



## **Royal County of Berkshire Pension Fund**

Final report to the Corporate Overview & Scrutiny Panel for the year ended 31 March 2019

Issued on 06 December 2019

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# Introduction

## The key messages in this report

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.

We have pleasure in presenting our final report to the Corporate Overview & Scrutiny Panel of Royal Borough of Windsor & Maidenhead (the "Panel") for the 2019 audit of the Royal County of Berkshire Pension Fund (the "Fund"). The scope of our audit was set out within our planning report presented to the panel in April 2019.

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### **Status of the audit – Pension Fund**

At the date of issue of this report we have completed our audit of the pension Fund for the year ended 31 March 2019.

As noted in our July paper, this is our first year auditing the Fund and we understand that the level of information we have requested from officers and nature of some of our procedures have been quite different to what the Fund has experienced in previous years.

The progress of the audit in the key areas of testing has been significantly delayed due to issues in the reporting of service organisations and advisers. On investigation the convertible bond was being held at cost and had not been included at fair value in the initial draft accounts and the longevity hedge had been valued using an out of date mortality assumption. Both these issues required additional valuation work by the Fund's service organisations before our internal specialists could begin to test the revised valuations. Furthermore, the investment manager, Local Pensions Partnership ("LPP"), has found it difficult to provide the requested information for our testing of the alternative investment funds. This included audited financial statements of the funds and evidence of capital movements, without which it is not possible for us to conclude on our testing. We have now received all the information we require in respect of the alternative investments.

Our work in respect of the convertible bond and the longevity hedge has now been concluded. We identified material misstatements in the statement of accounts presented for audit, such that the value of each instrument was overstated by £34.2m and £40.3m respectively. The final statement of accounts has been adjusted accordingly. We have included a section in this report providing observations arising from the work we have carried out on the areas of significant risk reported to you in our audit planning report. We have also identified recommendations in respect of significant control deficiencies in these areas in the Control Observations section of this report.

### **Conclusions from our testing**

We have set out a summary of misstatements and disclosure deficiencies identified to date in an appendix to this report (see pages 14 to 16).

Subject to the completion of the final audit procedures noted on page 4, we expect to issue an unqualified opinion on the Financial Statements of the Fund.

