



CIRCULAR

Internal controls assurance

July 2007

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This Circular is for the attention of:

- All Registered Social Landlords
- Registered Social Landlords' auditors

Relevant legislation:

The Friendly and Industrial and Provident Societies Act 1968 (Section 1)

Housing Act 1996

Regulation and/or policy requirements:

Housing Corporation Regulatory Code and Guidance

This Circular replaces Circular number:

25/01: Internal Controls Assurance issued in November 2001

Note: 'Housing association' is used as a generic term for registered social landlords.

'Corporation' means Housing Corporation.

1 Introduction

Housing Corporation Circular 25/01 set out our expectations in regard to internal controls assurance. It introduced an obligation for housing association boards to conduct an annual review of the effectiveness of their systems of internal control and consolidated several existing reporting requirements on internal controls, including fraudulent activity.

The Combined Code on Corporate Governance and its associated guidance on internal control, which underpinned Circular 25/01, have been reviewed and re-issued by the Financial Reporting Council (FRC) but not significantly changed. This Circular:

- takes account of the changes made to the Combined Code and guidance; and
- updates Circular 25/01 in light of current views on good practice on internal controls assurance.

This Circular refers to annual reviews and statements. However, it is essential that risk management and internal control and assurance processes are seen within the overall organisational 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 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.

Internal controls assurance is addressed within the Properly Managed part of the Regulatory Code, which sets out our regulatory requirements for associations. This forms part of the desk-based review work which feeds into the Housing Corporation Assessment (HCA) for larger associations. Areas we will consider include:

- the content of the internal control statement published alongside the financial statements;
- disclosure within the statement of any serious control failures;
- any negative references to the statement within the external audit report on the financial statements;
- the commitment and ability of the association to implement corrective

- measures satisfactorily where serious problems have been disclosed; and
- the likelihood that any points disclosed indicate a wider problem either within the association or across the group.

Except where stated, the Circular's requirements apply to all associations.

2 Main changes from our previous requirements

The board's report on its annual review of the effectiveness of its internal control systems must include confirmation that necessary action has been or is being taken to remedy any significant failings or weaknesses identified in its review.

The board of an association that has been in supervision for at least part of the year under review, or as at the date of the board report, must disclose this within its assessment of the internal control system. It should also confirm that **related** significant failings or weaknesses have been or are being acted upon.

Associations are required to report upon their arrangements for managing the risk of fraud.

The requirement to publish a report on systems of internal control alongside the

audited financial statements now applies to individual associations with 1,000 or more homes owned and/or managed. Smaller associations may voluntarily choose to include a statement on internal control.

3 Recent corporate governance developments in the sector

Since Circular 25/01 was issued, the Corporation has moved to a risk based approach to regulation. This is set out in our Regulatory Code and the How We Regulate series of publications.

The National Housing Federation (NHF) updated its Code of Governance for associations in its publication Competence and Accountability (2004) to enable its members to operate the highest standards of governance, accountability and probity, within an environment of change and risk.

The Statement of Recommended Accounting Practice (SORP) for registered social landlords sets out recommendations on how associations should present their financial statements. The SORP states that it is best practice for an Operating and Financial Review (OFR) to be published by the boards of social landlords with more than 5,000 units in management at the balance sheet

date. The OFR should include an appraisal of the association's objectives; known trends and risks; and the factors affecting and likely to affect its ongoing financial position. Smaller associations are encouraged to publish an OFR.

4 Basis of reporting

Although we use the term 'association' throughout, the 'association' reporting on its system of internal control may be an individual association or the parent of a formally constituted group.

The group parent has a responsibility for the internal control system for that group in its entirety, including unregistered subsidiaries, and that responsibility should be reflected in the scope and content of the published statement of internal controls of an association which is the parent of a group.

5 Roles and responsibilities

Every member of the association's board, management and staff 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 system of internal control and the management of risk, including reviewing the effectiveness of internal control;
- management is responsible for implementing board policies on risk and control. To achieve this, it designs, operates and monitors a suitable system of internal control and risk management; 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, but recognising that whilst tasks can be delegated, ultimate responsibility for the system of internal control remains with the board. Similarly, in a group structure it is important to establish a suitable framework of committees within and between the member organisations, with defined roles, delegations and

inter-relationships. Factors might include consideration of operational and legislative liabilities and responsibilities.

Responsibility for the oversight of audit issues is commonly delegated to a formally constituted audit committee, or through another committee with a wider but related role. The terms of reference will set out the extent to which the board and its audit committee will be involved in internal and external audit arrangements and approval of the annual accounts, as well as:

- establishing and overseeing a framework of delegation and systems of internal control;
- establishing and overseeing a framework for the identification and management of risk; and
- monitoring the organisation's performance in relation to these controls.

We would normally expect larger associations to have a separate audit committee and avoid using a wider constituted committee for such assurance functions.

If there is an internal audit service, the responsibilities of the internal auditor should be formally approved by the board

or the audit committee. However, 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.

6 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 whistleblowing 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, 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.

