



National Audit Office

## **Department for Education**

**Comptroller and Auditor General's Report on the Department for Education financial statements 2012-13**

# The Report of the Comptroller and Auditor General to the House of Commons

## Introduction

1. The Department for Education (the Department) is responsible for education and children's services. The Department sets policy and provides revenue and capital funding to Local Authorities, academies, free schools, further education colleges, sixth form colleges and other education providers. The Education Funding Agency (EFA) is the Department's delivery agency for funding and compliance.
2. The purpose of this report is to explain my audit opinion and the reasons for the qualification, the progress made by the Department and, where appropriate, my recommendations for addressing these issues. I have also qualified my opinion on the EFA financial statements on the same bases as the Department as academies were consolidated into the EFA financial statements.

## Explanation for Qualified Audit Opinion

### Regularity of expenditure

3. I qualified my regularity opinion on the Departmental group accounts for 2011-12. This qualification was made on the basis that the Department's control framework was not sufficiently well designed to identify whether academies had complied with all aspects of HM Treasury's *Managing Public Money*.
4. Following my report on the Departmental group accounts for 2011-12, the EFA revised the framework to gain assurance that academies are applying the grant for the purposes intended. The most significant change was to require academies to obtain a regularity opinion from their auditors, addressed jointly to the academy and the EFA, thereby providing them with direct assurance over the regularity of transactions.
5. The Departmental group accounts are on a financial year to March, whereas academies' reporting periods are aligned to the academic year to August. Auditor assurance for regularity is therefore provided on a lagged basis, with the results of the academic year audit feeding into my consideration of the regularity for the financial year to the following March. Thus for the 2012-13 Departmental group accounts, I have considered the results of the August 2012 auditor opinions on regularity.
6. The auditor opinion on regularity is part of a wider assurance framework adopted by the Department from the start of the 2012-13 academic year that includes assessment of financial management and governance within new academies and intelligence-led investigations.

### The assurance framework has not provided sufficient assurance for 2012-13

7. As part of my audit, I evaluated the scope of audit work underpinning the regularity opinions to August 2012 and assessed the impact of auditor qualifications and reports of potential irregular transactions. I found that:
  - Auditors had generally conducted an appropriate level of audit for the risks identified covering regularity but excluding compliance with *Managing Public Money*;

- The scope of the audit work did not wholly cover the risk of non-compliance with *Managing Public Money* in relation to obtaining approval for special payments, particularly non-contractual severance and other payments; and
- There were 21 qualifications of the regularity opinion for August 2012 accounts relating to unapproved non-contractual severance payments. Of these, one firm accounted for 15 qualifications. There are no factors to suggest that regularity risk is confined to the academies audited by this firm.

8. For the period to August 2012, I therefore conclude that the scope of the audit work did not fully meet the assurance requirements of the Department. In particular, they did not receive sufficient assurance over compliance by academies with the *Managing Public Money* requirements to obtain HM Treasury approval for certain types of transaction. Accordingly, I have qualified my opinion on regularity.

9. There is no evidence of widespread or material levels of irregular spend. In the financial year, the EFA identified a total of 37 non-contractual severance payments requiring approval. The total value of the payments requiring approval was £640,354. Under agreement with HM Treasury, the EFA conducted the initial assessment of the retrospective business cases and a sample of eight was presented to HM Treasury for its approval, which was duly granted except for two business cases that the EFA had already rejected. These two transactions totalling £99,550, both relating to extra-contractual severance payments, are therefore irregular.

#### **The assurance framework is designed to provide sufficient assurance in the future**

10. The late development of the new framework and publication of the guidance may have contributed to the limitation in the scope of the underlying audit work. In preparation for the August 2013 audits, the EFA has:

- strengthened its guidance further, and issued it on a timely basis;
- engaged directly with auditors and academies on the regularity requirements, providing guidance and training; and
- introduced delegated authorities, agreed with HM Treasury, for commitment to specified areas of expenditure including extra-contractual severance and other payments.

11. I welcome the positive steps that the Department and the EFA have taken to strengthen their guidance and engagement with the academy sector and their auditors.

12. I consider that the Department and EFA have designed a suitable assurance framework over regularity, consisting of the audit opinions from academies coupled with the other work the EFA undertakes to evaluate and investigate compliance. I therefore have not made any recommendations this year.

13. Nonetheless, as the number of open academies continues to grow rapidly, from 1664 academies at March 2012 to 2823 at March 2013, there will continue to be a challenge to the EFA on behalf of the Department to deliver robust, yet proportional assurance over the regularity of academies' expenditure. The EFA may not have sufficient capability and capacity to meet their objectives in an expanding academy sector.

#### **Qualification of my opinion on the group financial statements**

14. In 2012-13 the Department was required, for the first time, to consolidate academies into its group financial statements. Its annual report explains how the need for consolidation arose, and the

challenges it faced. In particular, there were four specific challenges that have required the Department to develop an unprecedented approach to this complex consolidation.

