

briefing

DECEMBER 1999

A Balanced Account

The audit arrangements for registered social landlords

Registered social landlords (RSLs) are legally required to engage external auditors to review their accounts. The cost of this service for the sector as a whole is substantial and the range of services offered is varied.

- in 1997, RSLs spent over £8 million on the external audit of their accounts, with the smallest 1,626 organisations paying a total of £2.76 million for this service
- these small RSLs (with less than 250 properties each) paid almost 6 pence in every pound from their turnover to cover the cost of external audit
- small RSLs tend to use local audit firms with limited experience of RSL accounts
- larger RSLs favour specialist audit providers, which are familiar with the sector's legal and accounting requirements

Most of the arrangements governing the external audit of RSLs are working well, but there are still issues that the sector and its regulator – the Housing Corporation – should address.

- tendering the external audit service can lead to a reduction in audit fees and improve quality, but the process has its costs and needs to be well managed
- RSL boards are often slow to react when they are dissatisfied with their external auditors' service



- both RSLs and their external auditors need to be clear about their respective roles and responsibilities
- RSL boards need to take a more proactive approach towards external audit; they could follow the Corporation's guidance, which advises board members to discuss relevant issues with their auditors with no executive officers present
- management letters are important documents, but those presented to boards tend to be bland; subsidiary documentation sent to the RSL executive may be more revealing

Internal audit was quite rare in the RSL sector until the Corporation required all RSLs to introduce mechanisms to review their internal controls in 1995. But there is no set view about the objectives of internal audit.

- at one extreme, internal audit can operate as a tool that provides an independent check for management as well as consultancy-type advice
- at the other, internal audit can only provide an independent check on management performance on behalf of the RSL board or, possibly, the Corporation
- potential conflicts of interest should be effectively managed
- RSLs are struggling to find either suitable staff or external suppliers to carry out internal audit work on their behalf
- smaller RSLs, particularly those with no staff, do not accept the need for formal internal control procedures

External and internal audit services supplied to RSLs are variable in both scope and quality. The Housing Corporation's review of the Code of Audit Practice is an ideal opportunity to examine the inconsistencies of the sector's audit arrangements. This report's recommendations (see back page) will feed into the Corporation's review.

Do current audit arrangements need reviewing?

1. Registered social landlords (RSLs) are independent organisations that are run by boards made up of volunteers. Their constitutions place them in the private sector. But RSLs have received more than £22 billion in public funding for their development programmes over the last 25 years, and they therefore need to account for the effective use of that financial support to the Government and other stakeholders.
2. Accountability for this investment is achieved partly through the Corporation's influence over key elements of the external audit process. The Corporation's *Code of Audit Practice* sets out a range of requirements for both RSLs and their external auditors on the nature and conduct of such audits.
3. External audit focuses exclusively on an RSL's financial statements and, in making judgements on those statements, reviews the reliability of the systems that underpin them. None the less the Corporation, as regulator, has the duty to ensure that RSLs properly account for the public funding that they have received.
4. The RSL's board is the body that is ultimately responsible for its affairs. The Corporation's *Code of Audit Practice* recognises the importance of the board's role and provides guidance on how the board's responsibility for external and internal audit should be discharged.
5. External audit for RSLs is a long-established function. Internal audit, by contrast, was little-used within the sector before the mid-1990s. The recent growth in internal audit is linked to its promotion by the Housing Corporation. To date, however, the nature of the internal audit service or the method of delivery has not been prescribed in detail.
6. There have been significant changes in the sector's operational and financial framework since the *Code of Audit Practice* was last revised. The 1995 *Code* itself also introduced a number of requirements and offered some guidance that have affected practices among RSLs. For these reasons the Commission has produced this report on auditing arrangements in RSLs, which also dovetails with the Corporation's own review of the *Code of Audit Practice* due to begin in early 2000.

What is happening on the ground?

