

City of London Corporation Pension Fund

DRAFT Report to the Audit and Risk
Management Committee on the Year Ended 31
March 2015 Pension Fund Audit

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The big picture

The Big Picture

We have pleasure in setting out in this document our report to the Audit and Risk Management Committee of the City of London Corporation Pension Fund for the year ended 31 March 2015 for discussion at the meeting scheduled for 20 July 2015. This report summarises the principal matters that have arisen from our audit for the year ended 31 March 2015.

This summary is not intended to be exhaustive but highlights the most significant matters to which we would like to bring your attention. It should, therefore, be read in conjunction with the report and the appendices thereto.

Status of the audit

We are satisfied that the status of the audit is as expected at this stage of the timetable agreed in our audit plan.

We have substantially completed our audit in accordance with our Audit Plan, which was presented to you prior to the commencement of the audit, subject to the satisfactory completion of the matters set out below:

- Completion of final review process on the financial statements;
- Completion of our testing on membership movements;
- Completion of our internal review processes;
- Receipt of signed management representation letter (see appendix 1); and
- Update of post balance sheet event review.

We will report to you orally in respect of any modifications to the findings or opinions contained in this report that arise on completion of these matters.

At the date of this report, and subject to the satisfactory completion of the outstanding matters referred to above, we expect to issue an unmodified audit opinion.

“I am delighted to present our final report on the findings from our 2014/15 audit.”

Heather Bygrave, Audit Partner

A reminder of our audit plan:

- Materiality: £5.1m (2013/14: £4.5m).
- Threshold for reporting misstatements: £0.252m (2013/14: £0.225m).
- Significant risks over contributions, benefits, Investments and management override of controls.



Significant audit risks

This section explains the nature of significant risks, how these risks have been addressed by our audit work and our conclusions. We also explain related presentational and/or disclosure matters within the financial statements.

1. Completeness and accuracy of contributions

Significant audit risk

Nature of risk

Unlike the positions in the private sector, we are not required to issue a separate statement on contributions for the Fund. Nevertheless, in view of the complexity arising from the participation of different employers within the Fund, we have included the identification, calculation and payment of contributions as an area of significant risk.

Impact on the financial statements and our audit challenge

Errors in processing contributions can lead to issues such as non-compliance with the Schedule of Contributions and deducting incorrect amounts from active members' payroll, which can be costly to rectify and result in reputational damage.

Work completed to address the significant risk

We have performed the following testing to address the significant risks around contributions:

- reviewed the design and implementation of controls present at the Fund for ensuring contributions from all Scheduled and Admitted bodies are identified and calculated correctly;
- we performed tests of details to test whether each material income stream was calculated in accordance with the actuarial valuation and schedule of rates; and
- we developed an expectation based on changes in membership numbers and changes in contribution rates to analytically review the contributions received in the year, the results of which fell within our tolerance level.

We note the following from our testing:

- We note that City of London as the administering authority is not responsible for the calculation of employers' contributions for each of the scheduled and admitted bodies. We have therefore performed our testing, where necessary, with the assistance of the individual bodies as necessary.

Deloitte view

We have formed a satisfactory conclusion in this area based on the results from the procedures performed.

2. Valuation of investments

Significant audit risk

Nature of risk

The scheme had investments of £817m as at 31 March 2015 and therefore a small degree of error in their valuation represents a significant risk of material misstatement.

This risk is compounded given the use of investments in unquoted investment vehicles, like private equity houses, and the use of derivatives within the scheme.

Private equity funds are complex to value and include an element of judgement on the part of the investment manager. In addition, further amounts are invested in managed funds which are complex to value due to the difficulty in visibility of the underlying investments.

Impact on the financial statements and our audit challenge

Incorrect valuations of investments can lead to misstatements in the financial statements impacting investment decisions and future recovery plans.

Audit procedures completed to address the focus area

The following tests were performed to address the significant risk around investments:

- we have reviewed the design and implementation of controls present at the Fund for ensuring investments are valued correctly;
- we have reconciled the total value of the investments held by the Fund as reported in the investment report from BNY Mellon to the value of investments reported in the Net Assets Statement;
- we have compared the valuations provided by BNY Mellon to the reports provided by the investment manager;
- we have performed a test of detail on a sample basis of quoted investment and compared the value reported by the BNY Mellon to the quoted price obtained from Bloomberg, DataStream or other third party sources;
- we have performed a test of detail on a sample basis of the unquoted pooled investments to the valuations received from the external investment managers;
- we have performed analytical review procedures to assess the reasonableness of the change in market value of investments; and
- we have used our treasury specialists to obtain confirmation of year end positions of derivatives.