- Academies produce accounts to 31 August each year, whereas the Department's year end is 31 March. Financial Reporting Standards would not normally allow consolidation of accounts where the year ends are more than three months apart. However, the Department did not believe that producing new accounts for each academy as at the end of March would produce a materially different position to using existing statutory accounts as at the end of August, and would prove an unnecessary administrative burden on the sector. The Department hypothesised that data for the year ending 31 August was a fair approximation for the equivalent to 31 March due to the limited financial complexity of individual trusts.
- The sector is growing rapidly, with an increase of 1,159 academies during this reporting period. This required the collection and validation of additional data where underlying accounts were not available, and led to careful consideration of the appropriateness of assumptions and the results of the proxy assumption above.
- Academies are charitable companies and report under a different accounting framework to the Departmental group. Identification of, and adjustment for, differences to present a consistent basis for reporting were key aspects of this methodology.
- Collecting so much data was a significant undertaking. Some data was subject to audit; other data needed to be centrally validated by the EFA. This was within the context of a growing sector where historic trend data did not exist.

15. To gain the evidence to support their hypothesis that August was a fair approximation for March, the Department asked a representative sample of established academies to submit audited returns for March 2013. In addition, they identified two specific areas where the approximation did not hold, and therefore sought national valuations for Local Government Pension Scheme liabilities and land and buildings as at March 2013. I am content that this exercise was conducted appropriately, and that the data is statistically valid. This showed that any two 12-month periods for an individual academy are materially similar in the context of the consolidation. However, there was a trend for increasing cash reserves across the sector, and capital expenditure profiles were less predictable. The continuing growth within the sector means that I cannot yet determine whether the proxy assumption will continue to hold for future financial periods.

16. In auditing the Department's application of this methodology I identified a number of errors and uncertainties. These included:

- A difference of £270 million between the grant paid by the EFA in the 2012-13 financial year, and the extrapolated revenue calculated from academy returns. This difference is a consequence of the methodology, and does not represent missing or misappropriated grant.
- Estimated or un-validated data for a residual number of academies who either did not submit a return or submitted a return too late for appropriate validation work to be undertaken. This related to 83 academy trusts, covering a total of £283 million grant. A further 40 trusts have been consolidated using "pre-opening accounts" at 31 August 2012, prior to operation.
- Gaps in the assurance obtained by the EFA from their validation exercise that it performed on all data submitted by academies. A large proportion of queries raised with academies by the EFA resulted in amendments to the submitted data. By the end of October when the EFA decided not to continue pursuing academies for responses, there were still 1,522 outstanding queries with those trusts.

- Under Companies law, an academy's first accounting period can be up to 18 months long to allow it to prepare financial statements to its chosen accounting reference date. As a result there are many short or long accounting periods within the August 2012 accounts returns. In order to match with the EFA funding, which is reported on a 12-month basis for these academies, the Department had to lengthen or shorten the reported data through extrapolation.

17. Therefore I concluded that there was a material level of error and uncertainty in the Departmental group accounts.

18. Whilst the Department has developed a process for presenting academy data to Parliament, providing new levels of transparency over their spend, this year's exercise may not be sustainable at current levels and there remain some challenges to overcoming the causes of qualification within this account.

### **Qualification of my opinion on the recognition of land and buildings**

19. Academies are charitable companies, meaning they have to prepare their financial statements in accordance with the charities' accounting framework. One area of difference between this financial reporting framework and that of the Departmental group's relates to the recognition of land and building assets within the balance sheet. The information needed by the Department to determine the appropriate accounting treatment for these academies' assets was not included in the returns from academies. The Department has made an assumption that all land and buildings used by academies should be capitalised within the group balance sheet. This may not comply with HM Treasury's Financial Reporting Manual, for example where buildings are occupied on a short term lease.

20. The Department does not have robust data to demonstrate that this assumption is appropriate. As a result, I have a limitation of scope in my audit opinion as I cannot determine the extent of land and buildings assets that are erroneously capitalised in the consolidated balance sheet. I am concerned that the Department will not be able to resolve this issue for a number of years.

### **Qualification of my opinion on the opening balance sheet**

21. All academies in existence on 1 April 2012 have been incorporated into these financial statements from that date. The Department has calculated these balances from the closing balances, making adjustments for in-year movements and conversions. I have qualified my opinion in respect of the opening balances, however, as the Department has not been able to reconcile these opening balances to the data reported to HM Treasury as part of the 2011-12 Whole of Government Accounts. In my view, I do not have the evidence to conclude that these balances are correct, although I consider that the impact does not remain within closing balances that are drawn from validated academy returns. I do not expect this qualification to persist in future years as a result.

