Department for Education

Comptroller and Auditor General's Report on the Department for Education financial statements 2013-14

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. As set out in my audit certificate I have qualified my audit opinions on the Department in the following respects:

- I have provided an adverse opinion on the group financial statements, concluding that they are not true and fair, and that the level of error I have identified is both material and pervasive; and
- I have qualified my opinion on regularity on the basis that the Department has exceeded the limit of resources voted to it by Parliament for Annually Managed Expenditure (AME).

3. I have also provided an adverse opinion on the EFA group financial statements concluding that they are not true and fair, and that the level of errors I have identified is both material and pervasive. This is because academies were consolidated into the EFA group financial statements.

4. This report provides more detail on the basis for my conclusions, actions taken by the Department following my qualification and report on the 2012-13 financial statements, and, where appropriate my recommendations for addressing the issues that I have identified through my audit.

5. My report also comments on the financial management challenges faced by the Department and the impact this has on HM Treasury's and the Department's ability to discharge their accountabilities to Parliament.

Adverse opinion arising due to the level of error and uncertainty in the financial statements

The challenges in producing the consolidated financial statements of the Department for Education

6. Since 2012-13, the Department's group financial statements have consolidated the financial statements of academy trusts, alongside those of the Department itself, its executive agencies and non-departmental public bodies. This followed a change in the accounting boundary of the Department which is determined by HM Treasury and set out in the Government Financial Reporting Manual (FReM). Whilst this provides greater transparency to Parliament of schools' spending, it has also greatly increased the complexity of the process of preparing the Department's financial statements. For 2013-14, there are 2,591 individual entities consolidated into the group financial statements. This includes 2,585 academy trusts operating 3,905 individual academies.

7. The consolidation of so many bodies is a complex and costly exercise. The Department estimates that it has cost approximately £12 million to prepare the 2013-14 group financial statements. This includes the cost of Departmental staff, the use of professional advisors and £7 million for academy trusts to prepare additional returns.

8. The Department and academy trusts have different financial reporting periods. 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. International Financial Reporting Standards recognise 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.

9. The Department has chosen not to change academy trusts' reporting periods as they consider that a reporting period aligned with the academic year better serves the trusts themselves, or to request audited returns to 31 March because they consider the cost of preparing a second set of financial statements would be better spent on delivery of education. Instead, the Department has sought to prepare the group financial statements using the academy trust financial statements to 31 August, making adjustments using centrally collated information where necessary. In doing so it has sought to demonstrate that the results are not materially different from those that would be derived from audited returns to 31 March.

10. The Department has hypothesised that, due to the limited financial complexity of individual trusts, income and expenditure and the valuation of assets and liabilities included in the financial statements to 31 August 2013 would not be materially different to the position at 31 March 2014. To reduce any differences, the academy trusts' financial statements are supplemented by centralised valuations of land and buildings and Local Government Pension Scheme liabilities. In addition, for those academies that had recently opened and not yet produced financial statements, the Department requires these academies to produce un-audited returns to March which are then validated by the Department. This approach is summarised in Figure 1.