Deloitte view

No issues were identified during the completion the testing.

We confirm there are no matters we wish to bring to the attention of the Committee.

3. Accuracy of benefit calculations

Significant audit risk

Nature of risk

Changes were made to the Fund from April 2008 which introduced complexities into the calculation of both benefits in retirement and ill health and death benefits which are in addition to the annual increases required by the 1997 Regulation and Pension (Increases) Act 1971.

Further changes have been implemented in 2014 which required the move to career average as the basis for calculation of benefits, effective from 1 April 2014.

The risk noted was that benefits payable could be inaccurately recorded and that unauthorised payments could be made to non-existent members.

Impact on the financial statements and our audit challenge

Incorrect benefit calculations or making payments to members who are not eligible can lead to misstatements in the financial statements, financial loss, pensioner's being wrongly paid and reputational damage.

Work completed to address the focus area

The following tests were performed to address the significant risk around benefits:

- we reviewed the design and implementation of controls present at the Fund for ensuring the accuracy, completeness and validity of benefits through discussion with the pensions team and testing that controls were in force during the year under review;
- we obtained a schedule of benefits paid and selected a sample of benefits for detailed testing. The sample was tested through agreement to supporting documentation, and review of the calculation, by reference to the qualifying service, scheme rules and benefit choices made by the member;
- confirmed that the Fund Account movements were consistent with membership movements by agreeing movements back to member documentation to verify the movement has been approved and recorded correctly; and
- we developed an expectation of pensions payable based on the prior year balance, adjusted for changes in membership numbers and pension increases to analytically review the pension benefits paid in the year.

All testing was completed with satisfactory results.

Deloitte view

We have formed a satisfactory conclusion in this area based on the results from the procedures performed. There are no matters to bring to the attention of the Committee.

4. Management override of controls

Presumed significant audit risk

Nature of risk

In accordance with ISA 240 (UK and Ireland) management override is always a significant risk. 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.

Work completed to address the significant risk

Our audit work included

- we reviewed the controls around the financial reporting process, including segregation of duties, existence of reporting manuals, reviews and processing and approval of journal entries;
- we have performed substantive testing on journal entries to confirm that they have a genuine, supportable rationale;
- we have reviewed ledgers for unusual items and on a test basis investigated the rationale of any such postings;
- we have reviewed significant management estimates and judgements such as year-end accruals and provisions and consider whether they are reasonable;
- we have made enquiries of those charged with governance as part of our planning and detailed audit processes; and
- we reviewed and challenged the financial statements and management judgements against the SORP, LGPS and UK pension regulations.

No significant issues were noted.

Deloitte view

We have formed a satisfactory conclusion in this area based on the results from the procedures performed. There are no matters to bring to the attention of the Committee.

We have not identified any significant judgements or estimates used by management and there is no indication of significant bias.

Insight - Internal control and risk management

In this section we set out our comments regarding your internal control and risk management processes. We communicate any significant deficiencies in the internal control environment to the audit committee.

Risk management and internal control systems



As set out in the “Briefing on audit matters” provided in the prior years, for controls considered to be ‘relevant to the audit’ we have evaluated the design of the controls and determined whether they have been implemented (“D&I”). We have taken a substantive approach to the audit and have not tested the operating effectiveness of controls. Our audit is not designed to provide assurance as to the overall effectiveness of the controls operating within the Plan.

Risk management and control observations

We discuss below the internal control matters that have come to our attention during the audit:

Use of dedicated Pension Fund bank account

As observed in the prior years, following the implementation of The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 that applied from 1 April 2011, the Regulations require each pension fund to have a separate bank account. Whilst the Fund has a dedicated bank account, it has not been used in line with the guidance as set out in the Regulations, with the process being that all transactions are monitored within the pooled cash account, with a net monthly transfer to the pension Fund bank account following the close of monthly accounting to clear down the pooling account.

We note that from January 2015 the bank account has been used in accordance with the regulations with contributions being received on a monthly basis.

Responsibility Statement

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 Audit & Risk Management Committee discharge their governance duties. It also represents one way in which we fulfil our obligations under ISA 260 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; and
- Our internal control observations.

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 board.
- In addition, there will be further information you need to discharge your governance responsibilities, such as matters reported on by management, the administrator or by other specialist advisers.
- Finally, our views on internal controls 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.

The scope of our work

- Our observations are developed in the context of our audit of the financial statements.
- This report should be read in conjunction with Briefing on Audit Matters which has been distributed in prior years.

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

Deloitte LLP
Chartered Accountants

St. Albans
10 July 2015

This report has been prepared for the Audit & Risk Management Committee, 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.

