

# NAO Communication with academy auditors 2016

## Sector Annual Report and Accounts: Consolidation of academies

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These group communications are aimed at academy auditors, to provide them with an understanding of:

- **their role in the group accounts;**
- **the NAO's expectation of them as component auditors in the group; and**
- **an understanding of the risks of material misstatement in the group financial statements.**

### Group auditor communication with auditors of academies

#### Introduction

1 The Comptroller and Auditor General (C&AG) is the appointed auditor of the Academies Sector Annual Report and Accounts. The National Audit Office (NAO) performs the audit on his behalf. Further information on the NAO is available on our website.

2 The Department for Education is changing the way that it reports the academy sector's financial performance to Parliament. For the academic year 2015/16 the Department will consolidate academy trusts into a dedicated Academies Sector Annual Report and Accounts. Where possible, the Department proposes to use existing data sources and centrally derived data to produce this consolidation. This includes academy financial statements prepared under the Companies Act 2006.

3 The academy accounts will no longer be consolidated in the group financial statements of the Department and the Education Funding Agency.

4 The NAO audits the consolidation and this communication is issued in accordance with paragraph 40 and 41 of the Financial Reporting Council's *ISA (UK&I) 600, Special Considerations – Audit of Group Financial Statements (Including the Work of Component Auditors)*.

5 This communication relates to the consolidation for the year to 31 August 2016, and therefore the financial statements and annual returns for academies to 31 August 2016, plus other data defined below.

## Definitions

5 The NAO conducts its audit of the group accounts in accordance with the *International Standards on Auditing (UK&I)*. The following table provides our understanding of responsibilities within the group in accordance with *ISA 600, Special Considerations – Audit of Group Financial Statements*:

ISA600 definitions	Interpretation
Group	All academy trusts that were open for all or part of the year between 1 September 2015 and 31 August 2016.
Group auditors	NAO
Group financial statements	The consolidation of academies, prepared in accordance with the HM Treasury's Financial Reporting Manual (FReM), which is an IFRS-based framework.
Components	Academy trusts, who prepare accounts under the Companies Act 2006.
Significant components	None identified.
Group audit	Conducted by NAO in accordance with <i>the ISAs (UK&amp;I)</i> , including a regularity opinion using the <i>APB's Practice Note 10 Audit Of Financial Statements Of Public Sector Bodies In The United Kingdom</i> .
Regularity	Defined by <i>Practice Note 10</i> as income and expenditure being applied, in all material respects, for the purposes intended by Parliament, that is, transactions comply with: <ul style="list-style-type: none"> <li>• primary legislation;</li> <li>• regulations issued under governing legislation;</li> <li>• Parliamentary authorities; and</li> <li>• HM Treasury authorities.</li> </ul> Interpretation of these for the academy sector is set down in the <i>Academies Financial Handbook</i> , extant from 1 September 2015.

6 We do not consider there to be any significant components for the purposes of this consolidation. Our approach is therefore designed to ensure we obtain sufficient, appropriate assurances, without imposing unnecessary burden on academies and their auditors.

## Communication with academy auditors

7 This document represents our communication with component auditors within the academy sector in accordance with ISA 600. It is intended to explain the role of the NAO as group auditor, group risks relevant to the academy auditors, and our expectations of academy auditors in completing:

- the audit of academy financial statements for the period to 31 August 2016, including the regularity opinion; and
- assurance work on the accounts return.

## Expectations of component auditors

**8** We are not requiring component auditors to perform specified procedures for the purposes of the group audit. However, we do expect component auditors to conduct their audit and assurance work as follows:

- carry out their audit of financial statements in accordance with ISAs (UK&I);
- comply with the requirements of the EFA's accounts direction with regards to the independent auditor's report on regularity. The accounts direction draws upon Institute for Chartered Accountants in England and Wales (ICAEW) Technical Release TECH08/12AAF Regularity Reporting for Academies and we consider compliance with the accounts direction to be consistent with compliance with the technical release. Both reference Practice Note 10, Audit of Public Sector Bodies in the UK, published October 2010;
- conduct of other assurance work, such as to reach an opinion on the annual accounts return, with due regard to the ICAEW Assurance Sourcebook and applicable guidance from EFA; and
- compliance with the Financial Reporting Council's Ethical Standards.

**9** We request academy auditors to notify us via the email address below, by exception in the following cases:

- non-compliance with the requirements in paragraph 8;
- any modified opinion on the independent auditor's report on the financial statements or on regularity (we will not provide advice on whether a report should be modified, and would expect these to be discussed with EFA in the first instance);
- conducting an audit of academy financial statements or regularity to a materiality exceeding £10 million. We request academy auditors to contact us in advance in order to discuss the implications;
- identification of significant risks of material misstatement to the group financial statements, whether through fraud or error, other than those noted below. To be material to the group financial statements, the risk at the component level would have sector-wide significance or exposure. Academy auditors may contact the group auditors to discuss significance; and
- post-balance sheet events: We request auditors to consider as part of the August 2016 engagements whether there are any events within academies that could create a post-balance sheet event of significance to the group financial statements. Such events are most likely to be, but are not limited to, identification of irregularity material to the academy, including fraud, or an academy ceasing to be a going concern.

