

Housing association circular

The term "housing association" in this and related documents means registered social landlord.

RSL 02/10

Internal controls and reporting

Purpose: This Circular sets out guidance for Housing Associations in Wales (HAs) in respect of internal controls

Effective date: 1st May 2010 .This guidance now replaces Circular RSL 028/09 – *Internal Controls*

Related documents:

- Circular RSL 33/09 - *Self Assessment: Guiding Principles for Housing Associations in Wales* (and accompanying cover note)
- Draft performance standards for HAs currently forming part of formal consultations by the Welsh Assembly Government (the Assembly Government)
- Circular RSL32/09 - *Accounting Determination*
- Circular RSL 05/08 – *Group Structures*

Distribution: To all HAs registered in Wales

Contact: Any queries arising out of the contents of this guidance should be addressed to the Housing Regulation Unit of the Housing Directorate at Welsh Assembly Government, Rhydycar, Merthyr Tydfil, CF48 1UZ. Alternatively this may also be done via an email to the Housing Regulation inbox: Housingregulation@Wales.GSI.Gov.UK.

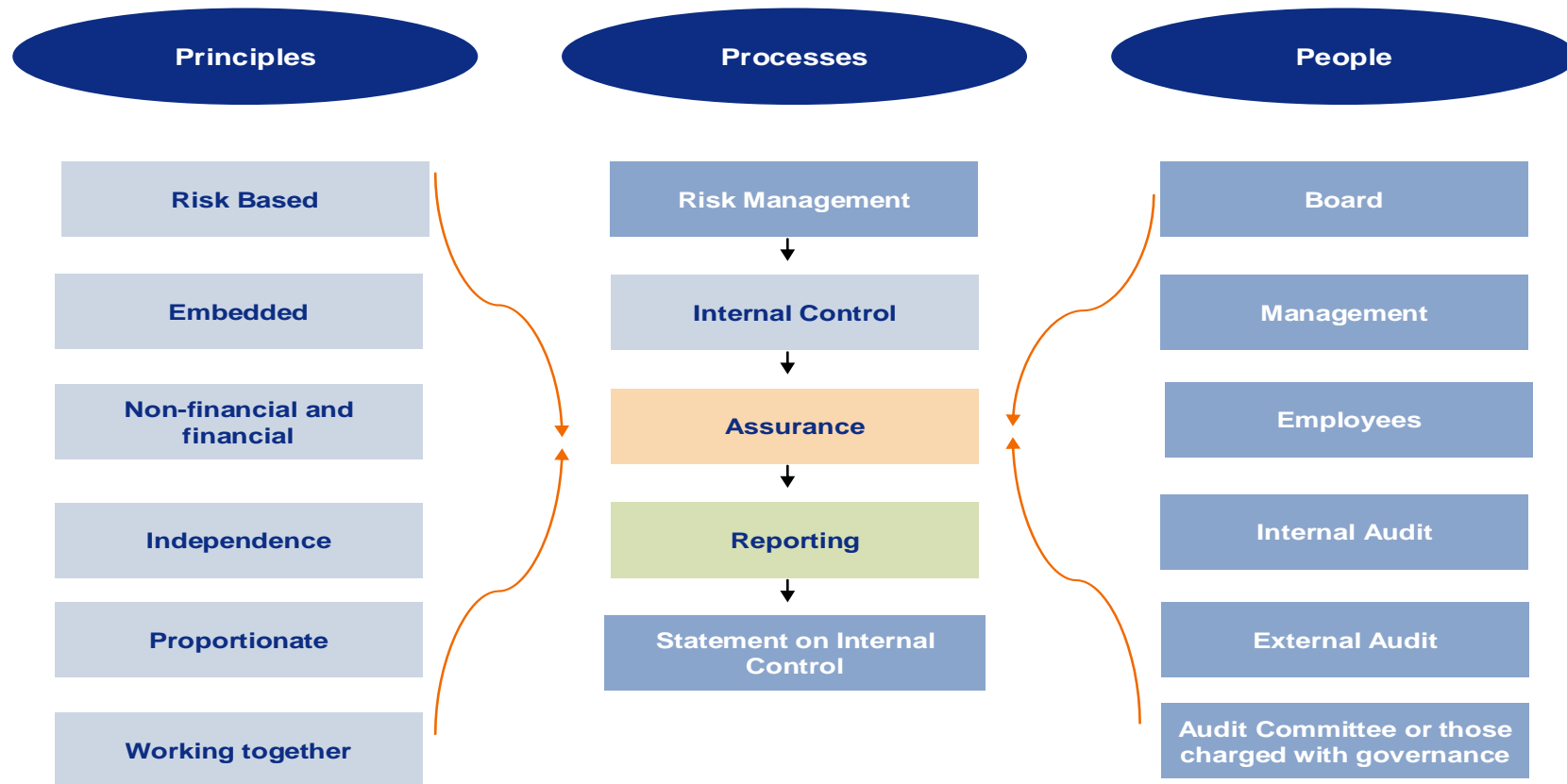
Introduction

The Assembly continues to review extant guidance and circulars in the light of changes to the regulatory framework and publish updates/rewrites as necessary.

The establishment and maintenance of effective internal financial controls is a fundamental element of a strong corporate financial management approach and culture, and which will need to be evaluated as part of a robust self assessment process and the intended Whole Association Assessment. Working with the sector and internal and external audit providers in Wales, new internal control guidance has now been prepared that outlines the most up-to-date principles and practices around internal control and the role of internal and external audit.

The Circular looks at internal control from three perspectives – Principles, Processes and People (See Exhibit 1). It also provides guidance on internal and external audit arrangements, fraud, and reporting arrangements.

Exhibit 1: Internal controls – Principles, Processes and People



Principles and processes

Every association should have clear aims and objectives. It should also identify, assess and understand the risks that might cause it to fail in meeting its objectives. The association should put in place a system of **internal control** that is designed to:

- manage, although not necessarily to eliminate, the risk of failure to achieve its objectives; and
- provide reasonable, although not absolute, assurance against material misstatement or loss.

