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# HEXAGON HOUSING ASSOCIATION

## FINAL REPORT TO THE AUDIT & RISK COMMITTEE

## 31 March 2016

**Date of issue: 19 July 2016**

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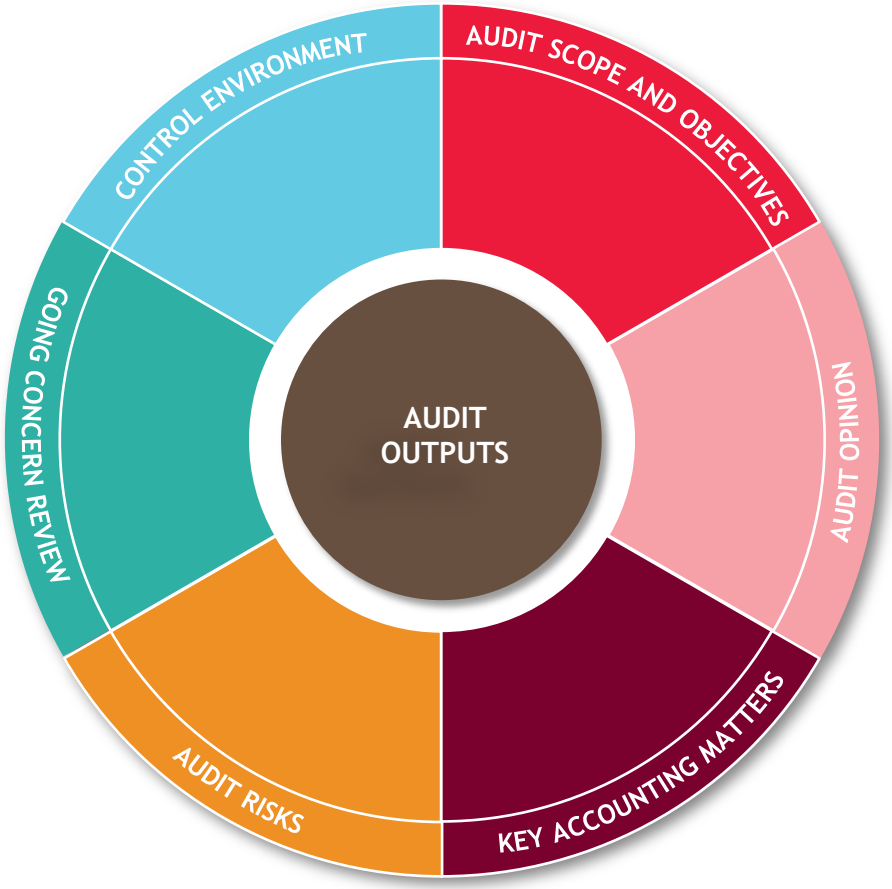
# Contents

# Overview of audit outputs



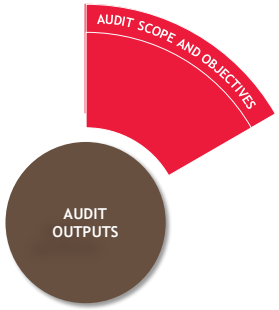

We present our report to those charged with governance which details the key findings arising from the audit, as required by International Standards on Auditing (UK & Ireland) 260. Its content has been discussed with management and the key audit outputs are set out using the headings opposite. The appendices also include other important information which we are required to communicate to those charged with governance.

As auditors we are responsible for performing our audit in accordance with International Standards on Auditing (UK & Ireland) which is directed towards forming and expressing an opinion on the financial statements that have been prepared by management with the oversight of those charged with governance. The audit of the financial statements does not relieve management nor those charged with governance of their responsibilities for the preparation of the financial statements.

The contents of this report relate only to those matters which came to our attention during the conduct of our normal audit procedures which are designed primarily for the purpose of expressing our opinion on the financial statements. As the purpose of the audit is for us to express an opinion on the financial statements, you will appreciate that our audit cannot necessarily be expected to disclose all matters that may be of interest to you and, as a result, the matters reported may not be the only ones which exist. As part of our work, we considered internal control relevant to the preparation of the financial statements such that we were able to design appropriate audit procedures. This work was not for the purpose of expressing an opinion on the effectiveness of internal control.

The matters raised in our report, prepared in connection with the audit, are those we believe should be brought to your attention. They do not purport to be a complete record of all matters arising. This report is prepared solely for the use of management and the Audit and Regulation Sub-Committee and may not be quoted nor copied without our prior written consent. No responsibility to any third party is accepted.

# Audit scope and objectives




## Our audit scope covers an audit in accordance with International Standards on Auditing (UK and Ireland) of the statutory financial statements, to form an opinion on whether:

1. The financial statements give a true and fair view of the state of the group's and the parent entity's affairs as at 31 March 2016 and of the group's and the parent entity's surplus or deficit for the year then ended.
2. The financial statements have been properly prepared in accordance with UK GAAP (FRS 102).
3. The financial statements have been prepared in accordance with the appropriate legislation, which for this group includes the Co-operative and Community Benefit Societies Act 2014, the Co-operative and Community Benefit Societies (Group Accounts) Regulations 1969, the Housing and Regeneration Act 2008 and the Accounting Direction for Private Registered Providers of Social Housing 2015, as applicable to each entity.
4. The information given in the Report of the Board and the Strategic Report for the financial year for which the financial statements are prepared is consistent with the financial statements.

## The legislation under which we report also requires us to consider by exception whether:

1. Adequate accounting records have not been kept by the parent entity, or returns adequate for our audit have not been received from branches not visited by us.
2. The parent entity financial statements are not in agreement with the accounting records and returns.
3. Other information contained in the Report of the Board and the Strategic Report is not consistent with the audited financial statements.
4. A satisfactory system of internal control has not been maintained over transactions.
5. We have not received all the information and explanations we require for our audit.



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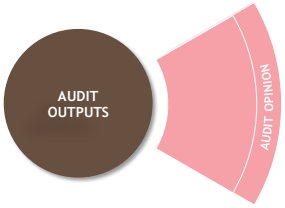
# Audit scope and objectives


The scope of our work as agreed in our engagement letter dated 4 February 2016 was to carry out an audit in accordance with International Standards on Auditing (UK and Ireland) and relevant legislation for all UK entities within the Group, which comprises:

| GROUP ENTITY | ACTIVITY | INCORPORATED UNDER | STATUS |
|---|---|---|---|
| Hexagon Housing Association | Registered Provider of Social Housing (parent) | Co-operative and Community Benefit Societies Act 2014 | Charitable |
| Horniman Housing Association | Registered Provider of Social Housing | Co-operative and Community Benefit Societies Act 2014 | Non-charitable |

Hexagon Housing Association is required to prepare consolidated accounts for the year ended 31 March 2016 under UK GAAP, which we have audited as well as the individual accounts of each group entity.

