



**Scottish Housing
Regulator**

**Regulatory Advice Note:
Internal Financial Controls
& the Regulatory Standards**

September 2014

About Us

We are the independent regulator of social landlords in Scotland. We regulate around 180 registered social landlords (RSLs) and the housing activities of Scotland's 32 local authorities.

Our statutory objective is to safeguard and promote the interest of current and future tenants, homeless people and others who use services provided by social landlords.

We were established by the Housing (Scotland) Act 2010 and are accountable directly to the Scottish Parliament. Our Regulatory Framework explains how we regulate landlords. You can download our Regulatory Framework and find out more about us on our website at www.scottishhousingregulator.gov.uk.



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1 Summary

Our Regulatory Framework sets out our Regulatory Standards of Governance and Financial Management and guidance. This can be found at <http://www.scottishhousingregulator.gov.uk/publications/our-regulatory-framework>

All RSLs must comply with these standards and guidance and, by doing so, demonstrate effective governance and sound financial management and deliver good outcomes for tenants. The standards are based on principles and are designed so that RSLs can apply them flexibly to suit their individual organisations.

We require the governing bodies of all RSLs to comply with our Regulatory Standards. This advisory note sets out what we expect in respect of internal financial controls and audit to comply with the standards and specifically what information about internal financial controls should be included in their annual audited accounts. It covers:

- an overview of the purpose of internal financial controls and the governing body's responsibilities;
- the requirement for the governing body to include a Statement of Internal Financial Control within their audited accounts;
- the requirement for auditors to include a report on corporate governance matters in respect of internal financial controls within the audited accounts, and;
- the additional requirements for the governing body of a systemically important RSL.

2 Introduction

Introduction

The governing body is responsible for putting in place an effective internal audit strategy, an appropriate approach to internal audit and a system of internal financial controls. When deciding on appropriate arrangements, the governing body should consider the size and complexity of the RSL and any factors which may prevent the RSL from achieving its purpose.

Regulatory Standard 4.3 states that:

“The governing body identifies risks that might prevent it from achieving the RSL’s purpose and has effective strategies and systems for risk management and mitigation, internal control and audit.”

The purpose of an effective internal audit function is to provide an independent assessment of the organisation’s policies and procedures to control and mitigate risks. One key aspect of the assessment is the adequacy and reliability of the RSL’s internal financial controls.

Each year, the governing body should make a formal statement that it has reviewed the effectiveness of its internal financial control systems. This statement is called the “Statement of Internal Financial Control” (“SIFC”) and is normally incorporated in the audited accounts.

The external auditor reviews the SIFC as part of the annual audit process. They include a report in the audited accounts which gives their independent opinion on whether the SIFC is consistent with what they found during their audit work. This report is called the “Auditor’s Report on Corporate Governance Matters” (“ARCGM”).

Background

In 1999 the Scottish Federation of Housing Association (“SFHA”) published the good practice guide “Raising Standards in Housing” for housing associations, co-operatives and other RSLs in Scotland. It was designed to help organisations improve their performance under the (then) new Regulatory Framework.

The guide included guidance on both internal and external audits:

- Chapter 3 Appendix 6 “Code of Audit Practice”, and;
- Chapter 10 Appendix 9 “Code of External Audit Practice.”

This guidance required the audited accounts to include both a SIFC and an ARCGM and referred to the relevant sections on internal financial controls within the good practice guide.

This guidance was withdrawn some years ago and the lack of new specific regulatory guidance on this issue has led to reporting inconsistencies within audited accounts across RSLs. Some RSLs and auditors have continued to include an SIFC and an ARCGM in audited accounts, even though there is no requirement to do so under the current Regulatory Framework (“the Framework”) while others no longer do so.

Without the SIFC and the ARCGM in the audited accounts, it is no longer obvious whether or not the governing body has carried out an independent review on the internal financial controls. The SIFC and ARCGM provide users with a significant level of assurance that an independent review considers internal financial controls are adequate.

Regulatory Expectations

We expect governing bodies to continue to include a SIFC and an ARCGM in their audited annual accounts to provide users with the assurance that an independent review of the internal financial controls has been carried out. The ARCGM should refer to the Regulatory Standards in our Framework.