It is essential that risk management and internal control processes are seen within the overall organisational and governance context. Amongst other things, good governance requires that an association is led by an effective board, that organisational and management structures reflect the association's business objectives and that the association operates a framework that effectively identifies and manages the risks to achieving those objectives. Consequently, risk management and internal control processes should be continuous and **embedded** across all of an association's activities.

Obtaining **assurance** on the effectiveness of internal controls should not be regarded as a separate exercise, but rather should be recognised as a basic and ongoing aspect of running an effective organisation. The system of internal control should also be capable of responding quickly to evolving risks to the organisation arising from factors within the association, to changes in the business environment and to risks arising from working with other partners.

The approach to establishing and monitoring an effective internal control environment should be **risk based**, including an evaluation of the likelihood and impact of risks becoming a reality. The following factors should be considered:

- the nature and extent of the risks facing the association
- the extent and categories of risk which the Board regards as acceptable for the association to bear;
- the likelihood of the risks concerned materialising;
- the association's ability to reduce the incidence and impact on the organisation of risks that do materialise;
- the costs of operating particular controls relative to the benefit thereby obtained in managing the related risks.

Appropriate responses to risk will include implementing internal controls, insuring against the risk, terminating the activity that is causing the risk, modifying the risk or, in some circumstances, accepting the risk.

Effective financial controls, including the maintenance of proper accounting records, help ensure that the association is not unnecessarily exposed to avoidable financial risks and that financial information used within the business and for publication is reliable. However, whilst financial risk is an integral element of internal control, effective risk management should encompass **more than just financial risk**, and should also consider all material compliance, operational, fraud, quality and reputational risks in addition to financial risk.

The system of internal control should include procedures for reporting immediately to appropriate levels of management any significant new or changed risks, control failings or weaknesses that are identified, together with details of corrective action being taken.

When assessing the system of internal control, the board should act with **independence** and provide rigour and challenge to the information obtained. Similarly, those providing assurance to the Board such as management and the internal and external auditors should demonstrate objectivity in their assessment of internal control systems.

