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

## Introduction

**1** The Department for Education (the Department) produces Resource Accounts in accordance with the Government Resources and Accounts Act 2000 and includes within these Resource Accounts the following:

- **The Department for Education financial statements** comprising the results of the Department, its three executive agencies for this reporting period (the Education Funding Agency (EFA), the National College for Teaching and Leadership, and the Standards and Testing Agency); and
- **The Departmental group financial statements** comprising the results of the bodies above, as well as the Office of the Children's Commissioner, the Equalities and Human Rights Commission, the Aggregator Vehicle plc and the 2,910 academy trusts that operated 5,552 academies as at 31 March 2016.

**2** In accordance with the requirements of the Government Resources and Accounts Act, I am required to examine and certify the above financial statements. I may also choose to issue a substantive report when I consider there are matters which may have a direct or indirect effect on public expenditure and warrant being drawn to the attention of Parliament.

## Scope and purpose of this report

**3** The purpose of this report is:

- To explain the qualification of my audit opinion on the group financial statements and comment on developments from the prior year (paragraphs 6-31); and
- To draw attention to the work by the Department and HM Treasury to implement an alternative approach to accounting for academy trusts to improve the transparency to Parliament of academy trusts' spending (paragraphs 32-39).

**4** With the exception of the EFA, the issues raised in this report do not relate to the audit opinions I have issued on the individual financial statements of the other bodies included in the group (the National College for Teaching and Leadership, the Standards and Testing Agency, the Office of the Children's Commissioner and the Equalities and Human Rights Commission). These bodies prepare their own individual financial statements and I have issued 'unqualified' true and fair and regularity opinions on each of these. Academy trusts and the Aggregator Vehicle plc also prepare individual financial statements and these are audited by separate auditors. I have not identified material inaccuracies in the financial statements of academy trusts or the Aggregator Vehicle plc which would have a material impact on the Department's group financial statements.

**5** I have given an adverse opinion on the EFA group financial statements. This is due to the issues that are discussed in this Report with regard to the Department's financial statements. These relate to the methodology by which Academy trusts are consolidated into the EFA group financial statements, which is the same as that used by the Department in preparing its group financial statements. Further details of the impact of these issues on the EFA financial statements are set out in my Report on those accounts.

## Adverse opinion on the Departmental group's financial statements

**6** In 2013-14 and 2014-15, I issued adverse opinions on the truth and fairness of the Department's group financial statements as I had identified a level of misstatement and uncertainty, which I considered was material and pervasive to the group financial statements. I noted that I did not believe that the Department would be able to address the challenge of consolidating so many academy trusts with different year-ends from the group without a significant change in the current consolidation methodology.

**7** For the 2015-16 group financial statements, I have continued to issue an adverse opinion due to a level of misstatement and uncertainty which I consider to be material and pervasive. The key areas of misstatement and uncertainty are:

- the financial statements are materially non-compliant with International Financial Reporting Standard 10 *Consolidated Financial Statements*. I have identified material and pervasive levels of error and uncertainty arising from the consolidation of academy trust results with a reporting date seven months prior to the Department's reporting date;
- a continuing limitation of scope over the academy trust land and buildings included in the group financial statements; and
- material and pervasive misstatements in the prior year comparatives.

**8** I discuss these matters further in paragraphs 9-21. In paragraphs 26-31, I explain that I have qualified my regularity opinion because the Department has breached two Parliamentary control totals. In paragraphs 32-39, I set out the progress that the Department has made towards introducing an alternative approach for accounting for academy trusts (the Academy Sector Annual Report and Accounts) that will, if implemented effectively, provide a solution to some, though not all, of the consolidation methodology issues it faces.

## Findings from my audit

## (a) Non-compliance with IFRS 10

**9** In my previous Reports on the Department's financial statements for 2012-13, 2013-14 and 2014-15, I set out the significant challenges faced by the Department in preparing its consolidated financial statements and the approach it has taken to try to address these. Annex D: Consolidation approach and methodology of the Department's Annual Report sets out the Department's approach.