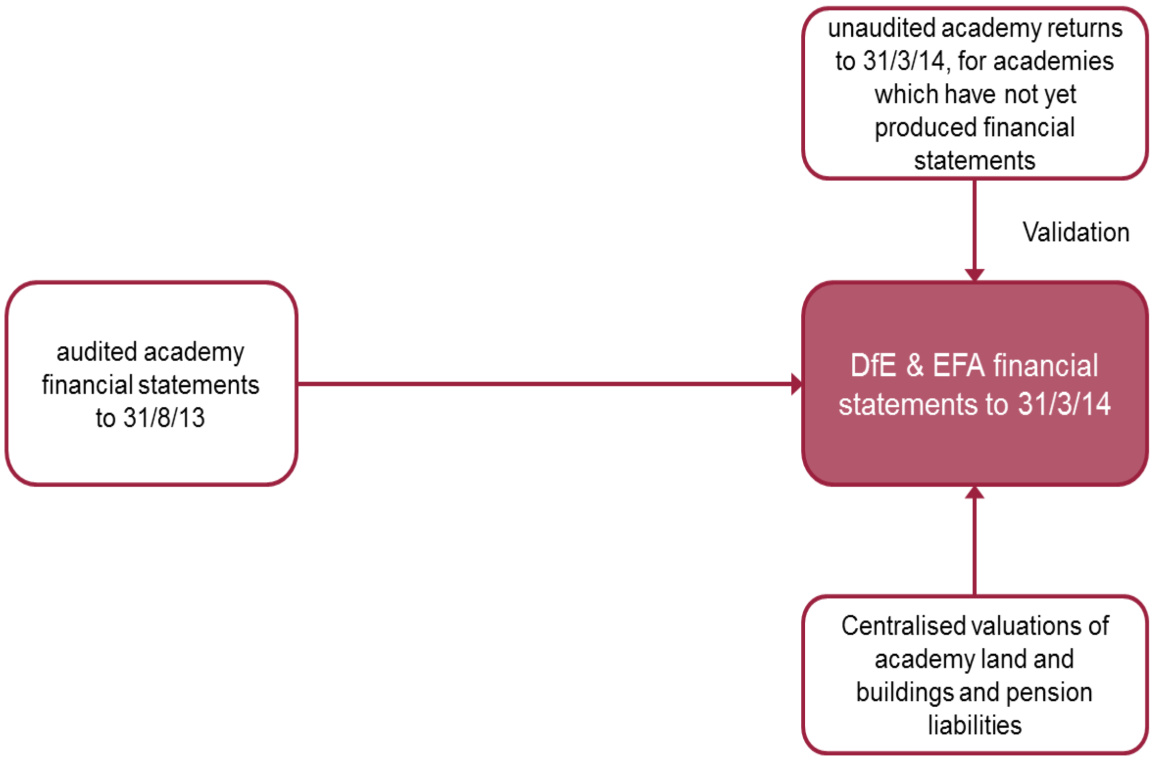


Figure 1: The Department's consolidation approach

11. This is the second year that the Department has followed this approach. My team have worked closely with the Department to understand the key assumptions underpinning their approach and to design an audit approach to test the reasonableness of these assumptions. For 2012-13, I qualified my opinion on certain aspects of the group financial statements. I also noted that growth in the academies sector might mean that the approach would not hold for future reporting periods and recommended that the Department and HM Treasury consider the long term sustainability of this approach.

12. I am pleased to note that the Department has made improvements to aspects of the consolidation process which include:

- Improvements to the timeliness of returns received, having only 22 academy trusts not providing information compared to 123 last year.
- Refining and improving the risk based approach to validate data that is received from academy trusts.
- Obtaining greater detail on academy trusts' pension liabilities, which has removed a source of error I identified in 2012-13.

13. The Department has also utilised the audited academy trust financial statements it has collected for other purposes, including assessing academy trusts' financial health and obtaining assurance that the expenditure they have incurred is regular.

14. However, with the number of academies growing by a further 1,082 during the year and increasing the impact of the academies consolidation on the overall group financial statements, I have concluded that the approach adopted by the Department does not give a true and fair view of

the financial performance or position of the Group in the year ended 31 March 2014. Furthermore, the approach does not provide the accountability to Parliament that is intended by the inclusion of academy trusts within the Departmental accounting boundary. In reaching this view on the group financial statements, I note that I have not identified material inaccuracies in the underlying financial statements of the individual bodies making up the group (the Department, its executive agencies, non-departmental public bodies, and the academy trusts).

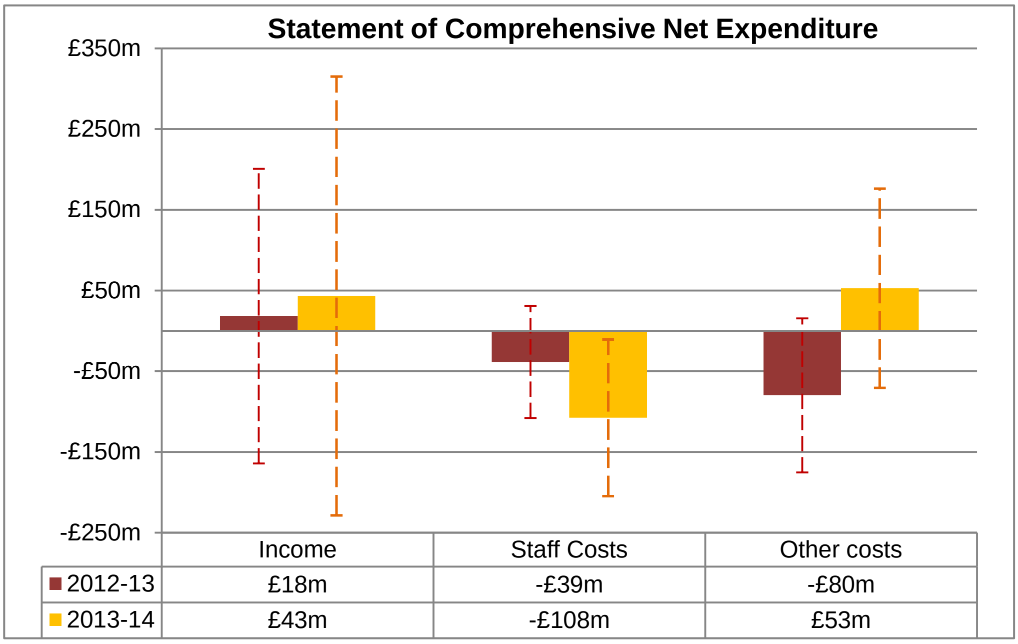
Findings from my audit of the consolidation process