7. Half a dozen or so large accountancy firms dominate the market for external audit. Overall, smaller RSLs seem to favour local audit firms, while larger RSLs tend to use national accountancy firms that are familiar with the sector's legal and accounting requirements. External auditors therefore range from the major nationals to a number of local players. The cost of external audit is insignificant for the sector's largest landlords but can represent a sizeable proportion of the revenue of small RSLs [TABLE 1].
8. The external auditor's role ranges from one of 'pure audit', where the client has a well-developed finance function and prepares full accounts, to a situation where the auditors themselves prepare and audit the accounts. Typically (but not exclusively), an auditor will undertake accounts preparation for those very small RSLs that have few, if any, finance staff. Despite the wide spectrum of audit services available, some RSLs do not adequately specify the service that they need or want and find themselves with an external audit arrangement that is inappropriate to their circumstances.
9. Tendering external audit can reduce fees and improve service quality, but RSLs must be clear about what they want from their auditors. The Corporation requires

larger RSLs (with over 2,000 properties) to re-tender their external audit at least every seven years. However, engagements can be reviewed annually, and RSLs should use this opportunity to evaluate the performance of their auditors.

10. The board’s role in the external audit process is critical. Board members should follow Corporation advice and meet their auditors without the presence of executives. In half the fieldwork cases, this advice was ignored.

11. The internal audit function is less well-established in the RSL sector. The *Code of Audit Practice* requires all RSLs to undertake a rolling review of their control systems, with appropriate compliance testing, and to submit annual reports to their boards. It is for management to safeguard the organisation’s assets, assess any risks that it may face, ensure that the RSL’s systems are reliable, and deploy resources appropriately. Internal audit’s task is to assess the adequacy of these management arrangements.

TABLE 1

Breakdown of the RSL sector by size and turnover (as at March 31 1997)

Stock size	Number	Average stock size	Average turnover (£m)	Average audit fee (£)	Audit fee as percentage of turnover	Total audit fee (£m)
10,000 plus	23	17,189	53.9	48,000	0.09	1.104
6,001-10,000	24	7,617	24.6	26,000	0.10	0.624
2,001-6,000	127	3,449	9.7	15,000	0.16	1.905
250-2,000	213	830	3.4	8,000	0.24	1.704
<250	1,626	40	0.03	1,700	5.67	2.764

Source: Housing Corporation

12. None the less, perceptions of the role of internal audit vary, the extremes of which are markedly different [EXHIBIT 1]. On the one hand, it can function as an arm of an RSL’s executive; alternatively, it can offer an independent check on management performance for the board (and the Corporation). Given the different methods for delivering an internal audit service, it is perhaps unsurprising that similar organisations have varying levels of provision and associated

costs. Most RSLs experience difficulty in calculating the cost of their internal audit function.

13. The Audit Commission’s report *A Balanced Account* sets out a range of recommendations which address these concerns. The Commission and Corporation would encourage board members in particular to examine their own practices in relation to each of the recommendations.

EXHIBIT 1

The role of internal audit

There are contrasting views on the role of internal audit in the RSL sector.

A management tool that:

- checks that systems operate as intended
- reports to executive officers, who are responsible for taking action
- offers management support and receives sponsorship

OR

An independent check on management performance on behalf of:

- RSL board
- the Housing Corporation

Source: Audit Commission

Recommendations for RSLs

- 1 When appointing your external auditors, ask for a statement of client expectations from the auditor that is consistent with the *Code of Audit Practice*.
- 2 Use the statement to ensure that the auditor's expectations of you are matched by your capabilities.
- 3 Critically consider the performance of your external auditors on an annual basis.
- 4 Assess whether your external auditors are delivering value for money.
- 5 Your board should meet its external auditors without officers being present at the meeting where it considers the year's accounts.
- 6 Your board should set clear expectations for internal audit – it needs to decide whether internal audit is an independent check on management with reporting lines to the board, or a tool of management with a consultancy-type role.
- 7 Ensure that your staff are able to meet the board's expectations on audit. In particular, if your board wants value-for-money and consultancy advice, resources will be needed to match these expectations.
- 8 Establish clear links between the risk-mapping process and any internal audit work plans.

If you want to know more:
the full national report, **A Balanced Account: The Audit Arrangements for Registered Social Landlords** looks at all these issues in more detail and includes background information, case studies and specific guidance.

Audit Commission, **A Balanced Account: The Audit Arrangements for Registered Social Landlords**
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