July 2013

# NAO Communication with academy auditors 2013

## Department for Education: Consolidation of academies

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

- **Their role in the DfE 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.**

## Introduction

**1** The Comptroller and Auditor General (C&AG) is the appointed auditor of the Department for Education (the Department) and Education Funding Agency (EFA) under the *Government Resources and Accounts Act 2000*. The National Audit Office (NAO) performs these audits on his behalf. Further information on the National Audit Office is available on our website.[1]

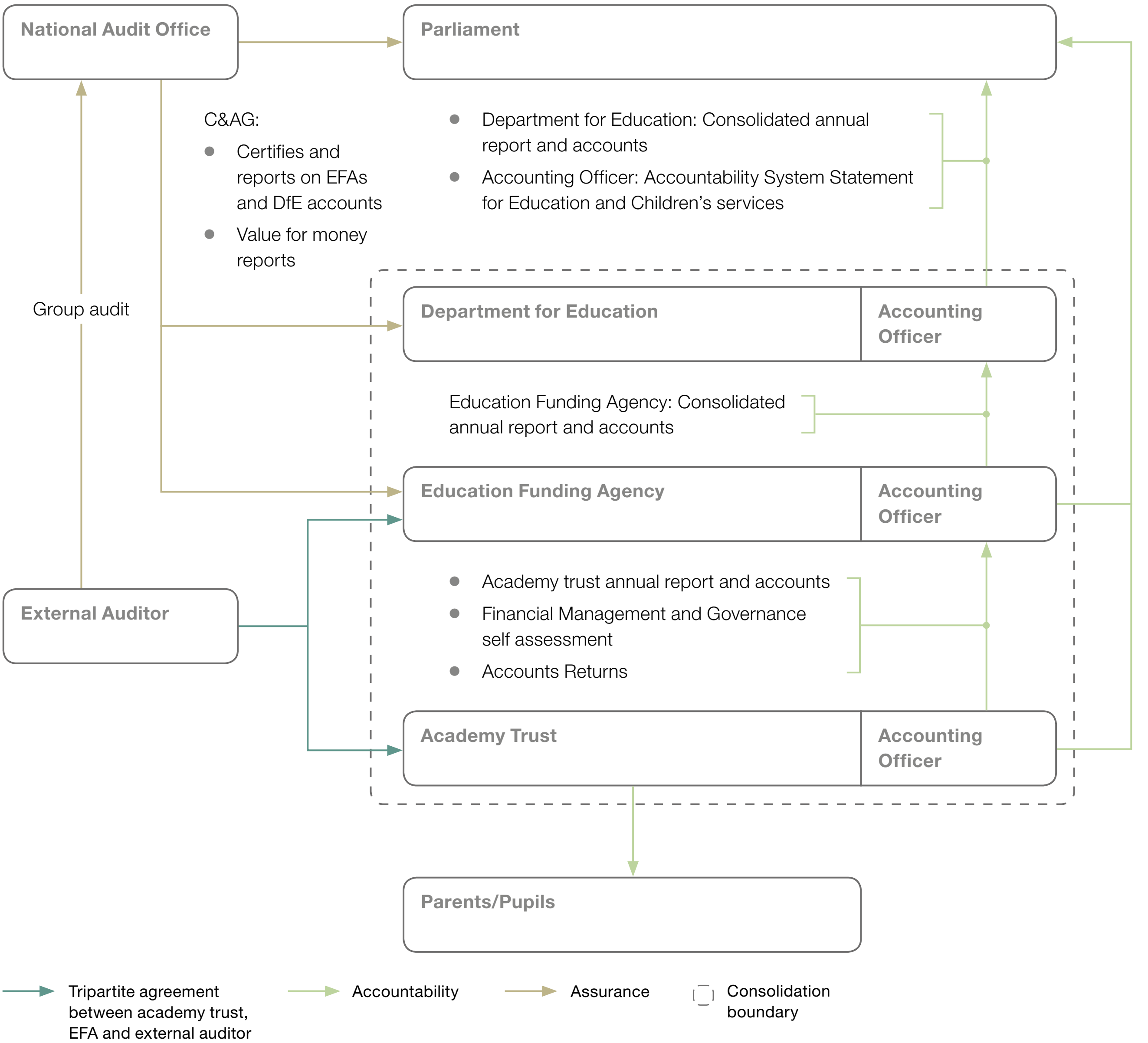
**2** The Department, through the EFA, are required by statute to consolidate academies and academy trusts into their financial statements each year. This is described in **Figure 1** overleaf. The Department's accounting period is to 31 March, whereas the academy year end is 31 August. Academies in existence at 31 March have to be consolidated at that point. Where possible, the Department propose to use existing data sources and centrally derived data to produce this consolidation. This includes academy financial statements prepared under the Companies Act.

