# **Hexagon Housing Association Ltd**

**Board of Management – 26th July 2016**

**Agenda Item 5**

**Internal Controls Assurance – Annual Review**

**Report by the Chief Executive**

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| ***1.0*** | ***Summary*** |
|  | This is the annual report from the Chief Executive to the Board. It is no longer a regulatory requirement that the Board receive an Internal Controls Assurance Statement. However for the past six years, the Audit & Risk Committee and the Board have taken the view that the Chief Executive should continue to produce an Internal Controls Assurance Statement for the Audit and Risk Committee and the Board to provide the level of assurance that the Board need in order to approve the Statement on Internal Control that the Board include with the audited annual accounts.  The report recommends that the Board approve the statement on Internal Controls contained in **Appendix A** for inclusion in the Financial Statements for 2015/16.  A draft of this report was considered by the Audit & Risk Committee and this final version reflects their comments and the comments emailed by Martin Large, who was unable to attend the re-scheduled meeting, but contributed nonetheless. |
| ***2.0*** | ***Recommendations*** |
| 2.1 | It is recommended that the Board note the contents of the report and approve the statement contained in **Appendix A** for inclusion with the Financial Statements for 2015/16. |
| ***3.0*** | ***Background*** |
| 3.1 | For the sake of continuity, I have retained the headings in this report as per my previous reports to the Board on the subject of Internal Controls Assurance, to reflect best practice. This year, I have added a new section relating to the timeliness and accuracy of our Regulatory Returns. This follows a request made by the Board in July 2015, following consideration of the HCA’s “Regulating the Standards” document. |
| ***4.0*** | ***Assurance on the Systems of Internal Control*** |
|  | The Board is ultimately responsible for the system of Internal Control and the management of risk, including reviewing the effectiveness of internal control. The Audit & Risk Committee undertakes much of the detailed work in this area and is central to the Board’s oversight of Internal Controls.  Risk management and control processes should be continuous, and obtaining assurance on the effectiveness should not be a separate exercise, but a fundamental and ongoing aspect of running an effective organisation. The annual review should be seen in that context. |
| a. | Strong Management Structures and Clear Accountability The Board has approved the Standing Orders and Delegated Authorities, which provide a clear statement of its role and responsibilities as well as the role of the Chief Executive and other senior managers.  These clearly outline who is delegated to do what, what the authorisation levels are.  The Standing Orders and Delegated Authorities are reviewed on a regular basis and changes are approved by the Board as required.  In the first half of 2013, officers undertook a substantial and comprehensive review of the Standing Orders & Delegated Authorities (SODA). We were assisted by an external consultant, SECTOR, who undertook 19 interviews to assist in shaping the changes needed. The document was reviewed by the Directors’ Group and Managers before this was put to the Board for approval in July 2013.  Some of the Board approved changes were simply to make the presentation more user friendly, but some other changes were meant to bring the document more up to date as several years had elapsed since some of the authorisation levels for approvals, for example, had been reviewed.  During 2015/16, the Board made two minor changes to the Standing Orders and Delegated Authorities (SODA). The first was a change to the Audit & Risk Committee Terms of Reference in relation to voting rights. This was made to ensure that SODA reflected the new NHF Code of Governance steer which suggested that the Chair should not be a voting member of the Audit & Risk Committee.  Another small change was made by the Board in September 2015 to ensure that a new postholder had delegated authority for expenditure within approved budgets.  As described above, the two changes approved were minor, but it is very important that the SODA document is kept up to date to ensure that everyone is clear on their role and responsibilities.  At the beginning of 2016, I reported to the Board that as a result of the recent investigation into a breach of the NHF Code of Conduct by a Board Member, that we were reviewing the SODA document to ensure that the procedures for investigating complaints and possible breaches of the Code of Conduct were fine-tuned and tidied up following some observations made by the Chair. I can therefore confirm that this will be put in place during 2016 for Board approval in November. |
| b. | **Management reports on operational and financial matters**  The Directors’ Group receive operational reviews from managers and these reports result in a Board report that identifies the key strategic matters arising from those reviews.  In the past year, the Board received strategic matters arising from annual review reports for a large number of areas including IT, Human Resources, Supported Housing, Housing Services, Community Investment, Resident Involvement, Finance, Stock Improvement, Responsive Repairs, Development and New Business.  Most reports included recommendations for actions to ensure the matters identified were properly addressed. This included risk mitigation measures where appropriate. |
