



**Royal County of Berkshire Pension Fund**

Planning report to the Audit and Performance Review Panel for the year ended 31 March 2019

Issued 1 April 2019 for the meeting on 9 April 2019

**Deloitte Confidential: Government and Public Services**

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# Introduction

## The key messages in this report:

We have pleasure in presenting our Planning Report to the Audit and Performance Review Panel for the 2019 audit of the Royal County of Berkshire Pension Fund ("the Fund"). We would like to draw your attention to the key messages of this paper:

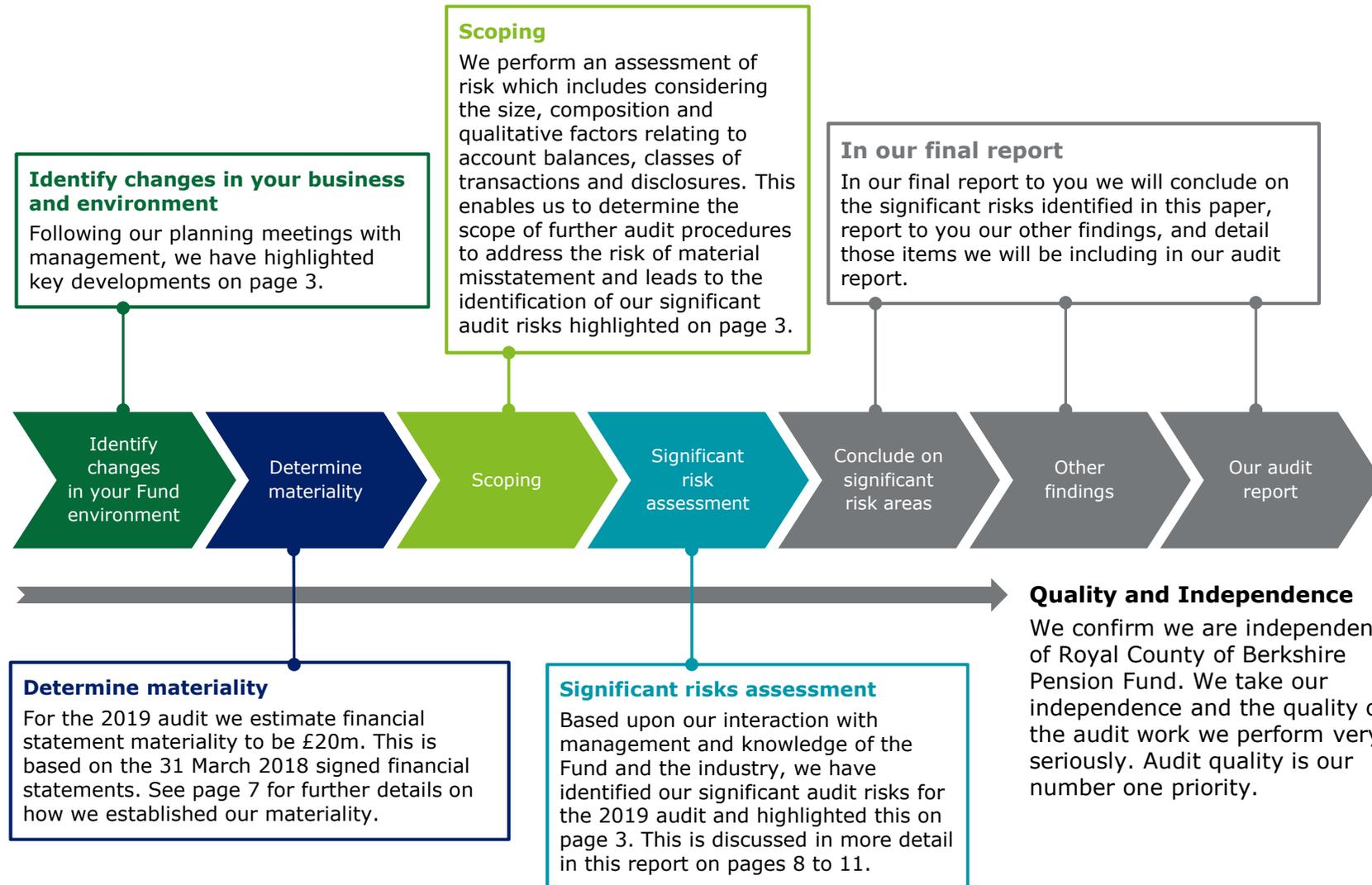
Audit quality is our number one priority. We plan our audit to focus on audit quality and have set the following audit quality objectives for this audit:

- A robust challenge of the key judgements taken in the preparation of the financial statements.
- A strong understanding of your internal control environment.
- A well planned and delivered audit that raises findings early with those charged with governance.