# Audit opinion

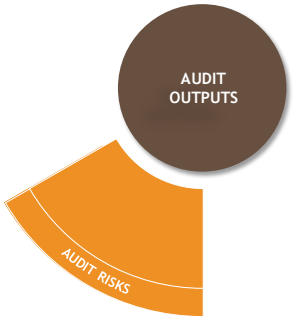



**We have substantially completed our audit work in respect of the financial statements for the year ended 31 March 2016 and anticipate issuing an unqualified opinion on the group financial statements.**

The following matters are outstanding at the date of this report. We will update you on their current status at the Audit and Finance Committee meeting at which this report is considered:

| | |
|---|---|
| 1 | Receipt of bank and loan lender confirmations from HSBC. |
| 2 | Final review and approval by you of the Board report, Value for Money statement and Strategic Report to be issued with the accounts |
| 3 | Final sign off of the individual financial statements for Horniman Housing Association |
| 4 | Subsequent events review |
| 5 | Management representation letter, as attached on page 32 to be approved and signed. |

# Audit risks




Our assessment of audit risks from the audit planning stage is set out below, together with an overview of the evolution of the audit outcome through the audit cycle for 2015/16. Further detail on each audit risk and the evolution through to audit conclusions is provided on the following pages. In summary:

| INITIAL ASSESSMENT OF AUDIT RISK | AUDIT RISK AREA | Consolidated group | Hexagon Housing Association | Horniman Housing Association | FINAL ASSESSMENT OF AUDIT OUTCOME |
|---|---|---|---|---|---|
| ● | Revenue recognition | ✓ | ✓ | ✓ | ● |
| ● | Management override | ✓ | ✓ | ✓ | ● |
| ● | Carrying value of fixed asset housing properties | ✓ | ✓ | x | ● |
| ● | Carrying value of properties developed for sale and write down to net realisable value | ✓ | ✓ | ✓ | ● |
| ● | Liquidity and going concern | ✓ | ✓ | ✓ | ● |
| ● | Loan covenant compliance | ✓ | ✓ | x | ● |

**Key:**

**Initial assessment of risk**

- ● Significant risk
- ● Normal risk

**Final assessment of audit outcome**

- ● Area of material audit judgement in need of further consideration by those charged with governance
- ● Audit matter concluded with either unadjusted error or significant control issue identified
- ● Audit matter concluded with no significant issues identified



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# Audit risks

## REVENUE RECOGNITION – SIGNIFICANT RISK

Under International Standard on Auditing 240 "The auditor's responsibility to consider fraud in an audit of financial statements" there is an assumption that revenue recognition is a fraud risk.

| INITIAL ASSESSMENT | WORK UNDERTAKEN | FINDINGS AND CONCLUSION |
|---|---|---|
| The main income stream is rental income, comprising 64.8% of total income. Changes to rents arise from new tenancies or increases in the rent charged. For social housing tenancies rent increases are currently restricted by the rent formula whilst rents from shared ownership properties will be increased periodically in accordance with the terms of the underlying lease.<br><br>Whilst most changes are made through an automated process there are variations in the increases applied and therefore we cannot rebut the presumption of a significant risk around revenue recognition in relation to rental income.<br><br>Other material income streams include grant income for the group nursing homes and income on those properties that are managed by agents. The main risks are around completeness and the cut-off, i.e. that the income has been recognised in the right period. | **Rental income**<br><br>The process and controls over changes to rental income from the different tenancy types vary; our testing was tailored to the controls identified.<br><br>We agreed a sample of weekly rentals from Genero back to lease agreements and rental uplift letters. The posting of these rents was traced through to Sun to ensure correct classification based on tenure type within the financial statements.<br><br>Cut off testing was performed for all rental income.<br><br>**Grant income and income from Properties Managed by Agents**<br><br>We compared the revenue recognised for a sample of contracts to the terms and conditions of the contract to confirm it had been recognised on an appropriate basis. | **Rental income**<br><br>No issues identified.<br><br>**Grant income and income from Properties Managed by Agents**<br><br>No issues identified. |

AUDIT OUTCOME EVOLUTION



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# Audit risks


## REVENUE RECOGNITION – SIGNIFICANT RISK

Under International Standard on Auditing 240 "The auditor's responsibility to consider fraud in an audit of financial statements" there is an assumption that revenue recognition is a fraud risk.

| INITIAL ASSESSMENT | WORK UNDERTAKEN | FINDINGS AND CONCLUSION |
|---|---|---|
| Proceeds on sale of first tranche shared ownership properties also form a significant part of income; the key risk here is in relation to cut off.<br><br>There is also a risk around profit recognition via cost apportionment for plots sold (shared ownership and outright sales) within a development scheme and ensuring that costs are apportioned on an appropriate and consistent basis. | **First tranche sales income**<br><br>A sample of first tranche sales in the year was agreed back to completion statements and bank receipts.<br><br>Cut off testing was performed to confirm that sales were recognised in the correct accounting period. | **First tranche sales income**<br><br>No issues identified. |
| | **Cost of sales allocation**<br><br>We reviewed the allocation of costs to tenure types and individual plots on development schemes that were subsequently taken to cost of sales to ensure a consistent and appropriate approach had been taken. | **Cost of sales allocation**<br><br>No issues identified. |

AUDIT OUTCOME EVOLUTION



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# Audit risks


## MANAGEMENT OVERRIDE - SIGNIFICANT RISK

Under International Standards on Auditing (UK and Ireland) 240, there is a presumed significant risk of management override of the system of internal controls.

The primary responsibility for the detection of fraud rests with Management. Their role in the detection of fraud is an extension of their role in preventing fraudulent activity. They are responsible for establishing a sound system of internal control designed to support the achievement of departmental policies, aims and objectives and to manage the risks facing the organisation; this includes the risk of fraud.

### INITIAL ASSESSMENT

We will consider the manipulation of financial results through the use of journals and management estimates as a significant fraud risk.

Financial controls around the posting of journals are robust with journals raised by members of the financial team subject to authorisation.

Our work around journals will focus on the completeness of data extracted from your accounting system as well as the validity of journals.

### WORK UNDERTAKEN

We have reviewed accounting estimates, including those used in assessing impairment and going concern; allocating construction and other costs to schemes under development; recharging costs from Hexagon to Horniman; and in determining the amounts to recognise in relation to the pension deficit.

We have obtained the complete list of journals and, using information gathered during the audit and our understanding of the entity, we have target tested those journals and adjustments that may be considered inappropriate or unusual. We have also reviewed transactions outside the normal course of business.

## AUDIT OUTCOME EVOLUTION



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# Audit risks

## MANAGEMENT OVERRIDE – SIGNIFICANT RISK (CONTINUED)

### FINDINGS AND CONCLUSION

Journals meeting at least one criteria were reviewed by considering the individuals posting them, the journal description, and our expectation based on our knowledge of the finance team.

Executive and Senior Management within Finance have not posted any journals during the year.

Journals posted by other management within Finance were reviewed. The following exceptions were identified:

- There was one clearly trivial reclassification journal posted by a member of the support staff.

Explanations were obtained with supporting evidence obtained to substantiate the nature of the posting. No suspect journals were identified.

Our review of accounting estimates showed management's judgements to be prudent and sensible. The main areas covered outside the items discussed as significant risks within this report include the categorisation of loans as basic or non basic, bad debt provisions and the final settlement of the R R Richardson account during the year.