| c. | **Management reports on operational and financial controls**  All reports for the Board provide information on significant risk areas identified. They outline the nature of the risk, and what is being done to mitigate against these risks crystallising. This is a fundamental element of our reporting structure. |
| d. | Risk Management Activities Hexagon’s Board keeps the Risk Management process under review via the Audit & Risk Committee, which receives four reports throughout the year. These reports were received in May, July, November 2015, and February 2016.  The risk assessment of the top risks during 2015/16, were primarily driven by the objectives laid out in our corporate strategy. The overall Corporate Risk map is held as a series of 15 departmental risk maps as well as one corporate consolidated risk map.  The Audit & Risk Committee’s final review of Corporate Risks carried out in 2015/16 was carried out in February 2016. This review focused on the highest gross risks and the highest net risks facing the Association.  The Committee considered the top 13 net risks (risks scoring higher than 35) and the top 6 gross risks (high gross but net below 28). |
|  | Crucially, all risks considered by the officers and the Audit & Risk Committee included an assessment of existing strategies in place, and where relevant, further action required, together with a clear timescale and a responsible person(s) identified.  The minutes of the February 2016 Audit & Risk Committee meeting were considered at the full Board meeting on 7th June 2016.  The top net risks to the Association at year end were are as follows:   1. Direct payment to tenants following the introduction of Universal Credit; 2. Management of variation orders in Responsive Repairs; 3. Further Welfare Reforms (i.e. introduction of the Welfare Cap); 4. Government plans to restrict HB to LHA levels for RPs; 5. Failure to meet LA S106 and GLA Affordability Criteria for shared ownership in high value areas; 6. Rising build costs; 7. Arrival of new maintenance contracts from February 2016; 8. Inability to purchase sites to deliver the 2015/18 programme in full; 9. LB Southwark withdrawing funding for support contracts to vulnerable residents; 10. Southwark withdrawing their voids underwrite agreement in the future; 11. Failure to meet first tranche shared ownership sales projections; 12. Voluntary Right to Buy being introduced without assurance of replacement on a like-for-like basis; 13. Changes in accounting policy leading to stakeholders forming an adverse view of Hexagon’s viability (arising from FRS 102).   All risks will be reviewed and re-assessed on a quarterly basis including an update to actions to prevent risks crystallising.  The Audit & Risk Committee attended a training seminar at its February 2016 meeting on the subject of ‘Risk Appetite’. This was followed up with further training at the May 2016 meeting. The seminars were led by Mazars, our internal auditors.  The two training seminars resulted in a paper which went to the June 2016 Board meeting entitled ‘Defining Hexagon’s Risk Appetite’. As a result, the Board has now adopted an overall statement of risk appetite and agreed a number of risk matrices. Some of these risk matrices, particularly the ones arising from financial risks, had previously been approved by the Board, but they were supplemented with some new risk matrices which the Board approved following the Audit & Risk Committee’s deliberations.  Lastly, changes to Corporate Risk were also considered by the Board at its March 2016 meeting following consideration by the Audit & Risk Committee. |
| e. | **Assignment of responsibility for oversight of audit activities**  As mentioned in Section 4d above, Hexagon’s Board structure includes an Audit & Risk Committee. The Terms of Reference for the Audit & Risk Committee have been agreed by the Board and amongst other things this ensures that the monitoring of corporate risks are carried out on a quarterly basis by the Committee.  At the Board meeting in March 2015, the Board considered and adopted the National Housing Federation’s Revised Code of Governance 2015 and agreed that the Board and the Audit & Risk Committee should consider the Terms of Reference to ensure that the Chair of the Board is not a voting member of the Audit & Risk Committee. This was formally implemented in September 2015 when the Board approved changes to the Terms of Reference.  The Audit & Risk Committee is also responsible for monitoring progress with the Internal Audit Plan and they receive all of the internal reports. (This is covered in more detail in Section g). The Audit Committee also looks at any cases of fraud, attempted fraud, or maladministration.  All of the Audit & Risk Committee minutes are reported to the Board. The Audit & Risk Committee Chair summarises the work of the Committee to the main Board via the minutes and the Chair highlights the most important points arising. |