**10** The EFA requires academies to provide a copy of the auditor's communication to those charged with governance under *ISA 260* in respect of findings from the audit to EFA.<sup>1</sup> We do not intend to seek additional documentation, providing these reports cover the requirements in *ISA 260*. When setting a threshold in accordance with *ISA 450* for clearly trivial misstatements,<sup>2</sup> we request auditors to consider the nature of the misstatement and its context to the group financial statements. We would also not expect such a threshold to exceed £250,000 in monetary terms.

**11** We do not require auditors to provide additional information to the NAO. However, we have established a point of contact for academy auditors to communicate issues to the group auditors, or to seek clarification on aspects of this document and our role. We can be contacted on [academy.grouppaudit@nao.gsi.gov.uk](mailto:academy.grouppaudit@nao.gsi.gov.uk)

<sup>1</sup> 'Management Letter', paragraph 1.6.2, *EFA Accounts Direction*, issued June 2015.

<sup>2</sup> *ISA 450, Evaluation Of Misstatements Identified During The Audit* – paragraph 5.

## Significant group risks

**12** Whilst we have identified a number of risks which affect the group financial statements, only one could have an impact academy accounts. Academy auditors should consider the impact of this risk on their client. They should also consider the risks to the Group audit which we have identified below.

### Risk 1 Consolidation Model (Group)

**13** The consolidation is complex due to the number of academies consolidated, structural changes within academy trusts (mergers and demergers) and the number of new academies opening each year. The nature and scale of adjustments processed in previous years have also complicated the process, and in instances where there is insufficient data from academies there is a risk that these adjustments can add rather than remove error and uncertainty.

**14** Given the complexity of the process, the Department has applied thresholds in deciding where adjustments to academy data are required. These thresholds need to be reviewed to ensure they are appropriate to the lower materiality for the SARA. Historically, a number of academies have failed to submit account returns to the EFA. Although the level of non-returners has not been material to the EFA and DfE group accounts, it could be material to the SARA, particularly as materiality for the SARA will be lower than it was for the EFA and DfE groups.

#### *How academy auditors can assist the SARA:*

- Ensure the accounts return includes the appropriate transactions and balances of all academies that were under the control of the Trust during the year;**
- Ensure the accounts return matches the contents of its financial statements. Therefore, a trust preparing consolidated financial statements should also submit a consolidated return, which includes the same academies and trading subsidiaries;**
- Where an academy has transferred from one academy trust to another academy trust, ensure the amounts reported in the financial statements match corresponding numbers reported on the other side of the transaction (third party assurance);**
- Ensure appropriate classification of transactions: transfers on conversion being different to transfers within the sector (see DfE guidance for details); and**
- Ensure appropriate categorisation of capital grants or transfer on conversion transactions separate to donations (see DfE guidance for details).**

### Risk 2 Accounting framework differences (Group)

**15** Academies prepare their accounts according to the Charities SORP whereas the SARA is prepared on a FReM(IFRS) basis. Some areas of the SORP and FReM are not, or have not been, aligned which may impact on academies' financial statements. In the dry-run (using data prepared pre-FRS102) we found a significant difference between what the Department and EFA have recognised as capital grant paid and what the SARA has recognised as income or additions. Other differences, such as accounting for leases incentives, presentation of commitments and accrued employee benefits (e.g. annual leave accrual) were aligned during the adoption of FRS102 into Charities SORP 2015 in time for the 2015/16 accounts.

#### *How academy auditors can assist the SARA:*

- None - all responsibility on this SARA matter lies with the Department.**

### Risk 3 Land & buildings (Group)

**16** The C&AG has limited the scope of his opinion over academy trust land and buildings in the EFA and DfE group accounts since 2012-13. Academy trusts recognise and value L&B in accordance with the Charities SORP rather than the FReM, which the SARA must follow. On receipt of the Account Returns, the Department overwrites the Trusts' values with centrally obtained valuations. These are obtained for all L&B that Trusts operate from and the Department has historically not been able to demonstrate whether all L&B should in fact be recognised under International Accounting Standards.

**17** Our prior year audits also noted limited evidence to support the basis of valuation for land and buildings. Issues included weaknesses in the professional valuation exercise carried out in 2015-16 and uncertainties over the appropriateness of the indices used to update valuations between professional valuations. We also found that the Department had not maintained its accounting records for estate assets in sufficient detail to enable it to reflect the impact of revaluations accurately in its accounts, as well as instances of multiple counting of the same asset. L&B are highly material and dominate the balance sheet.