Internal control processes should be **proportionate** to the risk. Each organisation should consider its own individual circumstances and bear in mind its size and complexity and the nature of the risks and challenges it faces.

Wherever possible, the different groups involved in internal control – both internal to the organisation and with partners - should **work together** to maximise the overall benefits to the association. It is everyone's corporate responsibility to ensure that internal controls are working.

People

Every member of the association's **board, management** and **employees** has some responsibility for internal control and achieving the corporate objectives. It is therefore crucial that the board engenders an appropriate culture and actively embeds risk management and internal controls in its decision making:

- the board is ultimately responsible for the association's system of internal control and the management of risk, and for the safeguarding of assets against unauthorised use or disposition. It should set appropriate policies on internal control and seek regular assurance that will enable it to satisfy itself that the system is functioning effectively. The Board should, at least annually, conduct a review of the effectiveness of the association's system on internal control;
- management is responsible for implementing board policies on risk and control. To achieve this, it should identify and evaluate the risks faced by the association for consideration by the board and design, operate and monitor a suitable system of internal control and risk

management which implements the policies adopted by the board;
and

- all employees have some responsibility for internal control, in that all are accountable for achieving objectives and should also understand the risk implications of the activities they perform.

Each association should consider carefully the extent to which responsibility is – and is not – delegated from the board to its committees, management and individual employees, but recognising that whilst tasks can be delegated, ultimate responsibility and accountability for the system of internal control remains with the board. Delegation should be relevant to the skills and experience of the staff involved, and should be clearly documented and fully understood by both the Board and officers.

Within a group structure, it is important to establish a suitable framework of communication within and between the member organisations, with defined roles, delegations and inter-relationships. Factors might include consideration of operational and legislative liabilities and responsibilities. It should be made clear where the ultimate responsibility over internal controls systems lies, considering factors such as the level of independence of subsidiaries and fiduciary boundaries.

Responsibility for the oversight of audit issues is commonly delegated to a formally constituted **audit committee** that, where appropriate, will include co-opted experience, or through another committee with a wider but related role. We would normally expect larger associations to have a separate audit committee and avoid using a wider constituted committee for such assurance functions. The terms of reference will set out the extent to which audit committee will be involved, but would normally include:

- overseeing and monitoring a framework for the identification and management of risk;
- overseeing and monitoring a framework of delegation and systems of internal control;
- approving the responsibilities of Internal Audit, receiving reports and assurances from them, and monitoring their performance;
- monitoring the performance of external auditors, discussion of the external audit plan, and receiving reports from the external auditor;
- recommending the appointment of Internal and External Auditors;
- reviewing the annual accounts, including the Statement on Internal Control, and recommending their approval to the Board, in accordance with the SORP and Accounting Determination.

Internal Audit arrangements

Internal Audit is defined by the Institute of Internal Auditors as follows:

“Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation’s operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.”

The main purpose of internal audit activity within a housing association is to provide the Board with an objective evaluation and opinion on the overall adequacy and effectiveness of the organisation’s framework of governance, risk management and internal control.

Appendix 1 summarises the regulatory framework in which internal audit operates.

The establishment of an internal audit function should not be seen simply as a function of a ‘policing nature’. It should also bring added value to the association by highlighting where resources can be utilised more effectively.

The process of this review should be as follows:

- prepare an audit needs assessment to identify activities which will be reviewed and grade them depending on risk;
- develop an internal audit programme which allocates activities over the cycle, with high risk activities being audited more frequently;
- approval by the Board or Audit Committee of the planned programme.

The Board or Audit Committee should receive periodic reports on the following;

- progress reports against the approved audit programme;
- reports on each individual review carried out by Internal Audit, highlighting in particular where weaknesses are identified;
- specific reports as requested.