| f. | Control and Risk Assessment As reported above, the organisation carried out four quarterly control and risk self-assessment exercises during 2015/16, the last of which was reported to the Audit & Risk Committee in February 2016. The same report was considered by the full Board on 29th March 2016. Both the Audit & Risk Committee and the full Board considered the top gross and net risks as described in the report and the actions proposed to address the risks identified.  The self-assessment is driven by the Association’s Corporate Plan in that it concentrates on the main risks that may prevent the Group achieving its objectives. The Risk Map is built up on a departmental level and is then reviewed by the senior management team as a matter arising from the corporate planning process. The risks are recorded and assessed in terms of their impact and probability. They are then scored to ensure that we concentrate on those risks which need the most attention.  The officers’ Risk Assessment Panel (RAP) meets on a monthly basis to keep these risks under regular review and reports any material or significant changes to the Audit & Risk Committee for further discussion/decision at each of their meetings. |
| g. | Internal Audit The Association has had an internal audit function in place for over 20 years and it is fundamental to the way that we work.  **General approach**  For the fifth year running, the Audit & Risk Committee has taken an approach to the Internal Audit which involves carrying out two distinct types of internal reviews:   * **Strategic Risk Reviews**: these are detailed internal audit assignments focusing on how effectively the association is managing the key risks that it faces. These generally focus on key risks faced by the Association, particularly where officers and the Audit & Risk Committee have jointly identified a possible area of weakness in relation to risk management; * **Compliance Reviews**: these are short regular checks of compliance with important internal controls, particularly around finance, recruitment and health and safety. These compliance reviews enable Mazars to provide objective, regular assurance to the Audit & Risk Committee that Hexagon colleagues are complying with important internal controls.   **Results of 2015/16 Internal Audits**  During 2015/16, Mazars carried out Compliance Reviews for the following areas:   * Gas Certificates * Water checks (Legionella) * Fire Risk Assessments * Portable Appliance Testing * Asbestos Checks * DBS Checks (relevant positions) * Voids (including Electrical Surveys) * Arrears * Nominal Ledger reconciliation * Purchases and Payments * Payroll * Compliance with Tendering and Financial Regulations * Fire Alarm Testing and Drills * IT Administration of Leavers and Starters * Property Disposals and Handbacks * New Tenant Sign-up   In respect of the Compliance Audit recommendations, there were a total of 12. This was a decrease from a total of 17 recommendations arising from the Compliance Reviews in the previous financial year.  All recommendations were accepted and were accompanied by a management action plan. These are implemented by officers under the scrutiny of the Audit & Risk Committee. The Committee receives regular reports at each of its meetings until all of the action points have been actioned.  Of the 12 recommendations, none were ‘fundamental’ (versus 3 in 2014/15), 7 were ‘significant’ (versus 12 in 2014/15), and 5 were ‘housekeeping’ (versus 2 in 2014/15).  In respect of the Strategic Reviews, Mazars carried out 5 Strategic Reviews, including the following areas:   * Serious Detriment * Assets & Liabilities Register * Legionella * Data Protection * Stress Testing   It should be pointed out, that the selection for the 5 Strategic Reviews is driven by a number of considerations including the Corporate Risk Map, as well as the Board, Audit & Risk Committee, and the Directors’ Group views on where there may be issues of internal controls that need to be strengthened.  For the 5 reports, Mazars concluded that two areas provided ‘substantial assurance’ (Assets & Liabilities Register and Stress Testing), whilst three areas provided ‘adequate assurance’ (Serious Detriment, Legionella, and Data Protection).  A total of 31 recommendations were made (this compares to a total of 16 in 2014/15). All of the recommendations were accepted and accompanied by a management action plan which was approved by the Audit & Risk Committee. These action points are implemented by officers under the scrutiny of the Audit & Risk Committee which receives regular reports at each of its meetings until all of the outstanding points have been actioned.  Of the 31 recommendations, none were considered ‘fundamental’ (same in 2014/15), 11 were considered ‘significant’ (versus 8 in 2014/15) and 20 were considered to be ‘housekeeping’ matters (versus 8 in 2014/15). Members should note that we carried out 5 Strategic audits rather than 4 so the volume comparisons for the recommendations are not quite like-for-like.  **The Internal Audit Plan for 2016/17**  At the February 2016 meeting, the Audit & Risk Committee received a detailed plan developed by Mazars, our internal auditors, following consultation with the Directors’ Group.  The 2016/17 Internal Audit Plan has been developed within the context of our Corporate Plan objectives, our Risk Map and an assessment of our performance.  