Financial Reporting Council

THE AUDIT OF DEFINED BENEFIT PENSION OBLIGATIONS

FINDINGS FROM 2017/18 AUDIT QUALITY REVIEWS

JULY 2018

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The audit of defined benefit pension obligations

Findings from 2017/18 audit quality reviews

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1 Background

In December 2016, the FRC announced that one of the areas that its audit quality monitoring during 2017-18 would pay particular attention to would be the audit of pension balances and disclosures. Our subsequent audit inspection work identified both weaknesses and examples of good practice which we felt would be of benefit to auditors, audit committees and investors to publish in a separate report.

The FRC's Corporate Reporting Review ('CRR') team has also completed a thematic review on pensions disclosures and published its report[1] in November 2017. This report should therefore be read in conjunction with the CRR report.

1.1 Why focus on the audit of pensions?

For many companies with defined benefit pension obligations, whilst the net pension obligation appearing on the balance sheet may not in itself be significant, the related pension assets and liabilities are significant balances. The valuation of these assets and liabilities rest on a range of assumptions and management judgements and are at risk of material misstatement or manipulation through management bias. To demonstrate the impact of the assets and liabilities on the financial statements, the following table sets out for the FTSE 100 companies with the largest pension scheme liabilities, both the gross assets and liabilities, the resultant net defined benefit liability/asset ('deficit/surplus') and the level of materiality set by the auditor. As can be seen from the table, a misstatement in either/ both the pension scheme assets or liabilities could easily lead to a material misstatement in the net defined benefit liability/asset in the entity's financial statements.

1 **http://www.frc.org.uk/getattachment/538ec144-05a0-499c-99b4-3f93bd21ad0b/091117-Pension-Disclosures-CRR-thematic-review.pdf**

Table 1: Ten largest FTSE 100 pension schemes – 2016 Annual Reports

Company	Defined benefit obligation £m	Pension scheme assets £m	Net defined benefit (liability)/ asset £m	Audit materiality £m
Royal Dutch Shell	72,788	62,665	(10,123)	617
BT Group	50,350	43,968	(6,382)	130
Lloyds Banking Group	45,822	45,578	(244)	325
RBS	43,990	49,229	5,239	270
BP	39,689	32,970	(6,719)	405
Barclays	33,033	32,657	(376)	320
BAE Systems	32,307	25,708	(6,599)	55
HSBC Holdings	32,235	34,384	2,149	770
National Grid	25,561	24,537	(1,024)	157
International Airlines Group	25,056	24,451	(605)	n/a[2]

Over the last few years, to reduce the risks and costs of funding pension schemes, scheme trustees have engaged in risk and financial management transactions, such as liability-driven investment strategies, partial buy-outs, and longevity swaps, adding further complexity to valuation judgements. Auditors therefore need to exercise sufficient professional scepticism when auditing these accounting estimates. Auditors will often engage their own experts to provide assistance in auditing valuations for both the pension obligation and these more complex investment assets.

The audit of pensions is further complicated by companies often having numerous schemes with differing benefit structures, arising from past acquisitions which may also include both private and public sector arrangements, and both open and closed schemes. Schemes will also use a range of investment managers and custodians to manage the pension scheme assets, and may engage a pension administrator to maintain membership details, collect contributions and pay benefits. In the light of the different parties involved, the auditor will need to decide upon whether they can rely on the work of the auditor of one or more of these parties or whether they need to perform their own audit work. The use of these management experts and service organisations therefore needs to be carefully considered when planning the audit.

2 Company not registered in the UK and therefore was not required to disclose the level of materiality in the auditor's report

Companies will employ an actuary to calculate annually the defined benefit obligation to be included in the financial statements. This is calculated on an accounting basis under International Accounting Standard 19 ('IAS19') which is a different basis to that used by the scheme actuary for the periodic (usually three years) actuarial valuation for the scheme trustees. All actuarial work should be performed in compliance with the FRC's Technical Actuarial Standards[3].

Where a company has a significant net defined benefit liability, the directors should carefully consider how this may affect the company's future viability or going concern. They should make sure that the relevant disclosures in the annual report and financial statements are fair, balanced and understandable so that users of the financial statements have the information they need to understand the risks that funding the pension scheme puts on the business. Auditors will need to evaluate the adequacy of these disclosures.

Auditing the company's defined benefit obligations and related pension assets therefore encompasses a number of the more complex aspects of audit including: auditing significant accounting estimates, use of service organisations and management's experts, use of auditor's experts, using the work of other auditors and the audit of disclosures. Audit teams need to tie all of the key threads together, carrying out their work with appropriate professional scepticism, to reach overall soundly-based conclusions.

