Restoring trust in audit and corporate governance

Consultation response

8 July 2021

Summary

In this response to the Department for Business, Energy and Industrial Strategy's consultation to audit reform, the National Housing Federation (NHF) agrees to extend the Public Interest Entity (PIE) definition to third sector organisations, including housing associations, with more than £100m of incoming resources. This is sensible given the public benefit housing associations provide to society, including affordable and supported housing, and wider community services.

However, we have a number of concerns about the potential impact of extending this definition to more of our members. The overwhelming evidence from the 2016 EU reforms that led to all housing associations with listed debt becoming PIEs is that, instead of increasing competition in the audit market, it led to a significant reduction in audit firms that would audit PIEs. We are therefore concerned that these new reforms will have the same results.

In addition, the barrier to entry for new firms hoping to enter the market is towering, with an increase in risk and personal indemnity insurance, and many more frequent audit quality reviews. This has already led to a situation where some housing associations have tendered for their external audit and received only one submission.

We have other concerns, including a risk for housing associations to face a duplication or contradictory regulation due to these new PIE requirements not aligning with requirements from the Regulator of Social Housing (RSH). We have not answered all of the 93 questions but selected the ones that are relevant to our members.

We therefore ask for the timetable to be extended for third sector entities, including housing associations, to allow sufficient time for the RSH to align their requirements with PIE regulations.

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We also request a meeting with you to further discuss these implications and to consider any mitigation strategies.

Introduction

We are the voice of England's housing associations. Our members provide homes for around six million people, and are driven by a social purpose: providing good quality housing that people can afford. They provide approximately half a million supported housing properties for people that require some element of support, but also for those that need a greater level of help, including those who need domestic abuse shelters, homelessness hostels and substance misuse housing solutions.

In addition, according to the 2020 Global Accounts of housing associations, as published by the RSH, housing associations invested £13.7bn in new housing supply during the year ended 31 March 2020, which included the development of 49,000 affordable homes. These developments constitute between a quarter and a third of all new homes developed in England every year and almost all new social and affordable homes.

As will become clear in our response, the sector is well regulated by the RSH and, so much so, that a housing association has never fallen into such corporate disarray that it has defaulted on its debt.

Response to specific questions

Q6. Should the government seek to include large third sector entities as PIEs beyond those that would already be included in the definitions proposed for large companies? If so, what types of third sector entities do you believe should be included and why?

We agree that a gap for third sector entities would not be desirable and we are therefore not advocating for an exemption for housing associations. We agree that large housing associations, in particular those with public debt, should be included in the PIE classification.

We wish to highlight however, that all housing associations have to register with the RSH, which subjects them to significant audit and governance regulation already. The risk of mismanagement and serious governance failure is therefore considerably limited for the sector, while any new regulatory regime will create a risk of duplication and an additional burden on resources, with a potential knock-on impact on housing associations' resources and therefore capacity to deliver affordable housing.

Q7. What threshold for 'incoming resources' would you propose for the definition of 'large' for third sector entities? Is exceeding £100m too high, too low or just right?

A number of housing associations are already PIEs, or have subsidiaries such as bond companies that are PIEs. Large housing associations who build at scale will often have complex group structures under a non-for-profit housing association parent. For instance, some housing associations are registered as charitable Community Benefit Societies (CBS), Charitable Friendly Societies (CFS), or charitable entities. A good understanding of these group structures and how these evolved needs to be carefully considered in drafting detailed legislation.

In order to simplify reporting for these complex structures, any threshold should allow for a group structure to report only once under the PIE regulation, regardless of whether company subsidiaries exceed the threshold themselves. This would prevent different subsidiaries within the same legal structure having to comply with different codes of governance and different internal control benchmarks, as well as being an additional burden on resources.

Q10. Do you agree that the government should provide time for companies to prepare for the introduction of a new definition of PIE?

Yes, and we ask for a more considered roll out of the proposals including three stages, with at least two years between each of the following phases:

1) High risk premium listed PLCs.
2) Next remaining commercial PIEs.
3) Third sector PIEs.

Third sector entities are already regulated, therefore delaying the implementation of the reform will not bring any major governance risk in the sector. A phased approach would provide an opportunity for the Charity Commission and the RSH to coordinate their regulatory requirements so that the emerging requirements detailed in the Social Housing White Paper complement rather than contradict the PIE legislation. Codes of Governance, accounting SORPs, including the specialist ones for housing associations and charities, would need to change to mirror the legislation, and an internal controls benchmark will need to be developed. There are not enough audit firms that have the expertise and skills to provide external audit services for the sector. Therefore there is a need for a significant delay before rolling out implementation to housing associations.