Five Strategic reviews for the coming year have been agreed as follows:   * Rent Setting * Arrears Management * Responsive Repairs * Customer Service Centre * Sales Processes   The Compliance Reviews will look at the following areas:   * Gas Certificates * Water Checks (Legionella) * Fire Risk Assessments * Asbestos Checks * Voids * Arrears * Property Disposals and Handbacks * Portable Appliance Testing\* * DBS Checks (relevant positions)\* * Fire Alarm testing and drills\* * Nominal Ledger Reconciliations * Purchases and Payments * Payroll * Compliance with Tendering and Financial Regulations * IT Administration of Leavers and Starters\*   *\*Test in Quarter 4 only*  **Mazars’ opinion for 2015/16**  The Internal Auditors’ annual report for 2015/16, which was considered by the Audit & Risk Committee on 10th May 2016, states that “**In our opinion, Hexagon Housing Association has in place an appropriate framework for identifying, evaluating and managing the significant risks faced by the Association.”**  **In respect of their areas of activity which we reviewed and subject to the weaknesses identified and reported in our internal audit reports, Hexagon Housing Association has an adequate, effective and reliable framework of internal control, and effective risk management and governance processes, which provide reasonable assurance regarding the effective and efficient achievement of the Association’s objectives.**  **No instances of actual or suspected fraud have been encountered directly during our internal audit work.”** |
| h. | **External Audit**  The Association receives a limited degree of assurance from the routine work of the external auditor. I refer to this as ‘limited’ as the annual management letter only refers to matters identified during audit work and usually only refers to weaknesses rather than positive assurance.  Nevertheless, this is piece of an overall puzzle, which the Board receives in relation to internal controls. The external auditors’ management letter is contained under **Agenda item 9.** I would draw Members’ attention to this document. |
|  | This year, our 205/16 Audit Management letter is “clean” in that it has not identified any material or significant deficiencies. |
| i. | Internal financial control The Board approved the annual budget for 2015/16 in March 2015 and each quarter, the quarterly management accounts were produced with a narrative showing progress against target and any remedial action required. |
| j. | **Quality Management Systems**  Investors in People (IIP) is a national standard which sets a level of good practice for improving our overall performance through better planning, implementation, and evaluation of learning and development programmes for our workforce.  In 2015, Hexagon received a ‘Gold’ award under the Choices Framework, by exceeding the national IIP standards by evidencing the achievement of a further 126 criteria. This followed on from six years of work starting in 2009 when we received a Bronze award and 2012 when we received a Silver award, where we implemented an action plan arising from the ‘Bright Ideas’ arising from the IIP Assessments carried out. We have been particularly focused on increasing levels of ‘employee engagement’.  IIP Gold is a fairly elite standard in that only approximately 7% of organisations assessed under the IIP framework achieve this award, so it should give the Board some assurance in respect of external quality management assessments.  The IIP Gold award followed on from the Opinion Research Corporation (ORC) award in June 2016 for having the highest levels of employee engagement of any of Europe’s small companies (less than 300 employees). A total of 452 organisations are included and Europe based companies represent a larger proportion of the group. We understand that there are approximately 43 housing associations within the 452 organisations that take part. In addition, Hexagon won a special award in 2016 for the highest positive score on “taking action”.  Whilst the ORC award is not be compared with the IIP award, it also provides some limited further assurance to the Board on how well the organisation is managing staff in pursuit of achieving our corporate objectives.  Hexagon is one of 65 housing associations to participate in the SHIFT (Sustainable Homes Index For Tomorrow) benchmarking scheme. SHIFT is a government endorsed scheme which analyses the environmental performance of housing associations including their homes, offices, and other operations. SHIFT looks at things such as energy efficiency, water use, waste, and adaptations to climate change.  Every two years, members receive an independent in depth assessment comparing them with other housing providers. Just six other housing associations across the country recently received a GOLD award and we reported in January 2015 that Hexagon was one of these associations, putting Hexagon at the very forefront of sustainability work across the sector.  The Board has approved a Sustainability Strategy and a Greening of the Stock Strategy, both of which have some read across to our Asset Management Strategy. The Board monitors progress on all three, but once again, we do receive some additional assurance from an external accreditation process which gives us some perspective on our relative performance compared to other housing associations. |