15. My opinion that the group financial statements do not provide a true and fair view was informed by three principal causes of error:

1) **Increasing divergence between academy trusts' financial position at 31 August and 31 March**

   In line with the approach adopted for 2012-13, the Department undertook a comparison exercise during the year to demonstrate the hypothesis that the transactions and balances of academy trusts at 31 August 2013 were not materially different to the position at 31 March 2014. This comparison exercise involved a sample of academy trusts providing audited financial returns for the year to March 2014 to compare to the audited financial statements for the period to August 2013. The exercise shows an increasing divergence compared to the prior year, largely as a result of the increasing number of academies opening and being consolidated in to the Department's financial statements.

   Using the results of this exercise, I have estimated that the net impact on the Statement of Financial Position of using academy trust data from August is to understate net assets by £384 million at 31 March 2014, but this could be as high as £738 million. I estimate that the most likely impact on income is to understate it by £43 million but this could be as high as £315 million and on expenditure to overstate by £55 million, but this could be as high as £270 million. Figure 2 shows the levels of error I have identified as a result of the use of academy trust financial statements at 31 August 2013 compared to the impact of errors identified in the 2012-13 group financial statements:



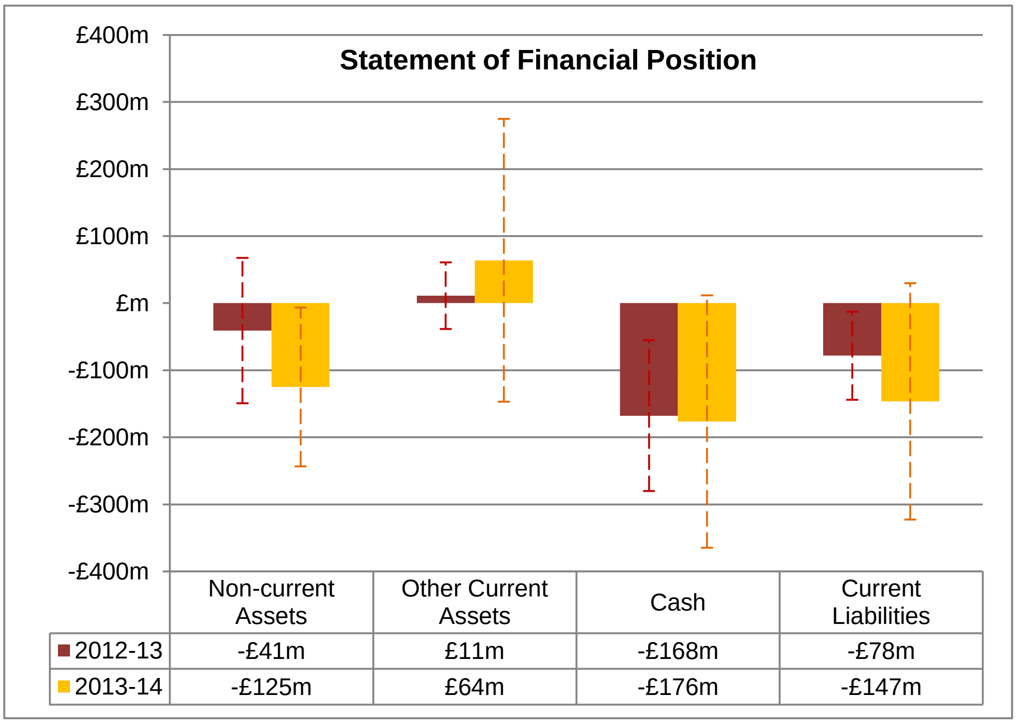


Figure 2: Estimated most likely difference between the academies sector at August and March in the 2012-13 and 2013-14 Departmental group financial statements and the upper and lower limits for this estimate