<b>Scope</b>	Our principal audit objective is to obtain sufficient, relevant and reliable audit evidence to enable us to express an opinion on the statutory accounts of the Fund prepared under the Code of Practice on Local Authority Accounting ("the Code") issued by CIPFA and LASAAC.
<b>Key developments</b>	<p>As part of our audit planning procedures to date, we have held planning meetings with key members of management to develop our understanding. Additionally, we have reviewed the prior year audit files held by KPMG. Our procedures have identified that the developments during the year have been:</p> <ul style="list-style-type: none"><li>• The investment management function of the Fund transferred to the Local Pension Partnership Investments Ltd ("LPPI") on the 1 June 2018; and</li><li>• From 1 June 2018, investment assets of the Fund are in the process of transferring into pooled vehicles provided by the Local Pension Partnership ("LPP"). Initially only the liquid assets are expected to transfer.</li></ul> <p>Our planning procedures are still in progress. We will continue to assess the audit risks throughout the audit and we will inform you of any changes.</p>
<b>Significant audit risks</b>	<p>As we continue to accumulate knowledge of the Fund we have developed our risk assessment so that our plan reflects those areas which we believe have a greater chance of leading to material misstatement of the financial statements.</p> <p>Our significant audit risks will be:</p> <ul style="list-style-type: none"><li>• Management override of controls;</li><li>• Valuation of the longevity hedge; and</li><li>• Valuation of the convertible bond investment.</li></ul> <p>Auditing Standards include a presumption that management override of controls and revenue recognition are significant risks for all our audits.</p> <p>We have rebutted the presumption of risk of fraud in revenue recognition for the Fund, as we consider that there is little incentive or opportunity for revenue (including investment income, transfers and contributions) to be fraudulently misstated and therefore there is limited risk of material misstatement arising due to fraud in this area.</p> <p>Please refer to pages 9-12 for full details.</p>