Once it has been established that actual or attempted fraudulent activity has taken place, we require it to be reported promptly to the Housing Corporation, together with the action proposed or taken, as follows:

- for small associations with fewer than 1,000 dwellings, all incidents individually involving amounts over £1,000 or equivalent in value;
- for associations with 1,000 or more dwellings, all incidents individually involving amounts over £5,000 or equivalent in value;
- for all associations, any incident involving or implicating board members, irrespective of the monetary or equivalent value; or
- for all associations, any incident involving or implicating senior management, again irrespective of the monetary or equivalent value.

Reports should be made at the earliest reasonable opportunity to the Field Director, and include details of the actual or attempted fraud and actions taken or to be taken.

We expect associations to 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 Housing Corporation. 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 fraud detected. 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.

Fraud committed against housing associations may be undertaken by organised groups, and associations may need to work at the appropriate time in partnership with other agencies and associations, including the police, external auditors and other internal auditors. Associations are encouraged to

engage in cross-sector and cross-agency initiatives which seek to identify fraudulent behaviour and activities, such as the Audit Commission's National Fraud Initiative.

The Housing Corporation 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 Corporation 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.

Any single loss of £25,000 or more will be referred to the Housing Corporation's Supervision Team and to the Corporation's Board. The Corporation is required to report losses involving public money to Communities and Local Government, and will take action to recover any public money found to have been fraudulently claimed from the Housing Corporation.

The Corporation may require an association to commission an investigation into a committed fraud, usually by independent consultants, which should conclude with recommendations for any necessary improvements in internal controls, reporting or delegated authorities.

7 The board's statement on internal control

The board should maintain a sound system of internal control which focuses on the significant risks that threaten the organisation's ability to meet its objectives and provides reasonable assurance of the safeguarding of assets.

The board should conduct an annual review of the effectiveness of the association's system of internal control. If the association is the parent company of a group, this review should cover the internal control systems of all companies, including unregistered subsidiaries. Where the board delegates responsibility for the annual review of the system of internal control to an audit (or similar) committee, the findings of that review should be reported to the board.

For associations owning and/or managing more than 1,000 homes at the start of the financial period, **the board is required to issue a formal statement within the annual report and accounts on the outcome of this review**, which will comprise:

- disclosures about the board's approach, its understanding and appreciation of

internal control, and its management of fraud:

- an acknowledgement by the board that it is responsible for the association’s system of internal control and for reviewing its effectiveness;
- recognition 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;
- a disclosure that the process for identifying, evaluating and managing the significant risks faced by the association is ongoing, has been in place for the year under review and up to the date of approval of the annual report and accounts and is regularly reviewed by the board; and
- 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 there has been a review of the effectiveness of the internal control system, to include:
 - a summary of the main policies which the board has established and which are designed to provide effective internal control;
 - a summary of the process and key sources of evidence utilised by the board in reviewing the effectiveness of the association’s system of internal controls; and
 - confirmation that the board reviewed the fraud register, and has reflected the information contained within it in its review; and
- confirmation that necessary action has been or is being taken to remedy any significant failings or weaknesses identified from that review, including where appropriate:
 - details of the process that the board has applied to deal with the material internal control aspects of any significant problems disclosed in the annual report and accounts;
 - a disclosure of any supervisory intervention by the Housing Corporation if this was in place for at least part of the year in question or as at the date of the board report, together with its relevance to the assessment of the effectiveness of the internal control system and/or confirmation that significant failings or weaknesses associated with the Corporation’s decision

- have been or are being acted upon;
- and
- reference to the occurrence of any reportable fraudulent activity and/or to other patterns of lesser levels of fraud detected and resolved.

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.

The internal controls statement in the board's annual report, taken with the OFR, should be used by the board as an opportunity to communicate with its stakeholders and other interested parties about the risk and internal controls issues facing the association, and include the main features of the association's risk management processes and the system of internal control. From one year to the next, we would expect many boards to record changes in their patterns of risk and control as plans are implemented and strategies evolve.

Although there is no prescribed format for the report, and a number of relatively standard disclosures should be included, we would discourage associations from compiling formulaic responses, both within

any one year and from year to year. Such an approach could be indicative of a culture where risk and internal control are not taken seriously by a board. In particular, the summary of processes used by the board in its annual review of the internal control systems should demonstrate that it employed a range of controls appropriate to the breadth and diversity of the key risks it faces.

To help the board review the effectiveness of the association's system of internal control, its chief executive or executive team should present it with an annual report on the effectiveness of the system. This should refer to the forms of assurance that the board considers appropriate to obtaining overall assurance on the system. Where there is an audit (or similar) committee in place, the chief executive or executive team may present their report to that committee.

Most associations currently have an internal audit service, either provided by their own staff or on a contract basis. If no internal audit service is in place and the association owns and/or manages more than 1,000 units, the board must annually consider the need for an internal audit service and record its decision.

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 2006/6, September 2006.

8 Effective date and transitional arrangements

The requirements of this Circular are effective in full for financial accounting periods commencing on or after 1 April 2007.

Most of the requirements were already contained within the previous Circular 25/01, and the additional requirements contained within section 7 of this Circular do not require substantial changes to associations' policies and procedures.

9 Enquiries

Please direct enquiries on this Circular to a member of the Regulation team at your local Field Office or:

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