2) Errors arising from the consolidation of financial statements to 31 August

Consolidating returns with a seven month difference in reporting periods introduces significant errors in the consolidation process, which include:

- The EFA, on behalf of the Department, awards grants to academy trusts. The grants will be shown as expenditure in the financial statements of EFA and income in the financial statements of individual academy trusts. In preparing the group financial statements, these grants should be eliminated to avoid, for example, double counting expenditure made by academy trusts but funded through grant from the EFA. I found that, due to the different reporting periods, there is significant difference in the grants recognised as being paid by the EFA for the period to March 2014 and the grants recognised as being received in the approximation of academy trust financial information. This has resulted in un-eliminated grants of £92 million in relation to revenue grants and £1,019 million in relation to capital grants. I note that this does not represent missing or misappropriated grant but is a consequence of the consolidation methodology adopted and a cause of error in the group financial statements.

- I estimate that between September 2013 and March 2014, at least £214 million of assets have been brought into use by academies which are not recognised in academy trust financial statements to August 2013, and therefore excluded from the Department's financial statements.
- The Department has had to create journals to ensure the internal consistency of their financial statements. This has resulted in an unsupported adjustment of £478m to balance the financial statements.

3) Inconsistencies with prior year returns

Under the approach adopted by the Department for 2012-13, 714 academies, which had not yet produced audited financial statements, produced unaudited returns to 31 March 2013. These academies have now prepared audited financial statements to 31 August 2013 which have been consolidated into the 2013-14 financial statements.

By comparing the audited accounts to 31 August 2013 to the un-audited returns to 31 March 2013, I have determined that the Department overstated academies income and expenditure by £387m for the period to 31 March 2013 reported within the Department's 2012-13 financial statements. The income and expenditure reported in the Department's 2013-14 financial statements is therefore understated by the same amount. This finding undermines the use of unaudited returns, which is a key aspect of the Department's consolidation approach.

In addition, under the approach adopted, the Department has used the transactions for the five month period between 1 April 2013 and 31 August 2013, derived by subtracting the transactions reported in the unaudited returns to 31 March 2013 from those reported in the audited accounts to 31 August 2013, and extrapolated them to provide an estimate of the twelve month period income and expenditure to March 2014. Whereas the Department undertook a comparison exercise to test the validity of the use of academy trust accounts to 31 August as a proxy for the year to the end of March, the Department has not been able to conduct a similar exercise to test the validity of this estimate. Therefore, they have not provided me with robust evidence to support the £2,003 million of income and £1,860 million of expenditure consolidated on this basis, although the resulting error in the financial statements is likely to be much smaller.

16. Based on the level of error above I consider that the Department's financial statements do not give a true and fair view of the state of the group's affairs as at 31 March 2014 and of its net expenditure for the year then ended. I consider this error to affect all academy transactions and balances reported in the financial statements except academies' Local Government Pension Scheme liabilities. Accordingly I have given an adverse opinion.

17. The errors that I have identified undermine two key aspects of the Department's chosen consolidation approach (the use of August financial statements and un-audited March returns) and I have considered the implications of this on the long term future of this consolidation below.

Qualification of my opinion - regularity

18. A primary objective of preparing consolidated financial statements is to provide accountability to Parliament for the financial activity it has approved for the year, which includes the financial activity of academy trusts, 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 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. Where these limits are breached, I qualify my regularity opinion on the financial statements.

19. The 2013-14 Statement of Parliamentary Supply shows that the Department had a net Resource Annually Managed Expenditure Limit of £243 million and an outturn of £409 million. This is, therefore, a breach of the Annually Managed Expenditure Limit control total and I have qualified my opinion in this regard.

20. 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. This challenge is compounded by the fact that the Department does not have in-year information on the forecast spend of academy trusts. Consequently, the Department was unable to determine whether or not it had remained within its control totals until the end of November, almost eight months after the financial year end.

21. The sector outturns reported in the Statement of Parliamentary Supply highlight the weaknesses in the Department's ability to forecast spend accurately for the group. The Department underestimated the increases to pension costs for CAFCASS, those academies that were included in the group as at 1 April 2013, and those schools that converted to academy status during the 2013-14 year by £104 million. In addition, depreciation and impairment costs incurred by academies were £50 million higher than anticipated and expected releases of provisions of £12 million within the Group did not arise. These factors resulted in the Department breaching the Resource Annually Managed Expenditure Limit by £166 million.