### **Weaknesses in the Department's strategic financial management**

22. A primary objective of preparing this consolidation is to report to Parliament the financial activity of academies and to present a national balance sheet that feeds into the Office for National Statistics' National Accounts. The Statement of Parliamentary Supply shows how the monies voted by Parliament have been applied, including outturns against HM Treasury's "control totals". These are a series of spending limits HM Treasury use to manage and control public spending: academy outturn, rather than EFA grant, is scored against the control totals. This reflects HM Treasury's responsibility for reporting public sector activity.

23. Academies have been established with a different financial management regime to the Department. Academies have freedom to determine their spending profiles and to carry forward unspent grant, but the Department's spend is controlled on an annual basis within a Spending Review cycle. This results in an inherent set of risks within the parliamentary reporting process where the Department is accountable for activity over which it has no direct control. So, while the Department remained within its control totals for the 2012-13 financial year, there remain risks for the future financial reporting.

24. Furthermore, the consolidation exercise has demonstrated some key risks to the Departmental Accounting Officer's responsibility for stewardship of public funds and for financial management that will impact on the Department's ability to manage in-year resources and, make appropriate financial decisions, including accurate forecasting and resource requests. These issues are a result of the accountability structure established for the academies sector and do not reflect weaknesses in the financial management of the rest of the Departmental group. There are four areas of risk:

- **Financial reporting:** The Department did not know until December, almost nine months after the year end, whether or not it had remained within its control totals. The Department seek budget forecasts at the start of the year and then the accounts return at the end of the period from academies. However, it was unable to manage the in-year position of academies. The timeliness and quality of academy returns is therefore crucial to oversight and reporting. Under this regime, the Department will always be at risk of an unpredicted overspend if, for example, academies spend their reserves more quickly than forecast.
- **Resource planning:** The late delivery of accounts will affect the Department's ability to finalise its resource needs and, if necessary, seek additional, appropriate Supply cover within the Supplementary Estimates. For example, the Department cannot accurately predict its resource requirements for the 2013-14 financial year because of the uncertainty around capital spending within academies. Accurate forecasting by academies and notification of significant change to priorities and timings are essential to this process.
- **Strategic financial management:** Academies are currently building reserves: cash balances stood at £1.9 billion at 31 March 2013. The comparative data is not reliable, but extrapolation of the pilot exercise results suggests an estimated 12% increase in such reserves in the seven months since August 2012. Academies determine their priorities based on local needs and, under the financial management regime it has established, the Department has no influence over the use or size of those reserves. The Department has informed me that funding will remain linked to student numbers, and there are no plans to take account of reserves when allocating funding. Nevertheless, the Department does not have the requisite data to enable it to make strategic financial management decisions affecting the sector.
- **Financial oversight:** The Department's ability to oversee financial sustainability within the sector could also be compromised by the quality of data. The Department is developing analytical techniques to assess financial strength and to help predict financial risk, but this remains dependent on accuracy and timeliness of submissions from the academies.

25. The uncertainty and levels of misstatement within the income and expenditure also affects the interpretation of outturn data within the Statement of Parliamentary Supply. Transparency of academy spend has improved as a result of the accounts consolidation exercise, but there remains a high degree of uncertainty within the sector outturns reported within these accounts. For example, significant underspends do not necessarily mean that the Department could have distributed additional funds or changed its priorities to divert funds elsewhere, as the cash sits within academies and is under their control. Likewise, the Department utilised the majority of its cash allocation,

spending all but £360 million (0.6 per cent) of its £56.4 billion limit, the “net cash requirement”. This does not therefore represent a failure by the Department to distribute funds.

## Recommendations

26. I recommend that:

- The Department and the EFA should engage with HM Treasury to consider the long term sustainability of this approach to reporting financial performance in the academy sector. I cannot envisage the current approach allowing the Department to deliver accounts prior to the Summer Parliamentary Recess, although I expect the Department to bring forward the timetable incrementally in the next two years.
- Regarding the land and buildings recognition qualification, I recommend that the Department and EFA work with HM Treasury to seek a solution to identify the school estate and appropriate accounting at the Whole of Government Accounts level. I recognise that a centrally coordinated review of all land and building ownership and leasing arrangements would be inefficient and costly. Instead, I recommend that the Department seek to refine the data requirements from academies, and seek through HM Treasury to develop the guidance for local authorities and academies to ensure consistency and appropriateness of accounting.
- The Department, through EFA, should develop the accuracy of forecasting by academies. This should include the development of guidance and validation, including strengthening the approach to managing late or inaccurate reporting. The Department and EFA should also strengthen their analytical capability to maximise their use of the data provided by academies to monitor financial sustainability within the sector and to inform their resource requirements and financial forecasting.

**Amyas C E Morse**

**Date: 14 January 2014**

**Comptroller and Auditor General**

National Audit Office  
157-197 Buckingham Palace Road  
Victoria  
London  
SW1W 9SP