# Our audit explained

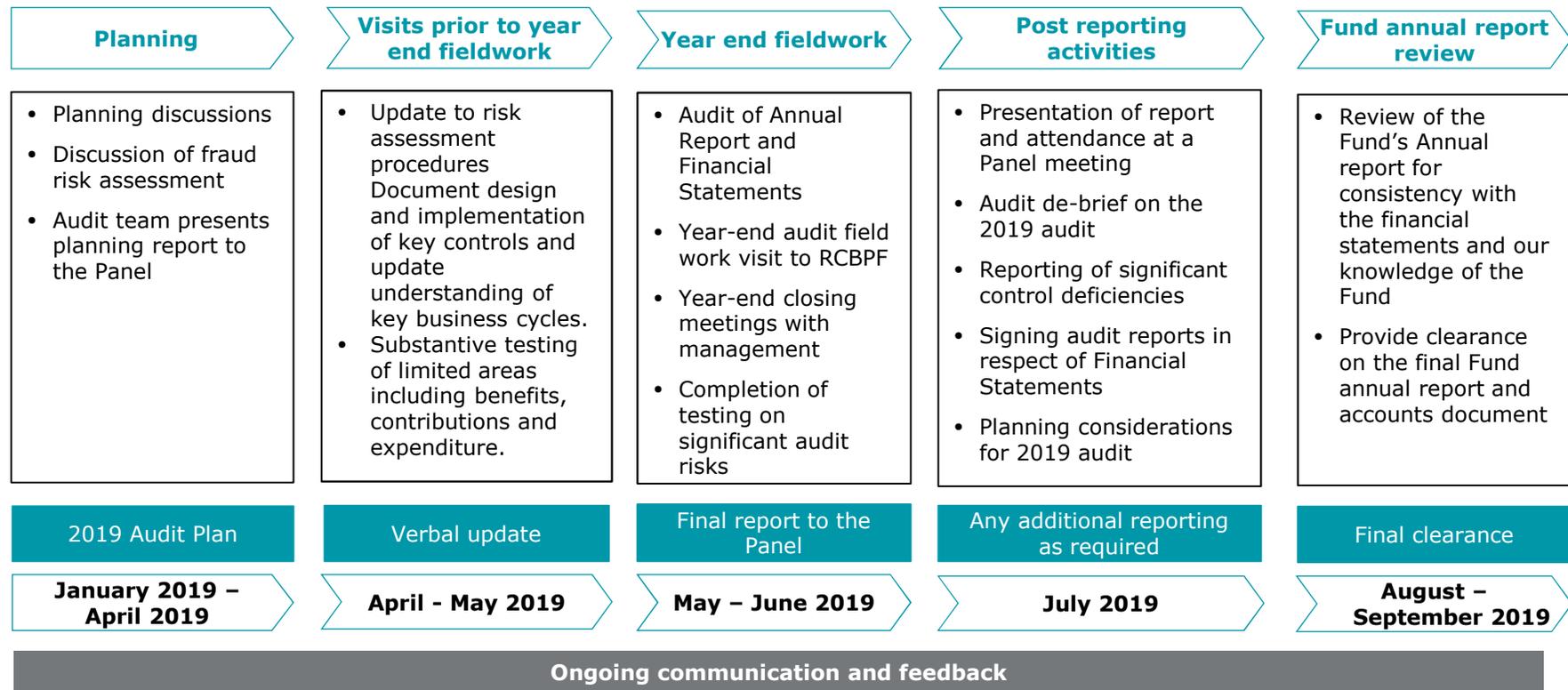
## We tailor our audit to your Fund



# Continuous communication and reporting

## Planned timing of the audit

As the audit plan is executed throughout the year, the results will be analysed continuously and conclusions (preliminary and otherwise) will be drawn and initial comments from the interim and final visits will be shared with management as required. The following sets out the expected timing of our reporting to and communication with you.



# Scope of work and approach

## Our approach

### **Liaison with internal audit**

The Auditing Standards Committee's version of ISA (UK and Ireland) 610 "Using the work of internal auditors" prohibits use of internal audit to provide "direct assistance" to the audit. Our approach to the use of the work of Internal Audit has been designed to be compatible with these requirements.

We will review their reports and meet with them to discuss their work. We will discuss the work plan for internal audit, and where they have identified specific material deficiencies in the control environment we consider adjusting our testing so that the audit risk is covered by our work.

Using these discussions to inform our risk assessment, we can work together with internal audit to develop an approach that avoids inefficiencies and overlaps, therefore avoiding any unnecessary duplication of audit requirements on the Council's staff.

### **Approach to controls testing**

Our risk assessment procedures will include obtaining an understanding of controls considered to be 'relevant to the audit'. This involves evaluating the design of the controls and determining whether they have been implemented ("D & I").

The results of our work in obtaining an understanding of controls and any subsequent testing of the operational effectiveness of controls will be collated and the impact on the extent of substantive audit testing required will be considered.

### **Promoting high quality reporting to stakeholders**

We view the audit role as going beyond reactively checking compliance with requirements: we seek to provide advice on evolving good practice to promote high quality reporting.

We recommend the Fund completes the Code checklist during drafting of their financial statements.

We would welcome early discussion on the planned format of the financial statements, and whether there is scope for simplifying or streamlining disclosures, as well as the opportunity to review a skeleton set of financial statements and an early draft of the annual report ahead of the typical reporting timetable to feedback any comments to management.