*R R Richardson*

The balance sheet at 31 March 2015 included two estimates in relation to amounts owed to R R Richardson: a creditor of £217,000 for invoices that had been received and not paid; and an accrual of £355,000 for works completed but not invoiced. The creditor balance was based on physical invoices received, though there was subjectivity around the likelihood of these ever being settled. The accruals amount arose following a detailed exercise of open repairs orders to identify whether the works had been completed.

During the year to 31 March 2016 the final account was settled with the administrators, resulting in an overall favourable outcome for Hexagon. The final correspondence indicates that Hexagon owes a total of £115,000 for jobs performed, however that R R Richardson also owed a total of £183,000 to Hexagon for jobs not performed; this results in a £67k debt owing to Hexagon. Management have taken a prudent approach to this debt, recognising the amount receivable but also providing against it, recognising that the debt is unlikely to be settled by the administrators. The brought forward creditor balances of £572,000 have been released to the income statement in the year to 31 March 2016.

We concur with managements judgement to release the creditor balances in the year and to recognise the debtor owing from the liquidators – as the debt is unlikely to be received, it is appropriate to provide against this amount. Overall we are satisfied with the treatment of the final account.

### AUDIT OUTCOME EVOLUTION



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# Audit risks

## CARRYING VALUE OF FIXED ASSET HOUSING PROPERTIES – SIGNIFICANT RISK

The 2015 Summer Budget included the announcement that social housing providers in England and Wales would have to reduce social rents (including affordable) by 1% a year for four years from April 2016. This will be taken forward via the Welfare Reform and Work Bill and will apply to both social and affordable rent. The Government indicates this will result in a 12% reduction in average rents by 2020/21, compared to current forecasts.

One of the indicators of impairment for assets is a significant adverse change in statutory or regulatory environment, which is met by the above budget announcement.

A full impairment review is therefore required for the year ended 31 March 2016 for all properties affected by the rent reduction and given the high degree of professional judgment there is a significant risk in relation to the carrying value of housing properties.

### INITIAL ASSESSMENT

Management's impairment review provides a detailed review of cash generating units and detailed calculations using the various valuation techniques available to them.

Initial calculations do not show there to be an issue relating to the carrying value of properties.

### WORK UNDERTAKEN

We reviewed management's detailed assessment of the indicators of properties across their portfolio, which indicated that the general needs housing, the supported housing, and the units managed by co-ops and agencies could be potentially impaired.

We have obtained the calculations and have requested the back up to verify the values used in the calculations. In particular the assumptions around depreciated replacement cost calculations, which rely upon information from third parties.

### FINDINGS AND CONCLUSION

Management's impairment review included rationale behind the way cash generating units had been defined by scheme which we agreed was appropriate. The review focused on using a replacement cost to estimate the value in use for:

- the small number of schemes currently within the pipeline, and
- the portfolio of general needs, supported housing, and agency properties.

For the schemes in the pipeline, the replacement cost was based on the original costs indexed using an appropriate building index to determine an appropriate replacement cost. The CGU was determined by management as all properties within the pipeline portfolio, and no impairment was identified.

The impairment review of the main housing stock portfolio focuses on the replacement cost through the cost of replacement. There have been no impairments identified by management. We concur with this judgement.

**AUDIT OUTCOME EVOLUTION**

# Audit risks


## CARRYING VALUE OF PROPERTIES DEVELOPED FOR SALE AND WRITE DOWN TO NET REALISABLE VALUE – SIGNIFICANT RISK

Properties developed for sale, including shared ownership first tranches, must be held at the lower of cost and net realisable value (sales proceeds less costs to sell and costs to complete). Due to the level of judgement involved in estimating both sales proceeds and costs to complete we consider this a significant risk.

### INITIAL ASSESSMENT

During the year a number of developments have been completed with sales currently ongoing. Profits on these developments have been positive.

Completed shared ownership properties (first tranche element) are valued at the lower of cost and net realisable value.

For properties under construction management has performed an assessment of their realisable value using the support of external valuations. Appraisals indicate the generation of significant profits when these schemes are completed and sold.

### WORK UNDERTAKEN

The status of each scheme under development for sale was considered.

There are seven schemes under construction at the year end; of these three are in relatively early stages of construction, and current margins appear healthy. Discussions around the scheme reveal no significant issues on these schemes.

For the other four schemes under construction, we have reviewed the estimates of costs to complete and the expected margins on the schemes. Margins again appear relatively healthy, and therefore no significant issues revealed on these schemes.

Prior to the year end Horniman Housing purchased the land at Biggin Hill and incurred a small number of development costs. Our work on the carrying value of WIP therefore includes an assessment on the carrying value of the Biggin Hill scheme within Horniman Housing.

### FINDINGS AND CONCLUSION

Current asset properties developed for sale are stated at the lower of cost and net realisable value and we agree that no provisions to write down carrying costs are required within either Hexagon Housing Association or Horniman Housing Association.

**AUDIT OUTCOME EVOLUTION**



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# Audit risks

## FRAUD & ERROR – SIGNIFICANT RISK

We are required to discuss with the Audit Committee the possibility of material misstatement, due to fraud or error. We are informed by management that they consider the risk of material fraud occurring in the group to be low and that there have not been any cases of fraud or error during the year, to their knowledge.

### INITIAL ASSESSMENT

Following the termination of the maintenance contract with Richardson's in 2015, Hexagon have continued using smaller contractors to undertake responsive maintenance until February 2016. These smaller contractors are not equipped to use the electronic purchase order system established in Hexagon and therefore Hexagon have had to revert to using a paper-based system for the matching and authorisation of purchase orders.

There continues to be an increased risk of:

- procurement fraud resulting from the high volume of low value transactions;
- transaction errors, for example: paying for services that have not been received; and
- incomplete accruals for work that has been performed and for which invoices have not been received.

### WORK UNDERTAKEN

We consider this area throughout the audit process. We have reviewed the fraud register and liaised where appropriate with internal audit to determine any actual, suspected or alleged fraud known to them. We have discussed with management any knowledge they have of suspected or alleged fraud. We have considered management's process for identifying and responding to the risks of fraud, including the nature, extent and frequency of such assessments. In particular, we have made enquiries of management outside of the finance function where the risk of fraud could originate.

We ask that board members advise us if they do not concur with the assessment made by management in your management representation letter to us.

We have perform controls testing on the maintenance costs to ensure that these are properly authorised and accurately recorded within the accounts.

We have performed sample testing on invoices received post year end to verify the completeness of accruals at year end.

We have reviewed the controls around the manual system interfaces to ensure that these continue to be reconciled and reviewed on a timely basis.

### FINDINGS AND CONCLUSION

Controls were identified as being in place over the following areas:

1) The transfer of data between Genero and Sun
2) The authorisation of the invoices being received, and
3) The authorisation over the payment runs.

Based on our testing, the controls appear to have been operating effectively.

No unrecorded liabilities were identified through our testing.