**3** 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).*

**4** This communication relates to the consolidation for the period to 31 March 2014, and therefore the financial statements and annual returns for academies to 31 August 2013.

1 www.nao.org.uk

**Figure 1**
Accountability and assurance in the academy sector



# 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 | The Department for Education, EFA, other departmental agencies (see annex) and all academy trusts in existence on 31 March 2014. |
| Group auditors | NAO |
| Group financial statements | The Departmental consolidation of academies, through the EFA, prepared in accordance with the *HM Treasury Financial Reporting Manual* (FReM), which is an IFRS-based framework. These are produced for each accounting period to 31 March. |
| Components | Academy trusts, who prepare accounts under the Companies Act 2006. |
| Significant components | None identified |
| Group audit | Conducted by NAO in accordance with the *ISAs (UK&I),* including a regularity opinion using the *APB's Practice Note 10 Audit Of Financial Statements Of Public Sector Bodies In The United Kingdom* |
| Regularity | Defined by Practice Note 10 as income and expenditure being applied, in all material respects, for the purposes intended by Parliament, i.e. transactions comply with:<br>• Primary legislation;<br>• Regulations issued under governing legislation;<br>• Parliamentary authorities; and<br>• HM Treasury authorities.<br>Interpretation of these for the academy sector is set down in the Academies Financial Handbook, extant from 1 September 2012 |

**6** We do not consider there to be any significant components for the purposes of this consolidation, but the aggregation of all academies is material. 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 component auditors in completing:

- the audit of component financial statements for the period to August 2013, including the regularity opinion;
- assurance work on the accounts return; and,
- where appropriate, the "pilot" exercise for March 2013; in which EFA are requesting additional audited returns at that date to compare against the financial statements for the period to August 2012.

## 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:

- 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 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 and the pilot exercise engagements, 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 component 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 the EFA in the first instance);
- Conducting an audit of component financial statements or regularity to a materiality exceeding £10 million. We request component 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 to have sector-wide significance or exposure. Component auditors may contact the group auditors to discuss significance;
- Post balance sheet events: the timetable for the completion of the group financial statements for the period to March 2013 overlaps with the component audits for August 2013. We request auditors to consider as part of the August 2013 engagements whether there are any events within components that could create a post balance sheet event of significant to the group financial statements. Such events are most likely to be, but are not limited to, identification of irregularity material to the component, including fraud, or a component ceasing to be a going concern.

**10** The EFA require[2] academies to provide them with the auditors' communication to those charged with governance under *ISA 260* in respect of findings from the audit. 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*[3] for clearly trivial misstatements, 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 component 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.groupaudit@nao.gov.gsi.uk**

# Significant group risks

**12** We have identified a number of risks which affect the Departmental Group financial statements, and we bring them to the attention of component auditors who should consider the impact of the risks on the audit of components.

## Risk 1: Regularity

**13** 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 have established a framework of authorities within the funding agreements, academies financial handbook, which derives the principles of regularity from HM Treasury's *Managing Public Money*.

**14** In 2011-12, the C&AG qualified the Young People's Learning Agency (YPLA) accounts on the basis that the control environment was not designed to identify compliance with *Managing Public Money*.

**15** As a result, YPLA's successor body, EFA, issued a revised academies financial handbook for the 2012-13 academic year. This includes a set of delegated authorities for academies for certain types of transactions. These have been negotiated with HM Treasury; transactions above these thresholds require prior approval from EFA. Failure to obtain approval would result in that expenditure being irregular.

**16** EFA also introduced the audit requirement to seek a limited assurance regularity report for each academy trust.

**17** The academies financial handbook, alongside the funding agreement with the Secretary of State and charity law make up the framework of authorities over academy activities.

**18** The version of the academies financial handbook, effective from 1st September 2012, introduced a number of delegated limits for certain transactions. Such transactions above these limits require approval from the Secretary of Stare.

**19** On conversion, or opening, an academy is unlikely to have a fully developed control framework to address all of it new responsibilities. New academy accounting officers are potentially unfamiliar with central government oversight and their responsibilities as accounting officers.

2 "Management Letter", para 1.6.2 EFA Accounts Direction, issued May 2013.
3 ISA 450 Evaluation Of Misstatements Identified During The Audit – paragraph 5.