# Materiality

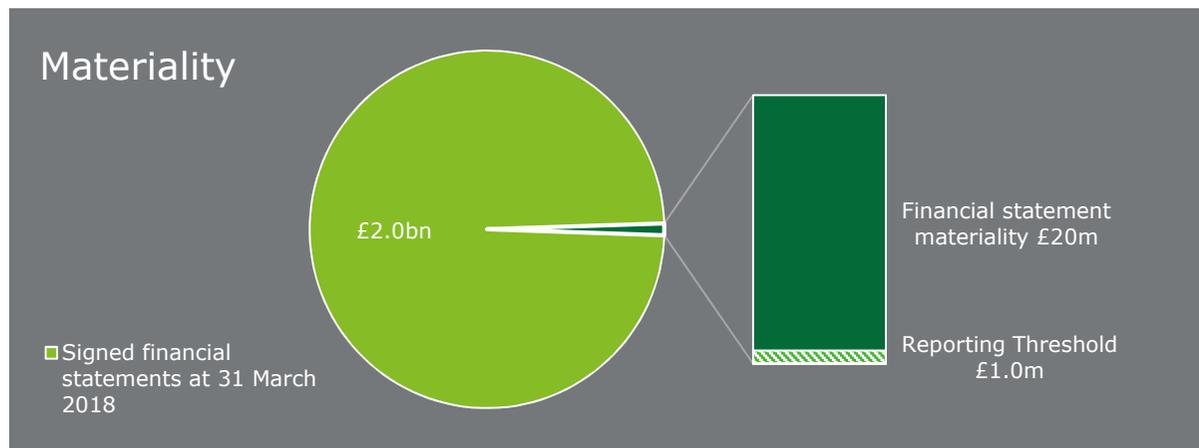
## Our approach to materiality

### Basis of our materiality benchmark

- We have estimated financial statement materiality as £20m based on professional judgement, the requirement of auditing standards, and the net assets of the Fund. As we complete our remaining planning procedures, we will consider further, together with the Royal Borough of Windsor and Maidenhead audit team, whether any reduction is required to the level of materiality applied to the Fund. If any changes are made to our assessment of materiality we will communicate those to the Audit Committee.
- We have used 1% of Fund net assets as the benchmark for determining our materiality levels.

### Reporting to those charged with governance

- We will report to you all misstatements found in excess of 5% of financial statement materiality. We will report to you misstatements below this threshold if we consider them to be material by nature.
- We will determine materiality figures for the 31 March 2019 audit, and report them to those charged with governance on receipt of the draft 2019 financial statements.



# Significant risks

## Our risk assessment process

### **Changes to prior year in risks identified as significant audit risks**

The risks we have identified as significant audit risks are summarised on the following pages. Our risk assessment reflects the following change from the prior year:

- In the prior year, our predecessor identified a significant audit risk in relation to the valuation of alternative investments, which they referred to as 'hard to value' investments. We have considered the investments held in the prior year, including the nature of the instruments held and the way they are priced. Based on our understanding, and the absence of past audit findings, we have concluded that the significant risk should not apply to the whole population of investments for which public pricing is not available. The vast majority of these holdings take the form of funds for which audited financial statements are regularly produced. These investments are diversified across a range of funds with audited accounts available reflecting audited fund prices. Whilst we will treat the valuation of these funds as a higher risk we believe the risk of material misstatement not to be significant for these reasons. We also identified a holding in property joint ventures for which valuation techniques can involve more judgement and estimation. However, due to the immaterial size of the holding we consider this to be only a higher risk. We have identified a convertible bond holding in Technology Enhanced Oil plc at a value of £35m last year. There is no publicly available pricing for this instrument. Convertible bonds are considered more difficult to price due the embedded optionality, the effect of multiple underlying characteristics and the use of complex calculation models. Therefore we have focused the significant risk on to this part of the investment portfolio.

### **Presumed risk of fraud in revenue recognition**

Auditing standards also presume there is a risk of fraud in revenue recognition. Following an analysis of the Council's income streams, we have rebutted this presumption. The key factors considered include: the amount of annual income from each source; the transaction size; the extent of any estimates; and the complexity of the recognition principles. Our conclusion is the same as that reached by our predecessor last year.

# Significant risks

## Management override of controls

### **Risk identified**

In accordance with ISA 240 (UK) management override is always a significant risk for financial statement audits. The primary risk areas surrounding the management override of internal controls are over the processing of journal entries and the key assumptions and estimates made by management.