| k. | **Performance information (including performance indicators)**  The Board receives quarterly detailed performance indicators and these go some way to assessing whether the organisation meets its objectives.  The Board also receives information about how our performance on key PIs compare to our peers.  The PI reports include commentaries that contain action points where we are not achieving the target with remedial actions for the Board to discuss. This is also covered in the Performance Indicator cover report. |
| l. | **Reports from regulatory and other external bodies**  In February 2016, the HCA published the following straplines on their website for Hexagon:  G1 (the provider meets the requirements on governance set out in the Governance and Viability Standard) and V1 (the provider meets the requirements on viability set out in the Governance and Viability Standard and has the capacity to mitigate its exposures effectively). These are the top ratings for both governance and viability.  The Homes and Communities Agency (HCA) also report on Hexagon’s financial viability based on a financial capacity model which we sent to the HCA during the year and based on our responses to their quarterly surveys which cover things such as cash flow and property sales.  In March 2015, Hexagon received an updated Viability Review from the Homes and Communities Agency (HCA), our regulator, and this was reported to the 31st March Board meeting.  The Viability Review confirmed that Hexagon retained the highest viability rating that he regulator can award, namely V1.  We have had no further updates since that time, but we are now aware that the regulator has moved away from doing regular viability reviews and intend to do new “stability checks” from time to time and that they will supplement these with an In-Depth Assessment (IDA). Their intention on IDAs is to ensure that all associations receive an IDA over a three-year period. Hexagon did not have an IDA during 2015/16.  On 26th January 2016, I reported to the Board that the Chair received a letter from the Greater London Authority (GLA) dated 23rd December 2015 with an attached report on procedural performance for our development (new build) activities. The report concluded that the audit results were “good” and that the overall procedural rating was “green”.  The Chair signed and returned the report on 8th January 2016. As there were no breaches of the GLA Funding Conditions, there were no recommendations to follow up. |
| m. | **Regulatory returns – timeliness and accuracy**  I can confirm to the Audit & Risk Committee and to the Board that the Finance Director has confirm to me that all regulatory returns were submitted on time during 2015/16.  There were some minor queries from the HCA on three of our returns (the Statistical Data Return (SDR), the Recycled Capital Grant Fund (RCGF) return, and the Financial Forecast Return (FFR), which led to these three returns being altered slightly, but none of the changes were significant.  The queries on the SDR have led to further checks being carried out on compliance with the Rent Standard in supported housing and then in general needs and this was reported to the Audit & Risk Committee (February 2016) and then to the full Board (March 2016). At the time of writing, we have yet to conclude the exercise, but this should be completed in July 2016, at which point the Chair will write to the Regulator with a full account of any non-compliance with the Rent Standard and what actions have been taken to ensure full compliance going forward. |
| n. | **Fraud**  Hexagon has a register of frauds and thefts which we keep up to date and report all incidents to the Audit & Risk Committee and Board as appropriate.  During the last financial year, there were two entries into the Fraud Register. The first in June 2015 was reported to the Audit & Risk Committee in July 2015. This involved an attempt to cash a fraudulent cheque from the Hexagon Number Two account via Nationwide Building Society in the sum of £3,700. The Nationwide queried the authenticity of the cheque and we confirmed it was not ours. There was therefore no financial loss to the Association.  The second entry in the Fraud Register relates to a duplicate payment made to one of our maintenance contractors which was identified in September 2015. A subsequent investigation concluded that this was a paperwork error rather than a duplicate payment.  In November 2015, the Audit & Risk Committee received a report relating to an investigation into duplicate components and a final report went to the Committee in March 2016. This concluded that all potential duplicates were in fact data errors. The report included a recommendation to increase the accuracy level of information provided to the Finance team on component replacements from the current levels of 98.6%.  The Finance Director is required to make a fraud return to the HCA which includes any tenancy fraud which may have been uncovered during the year. The return had not completed when this report was finalised, but I will update the position verbally at the meeting. |
| **5.0** | **Board Statement on Internal Financial Control** |
|  | I attach at **Appendix A** the Board statement on internal financial controls.  The statement confirms that the Board of Management have reviewed the effectiveness of the Association’s internal controls systems for the year ending 31st March 2016.  I would **recommend** that the Board approve this statement on Internal Controls in the context of this report. |