The method of procuring internal audit should be proportionate to the size of the association. There are a number of avenues open to Boards to ensure that their responsibilities are discharged and associations should determine which option provides the best value for money. Examples of these options include;

- employing your own internal audit staff. In determining whether to employ an internal auditor, associations need to be mindful of costs and workload. Further, since for most associations considering the direct employment of an internal auditor it will only be cost effective to

employ one staff member, there is the danger that the necessary span of work to provide a full audit service will result in some work being undertaken which is either above or below the post holder's capabilities, resulting in a restricted scope or the need for additional audit support;

- sharing internal audit staff. For many associations it would not be cost effective to have a dedicated internal auditor, but it may be realistic to share the costs and services of internal audit staff with other associations. This can have the added advantages of flexibility and seeing good practice in other associations.
- buy other external resources. Internal audit services could be outsourced to a separate professional firm with suitable experience.

There are two further options which could be considered by smaller, non-developing associations;

- using senior staff from one department with the relevant skills and experience to undertake an independent review of the activities of another department, supplementing this as necessary by buying in skills to cover areas where staff do not have the necessary expertise;
- by directly satisfying themselves that systems are properly operated and are adequate.

Whichever method is chosen for the procurement of internal audit, associations should be aware of the regulatory framework and guidelines in place to ensure audit standards are followed and practice is of the highest quality. Appendix 1 sets out the current regulatory framework governing internal audit standards.

The responsibilities of the internal auditor should be formally approved by the board or the audit committee. It is essential to maintain the independence and objectivity of internal audit, and recognise that management, rather than the internal audit service, is responsible for designing, operating and monitoring the internal control system.

External audit arrangements

The external audit is designed to form an opinion on the association's annual financial statements, including:

- compliance with UK GAAP, Industrial & Provident Societies Acts, the Housing Act, and the Accounting Requirements for Social Landlords Registered in Wales General Determination; and
- with respect to the Statement on Internal Control, an opinion on whether the disclosures required by this circular have been provided

and the statement is not inconsistent with the information which the auditors have been made aware of from their work on the financial statements.

Appendix 2 illustrates the regulatory regime in which the external auditor and the association operate.

External auditors make a preliminary assessment of the adequacy of the accounting system and the control environment as a basis for the preparation of the financial statements and the design of audit procedures. In addition, the external auditor will consider the Board's Statement on Internal Control and address any apparent misstatements in it, or material inconsistencies with the audited financial statements, in accordance with The Auditing Practices Board Bulletin 2009/2, April 2009 or successor bulletins.

The association's external auditors currently have no responsibility for assessing, or reporting upon, the association's arrangements for securing value for money (sometimes described as the economy, efficiency and effectiveness of the use of resources). Where auditors identify any value for money issues as part of their accounts audit work, then they should report them to management and the Audit Committee.

In order to avoid any misunderstanding regarding the objective and scope of the engagement of the external auditor, and the method of its reporting, a reference to the auditors' review of the Board's statement should be included in the engagement letter.

Working with internal audit

Internal and external auditors carry out their work with different objectives in mind, however many of the processes are similar and it is sensible and good professional practice that they should work together where practicable to maximise the value of the association's expenditure on audit effort. There are, however, professional standards of independence and objectivity, and on relying upon the work of other auditors, that must take precedence.

Exchange of information about internal control is important. When internal audit can provide positive assurance that internal control is adequate, external audit can use that information in determining the extent of its audit procedures. This will have particular value in supporting the overall control environment and the Statement on Internal Control. In this respect external audit will need to be assured that appropriate methods of risk assessment are in place to inform decisions about the coverage of internal audit activity.

Other benefits can be obtained from co-operation between internal and external audit. These include:

- a reduced audit burden resulting in less disruption;

- a better informed dialogue on the risks facing the organisation leading to more effective focussing of audit effort and consequently to more useful advice to management;
- a more effective audit based on a clearer understanding of respective audit roles and requirements;
- a better understanding by each auditor of the results arising from each other's work which may inform respective future work plans and programmes.

Audit Committees should enquire whether and how internal and external audit have been working together effectively.