Appendices

Appendix 1: Draft representation letter

Deloitte LLP
3 Victoria Square
Victoria Street
St Albans
AL1 3TF

Our Ref: *HAB/RLG/2015*

Date:

Dear Sirs

City of London Corporation Pension Fund (the “Fund”)

This representation letter is provided in connection with your audit of the financial statements of the fund for the year ended 31 March 2015 for the purpose of expressing an opinion as to whether the financial statements give a true and fair view of the financial position of the Fund, in accordance with the Code of Practice on Local Authority Accounting in the United Kingdom 2014/15, the financial transactions of the Pension Fund during the year ended 31 March 2015, and the amount and disposition of the fund’s asset and liabilities as at 31 March 2015, other than liabilities to pay pensions and other benefits after the end of the fund year.

We acknowledge as members of City of London Corporation Pension Fund our responsibilities for ensuring that the financial statements are prepared which give a true and fair view, for keeping records in respect of active members of the Fund and for making accurate representations to you.

We confirm, to the best of our knowledge and belief, the following representations.

1. All the accounting records have been made available to you for the purpose of your audit and all the transactions undertaken by the Fund have been properly reflected and recorded in the accounting records. All other records and related information, including minutes of Officer and Committee member meetings, have been made available to you.
2. We acknowledge our responsibilities for the design, implementation and operation of internal control to prevent and detect fraud and error.
3. 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.
4. We are not aware of any significant facts relating to any frauds or suspected frauds affecting the Fund involving:
 - (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.
5. We have disclosed to you our knowledge of any allegations of fraud, or suspected fraud, affecting the Fund’s financial statements communicated by members, former members, employers, regulators or others.
6. We are not aware of any actual or possible instances of non-compliance with laws and regulations, the effects of which should be considered when preparing financial statements.

Appendix 1: Draft representation letter (continued)

7. Where required, the value at which assets and liabilities are recorded in the net asset statement is, in the opinion of the Authority, the fair value. We are responsible for the reasonableness of any significant assumptions underlying the valuation, including consideration of whether they appropriately reflect our intent and ability to carry out specific courses of action on behalf of the Fund. Any significant changes in those values since the balance sheet date have been disclosed to you.

8. We confirm the completeness of the information provided regarding the identification of related parties, and the adequacy of related party disclosures in the financial statements.

We have made enquiries of any key managers or other individuals who are in a position to influence, or who are accountable for the stewardship of the Fund and confirm that we have disclosed in the financial statements all transactions relevant to the Fund and we are not aware of any other such matters required to be disclosed in the financial statements, whether under Statement of Recommended Practice – Financial Reports of Pension Schemes (revised May 2007) (“Pensions SORP 2007”), Code of Audit Practice on Local Authority Accounting in the United Kingdom in 2014/15: based on International Financial Reporting Standards or other regulations.

9. We confirm that the financial statements have been prepared on the going concern basis. We do not intend to wind up the fund. We are not aware of any material uncertainties related to events or conditions that may cast significant doubt upon the Fund's ability to continue as a going concern. We confirm the completeness of the information provided regarding events and conditions relating to going concern at the date of approval of the financial statements, including our plans for future actions.

10. You have been informed of all changes to the Fund rules during the year and up to the current date.

11. We have not commissioned advisory reports which may affect the conduct of your work in relation to the Fund's financial statements.

12. No claims in connection with litigation have been or are expected to be received.

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

14. There have been no events subsequent to 31 March 2015 which require adjustment of or disclosure in the financial statements or notes thereto.

15. There have been no irregularities involving management or employees who have a significant role in the accounting and internal control systems or that could have a material effect on the financial statements.

16. The pension fund accounts and related notes are free from material misstatements, including omissions.

17. The Fund has complied with all aspects of contractual agreements that could have a material effect on the financial statements in the event of non-compliance. There has been no non-compliance with requirements of regulatory authorities that could have a material effect on the financial statements in the event of non-compliance.