Governing bodies should apply this guidance to their annual audited accounts ending on or after 31 March 2015.

All RSLs must comply with Regulatory Standards 1 to 6 in our Framework. Systemically important RSLs must also comply with additional standards that supplement Standard 3 (see Chapter 5). The additional standards are called “Audit Guidance” in our Regulatory Framework.

RSLs which are not systemically important are not obliged to establish an Audit Committee. Their governing bodies should, however, consider whether it would be appropriate to do so in order to ensure effective internal financial controls. If a governing body decides to establish an audit committee then the Audit Guidance provides an overview of best practice to ensure that transparent arrangements are put in place and appropriate roles and responsibilities are allocated.

RSLs can also refer to the latest published version of The National Audit Office’s “Audit Committee Self-Assessment Checklist” for further information about audit committees.

3 Statement of Internal Financial Controls

We expect the SIFC to contain:

- an acknowledgement of the governing body's responsibility for the RSL's system of internal financial control;
- a description of the key procedures involved. This is a fundamental element of the statement. It should outline the specific high level procedures used by the RSL and the process by which the governing body reviews the effectiveness of the system of internal financial control;
- confirmation that the governing body has reviewed the effectiveness of the system of internal financial control;
- information on weaknesses that have resulted in material loss, contingencies or uncertainties which need to be disclosed in the audited accounts;
- an explanation that the system can only provide reasonable and not absolute assurance against material misstatement or loss;
- if the RSL has not complied with the requirements in relation to the statement then the governing body must disclose the reasons for the non-compliance in the SIFC;
- the governing body statement should cover the period of the financial statements and comment on material events or developments which have occurred between the balance sheet date and the date the accounts are signed;
- where the RSL is a parent preparing group accounts, the governing body statement should be in respect of the group as a whole, including unregistered subsidiaries and a separate statement is required for each RSL in the group.

Governing body members should note that they have the discretion to use their own wording for the SIFC and combine it with the ARCGM (see Chapter 4). See Appendix A for a sample SIFC. and Appendix B for a sample ARCGM.

4 External Auditor's Report on Corporate Governance Matters

We expect the governing body to ensure the external auditor includes an ARCGM in the audited accounts.

This report should comment specifically on the governing body's SIFC and it should be made clear that this ARCGM is in addition to and separate from the external audit of the financial statements.

The external auditors provide an independent external opinion:

- on whether or not the governing body has complied with the Regulatory Standards relating specifically to internal financial controls: and
- that the SIFC is consistent with what the auditors found during their audit work.

External auditors have the discretion to use their own wording in the ARCGM and combine it with the SIFC (see Chapter 3).

See Appendix A for a sample SIFC. and Appendix B for a sample ARCGM.

5 Systemically Important RSLs

References to the Regulatory Framework within the “Opinion” section of the auditor’s report on corporate governance matters should make it clear whether or not the review has been conducted for a systemic RSL.

All RSLs must comply with Regulatory Standards 1 to 6 in the Framework. Systemically important RSLs must comply with additional standards (“called Audit Guidance”) which supplement Standard 3.

The Audit Guidance requires systemically important RSLs to:

- have formal and transparent arrangements with their external auditor. Similarly arrangements should be in place for their internal auditor, where the RSL has one;
- define the structure and responsibilities of their Audit Committee

Auditors can determine whether or not an RSL is classified as systemically important by looking at our regulation plans on our website www.scottishhousingregulator.gov.uk. The “Opinion” section should then state the RSL is systemically important. If the RSL is not systemically important then there is no requirement to specifically state this in the “Opinion” section.

The criteria used to identify systemically important RSLs (as set out in Chapter 2 of “Our Regulatory Framework”) mean that it is likely an RSL will retain this status for a considerable time. In other words, our list of systemically important RSLs will remain broadly unchanged but may have minor changes from year to year.

We expect that if an RSL is deemed to be systemically important at any point during the financial year being audited, then:

- the auditors should consider the RSL to be systemically important for reporting purposes, and;
- a general statement about compliance with the relevant regulatory standards must be included in the ARCGM.

Auditors have the discretion to use their own wording – see Appendix B for a sample report.