#### *How academy auditors can assist the SARA:*

- None - academy trust valuations of L&B are overwritten with by a central valuation.**

### Risk 4: Assets under Construction

**18** There has been a significant expansion of EFA's capital programme. This includes a range of mechanisms including freehold purchase, long-term lease arrangements and shorter-term operating lease arrangements.

**19** A number of the construction projects span the year end, and therefore will be classified as Assets under Construction. There is a risk that the ownership arrangements are not correctly identified, resulting in assets being recognised in the EFA accounts as opposed to the academy trust accounts or vice versa. This may impact on the audit of individual academy trusts and should be considered by academy auditors. Last year we raised this risk under the heading "Capital Risk".

#### *How academy auditors can assist the SARA:*

- Ensure the academies accurately recognise and measure any assets under construction, paying particular attention to the date on which control transferred from one party to another.**

### Risk of Fraud from Management override of controls

**20** We will review the design and implementation of the SARA's controls around the creation and approval of journals; review of estimates and approval of any new significant or unusual transactions. We shall perform a risk based analysis of journals, testing those which could be at higher risk of management override. We will also consider significant estimates in the financial statements and any indicators of new, significant or unusual transactions

#### *How academy auditors can assist the SARA:*

- Maintain professional scepticism in instances where the academies have had to make adjustments between the statutory accounts and the accounts return, in particular when academies have failed validation tests.**

## Other matters to bring to your attention

### Regularity

**21** Academy auditors play an important role in providing the EFA accounting officer with assurance that the income and expenditure incurred by academies has been applied in accordance with the relevant legislation. EFA has established a framework of authorities within the funding agreements – the *Academies Financial Handbook* – which derives the principles of regularity from HM Treasury’s Managing Public Money.

**22** The main assurance mechanism to the Department and EFA is the independent reporting accountant’s assurance report on regularity for each academy trust. The format for this report is set out in the Academy Accounts Direction.

**23** The *Academies Financial Handbook*, the funding agreement with the Secretary of State and charity law make up the framework of authorities over academy activities.

**24** The version of the *Academies Financial Handbook*, effective from 1 September 2012, introduced a number of delegated limits for certain transactions. Such transactions above these limits require approval from the Secretary of State. Failure to obtain approval would result in that expenditure being irregular. These requirements remain in the versions of the *Academies Financial Handbook* which are applicable in the 2015/16 academic year.

**25** We consider, because of the number and variety of providers, there is an inherent risk that across the academies sector there could be material or systemic irregularity, which may be heightened in newly converted academies. Particular areas of concern include:

- approval from the Secretary of State not being sought for certain transactions above delegated authorities, outlined in the *Academies Financial Handbook*;
- related-party transactions entered into by academy trusts which may not be on an ‘arms-length’ basis or adhere to the ‘at cost’ principles set out in the *Academies Financial Handbook*;
- fraud or misappropriation of funds, especially at the Trust level in a multi-academy trust; and
- the increasing risk that academies with long-standing deficits may become insolvent.

**26** Academy auditors should also be aware of the investigations into irregularities conducted by EFA. These are available on EFA’s website.<sup>3</sup> There are a number of themes which the auditor should consider when identifying the risk of irregularity. These themes include:

- misuse of funds by head teachers (that is, using academy funds for personal gain);
- inappropriate expense claims for both staff and trustees and unjustified salary increases;
- transactions in breach of the *Academies Financial Handbook* and not in line with Parliamentary intentions;
- governance at multi-academy trusts (that is, oversight of activities of individual academies, or weak controls at the trust level);
- weaknesses in procurement (that is, non-compliance with EU procurement rules, and employment or contracting with related parties, or both); and
- related-party transactions (that is, whether they have been entered into on an arms-length basis and are in line with the new ‘at cost’ requirement).

## Contact with academy auditors

**27** Under ISA 600, where a group is made up solely of components which are not significant, some interaction with auditors is expected.<sup>4</sup> In such cases, further work is recommended on larger components within the group.<sup>5</sup> Therefore we shall select a small sample of multi-academy trusts where we shall contact the auditor directly to discuss the audit approach and some of the key issues identified at the trust.

**28** In addition, we plan to communicate directly with academy auditors more generally, through forums and seminars. We may also need to speak to auditors of smaller academy trusts.

<sup>3</sup> Available at: [www.gov.uk/government/collections/academies-financial-management-and-governance-reviews](http://www.gov.uk/government/collections/academies-financial-management-and-governance-reviews)

<sup>4</sup> ISA 600, Special Considerations – Audits of Group Financial Statements (Including the work of component auditors) – paragraph A53.

<sup>5</sup> ISA 600, Special Considerations – Audits of Group Financial Statements (Including the work of component auditors) – paragraph 29.

## Contacts

**29** Please send a summary of any modifications to audit reports, identified ethical breaches and queries to [academy.grouppaudit@nao.gsi.gov.uk](mailto:academy.grouppaudit@nao.gsi.gov.uk)

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Design & Production by NAO Communications  
DP Ref: 10797-001