### **Deloitte response management override of controls risk identified**

In order to address the significant risk our audit procedures will consist of the following:

- We will risk assess journals and select items for detailed follow up testing. The journal entries will be selected using computer-assisted profiling based on areas which we consider to be of increased interest;
- We will test the appropriateness of journal entries recorded in the general ledger, and other adjustments made in the preparation of financial reporting;
- We will review accounting estimates for biases that could result in material misstatements due to fraud; and
- We will obtain an understanding of the business rationale of significant transactions that we become aware of that are outside of the normal course of business for the entity, or that otherwise appear to be unusual, given our understanding of the entity and its environment.

In assessing the risk of management override, we will:

- Assess the overall position taken in respect of key judgements and estimates; and
- Consider our view on the overall control environment and 'tone at the top'.

# Significant risks

## Valuation of the longevity hedge

### **Risk identified**

The Fund holds a material longevity insurance policy to hedge longevity risk. A longevity hedge is designed to insure the Fund against the risk that pensioners live longer than the current mortality assumptions. Valuation of longevity hedges are sensitive to relatively small movements in the key assumptions used in the actuarial calculations. The setting of these assumptions involves judgement. Based on last year's audited accounts we expect the value to be material in size this year.

As a result of this we consider the valuation of the longevity hedge to be a significant risk.

### **Deloitte response to the risk identified**

In order to address this area of significant audit risk, we will perform the following audit procedures:

- Perform an assessment of the actuarial expert in respect of their knowledge and experience in this area;
- Test the design and implementation of the key controls with respect to the valuation of the longevity hedge;
- Obtain a valuation report directly from the actuary and reconcile this to the financial statements disclosure;
- Obtain the underlying documentation for the policy, including the population covered, the assumptions and other key inputs used in the calculation, and the agreed cash flows;
- Engage in-house actuarial specialists to challenge and assess the reasonableness of the valuation of the policy based on the underlying terms of the contract and the forecast cash flows; and
- Compare our expectation of the value with that reported by the investment manager, investigating any differences identified that are outside the range of results that we consider to be reasonable.

# Significant risks

## Valuation of the convertible bond

### **Risk identified**

Based on our review of the prior year investments portfolio, there is a material holding in a convertible bond. This instrument does not have publicly available pricing. Valuation of convertible bonds requires the use of a complex model that accounts for the embedded option to convert the initial bond holding to equity. The valuation method takes account of the nature of both the bond and equity characteristics, including volatility and spread, and involves the evaluation of discounted cash flows.

As a result we consider the valuation of the convertible bond to be a significant risk.

### **Deloitte response management override of controls risk identified**

In order to address the significant risk our audit procedures will consist of the following:

- Communicate with LPPI to identify the valuation methodology adopted and the relevant controls in place to govern that process;
- Test the design and implementation of the key controls with respect to the valuation of the convertible bonds;
- Obtain a valuation report directly from the investment manager and reconcile this to the financial statements disclosure;
- Obtain the key details of the convertible bond that have been used by the investment manager to value it;
- Engage our in-house specialists to assess the price of the convertible bond; and
- Compare our expectation of the value with that reported by the investment manager, investigating any differences identified that are outside the range of results that we consider to be reasonable.

# Purpose of our report and responsibility statement

## Our report is designed to help you meet your governance duties

### What we report

Our respective responsibilities are set out in "PSAA Statement of responsibilities of auditors and audited bodies: Principal Local Authorities and Police Bodies." The responsibilities of auditors are derived from statute, principally the Local Audit and Accountability Act 2014 and from the NAO Code of Audit Practice. The responsibilities of audited bodies are derived principally the Local Audit and Accountability Act 2014 and from the Accounts and Audit Regulations 2015.

Our report is designed to communicate our preliminary audit plan and to take the opportunity to ask you questions at the planning stage of our audit. Our report includes our preliminary audit plan, including key audit judgements and the planned scope.

### Use of this report

This report has been prepared for the Audit and Performance Review Panel, as a body, and we therefore accept responsibility to you alone for its contents. We accept no duty, responsibility or liability to any other parties, since this report has not been prepared, and is not intended, for any other purpose. Except where required by law or regulation, it should not be made available to any other parties without our prior written consent.