Fraud

As part of its system of internal control, the board must have a clear and well-communicated strategy and policy which defines fraud, and covers the prevention and detection of fraud within the association, and how it is reported both internally and externally, together with its expectations on the recovery of assets. A clearly established whistle-blowing policy should be included in the arrangements. Boards also must ensure that policies and procedures are in place should fraud or attempted fraud be reported, discovered or suspected.

The policy should recognise the potential for fraudulent activity to be perpetrated by board members and management, by staff at all levels of the association, by other organisations with which the association might contract, employ or otherwise do business (e.g. contractors, suppliers, partners, service providers), or by tenants. Particular attention should be given to the potential for fraud where there is limited segregation of duties at senior executive and other levels of the organisation.

The Board should receive reports from management on all cases of fraud in order to consider whether management has taken appropriate action and that internal controls are satisfactory.

Once it has been established that actual or attempted fraudulent activity has taken place, we require it to be reported promptly to the Assembly Government, together with the action proposed or taken, irrespective of the monetary or equivalent value.

Associations should be aware of relevant legislation and take all reasonable action to recover any assets that have been lost. Associations should take appropriate action, up to and including legal action, against those responsible, including against staff or board members who commit fraud or whose conduct allows fraud to be committed. Any proposed exceptions to this approach should be discussed with the Assembly Government. Associations are expected to ensure that their insurance arrangements cover the consequences of fraudulent activity.

Associations must maintain a register of all incidents of fraud and attempted frauds detected, and this should be open to inspection by the Regulator at any time. The board should regularly review the register and management must report to the board all cases of fraud and attempted fraud, detailing the nature and extent of the fraud and any implications for the association's internal control system.

The Assembly Government will respond to all notified fraud incidents on a case-by-case basis, as well as to allegations of fraud. The response will vary according to a number of factors, including the way in which the Assembly Government is made aware of it, how far it has been progressed, its materiality and what action, if any, the association has already taken or is taking.

The Assembly Government will take action to recover any public money found to have been fraudulently claimed from the Assembly Government.

Reporting

The annual report and financial statements should include such meaningful, high-level information as the board considers necessary to assist the readers' understanding of the main features of the organisation's risk management processes and system of internal control, and should not give a misleading impression.

The requirement to publish a Statement on Internal Control alongside the audited financial statements applies to all associations.

The Board of a parent body preparing group financial statements should make a Statement on Internal Control in respect of the group as a whole.

The form of the statement which the Board should make about the association's system of internal control is not prescribed, but should contain as a minimum:

- an acknowledgement by the Board that it is responsible for the association's system of internal control;
- an explanation that such a system is designed to manage rather than eliminate the risk of failure to achieve business objectives, and can only provide reasonable, and not absolute, assurance against material misstatement or loss;
- disclose that there is an ongoing process for identifying, evaluating and managing the significant risks faced by the association, that has been in place for the year under review and up to the date of the approval of the annual report and accounts;
- a description of the key procedures which the board has established and which are designed to provide effective internal control;

- confirmation that the board has a current strategy and policy on fraud covering prevention, detection and reporting of fraud, and the recovery of assets;
- confirmation that the Board has reviewed the effectiveness of the system of internal control (note – associations are not required to give an opinion on the *effectiveness* of the controls);
- information about those weaknesses in internal control that have resulted in material losses, contingencies, or uncertainties which require disclosure in the financial statements or the auditor's report on the financial statements, and confirmation that necessary action has been taken or is being taken to remedy these failings or weaknesses.

The Board should develop a process for collecting assurance on internal control from each party involved in the process. This is often recorded in the form of an assurance map which details each source and level of assurance received. The board may wish to consider presenting the assurance map, or a similar document, to the audit committee.

If the board has not conducted a review of the effectiveness of the association's system of internal control, or cannot comply with any of the requirements of the previous paragraph, it should make a statement to this effect and give an explanation.