22. The Statement of Parliamentary Supply also shows a £856 million underspend against the Resource Departmental Expenditure Limit of £52,870 million and a £377 million underspend against the Capital Departmental Expenditure Limit of £3,983 million. The Department does not fully understand all the causes for the underspend against Department Expenditure Limits, but considers that approximately £1,128 million (91%) arises either directly from academies, for example through retention of grant as cash to fund future capital expenditure as they are entitled to do under the financial framework within which they operate; or indirectly through the methodology applied to consolidate the results of the academies within the group financial statements.

23. I note that the Department has increased the transparency of academy spend through the publication of individual academy trust financial statements online. However, the current methodology adopted by the Department to consolidate these individual academy trust financial statements creates a high degree of uncertainty in reporting the results of the academy trust sector as a whole. The Statement of Parliamentary Supply as presented does not report 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. This limits the ability of Parliament to identify the actual spend by the academies sector for the year in question.

24. With an increasing population of academies and the levels of uncertainty in reported data, the financial management limitations will continue in the near future under the current consolidation methodology. The Department and HM Treasury will need to consider how best to address these risks and limitations to ensure they are meeting the accountability requirements of Parliament.

Update on issues raised in my 2012-13 Report

Progress made against previous qualification on regularity

25. I qualified my regularity opinion on the Departmental group financial statements for 2011-12 and 2012-13. This qualification was made on the basis that the Department's control framework was not sufficiently well designed to identify whether academy trusts had complied with all aspects of HM Treasury's Managing Public Money.

26. In my 2012-13 report, I stated that the Department and EFA had subsequently designed a suitable assurance framework over regularity, consisting of the audit opinions from academy trust auditors coupled with the other work the EFA undertakes to evaluate and investigate compliance.

27. I have reviewed the findings of academy trust auditors and contacted a sample of audit firms to discuss their work on regularity. I am content that these audits were conducted to identify any irregularity that would be material to the Departmental group financial statements.

28. I am therefore pleased to report that the Department's revised process has operated as expected and enabled me to provide an unqualified opinion on regularity of academy trust expenditure.

Land and buildings

29. In 2012-13 I qualified my audit opinion in respect of the valuation of land and buildings held by academy trusts. Academy trusts are charitable companies, meaning that financial statements are prepared in accordance with the charity accounting framework. One area of difference between this financial reporting framework and that of the Department relates to the recognition of land and building assets. 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 the FReM, for example where buildings are occupied on a short term lease.

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

31. I raised concerns in my report on the 2012-13 financial statements that I do not believe that the Department will be able to resolve this issue for a number of years. The Department has stated that collecting the required information would be very costly (£20 million to £40 million to collate the necessary data and a further £5 million to £10 million a year to keep these data current) and therefore they have decided not to collect the information on value for money grounds.

Opening balances

32. In 2012-13, I limited the scope of my opinion because the Department was unable to demonstrate the accuracy of the balances transferred on 1 April 2012 in respect of academy trusts open at that date.

33. In 2013-14, the Department has materially reconciled the balances reported at 31 March 2013 to the balances at 1 April 2013. However, a number of the errors I have described above have a material impact on the transactions and balances in both 2012-13 and 2013-14.

The future

34. This is the second year that the Department has prepared consolidated financial statements including academies. Of the four qualifications to my audit opinion in 2012-13, three remain in 2013-14 and the level of error I have identified has increased. In 2012-13, I made the following recommendations to the Department:

- 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.
- 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.
- The Department, through EFA, should develop the accuracy of forecasting by academy trusts. The Department and EFA should also strengthen their analytical capability to maximise their use of the data provided by academy trusts to monitor financial sustainability within the sector and to inform their resource requirements and financial forecasting.

35. Even though the Department has made a number of improvements to the consolidation process, I do not believe based on the evidence I have, that the current methodology is capable of producing financial statements that present a true and fair view and which meet the accountability requirements of Parliament. In particular, the volume of individual academy trusts and the difficulties in consolidating so many bodies with different reporting periods are challenges I do not believe the Department can address without a significant change in approach.

Recommendation

36. I therefore reiterate my previous recommendation that the Department and HM Treasury work together to identify a solution. HM Treasury should consider alternatives which provide more robust information for use in their fiscal modelling and the Whole of Government accounts.

Sir Amyas C E Morse **Date: 16 January 2015**

Comptroller and Auditor General

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