18. The Fund has satisfactory title to all assets.

19. We have recorded or disclosed, as appropriate, all liabilities, both actual and contingent.

Appendix 1: Draft representation letter (continued)

20. No transactions have been made which are not in the interests of the members of the Fund during the Fund year or subsequently.
21. We confirm that:
- all retirement benefits and schemes, including UK, foreign, funded or unfunded, approved or unapproved, contractual or implicit have been identified and properly accounted for;
 - all settlements and curtailments have been identified and properly accounted for;
 - all events which relate to the determination of pension liabilities have been brought to the actuary's attention;
 - the actuarial assumptions underlying the valuation of the scheme liabilities (including the discount rate used) accord with the directors' best estimates of the future events that will affect the cost of retirement benefits and are consistent with our knowledge of the business;
 - the actuary's calculations have been based on complete and up to date member data as far as appropriate regarding the adopted methodology; and
 - the amounts included in the financial statements derived from the work of the actuary are appropriate.
22. All trades in complex financial instruments are in accordance with our risk management policies, have been conducted on an arm's length basis and have been appropriately recorded in the accounting records, including consideration of whether the complex financial instruments are held for hedging, asset/liability management or investment purposes. None of the terms of the trades have been amended by any side agreement and no documentation relating to complex financial instruments (including any embedded derivatives and written options) and other financial instruments has been withheld.
23. We confirm that the Pension Fund Annual Report is compliant with the requirements of Regulations 34(1)(e) of the Local Government Pension Scheme (Administration) Regulations 2008 and related guidance.
24. We confirm that the information that is contained within the Pension Fund Annual Report and Accounts for the year to 31 March 2015 is complete, accurate and consistent with the information that is contained within the Accounts.

We confirm that the above representations are made on the basis of adequate enquiries of other officials of the Fund (and where appropriate, inspection of evidence) sufficient to satisfy ourselves that we can properly make each of the above representations to you.

Yours faithfully

Signed on behalf of City of London Corporation Pension Fund

Appendix 2: Audit adjustments

Unadjusted misstatements detail

Uncorrected misstatements

We report all individual identified uncorrected misstatements in excess of £252,000 (2014: £225,000) for the financial statements. There are no such misstatements that we would like to bring to the attention of the Committee.

Disclosure misstatements

Auditing standards require us to highlight significant disclosure misstatements to enable those charged with governance to evaluate the impact of those matters on the financial statements.

There were no disclosure deficiencies noted as part of our audit.

Appendix 3: Consideration of Fraud

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.

The primary responsibility for the prevention and detection of fraud rests with management 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.

ISA (UK and Ireland) 240 – ‘The auditor’s responsibility to consider fraud in an audit of financial statements’ requires us to document an understanding of how those charged with governance exercise oversight of management’s processes for identifying and responding to the risks of fraud in the Fund and the internal control that management has established to mitigate these risks. It also requires us to presume there is a risk of fraud in respect of revenue recognition; however, considering the nature of the Fund and the revenue streams (mainly contributions and investment income) we have rebutted this risk.

We have made inquiries of management and others within the Fund as appropriate, regarding their knowledge of any actual, suspected or alleged fraud affecting the Fund. In addition, we are required to discuss the following with the Trustee:

1. Whether the Trustee have knowledge of any fraud, alleged or suspected fraud
2. The role that the Trustee exercise in oversight of the:
 - Assessment of the risks of fraud and
 - Design and implementation of internal controls to prevent and detect fraud
3. The Trustee’s assessment of the risk that the financial statements may be materially misstated because of fraud.
4. Whether the Trustee have disclosed to us all information in relation to any fraud, alleged or suspected fraud

Representations from the Committee in this area is included in the draft letter of representation attached as Appendix 1.

Appendix 4: Independence and fees

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

Independence confirmation

We confirm that we comply with APB Ethical Standards for Auditors and that, in our professional judgement, we are independent and our objectivity is not compromised.

Fees

Our fee for the audit of the 2015 accounts was £21,000 plus disbursements and VAT (2014: £21,000).

Non-audit services

In our opinion, there are no inconsistencies between APB Ethical Standards for Auditors and the plan's policy for the supply of non-audit services or of any apparent breach of that policy. 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 advise as necessary.

Relationships

There are no business or personal relationships to report.

Appendix 5: Topical matters in the Pensions World

For reference, the following developments in financial reporting or regulatory matters may impact the financial statements and operations of the Scheme:

Changes in accounting standards: The 2015 Pensions SORP

The 2015 Pensions SORP was published in November 2014 and is effective for scheme year-ends commencing on or after 1 January 2015. The Scheme will therefore have to adopt this revised SORP for the year ending 31 March 2016.

The most fundamental changes to the revised SORP are the implementation of a fair value hierarchy for investments and the introduction of disclosure requirements for credit and market risks that a scheme is exposed to. In the majority of cases, these requirements will require pension scheme accountants to enhance their knowledge of investment pricing and strategy and require some practical considerations at the planning stage, perhaps far in excess of current practice.

There is also a key change to accounting policies for annuities held in the name of the Trustee. The previous SORP allowed annuities to be valued at nil on the net assets statement whereas the revised SORP comments that these should be valued at the amount of the related obligation.