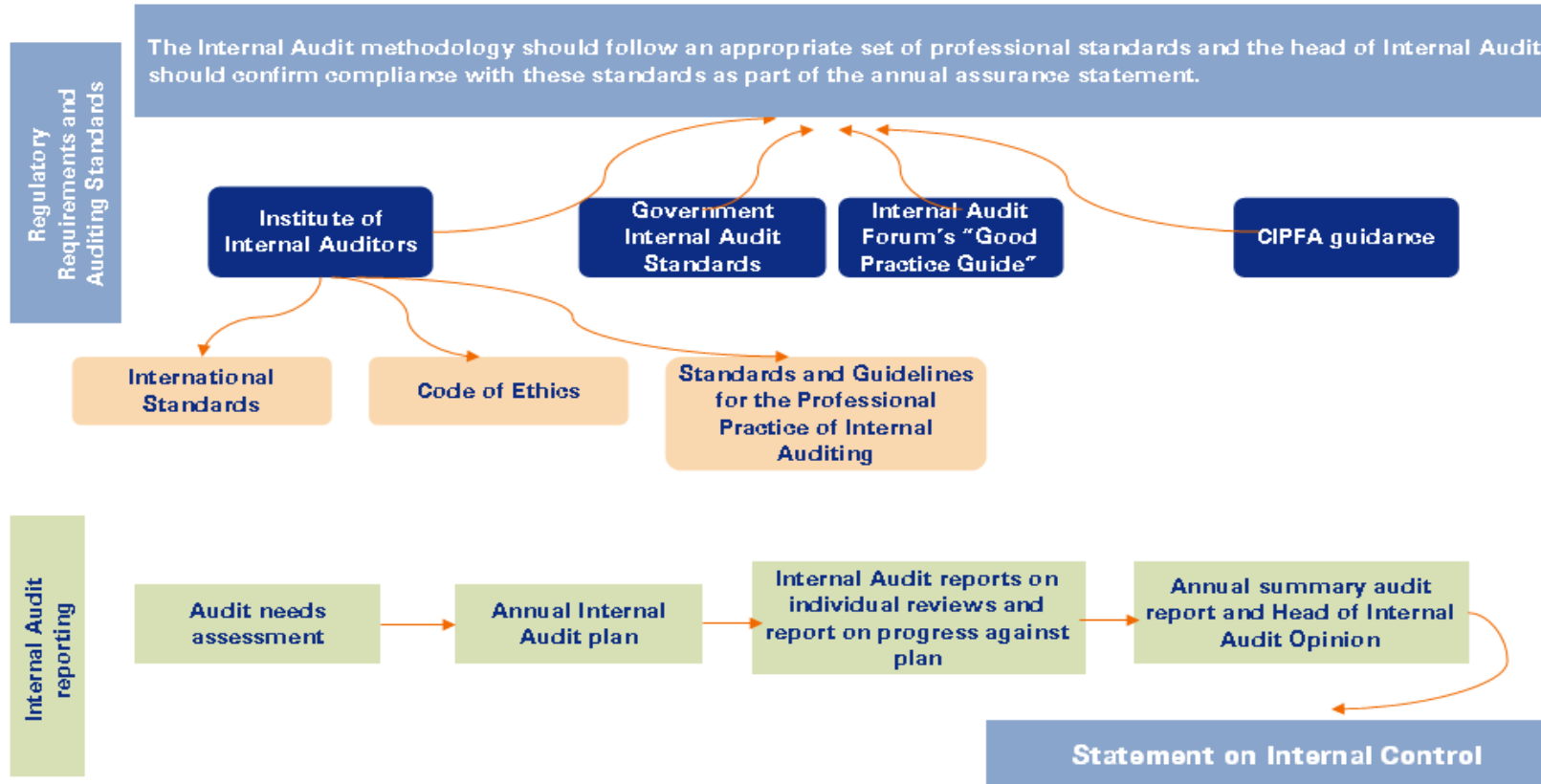
Acknowledgements

Financial Reporting Council – *The Combined Code on Corporate Governance*

Financial Reporting Council – *Internal Control – Revised Guidance for Directors on the Combined Code*

Housing Corporation – *Internal Controls Assurance July 2007*

Internal Audit of Welsh Housing Associations – Regulatory Framework



External Audit of Welsh Housing Associations – Regulatory Framework