**10** The main challenges facing the Department arise from the consolidation of a large (and increasing) number of academy trusts and the different financial reporting periods for the Department and academy trusts. Whereas the Department is required to produce its financial statements to a 31 March year end, academy trusts have a year end of 31 August which aligns with the academic year. IFRS 10 *Consolidated Financial Statements* recognises that group financial statements may comprise bodies with different accounting periods but limits the allowable difference to three months. This gives rise to a significant challenge for the Department to prepare financial statements which provide a true and fair view of the financial activity for the period in question and the financial position at the end of that period.

**11** The Department's approach to consolidating academies is based on three key sources of financial information:

- Audited academy trust financial statements to 31 August 2015 (my findings on this element are set out in paragraphs 12-13);
- unaudited returns to March 2016 for those academies that had recently opened and had not produced financial statements (paragraphs 14-15); and
- centrally collated information on land and buildings, pension liabilities and assets under construction (paragraphs 16-25)

**12** The Department has used audited academy trust financial statements to 31 August 2015 for 2,877 academy trusts. This approach is not in compliance with IFRS 10. In previous years, the Department commissioned a "comparison study" which sought to prove that there was no material difference between the financial information included in the group accounts for these academy trusts and the information which would have been included had financial statements to the Departmental year-end been used instead. However, the comparison study did not provide sufficient, appropriate evidence to support this assertion. Therefore, for 2015-16 the Department, following consultation with me, decided not to commission a comparison study as it was very unlikely to prove that there was no material difference between the financial information included in the group accounts and the March 2016 position.

**13** I cannot quantify precisely the extent of the difference between the group accounts and the March 2016 position. However, I consider the impact on the financial statements of this non-compliance with IFRS 10 to be material and pervasive, and as such, the financial statements as a whole do not present a true and fair view.

**14** Academy trusts that open during the 2015-16 financial year and new academies that join existing academy trusts between 1 September 2015 and 31 March 2016 and have yet to be included with audited academy trust financial statements, are required to submit an unaudited accounts return to the Department. The financial statements record £463 million expenditure, £581 million income, £179 million assets and £75 million liabilities for this population of 549 academies (excluding land and buildings and pension valuations, which, as noted in paragraph 11 were subject to a central adjustment).

**15** The Department and the EFA undertook validation testing and assurance visits to a sample of academies to agree balances in the unaudited accounts returns to books and records. I reviewed the effectiveness of these controls and found that they had been strengthened in comparison to the previous year when I concluded that they did not provide sufficient, appropriate evidence of the accuracy and completeness of the unaudited returns. Given the reduced size of the unaudited population in 2015-16, the improved controls were sufficient to provide reasonable assurance that the use of unaudited data did not give rise to a risk of material misstatement in the group financial statements. I welcome the actions that the Department has taken to strengthen its controls in this area. However, given the small size of the unaudited population relative to the academy sector as a whole, these improvements are not sufficient to change my audit opinion that the Department's non-compliance with the requirements of IFRS 10 has led to material and pervasive error and uncertainty in the accounts. In addition, further enhancements to controls could be required in future years to provide sufficient assurance over the unaudited data in the Academy Sector Annual Report and Accounts, depending on the size of the unaudited population. The Department has taken steps to address this risk by requiring all newly incorporated academies to submit audited accounts returns and accounts for the year to August 2016, which should remove unaudited data from future years' accounts.

## (b) Land and buildings

**16** In 2012-13, 2013-14 and 2014-15, I limited the scope of my audit opinion in respect of the value of land and buildings held by academy trusts that was recognised in the group accounts and I continue to do so for 2015-16. Academy trust land and buildings with a valuation of £43.3 billion have been recognised as at 31 March 2016.