# Introduction

## The key messages in this report (continued)

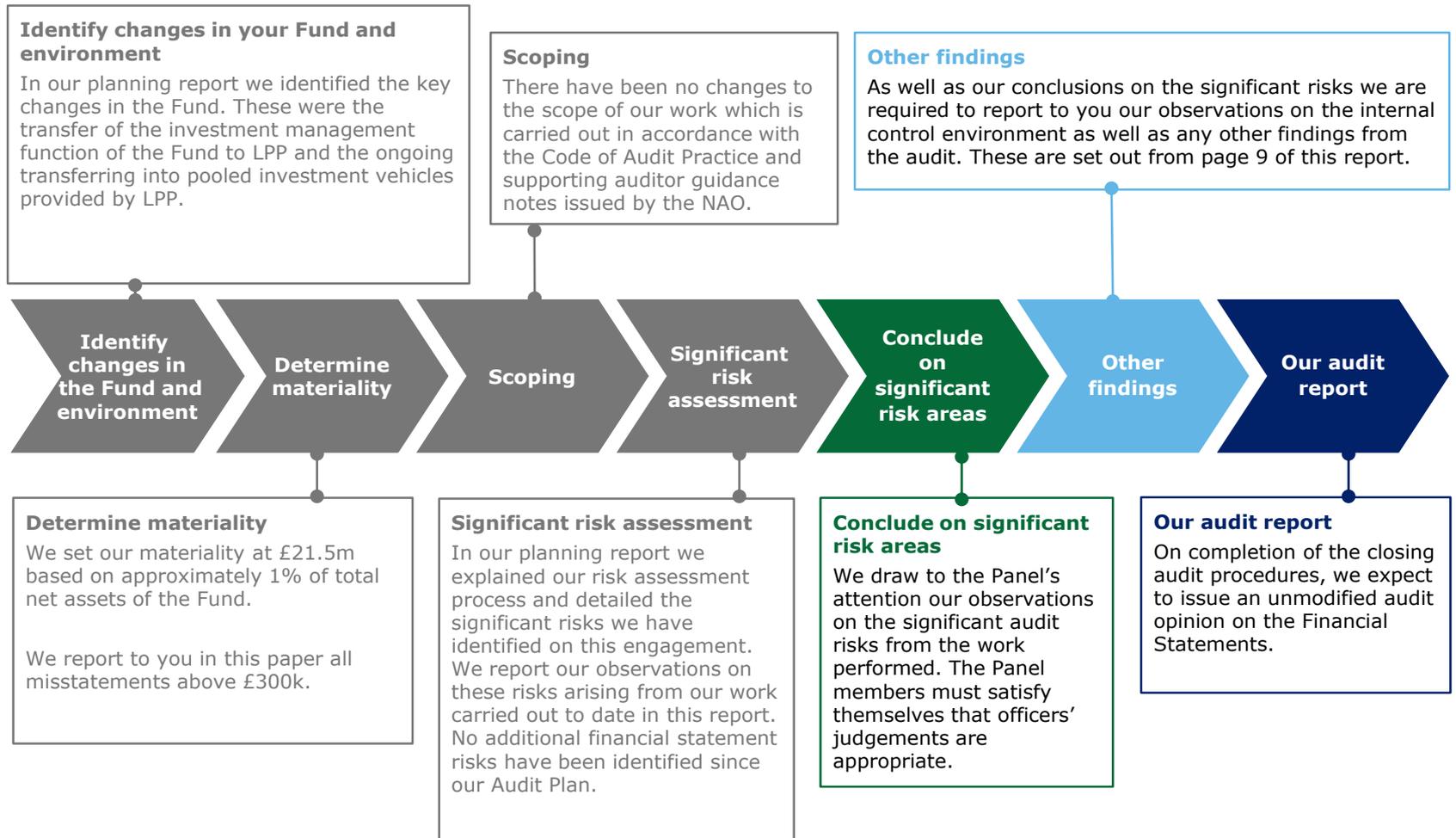
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<b>Audit procedures outstanding</b>	<p>The following audit procedures are ongoing at the time that this report was released:</p> <ul style="list-style-type: none"><li>• Update of our subsequent events and going concern procedures to the date of Deloitte signing; and</li><li>• Signing of the representation letter.</li></ul>
<b>Management representations</b>	<p>We will obtain written representations from the Chief Financial Officer on matters material to the financial statements when other sufficient appropriate audit evidence cannot reasonably be expected to exist. A copy of the representation letter has been issued ahead of signing the financial statements.</p>
<b>Audit fee</b>	<p>As explained in our fee letter, our audit fee is based on assumptions about the scope of our work, the completeness and quality of information provided to support the draft financial statements and the timeliness and quality of responses to subsequent requests for information and explanation. We expected our audit to be complete before the meeting on the 18 November 2019, but, for the reasons set out on the previous page, it was ongoing and has required substantial further input. We have estimated the additional costs incurred to date across the Council and Pension audits in our separate report on the Council statement of accounts. The pension fund related element of this estimated to be £38k. The additional time taken to complete the audit represents additional cost which will be charged using the rate card in the appendix to that separate report.</p>

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# Our audit explained

## We tailor our audit to your organisation



# Significant risks

## Management override of controls

### **Risk identified**

In accordance with ISA 240 (UK) management override of controls is always a significant risk. This risk area includes the potential for officers to use their judgement to influence the financial statements as well as the potential to override the Fund's controls for specific transactions.

### **Deloitte response**

We have considered the overall sensitivity of judgements made in preparation of the financial statements, and note that the Fund's draft statement of accounts was overstated by approximately £74.5m due to estimates used in the valuation of the longevity swap and the convertible bond being out of date.

We have considered these factors and other potential sensitivities in evaluating the judgements made in the preparation of the financial statements.

#### *Significant and unusual transactions*

We have not identified any significant transactions outside the normal course of business or any transactions where the business rationale was not clear in the current year.

#### *Journals*

We have performed design and implementation testing of the controls in place for journal approval.

We have used Spotlight data analytics to risk assess journals and select items for detailed follow up testing. The journal entries were selected using computer-assisted profiling based on areas which we consider to be of increased interest. In response to the initial results of other areas of testing, we reconsidered the selection criteria and tested additional journals.

We have tested the appropriateness of a sample of journal entries recorded in the general ledger, and other adjustments made in the preparation of financial reporting.