1.2 Scope of our review

In 2017/18 we reviewed 125 audits. In selecting which aspects of an audit to review, we take account of those areas considered to be higher risk by the auditors and Audit Committees, our knowledge and experience of audits of similar entities, and the significance of an area in the context of the financial statements. As we had identified the audit of pensions as an area of focus, for 51 audits of entities with significant pension schemes, we selected this area for review. These were selected across all of the audit firms[4] that we inspected during the year.

Actuaries from the FRC's actuarial policy team supported the FRC's Audit Quality Review team's review of the audit of pension scheme balances in the annual financial statements. The scope of the actuarial team's review focused on the review of the audit of the actuarial calculations of the pension liabilities against the auditing standards.

3 **https://www.frc.org.uk/actuaries/actuarial-policy/technical-actuarial-standards/technical-actuarial-standards-2017**
4 BDO (UK) LLP, Deloitte LLP, EY LLP, Grant Thornton LLP, KPMG (UK) LLP, Moore Stephens LLP, PKF Littlejohn LLP, PwC (UK) LLP, PwC Barbados, UHY Hacker Young LLP

2 Improvements for auditors and audit committees

Overall we concluded that there was some scope for improvement in a number of aspects of the work that auditors and their experts carry out in what is a very important area of the audit.

- In a quarter of audits we identified good practice in aspects of the pensions audit work performed and in eight audits we identified no areas for improvement.
- In just under half of the audits reviewed we found at least one aspect of the audit work performed over pensions where limited improvements were required. In two of these audits, the weaknesses we identified in relation to aspects of the pensions audit work performed contributed to assessing the overall audit work as requiring more than limited improvement.

We saw both scope for improvement and good practice in the same areas of the audit procedures performed at the same firms. We expect audit firms to perform root cause analysis on our findings to assist in achieving greater consistency across the audits that they deliver. To promote continuous improvement by auditors, we set out below a summary of those areas of auditing pension fund balances where auditors can bring about improvement by:

- carefully assessing the risk for the more sensitive assumptions and planning and performing appropriate procedures to conclude on the valuation of the defined benefit obligation (section 3.1.1).
- clearly evidencing the work done by the auditor's actuarial expert to assess the valuation of the defined benefit obligation and explaining the basis for the conclusions arrived at, on which the auditor relied in forming their opinion on the financial statements (section 3.1.2).
- considering, evidencing clearly and, where appropriate, communicating to the Audit Committee the financial impact of key assumptions at the optimistic or pessimistic end of the acceptable range, along with the auditor's view on whether the actual assumptions are at the appropriate place in the range, taking into account the specific circumstances of the entity (section 3.1.3).
- considering whether the source data used to calculate the valuation of the defined benefit obligation is materially accurate and complete, and performing appropriate audit procedures to be satisfied that a material misstatement is unlikely to arise (section 3.1.4).
- where the IAS 19 valuation of the defined benefit obligation has been calculated by adjusting and rolling forward the last triennial actuarial valuation, clearly evidencing the audit work done on this roll forward and clearly explaining how the auditor's conclusions have been reached (section 3.1.5).

- clearly analysing the different categories of investment assets and how they planned to obtain sufficient audit evidence for each of these categories so as to obtain a sufficient level of audit evidence for "harder to value" assets (section 3.2.1).
- obtaining sufficient audit evidence to support the allocation of the defined benefit obligation and pension scheme assets in a multi-employer scheme (section 3.2.2).
- carefully considering the completeness and accuracy of the pensions related disclosures in the financial statements and reporting errors or omissions to the Audit Committee (section 3.3).
- considering whether reference to the audit work on pensions should be included in the auditor's report and ensuring that the auditor's report clearly and accurately reports the audit procedures performed (section 3.4).

Further detail of our principal findings is set out in section 3.

In response to the findings from our reviews of the audit work in this area, a number of audit firms have already provided refreshed guidance to their audit teams to support them in their audit of the defined benefit obligation and related pension assets.

Audit Committees

Where companies have significant pension scheme balances, we expect Audit Committees and auditors to discuss the findings in our report and consider whether the audit approach taken could be enhanced. In particular, Audit Committees should ensure that:

- they discuss with their auditor how they have reached their independent estimates and ranges and how these have been used to benchmark against management's assumptions.
- their auditor clearly communicates the financial impact of assumptions that are at the optimistic or pessimistic end of the range.
- they consider whether the assumptions are positioned at an appropriate place in the range bearing in mind the circumstances of the entity, for example the economic environment and how changes in assumptions within a range impact upon the entity's reported financial performance.
- they clearly understand whether their auditor has taken a controls-based or substantive approach to the audit of the scheme assets and, in particular, where these are material, how the auditor has obtained evidence over the harder to value assets.