The fair value hierarchy defined by FRS 102 is not the same as IFRS. The SORP requires the use of the following hierarchy to estimate the fair value of investments, with the split within category (c) being optional:

SORP	Category a	Category b	Category c(i)	Category c(ii)
	Quoted daily price	Recent price	Valuation technique "Observable inputs"	Valuation technique "Non-observable"
Examples	Equities Exchange traded derivatives	Weekly priced PIVs	OTC derivatives Investment property	Private Equity Insurance policies
IFRS	Level 1	Level 2		Level 3
	Quoted daily price	Valuation technique with observable inputs (other than quoted prices)		Unobservable inputs

Investment risk disclosures

The SORP requires pension schemes to disclose information that enables users of its financial statements to evaluate the nature and extent of credit risk and market risk arising from financial instruments to which the scheme is exposed.

FRS 102 defines credit risk as the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.

FRS 102 defines market risk as: the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk:

- Interest rate risk – the risk that the fair value of future cash flows of a financial instrument will fluctuate because of changes in market interest rates.
- Currency risk – the risk that the fair value of future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.

Appendix 5: Topical matters in the Pensions World (continued)

Changes in accounting standards: The 2015 Pensions SORP (continued)

- Other price risk – the risk that the fair value of future cash flows of a financial instrument will fluctuate because of changes in market prices (other than those arising from interest rate risk or currency risk), whether those changes are caused by factors specific to the financial instrument or its issuer, or factors affecting all similar financial instruments traded in the market.

For each type of credit and market risk arising from financial instruments, the SORP requires the following disclosures:

- a) the exposures to risk and how they arise;
- b) its objectives, policies and processes for managing the risk and the methods used to measure the risk; and
- c) any changes in the above from the previous period.

At the end of June 2015, PRAG, in conjunction with the IMA, issued some detailed guidance on investment disclosures under the new SORP.

Annuities

The main change to accounting policies for pension schemes arising from the revised SORP relates to the requirement to value annuity policies at the amount of the related obligation. FRS 102 requires annuities, defined as an insurance policy that exactly matches the amount and timing of some or all of the benefits payable under the scheme, to be fair valued. The fair value of the asset is deemed to be the present value of the related obligation. The opportunity to value these policies at nil under the previous SORP has therefore been removed in the revised SORP.

The present value of the related obligation will depend on the basis of the valuation of the scheme liabilities. The SORP recommends that the basis adopted by the Trustee for pension scheme financial statements reflects the circumstances and purpose of the annuity arrangements. For example, if the intention is to hold the annuities in the scheme for the long term then the scheme funding valuation basis would seem most appropriate. If the annuity has been purchased with a view to moving to a buy-out then the Trustee may consider the buy-out basis more appropriate.

Appendix 5: Topical matters in the Pensions World (continued)

VAT

VAT remains a key issue for pension funds and their sponsoring employers. Pension funds often pay the wrong amount of VAT because the rules are increasingly complex and often misunderstood.

Whilst it is likely that VAT legislation will rumble on for some time, there are a number of steps that a pension fund and its sponsoring employer should be taking now.

HM Revenue & Customs issued two briefs on 26 November 2014 – 43/14: VAT on pension fund management costs and 44/14: VAT treatment of pension management services, by way of updated guidance following the CJEU judgements in *Fiscale Eenheid PPG Holdings BV* and *ATP Pension Services (ATP)*.

Employer/pension fund arrangements

The European Court decision in *Fiscale eenheid PPG Holdings BV cs te Hoogezand (PPG)* suggests that there may be significantly more scope for employers to recover VAT for costs incurred in connection with the operations of a pension fund.

In HMRC's brief addresses the following themes:

- The factors to be considered relevant when deciding whether pension-related services can actually be viewed as supplied to the employer include: (i) the payment and invoicing arrangements, (ii) "contemporaneous evidence" that the services are provided to the employer, and (iii) whether the employer is a party to the contract for services;
- In a departure from their prior position, HMRC now accept that there are no grounds to differentiate between costs incurred in the administration of a pension scheme and the management of assets; and
- HMRC view any recharges by an employer to the pension scheme as consideration for an onward taxable supply and consider that VAT should be charged accordingly.

Liability

The European Court recently found in *ATP Pension Services A/S (ATP)* that defined contribution (DC) schemes should be treated on a par with other 'special investment funds'.

In the brief HMRC accepts that eligible pension funds that many services provided by their managers or administrators should be, and always should have been, exempt from VAT. Trustees will need to determine whether any irrecoverable VAT has been incurred and take appropriate protective steps.

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