**17** As noted in paragraph 11, the Department has made a central adjustment for land and buildings rather than consolidating the balances included in the financial statements of academy trusts. This is because academy trusts prepare their accounts in accordance with *Accounting and Reporting by Charities: Statement on Recommended Practice* (the Charities SORP). The criteria for recognising and valuing assets in the Charities SORP are not fully aligned with those in International Accounting Standards and HM Treasury guidance (the basis under which the group accounts are prepared).

**18** The Department has made an assumption that all land and buildings used by academy trusts should be capitalised within the group statement of financial position. This may not comply with the requirements of International Accounting Standards and HM Treasury guidance, for example where buildings are occupied on a short term lease or are owned by another entity.

**19** The Department does not have robust data to demonstrate that its assumption is appropriate. As a result, I cannot determine the extent of land and buildings assets that may be erroneously capitalised in the consolidated statement of financial position.

**20** The Department has also been unable to provide me with sufficient, appropriate evidence that the carrying value of academy land and buildings in its accounts is a materially accurate reflection of the fair value of the underlying estate. The Department commissions external professional valuations of its land and buildings every five years. In the years between professional valuations, carrying values are updated using indices. In principle, this approach is in line with the requirements of International Accounting Standards and HM Treasury guidance. However, I identified weaknesses in the way that the policy had been implemented that meant I was unable to obtain assurance that the Department's approach was sufficiently robust to arrive at a materially accurate valuation of its land and building assets. In particular, I was unable to obtain evidence that the professional revaluations carried out in 2015-16 were sufficiently robust and applied consistent assumptions across the estate. I also found that the Department had not maintained its accounting records for estate assets at a sufficiently granular level to enable it to reflect the impact of revaluations accurately in its accounts.

**21** The challenges that the Department faces in accounting for its land and building assets will not be resolved by the move to an alternative approach for accounting for academy trusts. The Department recognises this and is undertaking a pilot exercise across 50 schools to establish whether there are practicable ways in which it can address the recognition issue going forward. It is also considering how it can improve its approach to valuation. Given the scale of the academy estate, these issues are likely to take time to address and it is unlikely that they will be resolved in time for the first Academy Sector Annual Report and Accounts.

## (c) Capital projects

**22** The Priority Schools Building Programme (PSBP) is a programme to address the needs of the schools most in need of urgent repair. The aim of the £4.4 billion programme is for 537 schools (including 46 using private finance) to be rebuilt or have their condition needs met by the EFA. The majority of the 260 schools in the first phase are expected to be open by the end of 2017. In addition, the Government has pledged to open 500 free schools by 2020. As a result, there has been a significant expansion of the EFA's capital programme over the last two years with over 600 active capital projects at schools across England during 2015-16, an increase from less than 200 during 2013-14.

**23** In 2014-15, I reported that the expansion of the EFA's capital programme within a short timeframe had challenged the EFA's capacity and capability for central record keeping and financial management. My audit identified significant, but not material, uncertainties due to weaknesses in record management and sharing of information between the EFA capital group and the finance teams of the EFA and the Department. I also noted that delays in provision of capital project information for audit and the volume of issues noted in this area had led to a significant delay to the Department's accounts preparation timetable.

**24** In 2015-16, I found that there had been significant improvements in the Department's accounting for capital projects. Capital project information was provided to my team several months earlier and was of a higher quality than in the previous year. This reflects improvements that the Department has made to the financial management of capital transactions including record keeping, enhanced training and guidance for staff; revision of internal processes; and strengthening of project monitoring. The Department has also worked with HM Treasury to agree a revised framework of delegations for its capital programmes, which has clarified which types of transaction require HM Treasury authorisation. I welcome these improvements to the Department's accounting for capital projects.

**25** Although the level of error that I identified in capital projects in 2015-16 was much reduced, there remain opportunities for further improvement. For example, I found examples of assets not being transferred into land and buildings and revalued when they had been brought into use. Although these were not material in the 2015-16 accounts, the Department will need to continue to work to address these issues to ensure that they do not result in material error in the Academy Sector Annual Report and Accounts.