#### *Accounting estimates*

We have performed a review of the accounting estimates.

The key judgements in the financial statements are those selected as significant audit risks and other areas of audit interest.

We reviewed accounting estimates for biases that could result in material misstatements due to fraud.

We tested accounting estimates and judgements, focusing on the areas of greatest judgement and value. Our procedures included comparing amounts recorded or inputs to estimates to relevant supporting information from third party sources. The findings from our work on the longevity swap valuation and convertible bond valuation are included on pages 9 and 10 of this report.

### **Issues identified**

- We have identified control deficiencies, set out on pages 9 and 10;
- We have not identified any significant bias in the key judgements made by officers based on work performed; and
- We have not identified instances of management override of controls in the current year.

# Significant risks (continued)

## 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. The longevity hedge was valued as a liability of £63.1m in the 2017/18 Statement of Accounts and £63.5m in the 2018/19 Statement of Accounts presented for audit and is therefore quantitatively material. As a result of this we consider the valuation of the longevity hedge to be a significant risk.

### Key judgements and our challenge of them

The Fund held a longevity hedge liability of £63.5m (PY: £63.1m) at 31 March 2019 which is required to be recorded at fair value.

The Fund's practice is to obtain a valuation from the Fund's actuary as at each year end. The actuary also reviews the assumptions relating to the overall Fund's liability on a triennial basis. The most recent triennial valuation was completed as at 31 March 2016.

Key judgements include:

- The discount rates used in discounting the estimated cash flows associated with the instrument; and
- The mortality improvement assumptions

### Deloitte response

We obtained an understanding of the approach adopted for the valuation, including assessing the actuary's qualifications, objectivity and independence and reviewing the methodology used.

We obtained a valuation report directly from the actuary and reconciled this to the financial statements disclosure.

We obtained the underlying documentation of the policy, including the population covered, the assumptions and other key inputs used in the calculation, and the agreed cash flows.

An assessment was completed of the design and implementation of key controls in place around the longevity hedge valuation, including how the Fund ensures that the discount rate and mortality rates are appropriate.

Our in-house actuarial specialists challenged and assessed the reasonableness of the valuation of the policy based on the underlying terms of the contract and the forecast cash flows, and provided a view on the key judgements used.

### Deloitte view

Following the initial review by our internal specialists we concluded that the mortality assumption was not in line with the market. The mortality tables used were not in line those used in the current valuation of the overall Fund's liability. Aligning the mortality tables with those of the triennial valuation resulted in a revised valuation from the actuary of £104m liability. **This therefore indicates a misstatement in the statement of accounts presented for audit of £40.3m.** Testing of the revised balance has been concluded with no additional valuation issues noted.

We have identified **significant control weaknesses** in this area and made recommendations for management to consider when valuing the longevity hedge in future. Our recommendations have been summarised from page 9.

# Significant risks (continued)

## Valuation of the convertible bond

### Risk identified

The Fund holds a convertible bond as at the 31 March 2019. This instrument is listed on a foreign stock exchange, but it 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. The convertible bond is quantitatively material in the draft financial statements. As a result we consider the valuation of the convertible bond to be a significant risk.

### Key judgements and our challenge of them

The Fund's draft financial statements reflected an investment in a convertible bond of £36.4m (PY: £34.9m) at 31 March 2019 which is required to be recorded at fair value.

The Fund's practice is to obtain a valuation from the Fund's custodian (JP Morgan) as at each year end. The custodian obtains the reporting on this instrument from the Fund's investment manager (LPP). The investment manager is responsible for pricing the instrument.

Key judgements include:

- The estimated ability of the bond issuer to make the interest payments;
- The estimated future value of the equity holding for the converted bond; and
- The discount rate used to discount the future cash flows to calculate the present value.

### Deloitte response

We communicated with LPP to identify the valuation methodology adopted and the relevant controls in place to govern that process.

We obtained a valuation report directly from both the custodian and the investment manager and reconciled this to the financial statements disclosure.

We obtained the key details of the convertible bond that have been used by the investment manager to value it.

An assessment was completed of the design and implementation of key controls in place around the convertible bond valuation, including how the Fund assures itself that the estimated future performance of the bond issuer and the discount rate are appropriate.