6 Matters of Governance Interest

Under International Standard on Auditing 260 “Communication with those charged with governance”, auditors are required to communicate matters of governance interest from the audit and discuss the implications of those issues with those charged with governance, in this case the governing body of the RSL.

The output and outcome of such discussions are relevant when it comes to demonstrating that the RSL has complied with our Regulatory Standards. We expect RSLs to send us a copy of communications from auditors on matters of governance interest along with the management letter and response.

Appendix A

Sample Statement on Internal Financial Control

The governing body acknowledges its ultimate responsibility for ensuring that the RSL has in place a system of controls that is appropriate for the business environment in which it operates. These controls are designed to give reasonable assurance with respect to:

- the reliability of financial information used within the Association, or for publication;
- the maintenance of proper accounting records;
- the safeguarding of assets against unauthorised use or disposition.

It is the governing body's responsibility to establish and maintain the systems of internal financial control. Such systems can only provide reasonable and not absolute assurance against material financial mis-statement or loss. Key elements of the Association's systems include ensuring that:

- formal policies and procedures are in place, including the ongoing documentation of key system and rules in relation to the delegation of authority, which allow the monitoring of controls and restrict the unauthorised use of the Association's assets;
- experienced and suitably qualified staff take responsibility for important business functions and annual appraisal procedures have been established to maintain standards of performance;
- forecasts and budgets are prepared which allow the management team and the governing body to monitor the key business risks, financial objectives and progress being made towards achieving the financial plans set for the year and for the medium term;
- quarterly financial management reports are prepared promptly, providing relevant, reliable and up-to-date financial and other information, with significant variances from budget being investigated as appropriate;
- Regulatory returns are prepared, authorised and submitted promptly to the relevant regulatory bodies;
- all significant new initiatives, major commitments and investment projects are subject to formal authorisation procedures, through the governing body;
- the Audit Committee/Governing Body received reports from management and from external and internal auditors, to provide reasonable assurance that control procedures are in place and are being followed and that a general review of the major risks facing the Association is undertaken;
- formal procedures have been established for instituting appropriate action to correct any weaknesses identified through internal or external audit reports

The governing body has reviewed the effectiveness of the system of internal financial control in existence in the Association for the year ended <INSERT DATE>. No weaknesses were found in internal financial controls which resulted in material losses, contingencies or uncertainties which require disclosure in the financial statements or in the auditor's report on the financial statements.

Appendix B

Sample Auditor's Report on Corporate Governance Matters

REPORT BY THE AUDITORS TO THE MEMBERS OF <INSERT NAME OF RSL> ON CORPORATE GOVERNANCE MATTERS

In addition to our audit of the Financial Statements, we have reviewed your statement on Page <INSERT NUMBER> concerning the Association's compliance with the information required by the Regulatory Standards [for systemically important RSLs] in respect of internal financial controls contained within the publication "Our Regulatory Framework" and associated Regulatory Advisory Notes which are issued by the Scottish Housing Regulator.

Basis of Opinion

We carried out our review having regard to the requirements to corporate governance matters within Bulletin 2006/5 issued by the Financial Reporting Council. The Bulletin does not require us to review the effectiveness of the Association's procedures for ensuring compliance with the guidance notes, nor to investigate the appropriateness of the reason given for non-compliance.

Opinion

In our opinion the Statement on Internal Financial Control on page <INSERT NUMBER> has provided the disclosures required by the relevant Regulatory Standards [for systemically important RSLs] within the publication "Our Regulatory Framework" and associated Regulatory Advisory Notes issued by the Scottish Housing Regulator in respect of internal financial controls and is consistent with the information which came to our attention as a result of our audit work on the Financial Statements.

Through enquiry of certain members of the Management Committee and Officers of the Association and examination of relevant documents, we have satisfied ourselves that the Management Committee's Statement on Internal Financial Control appropriately reflects the association's compliance with the information required by the relevant Regulatory Standards [for systemically important RSLs] in respect of internal financial controls contained within the publication "Our Regulatory Framework" and associated Regulatory Advisory Notes issued by the Scottish Housing Regulator in respect of internal financial controls.