**Appendix A**

**ASSESSMENT OF THE EFFECTIVENESS OF INTERNAL CONTROLS**

The Board is responsible for the Association’s system of internal control and for reviewing its effectiveness. The system, which is also used by the Association’s subsidiary, is designed to manage rather than eliminate the risk of failure to achieve business objectives and as such can only provide reasonable, but not absolute, assurance against material misstatement or loss. The Board has carried out a review of the effectiveness of the system of internal control for the year under review. The key processes the Board has adopted in reviewing the effectiveness of the Association’s system of internal control are as follows:

***Control environment:*** the Association has an organisational structure with clearly defined lines of responsibility, job descriptions and delegation of authority. These are set out in the Delegated Authorities and Standing Orders and in departmental procedure manuals. The staff handbook sets out standards of professionalism and integrity for operations.

***Key policies:*** within the delegation of authority the Board retains for itself responsibility for approving the key strategies and policies that are designed to provide effective internal control. These include strategies and policies for development projects and new business ventures, fraud, theft and bribery corporate and business planning, risk and treasury management.

***Risk management:*** the Board and senior officers have a clear responsibility for identifying risks facing the Group and for putting in place procedures to mitigate and monitor risks. Risks are formally assessed through a process of reporting to the Audit & Risk Committee and the Board four times a year, plus an annual report to the Board by the Chief Executive. The system for managing the significant risks faced by the Group is ongoing and it has been in place for the year under review and up to the date of approval of the accounts.

***Performance reporting*:** the Group has a comprehensive system of performance reporting. Key performance indicators are reviewed monthly by senior management and are considered by the Board quarterly. Corrective action is taken by management with respect to areas of adverse performance.

***Corporate planning and budgeting:*** the Board approves the annual budget, 3-year corporate plan and 30-year financial forecast. Monthly financial results are reported against budget and remedial action taken with regard to any significant adverse variances.

***Internal audit:*** the Group’s control procedures are subject to review by Mazars, whose work is focused on the areas of greatest risk. The Audit & Risk Committee monitors the work of internal audit on a regular basis.

***Service quality:*** The Association has had an annual programme of Service Quality reviews aimed at improving performance, efficiency, and effectiveness. From 15/16 onwards, a new Business Improvement team has been set up to provide further resources for analysis and management of improvement projects.

***Fraud prevention, detection, and reporting:*** the Group has a whistle-blowing policy in place to enable staff to report suspicious activities to senior management or the Board without fear of reprisal. The Board has adopted a policy for the investigation and reporting of all cases of actual or suspected fraud theft and bribery from the Group. The Audit & Risk Committee receives regular reports on all such cases and actions taken to improve controls where necessary.

The Board has received the Chief Executive’s Annual Report on internal controls, has conducted its annual review of the effectiveness of the system of internal control and has taken account of any changes required to maintain the effectiveness of the risk management and control process.

The Board confirms that there is an ongoing process for identifying and managing significant risks faced by the Group. This process has been in place throughout the year under review, up to the date of the approval of the Financial Statements, and is regularly reviewed by the Board.