### What we don't report

As you will be aware, our audit is not designed to identify all matters that may be relevant to the Fund.

Also, there will be further information you need to discharge your governance responsibilities, such as matters reported on by officers or by other specialist advisers.

Finally, the views on internal controls and business risk assessment in our final report should not be taken as comprehensive or as an opinion on effectiveness since they will be based solely on the audit procedures performed in the audit of the statement of accounts and the other procedures performed in fulfilling our audit plan.

### Other relevant communications

We will update you if there are any significant changes to the audit plan.

**Jonathan Gooding**

for and on behalf of Deloitte LLP

St Albans | 1 April 2019

# Appendix 1: Fraud responsibilities and representations

## Responsibilities explained



### Your Responsibilities:

The primary responsibility for the prevention and detection of fraud rests with management and the Panel, including establishing and maintaining internal controls over the reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations.



### Our responsibilities:

- We are required to obtain representations from your management regarding internal controls, assessment of risk and any known or suspected fraud or misstatement.
- As auditors, we obtain reasonable, but not absolute, assurance that the financial statements as a whole are free from material misstatement, whether caused by fraud or error.
- As set out in the significant risks section of this document, we have identified the management override of controls, the valuation of the longevity hedge and the valuation of the convertible bond as the key audit risks for the Fund.



### Fraud Characteristics:

- Misstatements in the financial statements can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional.
- Two types of intentional misstatements are relevant to us as auditors – misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets.

### We will request the following to be stated in the representation letter signed on behalf of the Panel:

- We acknowledge our responsibilities for the design, implementation and maintenance of internal control to prevent and detect fraud and error.
- We have disclosed to you the results of our assessment of the risk that the financial statements may be materially misstated as a result of fraud.
- We are not aware of any fraud or suspected fraud / We have disclosed to you all information in relation to fraud or suspected fraud that we are aware of and that affects the entity or group and involves:
  - (i) management;
  - (ii) employees who have significant roles in internal control; or
  - (iii) others where the fraud could have a material effect on the financial statements.
- We have disclosed to you all information in relation to allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others.

# Appendix 1: Fraud responsibilities and representations (continued)

## Inquiries

We will make the following inquiries regarding fraud:



### **Management:**

- Management’s assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent and frequency of such assessments.
- Management’s process for identifying and responding to the risks of fraud in the entity.
- Management’s communication, if any, to the Panel regarding its processes for identifying and responding to the risks of fraud in the entity.
- Management’s communication, if any, to employees regarding its views on business practices and ethical behaviour.
- Whether management has knowledge of any actual, suspected or alleged fraud affecting the entity.
- We plan to involve management from outside the finance function in our inquiries.



### **Internal audit**

- Whether internal audit has knowledge of any actual, suspected or alleged fraud affecting the entity, and to obtain its views about the risks of fraud.



### **The Panel**

- How the Panel exercise oversight of management’s processes for identifying and responding to the risks of fraud in the entity and the internal control that management has established to mitigate these risks.
- Whether the Panel has knowledge of any actual, suspected or alleged fraud affecting the entity.
- The views of the Panel on the most significant fraud risk factors affecting the entity.

# Appendix 2: Independence and fees

## A Fair and Transparent Fee

As part of our obligations under International Standards on Auditing (UK), we are required to report to you on the matters listed below:

<b>Independence confirmation</b>	We confirm the audit engagement team, and others in the firm as appropriate, Deloitte LLP and, where applicable, all Deloitte network firms are independent of the Fund and will reconfirm our independence and objectivity to the Panel for the year ending 31 March 2019 in our final report to the Panel.
<b>Fees</b>	Our audit fee for the year ending 31 March 2019 is £24,831 for the Fund. The above fees exclude VAT and include out of pocket expenses.
<b>Non-audit fees</b>	There are no non-audit fees.
<b>Independence monitoring</b>	We continue to review our independence and ensure that appropriate safeguards are in place including, but not limited to, the rotation of senior partners and professional staff and the involvement of additional partners and professional staff to carry out reviews of the work performed and to otherwise advise as necessary.
<b>Relationships</b>	We have no other relationships with the Authority, its members, officers and affiliates, and have not supplied any services to other known connected parties.



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