## Qualification of my regularity audit opinion

**26** A primary objective of preparing consolidated departmental financial statements is to provide accountability to Parliament for the financial activity it has approved for the year for the whole Departmental group, which includes the financial activity of academy trusts. The Statement of Parliamentary Supply is the parliamentary accountability statement and shows how the monies authorised by Acts of Parliament have been applied, including outturns against a series of annual limits on the net expenditure which each department may not exceed and on the total cash each department can use.

**27** Any expenditure outside of these limits will result in an 'Excess Vote'. Such expenditure potentially undermines parliamentary control over public spending. Where these limits are breached, I qualify my regularity opinion on the financial statements.

**28** In my 2013-14 and 2014-15 reports, I highlighted the weaknesses in the Department's ability to forecast spend accurately for the group, mainly due to the Department's lack of timely and accurate in-year information on the forecast spend of academy trusts. Academy trusts have some discretion in how they use the funds provided to them by the Department; they have freedom to determine their spending profiles and carry forward unspent grant. This represents a financial management and accountability challenge to the Department and HM Treasury's ability to manage in-year resources and make appropriate financial decisions including accurate forecasting and resource requests.

**29** I qualified my regularity opinion on the Department's group financial statements for 2014-15 on the basis that the Department had breached its control totals for Capital Departmental Expenditure (breach of £31.2 million), Resource Annually Managed Expenditure (£101.4 million) and Non-Budget (£3,072.9 million). These breaches were due to the Department incorrectly reflecting the impact of donated assets when setting its budget, higher than anticipated impairment charges and the Department not seeking Non-Budget provision for prior period adjustments.

**30** I have again qualified my regularity opinion on the Department's group financial statements for 2015-16 as the Department has incurred two breaches of its Parliamentary control totals:

- Net expenditure of £5,001 million has been incurred against the Capital Departmental Expenditure Limit of £4,885.1 million. The breach of this limit by £115.9 million relates to the budgetary impact of the Aggregator Vehicle plc and its financing of school capital projects, which the Department did not provide for in its budget. The Department did not identify this issue in time for its 2015-16 budget to be adjusted. HM Treasury has agreed to provide the Department with additional budget cover in future years.
- Net expenditure of £1,354.2 million has been incurred against the Resource Annually Managed Expenditure Limit of £1,179.1 million. The breach of this limit by £175.1 million is due to higher than anticipated impairment charges on academy land and buildings. The Department is considering how it can improve its approach to valuation, although this particular issue will no longer give rise to a risk of breaching control totals in future years, as (under the Academy Sector Annual Report and Accounts) impairments of academy land and buildings will no longer score against parliamentary control totals.

**31** The impact of the level of error and uncertainty within the income and expenditure which has led to my issue of an adverse opinion on the financial statements is not captured within the Statement of Parliamentary Supply. This limits the ability of Parliament to identify the actual spend by the academies sector for the year in question.

## Alternative approach to accounting for academy trusts' financial results – the Academy Sector Annual Report and Accounts

**32** In 2013-14, I recommended that the Department and HM Treasury work together to identify a solution to the causes of my qualification and that any alternative approach for accounting for academy trusts should provide more robust information for use in the HM Treasury's fiscal modelling and the Whole of Government accounts.

**33** I reported in 2014-15 that the Department's preferred option was to remove the academy trusts' financial results from the Department's group financial statements and to reflect only grants paid to academies. The Department would then prepare a separate aggregated account for academies as at 31 August (the Academy Sector Annual Report and Accounts or SARA). I reported that the Department had received an 'in principle' agreement from HM Treasury to develop the proposals for a Sector Report alongside a range of challenging conditions that would have to be met. These proposals had been reviewed and approved by the Alignment Review Committee, Scrutiny Unit, Education Select Committee and Liaison Committee.