Our in-house specialists assessed the price of the convertible bond, compared our expectation of the value with that reported by the investment manager and investigated any differences identified that are outside the range of results that we consider to be reasonable.

### Deloitte view

Following our initial investigation into the valuation approach adopted by LPP, it was noted that, while other independent third parties were involved in providing pricing information, a valuation of the bond as at 31 March 2019 had not been prepared on a fair value basis. This is a significant deficiency in the preparation of the Statement of Accounts. We therefore requested that a revised valuation be prepared. We raised this issue with management and, subsequently, LPP engaged KPMG to perform the valuation. The resulting valuation report showed that the value of the bond at the year end was approximately £2.2m. **Therefore, this indicates a misstatement of the financial statements presented for audit, of £34.2m.**

Testing of the revised balance by our internal specialists has been completed. No additional adjustments are recommended. It should be noted that the primary reason for the significant drop in value from previous periods is the judgement that the bond issuer will default on interest payments during 2020, and that the remaining assets of the company at that time will have little or no value due to the bespoke nature of the company's operations.

We have identified **significant control weaknesses** in this area and made recommendations for management to consider when valuing the convertible bond in future. The most significant of these have been summarised from page 9.

# Control observations

During the course of our audit we have identified internal control findings which we have included below for information.

The purpose of the audit was for us to express an opinion on the financial statements. The audit included consideration of internal control relevant to the preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control. The matters being reported are limited to those deficiencies that we have identified during the audit and that we have concluded are of sufficient importance to merit being reported to you.

Area	Observation
<b>Valuation of the longevity swap</b>	<p>When our specialists challenged the assumptions used in the initial valuation of the longevity swap as prepared by the Fund actuary it was noted that the mortality improvement assumption was out of date. While the assumption had been updated on the most recent triennial valuation of the overall Fund liability, this approach had not been applied to the Fund. When the valuation had been amended on our request, the result was a material change as noted on page 7. From our investigation of the design and implementation of the control around the longevity valuation, it appears that:</p> <ul style="list-style-type: none"><li>• There is no control specifically around challenging the assumptions used by Barnett Waddingham; and</li><li>• The broader control around the review of the investment valuations in general had not been implemented for the year end figures.</li></ul> <p>We recommend that the Panel ensures that the valuations provided by the actuary are reviewed and that the assumptions are challenged, understood, and agreed before inclusion of the valuation in the financial statements.</p>
<b>Valuation of the convertible bond</b>	<p>The draft financial statements included a value for the convertible bond as provided by JP Morgan, the Fund custodian. When our internal specialists requested additional details from JP Morgan they were directed to Thomson Reuters for the pricing used in the valuation report. Communication with Thomson Reuters revealed that they were relying on reporting from a broker called Stifel. In subsequent discussions, Stifel confirmed that they were not valuing the bond and were simply providing indicative pricing. We requested that the bond be fair valued and LPP engaged KPMG to prepare a valuation. This KPMG report valued the bond at approx. £2.2m compared with the original value of £36.4m. From our investigation it was clear that:</p> <ul style="list-style-type: none"><li>• The bond had not been fair valued by anyone involved in pricing the bond;</li><li>• That there was a lack of understanding at the Fund as to who was providing the pricing and as to the valuation approach adopted; and</li><li>• There was no control in place at the investment manager to challenge the pricing before it was reported to the Fund.</li></ul> <p>We recommend that the Panel ensures that the valuation of all bespoke investments is understood by the investment manager and that controls are implemented to ensure an appropriate challenge is made of valuations received from any service organisation.</p>