AUDIT OUTCOME EVOLUTION



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# Audit risks


## LIQUIDITY AND GOING CONCERN - NORMAL RISK

The going concern principle is an important one that we consider in accordance with International Standard on Auditing (UK and Ireland) 570. The re-issue of Audit Practice Note 14 (Revised) in January 2014 is helpful as further reference material specific to the social housing sector.

### INITIAL ASSESSMENT

Financial viability is an area of focus in the sector and of particular interest to the HCA as regulator.

### WORK UNDERTAKEN

We reviewed:

- Commitments and future development intentions
- Availability of loan finance
- Ability to repay loans which normally means consideration of a long term financial plan
- Covenant compliance
- Adverse variations from expected funding or revenue and additional unexpected costs
- Comparison of actual performance against the prior period assessment/budget.

### FINDINGS AND CONCLUSION

Based on forecasts for the period to 31 March 2018 along with secured available funds we can conclude that the Group has sufficient resources to pay its liabilities and commitments as and when they fall due. The Going Concern section which appears later in this report sets out our high level overview of liquidity based on the main operating and property development cash-flows.

Following EU Referendum swap rates have fallen, this creates exposure for Hexagon to be subject to a cash call on its swaps in order to offset any fall in value. The amount is currently £2.7m. In the very short term existing cash resources will be used, with development expenditure being financed form the Santander loan. On 18 July £17m of cash from AHF will be available and will be used to repay Santander.

See pages 18 and 19 for additional findings relating to going concern.

AUDIT OUTCOME EVOLUTION



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# Audit risks


## LOAN COVENANT COMPLIANCE – NORMAL RISK

Loan covenant compliance remains a risk due to the significant consequences of any breach.

| INITIAL ASSESSMENT | WORK UNDERTAKEN | FINDINGS AND CONCLUSION |
|---|---|---|
| Financial and non-financial covenants are carefully monitored with both retrospective checks as well as part of any forward looking modelling. | The group has a series of loan covenant requirements which differ slightly across the portfolio of loans.<br><br>The main covenant relates to Interest Cover – this is measured on all loans at a minimum of 110%.<br><br>The other covenant is borrowings as a % of net worth (this includes revenue reserves and grants) and is measured at a maximum of 70% on most loans.<br><br>Our audit work did not identify any non-compliance with the above financial ratios. | Our audit work did not identify any non-compliance with the above financial ratios or non financial ratios.<br><br>The gearing percentage calculation is 49.1% at the year end, compared to the most stringent gearing covenant of 70%.<br><br>A re-performance of the forecast calculations during the going concern period did not highlight any issues. |

**AUDIT OUTCOME EVOLUTION**



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# Other matters considered as part of the audit


| RISK | BACKGROUND | WORK PERFORMED | CONCLUSION | AUDIT OUTCOME ASSESSMENT |
|---|---|---|---|---|
| **Consideration of related party transactions** | We need to consider if the disclosures in the financial statements concerning related party transactions are complete and adequate and in line with the requirements of accounting standards. | We documented the related party transaction identification procedures in place, reviewed relevant information concerning any such identified transactions and made enquiries of management.<br><br>We requested all those considered to be part of the senior management team, and Non Executive Board members, complete a form to declare any interests.<br><br>We reviewed ledger transactions for any related parties not identified as part of the above management procedures. | We are not aware of any additional related party transactions that have not been disclosed in the financial statements. | |

# Other matters considered as part of the audit


## Audit of taxation

| GROUP ENTITY | TYPE OF ENTITY | TAXABLE PROFIT BEFORE MITIGATIONS (£'000) | STATUS |
|---|---|---|---|
| Hexagon Housing Association | CCBSA 2014 - provider of social housing | nil | There are no taxable activities within this entity and therefore no liability to tax in the current year.<br><br>Hexagon Housing Association treats shared ownership first tranche disposals as capital. This is an opposing view to that taken by HMRC who view these as trading transactions. There is a risk if the disposals are made to non-charitable beneficiaries that this would be non-primary purpose trading and taxable. There is a £159k profit on first tranche shared ownership sales this year. We are aware that management has documentation in place to demonstrate the purchases of these properties was on a necessitous basis. |
| Horniman Housing Association | CCBSA 2014 - provider of social housing | 14 | Horniman has paid Gift Aid of £21,500 within the year. Due to timing differences, tax of £3k is due for the year. |



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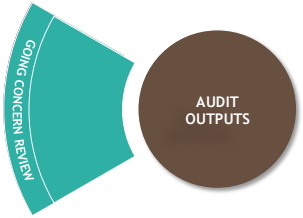
# Going concern review




## Forecast property development net cash flows

| Forecast development cash flows - 1 April 2016 to 31 March 2018 | £m |
|---|---|
| Contracted development commitment outflows | 26 |
| Approved SHG inflows against the above commitments which will be received in the 24 month period | (4) |
| Committed net development cash outflows | **22** |
| Development intentions authorised by the Board but not contracted at the date of approval of the accounts | 16 |
| Expected SHG against the above development intentions | (2) |
| | **36** |

### Availability of loan finance and security to underpin draw downs

The Group has negotiated facilities of £189m of which £152m has been drawn at year end. There has been no significant repayment of loans since year end. Therefore, this provides £37m in undrawn facilities which has all been secured against existing rented properties and is ready for drawdown; £20m of this is available within 3 days notice.

Capital repayments forecast for the Going Concern Review Period total £10.9m. The undrawn facilities of £37m and the cash balances of £11m as at 31 March 2016 provide good headroom over the net committed development cash outflows of £22m over the going concern period.



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# Going concern review

## Operating net cash flows (lettings activity and property sales)

| Operating cash flows (£m) | Actual - year ended 31 March 2016 £'000 | Forecast - going concern review period to 31 August 2017 £'000 |
|---|---|---|
| Net inflow from operating activities | 12,457 | 26,429 |
| Outflow from interest payments | (5,394) | (12,041) |
| Net inflow before sales of properties | 7,063 | 14388 |
| Net inflow from sale of outright sale/1st tranche properties | 4,654 | 9,801 |
| Net inflow from sales of fixed asset housing properties | 8,218 | 9,569 |
| Net inflow from operating activities & property sales | 19,935 | 33,758 |

For the year under review to 31 March 2016, the Group was able to fund its interest payments through the inflow of cash from operating activities, excluding the sales of properties.

The Group is reliant on debt financing to continue with future committed and intended development plans; group loan balances are currently £151.9m with an additional £37m able for drawdown. Projections show that the Group is expected to make an overall surplus for at least the next 5 years.

**Horniman**

The development for outright sale is dependant on the loan available through Hexagon Housing. The total loan facility available to Horniman from Hexagon is £10.5m which is sufficient to cover the total scheme costs at Biggin Hill of £3.4m. The surplus of £670k expected on sale is sufficient to cover the 9% of interest to be charged on the total drawdowns.



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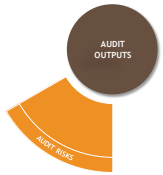
# FRS102




## Background

FRS 102 is the core of new UK GAAP, providing a concise and simplified accounting framework for entities in its scope. FRS 102 replaces all current UK accounting standards (SSAPs, FRSs and UITFs) with a single FRS. It completes the suite of new UK GAAP standards, the others being:

- FRS 100 'Application of Financial Reporting Requirements';
- FRS 101 'Reduced Disclosure Framework';
- FRS 103 Insurance Contracts;
- FRS 104 Interim Financial Reporting; and
- FRS 105 The Financial Reporting Standard applicable to the Micro-entities Regime.