Ideally there would be the opportunity to review the lessons from the first stages, with two to three years following each stage, before agreeing to the next stage of the roll out.

Q11. Do you agree that the government should seek to offer a phased introduction for a new definition of PIE?

Yes, as detailed in Q10, a phased approach will be needed to minimise the negative impacts on the sector's audit firms, as well as on the new PIEs. Both audit firms and the new PIEs will need time to build up skilled resources.

A phased approach for third sector entities is necessary to enable stakeholders such as the charities and social housing regulators to align their requirements.

There would also need to be clarity on whether housing associations that fall under the new PIE regulation will still be able to use our Code of Governance, which is used extensively by housing associations, or whether the reform will require them to sign up to the enhanced provisions of the Corporate Code.

Q12. Is there a case for strengthening the internal control framework for UK companies? What would you see as the principal benefits and disbenefits of stronger regulation of internal controls?

We agree with the principle of strengthening the internal control framework for UK companies. As leading property developers in the country, housing associations work closely with a variety of companies in the UK and would benefit from stronger requirements for the commercial sector. The demise of Carillion, for instance, had a knock on impact on sub-contractors, which detrimentally affected housing associations' supply chains.

Please see our responses to Q13 and Q14 below for the risks and concerns we have about this strengthened control framework for housing associations.

Q13. If the control framework were to be strengthened, would you support the government's initial preferred option? Are there other options that you think government should consider? Should external audit and assurance of the internal controls be mandatory?

Option A. Require an explicit directors' statement about the effectiveness of the internal control and risk management systems.

Housing associations already do this, however not to an external benchmark.

Option B. Require auditors to report more about their views on the effectiveness of companies' internal control systems.

Currently external auditors for housing associations carry out a balance sheet audit. The proposed increased audit scope would be a new task for current audit firms and will result in increased costs and resourcing for them.

To understand the impact of this proposal on housing associations, it would be advisable to consult with the main audit firms who have specialism in the social housing sector such as KPMG or BDO.

Option C. Require auditors to express a formal opinion on the directors' assessment of the effectiveness of the internal control systems.

The benchmarking of internal controls against external standards would be a new requirement for housing associations. A relevant benchmark for the social housing sector would first need to be created, and these new requirements are likely to increase management time, require extra resources and inflate audit costs.

Housing associations have shared serious concerns that the strengthened control framework will not lead to an increase in competition within the external audit market as suggested in the consultation document.

Housing associations are already experiencing difficulties tendering for external audits, with evidence of some housing associations receiving only one submission to their tenders. Audit firms have fed back to housing associations that due to the increased resourcing required to implement the Financial Reporting Council's (FRC) existing requirements, they are not in a position to take on the additional risk and resourcing required to expand into another small, specialised external audit area. The social housing sector is seen as niche and requiring particular specialism, preventing new entrants to the external audit market.

Housing associations also raised concerns about greater audit controls over non-financial KPIs.

Q14. If the framework were to be strengthened, which types of company should be within scope of the new requirements?

We agree that housing associations over the threshold should be included in the scope of the new requirements, but we are concerned about the speed that this reform sets out. The proposal is that requirements are implemented for premium listed companies from 2023, and for all other PIEs, only two years later.

As mentioned in Q10, we believe this timetable is too rapid. We are concerned that the audit firms will have to focus their services for premium listed companies, and will have no incentive nor sufficient time to acquire the skills and resources to be able to provide external audit services for a small and niche sector like housing associations.

Q19. Do you agree that the above matters should be included by all companies in the Resilience Statement? If so, should they be addressed in the short or medium term sections of the Statement, or both? Should any other matters be addressed by all companies in the short and medium term sections of the Resilience Statement?

Housing associations already provide a Resilience Statement and carry out stress testing for the RSH. There is therefore a risk that if these are not aligned with the PIE requirements, housing associations will have to duplicate their reporting. Ideally the implementation of these new requirements for housing associations can be delayed to give sufficient time for the RSH to coordinate their requirements with PIE legislation.

Q20. Should resilience statement be a vehicle for Taskforce on Climate change related Financial Disclosures?

This needs to work in conjunction with the social housing sector's ESG reporting standard.

Q21. Do you agree with the proposed company coverage for the Resilience Statement, and the proposal to delay the introduction of the Statement in respect of non-premium listed PIEs for two years? Should recently-listed companies be out of scope?

As stated in Q10, we ask for the implementation of the reform to take place in three phases. There is a risk of duplication with requirements from the RSH, therefore a longer delay to address this would be advisable for housing associations.