## Control observations (continued)

Area	Observation
<b>Valuation of the convertible bond (continued)</b>	<p>On review of the audited financial statements of the invested-in entity it was noted that the Pension Fund Manager was one of the directors of the company from 23 September 2016 to 29 January 2019. In this role, the Pension Fund Manager would have been involved in setting the investment direction for the Fund. We have considered the arrangements in place at the Pension Fund around declarations of interest, segregation of duties, authorisation to invest, governance and monitoring procedures, and valuation controls.</p>
	<p>We note that the Council had in place policies to cover declarations of interest and investment due diligence. We also note that independent strategy advisers to the investment working group were part of the meeting on the 26 May 2016 during which the investment was initially discussed, and form part of the working group, which ultimately made the decision about the investment. We have also seen evidence of approval from the investment working group, for the initial \$25m investment in this entity and the option of an additional \$25m. The second \$25m was approved contingent on agreement with the invested-in entity about production targets.</p>
	<p>However, we also note that Pension Fund management were unable to provide evidence of the subsequent review of the initial investment and the securing of this agreement before the second tranche was invested. We have also been informed by management of the Pension Fund that no conflicts of interest were recorded in the minutes at meetings of the Investment Management Group or the Pension Fund Panel; and that they were not able to locate the conflict of interest disclosures for the second tranche of the investment. We have, however, been informed that the Fund was aware of the Pension Fund Manager's appointment as a director of the invested-in entity, but that no official documentation was available to demonstrate his declaration of this appointment, or to demonstrate that the Fund had given him authority/instruction to take up the appointment. For these reasons, and as the reduction in value of the investment was not identified by management, and only identified through our audit, we have made the recommendation to the Council and to the Pension Fund that a review is performed of the arrangements around pension asset investment decision making, monitoring and reporting of the valuation of those investments. We have recommended that this should include a retrospective review of the arrangements with respect to the specific assets that were adjusted significantly to identify the lessons that can be learned and to embed this learning into the new arrangements. We have recommended that the outcome from these reviews should be reported to both the scrutiny committee and the pension panel. We have also added a qualification point to our value for money conclusion with respect to the pension fund as follows: "the audit identified weaknesses in the system of governance and internal control in relation to the Royal County of Berkshire Pension Fund investments and the Fund's evaluation and monitoring of the controls in place at the service organisations it uses. Arising from the audit, material adjustments were made that reduced the valuation of the asset portfolio."</p>

## Control observations (continued)

Area	Observation
<b>Valuation of the private equity portfolio and other alternative funds</b>	<p>Our standard testing approach for alternative investment funds includes obtaining the most recent audited financial statements of the investment fund along with information about capital committed and any capital transactions that occurred since the date of the audited financial statements. Obtaining the specific information we require and receiving this in a timely manner has been difficult. We have experienced delays and have been supplied with incorrect or irrelevant information in some instances. While this has directly impacted the progress of this testing, it is also an indicator of an absence of robust controls around these funds.</p> <p>We would expect that the Fund have controls in place based around challenging the valuations and the performance of these funds. Given the difficulties in obtaining this information for the purposes of our audit, it appears that there are inadequate controls to ensure that valuations are challenged and that investment existence is checked as a standard practice.</p> <p>We recommend that the Fund reviews the terms and conditions of its relationship with all investment service providers and seeks assurance that controls are place to ensure that the most recent audited financial statements of each fund, along with the regular capital valuation statements and any evidence of any capital transactions are received and regularly reviewed in a timely fashion.</p> <p>We also recommend that the Fund performs a review of the arrangements around pension asset investment decision making, monitoring and reporting of the valuation of those investments. This should include a retrospective review of the arrangements with respect to the specific assets that were adjusted significantly to identify the lessons that can be learned and to embed this learning into the new arrangements. The outcome from these reviews should be reported to both the Corporate Overview and Scrutiny Panel and the Pension Fund Panel.</p>

# Purpose of our report and responsibility statement

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

### What we report

Our report is designed to help the Corporate Overview & Scrutiny Panel and the Fund discharge their governance duties. It also represents one way in which we fulfil our obligations under ISA 260 (UK) to communicate with you regarding your oversight of the financial reporting process and your governance requirements. Our report includes:

- Results of our work on key audit judgements and our observations on the quality of your Annual Report.
- Our internal control observations.
- Other insights we have identified from our audit.

### What we don't report

As you will be aware, our audit was 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, our views on internal controls and business risk assessment should not be taken as comprehensive or as an opinion on effectiveness since they have been based solely on the audit procedures performed in the audit of the financial statements and the other procedures performed in fulfilling our audit plan.

### The scope of our work

Our observations are developed in the context of our audit of the financial statements. We described the scope of our work in our audit plan and again in this report.

This report has been prepared for the Corporate Overview & Scrutiny Panel and the Fund, 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.

We welcome the opportunity to discuss our report with you and receive your feedback.