FRS 102 applies to accounting periods beginning on or after 1 January 2015 and will lead to a change in accounting for most UK entities unless they are required (or otherwise voluntarily choose) to apply EU endorsed IFRS.

A new Statement of Recommended Practice (SORP) for registered providers of social housing was issued in September 2014 to provide guidance on formats, accounting treatments and disclosures which enables social landlords to comply with the new accounting standard. In due course a new Accounting Direction for Private Registered Providers of Social Housing will be issued by the HCA, setting out the statutory format of the financial statements prepared under FRS 102. This was not available at the time of completing the scope of work below but we are aware of most of the expected content based on earlier consultation drafts and BDO's involvement in preliminary discussions with the HCA on content.

## Scope

The scope of our assignment was to audit the restated financial statements for the year ended 31 March 2015. These financial statements include the Statement of Financial Position at 31 March 2015 and the Statement of Comprehensive Income for the year ended 31 March 2015. In order to restate these financial statements under FRS 102, it was first necessary to restate the opening balances at 1 April 2014 (being the balance sheet position as per the 31 March 2014 financial statements).

In our audit work we have calculated materiality on a consistent basis with the audit of the financial statements at 31 March 2015 but using the restated figures.



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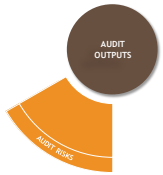
# FRS102




Below we have provided a detailed analysis of our audit work and the changes required by FRS 102. Below is a summary of the key changes and our findings. We will produce a separate report to the board incorporating our detailed audit findings.

| KEY AREA | RESERVES 2014 | I & E SURPLUS 2015 | RESERVES 2015 | SUMMARY |
|---|---|---|---|---|
| **Areas leading to FRS 102 adjustments** | | | | |
| *As previously stated (old UK GAAP)* | *43,990* | *9,121* | *53,111* | |
| Housing Properties - additional grant amortisation | (35,330) | (2,346) | (37,676) | We have audited these adjustments and are satisfied that there is no material misstatement. |
| Housing Properties – additional depreciation | 25,892 | 1728 | 27,620 | |
| Interest rate swaps | (13,895) | (10,215) | (24,110) | |
| Change in estimation of debtor provision | 358 | 86 | 444 | |
| Holiday pay accrual | (84) | (6) | (90) | |
| SHPS pensions deficit funding plan provision | (5,158) | 167 | (4,991) | |
| ***As restated (new UK GAAP)*** | | | | |
| Accounting policies and format of financial statements | | | | We have provided detailed comments on the accounting policies and the format of financial statements. |



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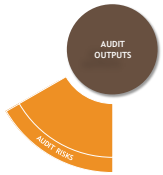
# FRS102




| KEY AREA | SUMMARY |
|---|---|
| **Areas assessed as requiring FRS 102 adjustment** | |
| Housing properties | Management and the board have opted to remain under the historic cost model for their housing properties.<br><br>Grants separated from the costs within Housing Properties is deferred income which is then released systematically to the Statement of Comprehensive Income (SOCI) over the life of the asset. On reclassification as a long term creditor an adjustment to opening reserves of £25,892k has been made to represent amortisation to the 1 April 2014. A subsequent release of £1,728k of grant has been made to the SOCI for the year ended 31 March 2015.<br><br>The accumulated depreciation figure has been adjusted by £35,330k to reflect the additional depreciation charge arising from the reclassification of Social Housing Grant to deferred income on the balance sheet; this is offset by the amortisation of the Social Housing Grant. A subsequent release of £2,346k of grant has been made to the SOCI for the year ended 31 March 2015. |
| Investment Properties | Properties held to earn commercial rentals or for capital appreciation, or both, must be treated as investment properties and measured at fair value. Hexagon have identified a small portfolio of commercial properties that should be classified as investment property.<br><br>Under old UK GAAP the properties were recorded at cost less impairment; management have made an assessment that the fair value of these properties is not materially different from the carrying values of historic cost less depreciation based on a discounted cash flow calculation. We have reviewed the calculations and concur with this judgement – an unadjusted difference has been detailed on page 28.<br><br>On recent discussions with management, a number of commercial properties have been disposed of and therefore the amount of any difference has reduced since the transition balance sheet. There are now few commercial properties left remaining. |



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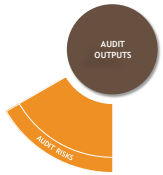
# FRS102




| KEY AREA | SUMMARY |
|---|---|
| **Areas assessed as requiring no FRS 102 adjustment** | |
| Financial Instruments | Financial instruments must be assessed under FRS102 as being 'basic' or 'non-basic'. Management have reviewed all their loan instruments and classified them as 'basic' financial instruments and assessed that there is no material difference between the carrying amount of the loans (transaction price less loan issue costs) and their amortised cost.<br><br>We have agreed the assessment that all loans can be classified as 'basic instruments' and have reviewed management's assumptions that the amortised cost is not materially different to the transaction price less loan issue costs. We are satisfied that the financial statements are not materially misstated as a result. We have not identified any loans with embedded or separate derivatives, interest rate swaps, options and forward contracts that would be classified as non-basic.<br><br>This position will need to be confirmed annually by management to ensure that it remains an immaterial difference.<br><br>Hexagon Housing holds certain derivatives for hedging purposes to manage and mitigate interest rate risk in the form of interest rate swaps. These swap arrangements are considered 'other' financial instruments and therefore are recognised at fair value and presented as liabilities in the affected financial statements.<br><br>A small number of swaps cannot be hedged as these are cancellable swaps and each arrangement permits the bank to cancel the option without financial penalty. The changes in fair value of these swaps is charged directly to the surplus/(deficit) in the year.<br><br>Where management are able to they have applied hedge accounting as the terms of the swap directly match the payment profile of the loans they are hedged against; the changes in fair value of the 'effective' part of the hedging instrument will go through the Other Comprehensive Income, and not directly affect the surplus for the year.<br><br>Hedge accounting under FRS102 also requires the creation of a cash flow hedge reserve which represents the cumulative movements in the 'effective' part of the hedge. FRS102 states that the amounts taken to the cash flow hedge reserve are the lower of the change in fair value in the hedging instrument and the 'hypothetical derivative' (being an interest rate swap that matches all the terms of the loan. In the case of Hexagon's hedged swaps, all of the terms of the swaps match the loans directly except for their term (which is shorter than the relevant loans); management have assessed that since Hexagon's swaps are shorter in length than the loan, the change in fair value of the 'hypothetical' swaps will always be greater than the change in fair value of the swaps and therefore all of the change in fair value of the hedged swaps will go through the Other Comprehensive Income to the Cash Flow Hedge reserve. We concur with this judgement.<br><br>An opening fair value adjustment of £13,895k was taken to reserves with £8,603k going through to the cash flow hedge reserve. A further charge of £4,440k was made to the Statement of Comprehensive Income in 2015 relating to the cancellable swaps, and a charge of £5,775k was taken through the Other Comprehensive Income to the cash flow hedge reserve on the hedged swaps. |