Q22. Do you agree with the proposed minimum content for the Audit and Assurance Policy? Should any other matters be addressed in the Policy by all companies in scope?

We tentatively agree with the first three points in the required content of the Audit and Assurance policy, however we would like the opportunity to consult more widely with our members during the extended timetable we have suggested.

We are more concerned about the last point, on "whether, and if so how, shareholder and employee views have been taken into account in the formulation of the Audit and Assurance Policy", as it is not clear when the majority of housing associations are CBSs and if members of CBSs would be considered as being equivalent to shareholders.

Any additional assurance required on Alternative Performance Measures (APM), KPIs and the Section 172 statement of the Companies Act needs further consideration as there is likely to be interaction with the Social Housing White Paper, when this is published. We therefore reiterate our request for a longer implementation time period and a meeting to further understand how these proposals will jointly land in practice.

Q23. Should the Audit and Assurance Policy be published annually and subject to an annual advisory shareholder vote, or should it be published and voted on at least once every three years?

The consultation states that **"**the government recognises that the Audit and Assurance Policy requirement for unlisted PIEs would not include the requirement for a shareholder vote or statement of how shareholder views had been taken into account."

We agree with this proposal but we ask that this also includes third sector entities, including housing associations registered as CFS, CBS or charitable entities.

Q26. To which companies should improvements in supplier payments reporting apply: companies which are PIEs and already reporting under the Payment Practices Reporting Duty, or PIEs with more than 500 employees?

Housing associations are already required to report on supplier payments as they are defined as public bodies in the UK procurement regulation requirements (OJEU requirements). These interactions need to be understood and not replicated or contradictory. For example, payment days are already measured as a standard under OJEU requirements.

The added complexity for our members is that current accounting reporting packages do not allow for this, particularly the ability to exclude the period where an invoice is under dispute. This again demonstrates the need for a longer timetable so that software suppliers operating in our sector can improve their systems.

Q28. Do you have any comments on the government's proposals for strengthening the regulator's corporate reporting review function set out in this chapter?

We request that there is engagement with the RSH to understand how these proposals interact with existing regulatory requirements.

5.1. Enforcement on company directors

If these enforcements are extended to non-company PIEs, such as our members, we are concerned about the impact this will have on recruiting and retaining our non-executive board members. There are already significant added challenges and requirements in recent years stemming from building safety and the upcoming Social Housing White Paper.

5.2 Strengthening clawback and malus provisions in directors' remuneration arrangements

As housing associations are not-for-profit organisations that don't have shareholders, we would like to understand how this interacts with our corporate structures (charitable and CBS/CFS).

6.4 Tackling fraud

Q42. Do you agree with the government's proposed response to the package of reforms relating to fraud recommended by the Brydon Review?

We have no comment on this package of reforms but would like to emphasise the likely negative impact on the number of audit firms operating on PIEs in our sector.

6.7 Audit of Alternative Performance Measures and Key Performance Indicators linked to executive remuneration

It is likely that these, or similar, KPIs will be included in the Social Housing White Paper. We therefore reiterate our ask to extend the timetable for third sector entities, and agree to our request for a meeting in order to discuss these overlapping requirements.

<u>7.1 Audit Committees – role and oversight</u> – the Audit, Reporting and Governance Authority should be given powers to set, monitor and enforce compliance with additional requirements for audit committees in the appointment and oversight of auditors.

These powers need to be considered with the public procurement regulations that apply to our members. These procurement regulations already conflict with the requirements incorporated into UK law by the Audit Directive on the appointment of auditors by the board. Housing associations are unusual, if not unique, in falling under both of these regimes.

Q57. What other regulatory tools might be useful when a company has failed to find an auditor or in the circumstances described by Sir John Kingman (i.e. when quality issues have been identified around the company's audit; when a company has parted with its auditor outside the normal rotation cycle; and when there has been a meaningful shareholder vote against an auditor appointment)?

We are deeply concerned about the impact on the number of auditors operating in our sector – see our response to Q13 and our summary above for more comments on this issue.

Q58. Do you agree with the proposals and implementation method for giving shareholders a formal opportunity to engage with risk and audit planning? Are there further practical issues connected with the implementation of these proposals which should be considered

Our members do not have shareholders as they are all not-for-profit organisations. These proposals should not be required for members of charitable and CBS/CFS organisations.

Q59. Do you agree with the proposed approach for ensuring greater audit committee chair and auditor participation at the AGM? How could this be improved?

This approach could further reduce both the number of auditors and non-executive board members working for housing associations.