**Jonathan Gooding**

for and on behalf of Deloitte LLP

St Albans

06 December 2019

# Appendices



# Audit adjustments

## Unadjusted misstatements

The following misstatements have been identified up to the date of this report which have not been corrected by officers due to their immaterial nature. We nonetheless communicate them to you to assist you in fulfilling your governance responsibilities, including reviewing the effectiveness of the system of internal control.

		Debit/ (credit) Fund account £m	Debit/ (credit) in Net asset statement £m	If applicable, control deficiency identified
<b>Misstatements identified in current year</b>				
Uncorrected Misstatement of the Valuation of the Gresham House Strategic Public Equity Fund LP	Investment assets		(2.0)	Yes
Uncorrected Misstatement of the Valuation of the Gresham House Strategic Public Equity Fund LP	Change in market value of investments	2.0		Yes
Uncorrected Misstatement of the Valuation of the WP Global Mezzanine Capital Strategy II LP	Investment assets		1.2	Yes
Uncorrected Misstatement of the Valuation of the WP Global Mezzanine Capital Strategy II LP	Change in market value of investments	(1.2)		Yes
<b>Misstatements identified in prior years</b>				
		-	-	
<b>Total</b>		<b>0.8</b>	<b>(0.8)</b>	

# Audit adjustments (continued)

## Corrected misstatements

The following misstatements have been identified which have been corrected by officers. We nonetheless communicate them to you to assist you in fulfilling your governance responsibilities, including reviewing the effectiveness of the system of internal control.

		Debit/ (credit) Fund account £m	Debit/ (credit) in Net asset statement £m	If applicable, control deficiency identified
<b>Misstatements identified in current year</b>				
Revaluation of longevity hedge:	Investment liabilities		(40.3)	Yes
Revaluation of longevity hedge:	Change in market value of investments	40.3		Yes
Revaluation of convertible bond:	Investment assets		(34.2)	Yes
Revaluation of convertible bond:	Change in market value of investments	34.2		Yes
<b>Misstatements identified in prior years</b>				
		-	-	
<b>Total</b>		<b>74.5</b>	<b>(74.5)</b>	

# Audit adjustments (continued)

## Disclosures

### **Disclosure misstatements**

The following disclosure misstatements have been identified which officers have corrected.

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#### Disclosure

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There are no significant unadjusted disclosure deficiencies in the current draft of financial statements.

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# Fraud responsibilities and representations

## Responsibilities explained



### Responsibilities:

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



### Required representations:

We have asked the Fund to confirm in writing that you have disclosed to us the results of your own assessment of the risk that the financial statements may be materially misstated as a result of fraud and that you have disclosed to us all information in relation to fraud or suspected fraud that you are aware of and that affects the Fund.

We have also asked the Fund to confirm in writing their responsibility for the design, implementation and maintenance of internal control to prevent and detect fraud and error.



### Audit work performed:

In our planning we identified valuation of the longevity hedge, valuation of the convertible bond and management override of controls as key audit risks for the Fund.

During course of our audit, we have had discussions with officers and those charged with governance.

During course of our audit, we have had discussions with relevant officers and those charged with governance.

In addition, we have reviewed officers' own documented procedures regarding fraud and error in the financial statements.

# Independence and fees

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

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## Independence confirmation

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.

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## Non-audit fees

There are proposed audit related services to be carried out regarding the issuance of assurance letters to the auditors of participating employers. There are no other non-audit fees.

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## Independence monitoring

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.

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## Relationships

We have no other relationships with the Fund, its members, officers and affiliates, and have not supplied any services to other known connected parties.

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## Independence and fees (continued)

	Planned fee £'000s (excl. VAT)
Code audit fee – Pension fund	19
Audit overrun – Pension fund	20 See note 1 below
<b>Total audit</b>	<b>39</b>
Fees for issuing IAS 19 assurance letters to other auditors in respect of participating employers	TBC See note 2 below
<b>Total assurance services</b>	<b>TBC</b>

1. We have incurred additional costs in our work on the 2018/19 audit due to difficulties and delays in obtaining information and errors identified in the report. We have agreed an overrun of £20k related to the Pension Fund.
2. Our fee for issuing IAS 19 assurance letters will be based on the hours incurred to complete the work based on the rate card below. The hours incurred is dependent on the scope of the work the requesting auditors have asked us to perform.

Grade	Fee per hour £ (excl. VAT)
Partner/director	132
Senior manager/manager	73
Audit auditor	47
Other staff	36



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