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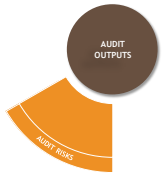
# FRS102




| KEY AREA | SUMMARY |
|---|---|
| **Areas assessed as requiring no FRS 102 adjustment** | |
| Bad debt provision | FRS102 requires provisions to be made on the basis of empirical evidence. The basis for the bad debt provision has been revisited for 2016 along with the comparative balance sheets - the provision is now based on the following:<br>1. where the tenant is no longer in the property (former tenant arrears)<br>2. where the tenant has been issued a Possession Order has been issued to the tenant.<br>We are comfortable that the provision has been calculated on a suitable specific basis, based on empirical evidence. The value is not material to the financial statements. |
| Holiday Pay accruals | The holiday pay accrual has been calculated for the year ends 31 March 2014 and 2015, with a charge of £84k against the reserves as at 1 April 2014, and then a charge of £6k in the year to 31 March 2015. The amount is not material to the financial statements. |



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# Control environment


## Audit management letter - new matters arising 2016

We are required to report to you, in writing, significant deficiencies in internal control that we have identified during the audit. These matters are limited to those which we have concluded are of sufficient importance to merit being reported to you.

As the purpose of the audit is for us to express an opinion on the group's financial statements, you will appreciate that our audit cannot necessarily be expected to disclose all matters that may be of interest to you and, as a result, the matters reported may not be the only ones which exist. As part of our work, we considered internal control relevant to the preparation of the financial statements such that we were able to design appropriate audit procedures. This work was not for the purpose of expressing an opinion on the effectiveness of internal control.

We have not identified any management letter points through our work in the current year, nor are there any to follow up from prior years.

# Control environment


## Observations on the finance function

| | | |
|---|---|---|
| Full working papers file presented on Day 1 of audit with appropriate supporting documentation | Fair | There have been small delays in getting information to us, largely down to the first time implementation of FRS102 in the financial statements.<br>The Horniman FRS102 adjustments were not provided until after our onsite time. |
| Draft financial statements presented on Day 1 | Fair | The draft financial statements for Hexagon appeared in good order, though a number of disclosures were still to be worked on.<br>The draft financial statements for Horniman were prepared under old GAAP and were not available in an appropriate format until after the onsite time. |
| Monthly reconciliations performed on key areas such as bank reconciliations, WIP, debtors ledger | Good | These continued to be carried out as normal. |
| Quality of finance team | Good | There are no significant causes for concern. |
| Finance department appropriately resourced | Good | There are no significant causes for concern. |
| Reliance on manual controls | Good | There are no significant causes for concern. |
| Proper audit trail re key projects | Good | There are no significant causes for concern. |

**We made the above observations during the course of our normal audit work.**

Key: Good Fair Improvement required



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# Appendices

# Unadjusted audit differences

We are required to bring to your attention audit adjustments that the Audit and Risk Committee is required to consider. A schedule of such adjustments is included below and we request that you correct them. Identified misstatements should, where practicable, be corrected even if not material.

There are no unadjusted audit differences identified by our audit work for Hexagon Housing Association for the audit of the 2016 financial statements, however during our audit of the FRS102 transition information, we noted the following items, which management do not propose to adjust as they are considered to be immaterial individually and in total.

| FRS102 TRANSITION - | | INCOME AND EXPENDITURE | | BALANCE SHEET | |
|---|---|---|---|---|---|
| UNADJUSTED AUDIT DIFFERENCES | £'000 | DR £'000 | CR £'000 | DR £'000 | CR £'000 |
| Adjusted reserves at 31 March 2015 | 14,308 | | | | |
| DR Investment Properties | | | | 735 | |
| CR Housing Properties | | | | | 735 |
| *Being the reclassification of the commercial properties as investment properties* | | | | | |
| DR Other debtors – holiday pay | | | | 17 | |
| CR Wages and Salaries | | | 17 | | |
| *Being the recognition of the holiday pay debtor where employees have take more than their entitlement* | | | | | |
| **TOTAL UNADJUSTED AUDIT DIFFERENCES** | - | | | | |
| Reserves at 31 March 2015 if adjustments accounted for | 14,325 | | | | |



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## Materiality

| ENTITY | INCORPORATION STATUS | NATURE OF ACTIVITIES AND OTHER RELEVANT INFORMATION | BASIS OF CALCULATION FOR MATERIALITY | BASIS OF CALCULATION FOR SPECIFIC MATERIALITY | MATERIALITY £'000 | SPECIFIC MATERIALITY £'000 | CLEARLY TRIVIAL THRESHOLD £'000 |
|---|---|---|---|---|---|---|---|
| Hexagon Housing Association - consolidated figures | Community Benefit Society (CCBSA 2014) | Registered provider of social housing | 2% of Total assets | 5% of operating surplus adjusted for depreciation, impairment, open market sales and gift aid receipts | 8,711 | 740 | 15 |
| Hexagon Housing Association - entity only figures | Community Benefit Society (CCBSA 2014) | | 2% of Total assets | As above | 8,650 | 738 | 15 |
| Horniman Housing Association | Community Benefit Society (CCBSA 2014) | Registered provider of social housing | 2% of Total assets | N/A | 61 | 2 | - |



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# Independence

## INDEPENDENCE

Under Auditing and Ethical Standards, we are required as auditors to confirm our independence to 'those charged with governance'. In our opinion, and as confirmed by you, we consider that for these purposes it is appropriate to designate the Audit and Finance Committee as those charged with governance.

Our internal procedures are designed to ensure that all partners and professional staff are aware of relationships that may be considered to bear on our objectivity and independence as auditors. The principal statements of policies are set out in our firm-wide guidance. In addition, we have embedded the requirements of the Standards in our methodologies, tools and internal training programmes.

The procedures require that audit engagement partners are made aware of any matters which may reasonably be thought to bear on the firm's independence and the objectivity of the audit engagement partner and the audit staff. This document considers such matters in the context of our audit for the year ended 31 March 2016.