**34** Since my 2014-15 report, the Department has continued to work with HM Treasury to develop the proposals for the move to the SARA. It produced a dry-run of the SARA for the Education Select Committee in October 2016 and I reviewed this document, reporting my findings to the Committee in November 2016. The first SARA will cover the year ending 31 August 2016 and is currently due to be published in June 2017. The 2016-17 Departmental accounts will not consolidate academy trusts and will instead reflect only grants paid to academies. The Department has not yet fully developed its proposals to allow robust information on the results of academy trusts to be incorporated into the Whole of Government Accounts (WGA) on a more timely basis.

**35** The Department has a challenging programme of accounts to deliver in the next few months. As well as the first SARA, it is planning to deliver its 2016-17 Departmental accounts before the summer 2017 Parliamentary recess. Although the Departmental accounts will no longer consolidate academy trusts, they will cover the responsibilities for Higher Education and Further Education that were transferred to the Department as part of the Machinery of Government changes in summer 2016. The Department is currently reviewing its project plans and has indicated that it will take a decision in February 2017 on whether the planned timetable for the SARA remains achievable or whether it should seek to extend the timetable for the first year. I welcome this review and encourage the Department to ensure that it sets a realistic timetable that is supported by a robust project plan.

**36** The problems with accounting for academies extend beyond the current consolidation methodology and the issues of non-coterminous year ends, into wider issues of Parliamentary accountability, financial accounting and financial management. The SARA, if implemented effectively, will provide a solution to a number of the consolidation methodology issues faced by the Department. It will not, however, address all of the causes of error and uncertainty and limitations which I have detailed in this Report, such as the recognition and valuation of land and buildings.

**37** The Department recognises that it needs to address these issues if it is to move towards its goal of an unqualified audit opinion on the SARA. For instance, as noted in paragraph 21, it is carrying out a pilot exercise to establish whether there are practicable ways in which it can address the recognition of land and buildings and is also considering how it can improve its approach to valuation. I support the Department's efforts in these areas, but I note that many of the areas of error and uncertainty are complex and will be challenging to resolve. In addition, some areas of error and uncertainty that are not currently material to the group financial statements may be material to the SARA, given its smaller size. The Department will need to ensure that it has robust project plans in place to address these issues. As the Department has recognised, it is unlikely that all of the areas of error and uncertainty will be resolved in time for the first SARA.

**38** The Department's policy of autonomy for academies brings with it significant risks if the financial capability of the Department and academies are not strengthened; and if the financial statements do not present a true and fair view and meet the accountability requirements of Parliament. This will become even more significant in the context of the continuing expansion of the academy sector.

**39** The Department has developed a programme of work to improve financial management in the sector and it is positive to see a coherent view of the work across the Department. I will continue to liaise with the

Department to ensure that progress is being made, particularly to ensure that appropriate measures are developed to assess how financial management in the academy sector is changing over time.

## Recommendations

**40** As discussed in paragraph 34, this is the last year that academies will be included in the group financial statements. However, there are a number of issues that the Department needs to address to ensure that it is able to implement its plans for the SARA effectively and to move over time to an unqualified audit opinion:

- The Department should ensure that it sets a realistic timetable for its challenging programme of accounting deliveries over the next few months. The timetable will need to be supported by a robust project plan.
- The Department should review all the areas of error and uncertainty that I have identified in the 2015-16 group accounts and consider their potential impact on the SARA. The Department should ensure that it has robust project plans in place to address those issues which could have a material impact on the SARA.
- In order to prevent any erosion of Parliamentary accountability, significant improvements should be made to the Department's forecasts and management information to ensure in-year monitoring of spend is improved. As I have noted in my Report, there are weaknesses in the Department's ability to forecast spend accurately for the group.
- The Department's proposals to allow the results of academy trusts to be incorporated into the Whole of Government Accounts on a more timely basis should be developed fully. I will continue to monitor these proposals to ensure that the Department produces an acceptable methodology.

**Sir Amyas C E Morse** **15 December 2016**

**Comptroller and Auditor General**

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