**20** We therefore 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;
- 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.

**21** Academy auditors should also be aware of the investigations into irregularities conducted by the EFA. These are available on their website.[4] 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 (i.e. using academy funds for personal gain);
- Governance at multi academy trusts (i.e. oversight of activities of individual academies, or weak controls at the trust level)
- Weaknesses in procurement (i.e. non-compliance with EU procurement rules, or employment/contracting with related parties)

## Risk 2: Non-coterminous year ends

**22** EFA are preparing the group accounts using a series of data sources, including:

- Academy accounts to August, where accounts are prepared under the Companies Act;
- Annual Return to August;
- Consolidation returns as at March for those academies who have yet to produce statutory accounts;
- Centrally determined valuations for land and buildings and pension liabilities.

**23** EFA are developing a consolidation model and validation methodology to support the financial data.

**24** This approach is based on the assumption that, with the exception of the valuations for land and buildings and pension liabilities, academy expenditure and working capital is relatively consistent and even throughout the academic year. This allows them to develop an account at March using proxy data. To demonstrate this assumption, they have commissioned pilot exercises to obtain audited financial information at March for a sample of academies who have previously published financial statements and demonstrate that the financial information is not materially different to August.

**25** The risks within this approach are:

- That the assumption cannot be verified;
- Pilot exercise data is of insufficient quality, or there are insufficient participants. It is particularly important that such exercises are conducted with reference to the March position, taking account movements and developments up to that point;
- The impact of short or long first accounting periods cannot be appropriately factored into the model and assumptions. For example, General Annual Grant recorded in EFA's accounts over a financial year against a shorter or longer period within the academy account, which can be compounded by a different basis of recognition with the two sets of accounts. This also affects the period to which gains or losses on conversion to academy are recorded. Both issues caused material misstatement within the Whole of Government Accounts sub-consolidation recently completed;

4 www.education.gov.uk/aboutdfe/executiveagencies/efa/efafundingfinance/b00212647/external-assurance/investigation-reports

- Macro assumptions on pension liabilities or land and building valuations are inappropriate, or are based on invalid or incomplete input data;
- There are irreconcilable differences between closing balances one year and opening balances the next year (e.g. through prior period adjustments that are not captured in annual returns); or
- Post balance sheet events occur that affect the group position, e.g. material irregularities at an academy, an academy failing to be a going concern, or creation of large multi-academy trusts that could render those components significant to the group financial statements.

### Risk 3: Counter party balances and transactions

**26** As part of the accounts return, academies are required to identify counter party balances and transactions, which will be used for elimination in the Departmental group accounts, and then in the Whole of Government Accounts. In the 2010-11 Whole of Government Accounts academies sub consolidation, numerous errors were identified in these balances. Additionally there was inconsistent identification of those balances with wider government (for example HMRC, Local Authorities). There is therefore a risk that a significant proportion of counter party balances and transactions are not accurately identified.

## Large components

**27** Under *ISA 600*, where a group is made up solely of components which are not significant, some interaction with auditors is expected.[5] In such cases, further work is recommended on larger components within the group.[6] 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. This sample will be selected by 31 August 2013, and we shall be in touch with the relevant auditors by that date to explain our requirements and agree timetables for evidence provision.

**28** In addition, we plan to communicate directly with component auditors more generally, through forums and seminars, as well as direct contact.

### Contacts

Please send a summary of any modifications to audit reports, identified ethical breaches and queries to **academy.groupaudit@nao.gov.gsi.uk**

5 ISA 600 Special Considerations – Audits of Group Financial Statements (Including the work of component auditors) – paragraph A53.

6 ISA 600 Special Considerations – Audits of Group Financial Statements (Including the work of component auditors) – paragraph 29.

# Appendix A

## Related parties

**1** The Departmental group accounts for the period to March 2014 will consolidate:

- The Department for Education;
- The Education Funding Agency;
- The Standards and Testing Agency (STA);
- The National College for Teaching and Leadership (NCTL), formally the National College for School Leadership and the Teaching Agency, who merged in March 2013.
- The Children and Family Court Advisory and Support Service (CAFCASS);
- The Office of the Children's Commissioner; and
- Academies

**2** The EFA have prepared a list of group related parties within the accounts return. These include those bodies that are part of the HM Treasury Whole of Government Accounts, and for which elimination of intra-government balances and transactions will be made. We are not aware of any additional related parties that are material to the group financial statements.

NAO National Audit Office

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