A summary of fees for audit and non-audit services for the period from 1 April 2015 to date is set out opposite. The FRC Guidance on Audit Committees requires audit committees to explain to shareholders in the annual report, how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded. The explanation should, among other things, set out or cross refer to the fees paid to the auditor for audit services, audit related services and other non-audit services. The fees schedule provided on page 31 is designed to facilitate this disclosure.

| SUMMARY OF FEES (detail shown on next page) | £ |
|---|---|
| Audit fee | 30,800 |
| Fees for audit related services | 9,860 |
| Fees for non-audit services | 11,759 |
| **TOTAL FEES** | **52,419** |

## INDEPENDENCE - ENGAGEMENT TEAM ROTATION

| SENIOR TEAM MEMBERS | NUMBER OF YEARS INVOLVED | ROTATION TO TAKE PLACE IN YEAR ENDED |
|---|---|---|
| Liz Kulczycki - Audit Partner | 4 | 2023 |
| Paul Jagger - Audit Manager | 2 | 2025 |



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## Independence

| | 2016 £'000 | 2015 £'000 | THREATS TO INDEPENDENCE ARISING | SAFEGUARDS APPLIED AND WHY THEY ARE EFFECTIVE |
|---|---|---|---|---|
| **Audit of parent undertaking** | 25,400 | 28,400 | N/A | |
| **Audit of subsidiaries** | 5,400 | 4,400 | N/A | |
| **TOTAL AUDIT** | **30,800** | **32,800** | | |
| Service Charge audits | 2,860 | 2,100 | The threat to auditor independence from Audit Related Services is clearly insignificant. (ES5:54) | No safeguards required |
| FRS102 conversion work | 7,000 | 5,000 | The threat to auditor independence from Audit Related Services is clearly insignificant. (ES5:54) | No safeguards required |
| **TOTAL ASSURANCE SERVICES** | **9,860** | **7,100** | | |
| Tax compliance services (i.e. related to assistance with corporate tax returns) | 2,125 | 1,600 | Making judgement and policy decisions which are the responsibility of management.<br>Auditing our own work. | Tax provisioning work is carried out by a separate team of corporation tax specialists.<br>The audit team carries out an independent review from an audit perspective. Based on this review there are no subjective judgements involved. |
| Tax advisory services | 14,084 | 4,500 | | |
| iXBRL tagging services | 525 | 525 | Making judgement and policy decisions which are the responsibility of management.<br>Auditing our own work. | Work is carried out by a separate team of corporation tax specialists.<br>The audit team carries out an independent review from an audit perspective. Based on this review there are no subjective judgements involved. |
| **SERVICES RELATING TO TAXATION** | **16,374** | **6,625** | | |
| **TOTAL NON-AUDIT SERVICES** | **26,234** | **13,725** | | |
| **TOTAL AUDIT RELATED SERVICES** | **57,034** | **46,525** | | |



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# Draft representation letter

TO BE TYPED ON YOUR HEADED NOTEPAPER
BDO LLP
2 City Place
Beehive Ring Road
Gatwick
West Sussex
RH6 0PA

Dear Sirs

**Financial Statements of Hexagon Housing Association for the year ended 31 March 2016**

We confirm that the following representations given to you in connection with your audit of the consolidated and parent association's financial statements (together the "financial statements") for the year ended 31 March 2016 are made to the best of our knowledge and belief, and after having made appropriate enquiries of other directors and officials of the association and other group companies as appropriate.

We have fulfilled our responsibilities as directors for the preparation and presentation of the consolidated and parent financial statements as set out in the terms of the audit engagement letter, and in particular that the financial statements give a true and fair view of the financial position of the group and company as 31 March 2016 and of the results of its operations and cash flows for the year then ended in accordance with United Kingdom Generally Accepted Accounting Practice and for making accurate representations to you.

We have provided you with unrestricted access to persons within the entity from whom you determined it necessary to obtain audit evidence. In addition, all the accounting records have been made available to you for the purpose of your audit and all the transactions undertaken by the group and association have been properly reflected and recorded in the accounting records. All other records and related information, including minutes of all management and shareholders' meetings have been made available to you.

In relation to those laws and regulations which provide the legal framework within which our business is conducted and which are central to our ability to conduct our business, we have disclosed to you all instances of possible non-compliance of which we are aware and all actual or contingent consequences arising from such instances of non-compliance.

There have been no events since the balance sheet date which either require changes to be made to the figures included in the financial statements or to be disclosed by way of a note. Should any material events of this type occur, we will advise you accordingly.

We are responsible for adopting sound accounting policies, designing, implementing and maintaining internal control, to, among other things, help assure the preparation of the financial statements in conformity with generally accepted accounting principles and preventing and detecting fraud and error.

We have considered the risk that the financial statements may be materially misstated due to fraud and have identified no significant risks.

To the best of our knowledge we are not aware of any fraud or suspected fraud involving management or employees. Additionally, we are not aware of any fraud or suspected fraud involving any other party that could materially affect the financial statements.

To the best of our knowledge we are not aware of any allegations of fraud or suspected fraud affecting the financial statements that have been communicated by employees, former employees, analysts, regulators or any other party.

We attach a schedule showing accounting adjustments that you have proposed together with the reasons why we have not recorded these proposed adjustments in the financial statements. In our opinion, the effects of not recording such identified financial statement misstatements are, both individually and in the aggregate, immaterial to the financial statements.



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# Draft representation letter

There were no loans, transactions or arrangements between the group, the company and its directors and their connected persons at any time in the year which were required to be disclosed.

We have disclosed to you the identity of all related parties and all the related party relationships and transactions of which we are aware. We have appropriately accounted for and disclosed such relationships and transactions in accordance with the requirements of United Kingdom Generally Accepted Accounting Practice and the Accounting Direction 2015.

We have no plans or intentions that may materially affect the carrying value or classification of assets or liabilities reflected in the consolidated and parent financial statements.

None of the association's current asset properties for sale or work in progress balances are stated in the balance sheet at 31 March 2016 at an amount exceeding their recoverable amount.

We confirm that the balance sheet amount of £2,598,000 carried within current asset properties developed for sale, representing the cost apportioned to first tranche shared ownership properties, properly represents the proportion of the total cost we believe will be marketed and sold after the balance sheet date based on our knowledge of these developments and market conditions.

We confirm that none of the group or association's assets are stated in the balance sheet at 31 March 2016 at an amount exceeding their recoverable amount as defined in FRS102 Section 27 – Impairment of assets.

All housing properties are in existence and beneficially owned by the group. Title deeds are held by mortgagees, local authorities or solicitors as security for specific charges against the properties, in respect of housing loans outstanding at the balance sheet date, where appropriate.

We confirm that the bad debt provision of 100% of former tenants and specific provision against those tenants under a court possession order is appropriate based on receipts during the current year.

We confirm that cash flow forecasts used in our assessment of going concern are based on our best estimate of committed development costs, loan drawings and related interest charges and overheads adjusted for inflation.

We confirm that the valuation of the SHPS pension deficit provision is calculated with reference to the most relevant financial assumptions at 31 March 2016.

We consider that the group is able to continue to operate as a going concern and that it is appropriate to prepare the financial statements on a going concern basis.

We have disclosed all known actual or possible litigation and claims whose effects should be considered when preparing the financial statements and these have been disclosed in accordance with the requirements of accounting standards.

We have disclosed all known actual or possible cross guarantees between entities in the group or with third parties and in particular any such guarantees between regulated and non regulated entities.

We confirm that the above representations are made on the basis of enquiries of management and staff with relevant knowledge and experience (and, where appropriate, of inspection of supporting documentation) sufficient to satisfy ourselves that we can properly make each of the above representations to you.
We confirm that the financial statements are free of material misstatements, including omissions.

We acknowledge our legal responsibilities regarding disclosure of information to you as auditors and confirm that so far as we are aware, there is no relevant audit information needed by you in connection with preparing your audit report of which you are unaware. Each director has taken all the steps that they ought to have taken as a director in order to make themselves aware of any relevant audit information and to establish that you are aware of that information.

