address the challenges above;
- *This is before the impact of Equal Pay, and the costs of borrowing to fund Equal Pay;*
- There are also other risks such as Highways PFI.
- As such, from an accounting perspective we are in a **negative general fund position**.

Source: 29 November 2023 BCC Audit Committee papers, item 12 Financial update

Why did nobody 'see it coming'?

Differences in accounting systems, and changes to accounting rules meant there was often little visibility of the problems at BCC. Local authorities are now obliged to adopt IFRS-style accounts, but these are very difficult to reconcile back to the historic budgetary and General Fund positions that underlie s114 requirements. s114 tests and notices pre-date the adoption of full IFRS accounting in local government in 2010/11, with adjusted General Fund figures still based on a form of partial cash accounting[2]. Similarly, the reserves requirements under an

[2] See the various 'adjustments between the accounting basis and funding basis under statute' on the face of the Movements in Reserves Statement any set of local authority accounts

s114 do not refer to *total* reserves (as it would in an IFRS net asset calculation), it refers specifically to the adequacy of *useable reserves within the General Fund*. This gap between IFRS reporting and the reporting of budgetary positions has encouraged creative accounting solutions, such as the transfer of amounts between reserves to 'protect' the General Fund. For example, in an earlier phase, BCC had recognised equal pay provisions of £121m, but these were charged against other 'unusable' reserves, effectively 'protecting' the General Fund, reducing s114 risks. This reallocation of funds has hollowed out those other reserves - leaving thinner buffers and obscuring problems of overspend[3]. It is within this context that councils are able to move from what appears to be a strong financial position under IFRS reporting to 'effectively bankrupt' under budgetary accounting in a short space of time.

To illustrate, BCC's most recent statutory accounts - the 2021/22 accounts (the 2022/23 accounts are 'delayed') - show remarkably little indication of financial difficulty (Table 2). Those accounts suggest that BCC had an accrual accounting surplus of £85m, total useable reserves of more than £1.5bn, a net operating cash flow of £463m, and a relatively stable income stream. Yet it was declared 'effectively bankrupt' within 18 months.

Table 2: Income and expenditure to 31 March 2022

Total Cost Of Services	**861.4**
Other Operating Expenditure	92.5
Financing and Investment Income and Expenditure	209.3
Taxation and Non-Specific Grant Income	(1,248.3)
(Surplus) / Deficit on Provision of Services	**(85.1)**

Reserves as at 31 March 2022

Usable Reserves	
Unearmarked Reserves	230.1
Earmarked Reserves	383.3
Grant Reserves	369.4
Unearmarked Non-Schools DSG	11.9
Ringfenced Reserves	117.2
Capital Reserves	400.3
Total Usable Reserves	**1,512.2**

[3] This is not to suggest that the IFRS accounts present any more a reliable position than the budgetary or reserves position summarised by the s151 officer – they certainly do not, due to a range of accounting practices under IFRS that allow assets to be speculatively revalued at estimated market values. One extreme example being that of Thurrock Council, with a recent value for money report finding that they had overstated the value of their investments by hundreds of millions of pounds in their accounts.

Cash flow to 31 March 2022

Net Surplus/(Deficit) on the provision of services		85.1
Adjustments to net Surplus/Deficit on the provision of services for non-cash movements	36	602.6
Adjustments for items included in the net Surplus/(Deficit) on the provision of services that are investing and financing activities	36	(223.8)
Net cash flows from Operating Activities		**463.9**
Investing Activities	34	(283.8)
Financing Activities	35	(177.0)
Net increase/(decrease) in cash and cash equivalents		**3.1**

The reason it is so different this time round is because a new accounting rule introduced in 2020/21 prevents councils from protecting their General Fund from equal pay claims for any new liabilities arising after April 2020, whereas previously these had been charged to unusable reserves[44]. This exposed the General Fund directly to equal pay claims with devastating implications for s114 at BCC. Curiously the potential impact of the equal pay liability was downplayed in both the 2023 budget and the 2023-2027 financial plan, with a 0% risk being attached to the equal pay provision (Table 3)[55]. It is unclear, as we write, what the reasons for this were, and whether the council were themselves aware of the new rule - an ambiguity no doubt not helped by significant turnover of key staff, including the s151 officer in March 2023. But this may have also contributed to the sense that BCC were not in any financial difficulty.

Table 3: Birmingham City Council Financial Plan 2023-2027 (Appendix C):

Risk	Mitigation	Existing Reserve/Provision £m	Residual Risk	Maximum Impact over Medium Term Financial Plan £m	Likelihood	Probability weighted medium term potential impact £m
Successful Equal Pay disputes	Provision has been set aside for outstanding Equal Pay claims.	270		0	0%	0

Where were the auditors?

The external auditors, Grant Thornton, have still not, at the time of writing, signed off their audits of the 2020/21 or 2021/22 accounts. This is symptomatic of a sector wide collapse in the external audit market – of the 467 local authority accounts across the country, only 12% received audit opinions on time in 2021/22, dropping to just 1% in 2022/23. As covered comprehensively by Research for Action in their recent report, since the abolition of the Audit Commission in 2015 and the privatisation of the external audit function, the market for external audit as a timely assurance statement on the accounts has effectively ceased to

[4] See pg.44 of the 2021/22 Birmingham City Council accounts for the disclosure of the change in accounting treatment under Section 8 of the CIPFA code, and IAS37.

[5] See page 84 of the 2023-2027 BCC financial plan.

function at local authority level. This is an especially acute issue when it comes to the audit of Going Concern – which, in the context of Local Authorities we can think of as an assurance statement on their ability to avoid a s114 for at least 12 months from the date of the accounts. If it takes the auditors more than 12 months to issue that assurance then the whole exercise becomes meaningless. And, worse than this, if auditors refuse to sign off their audit work *because* they have concerns over the Going Concern status of authorities, then it becomes meaningless not just in particular instances but in general. A watchdog trained not to bark for fear of giving away the burglar is not much of a watchdog.

In the case of Birmingham, particular questions need to be asked of the auditors in relation to their audit of the equal pay liability: why they failed to raise any concerns in relation to the possible understatement of the liability, and why, more broadly, they failed to disclose any issues with Going Concern throughout 2022 and 2023, until their correspondence with the s151 officer on 1st September 2023. They now appear to acknowledge that the provision was materially misstated in both the 2021 and 2022 accounts, despite previously completing their audit work on equal pay and finding no issues.

In investigating this issue further, we submitted an FOI request for the correspondence between the Council and the External Auditors in relation to their audit work on the equal pay liability in the 2021 and 2022 accounts. The full request, and the refusal notice from the Council, can be accessed here. In their response the Council accept that they do hold this information, and they also accept that it would be at their discretion as to whether or not to disclose this information. In choosing not to do so, they acted on the advice of Grant Thornton, who are quoted in the response as advising that:

"releasing this information in advance of any reporting by Grant Thornton runs the risk of distorting and/or diluting the usefulness of our conclusions".

This refers to the release of the audit opinions on the 2020/21 and 2021/22 accounts, which as of the time of writing, are still yet to be finalised. Whether or not they will be happy to publish this information after they have reported remains to be seen.

Under normal circumstances it might be understandable for an auditor not to want to disclose correspondence with an audit client, even where this was at the request of the client. However, in this case, the correctness of the equal pay provision will impact upon significant budgetary decisions and has major public interest consequences at the largest local authority in Europe. As we cover in part 2 of this update, these include a possible fire sale of assets and cuts to core public services that could leave the Council financially unviable. We urgently need an effective assurance statement on the equal pay liability, and, further than that, we need to know how the amount is calculated and what audit work has been performed.