Yours faithfully

(Signed on behalf of the Board)

NB: this must be the same date of signature as the financial statements



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# Looking forwards

# Voluntary code on Mergers, Group Structures and Partnerships

## Overview

The National Housing Federation (NHF) approved a voluntary code on Mergers, Group Structures and Partnerships in November 2015. There is an expectation that although the code is voluntary, Housing Associations will declare their commitment to this code in their annual financial statements and once it has been adopted boards will be expected to keep a record of all activity under the code including any proposals reviewed or submitted.

The new code comprises ten general principles of conduct, and aims to establish a set of core principles to which any housing associations seeking, or exploring such dialogue should adhere. It encourages boards and chief executives to focus on an association's core purpose, maintain transparency and follow structured negotiations. It focusses on the early stages of any merger processes, setting out how options available should be fully and formally explored.

## Principles

Whilst the code holds voluntary status, the NHF says many of the principles within it are embedded in relevant law, other codes of practice, codes of governance and regulatory guidance or regulatory standards.

Among the principles are that boards should be informed promptly of discussions between chief executives, and that dialogue should be handled 'in an open and constructive manner'. First stage proposals should be written and 'must be considered by the board(s), who should take an informed in principle decision to proceed to further explore and test the opportunity or to reject the proposal(s)'. No board member or member of the executive should 'behave in a way which could frustrate due consideration of a first stage proposal by the whole board'.

Where proposals are rejected, a record should be retained of how the decision was made and the reasons for rejection having regard to the business purpose. Detailed guidance on dealing with any conflicts of interest for board members is also included within the code appendices.

The code also sets out different approaches to mergers, including:

- Transfer of engagements
- Amalgamations
- Joining or forming group structures
- Strategic alliance
- Cost sharing groups

The ten principles can be found online at: http://s3-eu-west-1.amazonaws.com/pub.housing.org.uk/Mergers__Group_Structures_and_Partnerships_Code.pdf

The NHF is looking to produce a mergers and group structures 'good practice guide' in the new year, and will consider including something around the decision-making process for CEO and other executive leaving packages. It will still ultimately be for boards to decide and cross-reference such packages to the relevant contract of employment.

## Next steps

The board of each registered provider needs to decide whether or not to adopt the code. The HCA has "urged landlords to consider the code but will not enforce it." Where the code is adopted by a Housing Association, the boards of registered providers need to ensure that they declare their commitment to the code in their financial statements. Systems need to be put in place to ensure that the board are informed promptly of any activities relevant to the code and that they are sufficiently documented.

# General data protection regulation

## Overview

The EU General Data Protection Regulation (GDPR) has been under discussion for more than three years, and its adoption target has been postponed several times. It is now expected to be adopted in Spring 2016 with enforcement from Spring 2018.

The new regulation is expected to bring harmonised rules, wider scope, increased obligations, strengthened rights to individuals and increases in enforcement and fines.

It is likely to affect any business that operates within the EU, does business within the EU or stores data in EU member countries.

## Key changes that will impact the sector

- The definition of personal data will become broader, bringing more data into the regulated perimeter
- Rules for obtaining valid consent will change
- The appointment of a data protection officer (DPO) may be mandatory
- The introduction of mandatory privacy risk impact assessments
- The introduction of data breach notification regulations and changes in liability
- The right to be forgotten
- The international transfer of data
- Data portability
- Privacy by design

## Penalties

When it is finally released, the Regulation will enforce tough penalties – proposed fines of up to 5% of an enterprise's global annual turnover or €100 million.

## Next steps

Boards have until Spring 2018 to:

- Understand the new rules
- Assess the impact on their business
- Devise a strategy for implementation
- Execute a change management programme

IT Governance should consider ISO 27001 - the international standard for information security, offering a framework for the implementation of an information security management system that protects, manages and maintains information and data security.

# Market sale risk

## Overview

According to the Land Registry average property prices for Greater London have increased by more than 40% in the last three years alone. Whilst this is not entirely reflective of national house prices, these have nevertheless also shown some increase in the same period. This upward trend however may be about to go into reverse: estate agent Knight Frank believes that asking prices have fallen by as much as 7% in premium London areas such as Knightsbridge over the past year. Whilst the properties in question are multimillion pound luxury flats and therefore limited to exclusive locations, it still marks the first halt in the upward trend in London since the 2008 downturn. This may be the first indications of a slowing in the market which could impact nationwide.

Housing associations are now the developers of one in ten homes in the capital and contribute significantly to development in the rest of the UK. The HCA has recently cautioned that an "increased dependence on sales" for housing associations has changed the sector's risk profile and associations need to have mitigation strategies in place to cope with any market downturn.

## Key changes that will impact the sector

One of the things that has driven the property market - particularly in London - apart from low interest rates, is the influx of foreign cash. High commodity prices have meant that those with spare cash have been looking for a safe haven for their money. Combined with the ability to avoid most taxes by using overseas companies to buy properties has resulted in the UK property market being a prime location to invest.

Collapsing oil prices, uncertainty over the EU membership referendum and the introduction of a 3% stamp duty hike for buyers of properties of £1m or greater have resulted in a diminishing demand for development. Property consultant JLL has amended its forecast to a 3% reduction in residential prices this year, with certain banks feeling this does not go far enough.

Business models for housing associations have until recently been long term, relying on steady rental income rather than property sales. Due to the use of grant funding, associations were able to continue building affordable rental accommodation while private developers were forced to stop development during recessions.

Grant funding has reduced to a level which no longer subsidises the development of affordable rent programmes and income has been squeezed by government rent cuts and welfare reforms. Some social landlords are therefore building more shared ownership, and sometimes commercial outright sale, to subsidise their income. This is giving them an increasing exposure to sales risk, although this activity continues to be more prevalent in the south compared to other parts of the country.

The 2015 HCA global accounts show a sector surplus hitting £3bn for the first time, £501m coming from properties developed for sale (first tranche shared ownership plus commercial outright sales). First tranche sales surplus increased to £250m, with all signs indicating the increases to be a continuing trend.

However, at a time when housing associations are increasing development (56% of social landlords have only started building market sale properties within the last two years), luxury developers are pulling out. The increasing reliance on the development of properties for market sale is of concern to the regulator and the viability of housing association business models. Given some associations have cash resource but tight financial covenants, there is a risk that their retained earnings do not cover the exposure to development risk. Several associations have already been downgraded by ratings agency Moody, due to their reliance on market sale to repay debt.

Concerns about the luxury housing market may or may not lead to an overall decrease in the market, but housing associations need to be mindful of another residential property downturn and resilience to respond quickly.

## Next steps

The HCA is enforcing vigorous stress testing to be carried out by housing associations, requiring them to assess multiple scenarios with significant constraints. Boards should ensure that they have actively looked at restrictions to market sale and considered what would happen where properties for sale were converted to intermediate market rent or suffered significant write downs in conjunction with other detrimental business scenarios – for example further government rent cuts. Boards of developing associations also need to consider their skill set to be comfortable they can handle the level of market sales risk they are exposed to.



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