3 Principal findings

3.1 Defined benefit obligations

The valuation of the defined benefit obligation is a complex calculation involving a number of significant judgements and assumptions. Auditors should therefore adequately assess the risk of material misstatement and obtain sufficient audit evidence to support the basis of judgements, assumptions and methodologies used to assess whether the obligations are appropriately valued.

3.1.1 Assessment of defined benefit obligation valuation risk

The auditor is required to assess, for each balance in the financial statements, whether there is a risk of material misstatement. If so, this should be identified by the auditor as a significant risk requiring a greater level of audit evidence to be obtained.

In half of the audits we reviewed, the valuation of the defined benefit obligation was identified by the audit team as a significant risk of material misstatement. In many cases, the audit team specified the key assumptions, applied in the valuation, where the risk of material misstatement was most likely to arise. We identified one case (case study example A) where this risk assessment did not adequately consider one of the assumptions which was sensitive to change and could have had a significant impact on the financial statements.

CASE STUDY EXAMPLE A[5]

The group operated a defined benefit pension scheme with a net defined benefit liability of £100 million at the year-end. The pension note disclosed that an increase in the mortality rate assumptions by one year would increase the obligation by £83 million. Materiality was £8 million.

The mortality rate assumptions had been adjusted to account for the actual experience of the scheme when compared to standard mortality tables, increasing the level of judgment involved in setting the assumption.

The audit team did not evidence why they did not consider the mortality rate assumptions to be a significant risk given the sensitivity of the pension scheme obligation to this assumption and the use of scheme-specific adjustments.

5 The amounts have been altered to preserve confidentiality

For the remaining half of the audits where the valuation of the defined benefit obligation was not identified as a significant risk of material misstatement, we identified one audit where we considered that the audit team should have treated this valuation as a significant risk area, given the judgemental nature of pension scheme assumptions and the significant size of the defined benefit obligation.

Key assumptions used in calculating the pension obligations are subjective and involve significant judgement. Audit teams should therefore assess the risk for the more sensitive assumptions appropriately and plan and perform appropriate procedures in order to conclude on the valuation of the defined benefit obligation.

3.1.2 Use of the auditor's actuarial expert in the audit

When the auditor needs to use actuarial expertise to challenge effectively the assumptions used and key judgements reached in valuing the defined benefit obligation, this is often done by engaging an actuarial specialist who is part of the audit team, or by engaging an actuarial expert to perform some specific work and report to the audit team. In most of the audits we reviewed the auditor had engaged an actuary as either a specialist or an expert. The scope of the actuaries' work supporting the audit generally included a review of the key assumptions underpinning the valuation and checking the calculation of and the movement in the defined benefit obligation over the financial year.

Where the actuarial expert is not a member of the audit team, the actuarial expert's working papers are not included on the audit file. Instead, the main audit evidence is the expert's report to the audit team. This report should include sufficient information for the audit team to fully understand the actuarial expert's work, the judgements made and the basis for the conclusions and opinions expressed by the expert. Where the actuary is a member of the audit team, all of their working papers should be included on the audit file as audit evidence.

GOOD PRACTICE EXAMPLES

Strong use of specialists/auditor's experts

In a number of audits, we saw good integration of the work of the audit team, the auditors' actuarial expert and management's actuarial expert for the group's defined benefit obligations. In particular, we observed that the audit team demonstrated a good understanding of their actuarial expert's findings in respect of the key judgements over pension obligations and there was effective use of and follow up of the auditor's expert work.

In another case, we considered the auditor's actuaries work to be of a particularly high standard, as they comprehensively and clearly set out the procedures that they had undertaken to assess the reasonableness of the key assumptions and their recommendations to the audit team.

In some of the other audits that we reviewed, it was not always clear whether the actuaries were or were not part of the audit team and hence what type of evidence should have been included on the audit file (the requirements of auditing standards in terms of evidence requirements differ depending upon whether or not the actuaries are deemed to be part of the audit team).

On a quarter of audits, where the auditor's actuary provided a report to the audit team, the evidence of the work performed by the auditors' actuary did not fully explain the basis for the conclusions arrived at and reported to the audit team.

CASE STUDY EXAMPLE B

The auditor's actuary's report to the audit team did not sufficiently demonstrate how certain aspects of the assumptions and methodology used in the valuation of the defined benefit obligation had been evaluated. In particular, there was insufficient evidence of:

- Appropriate challenge of certain key changes in assumptions from prior periods, such as the RPI to CPI differential and the use of updated mortality tables;
- The basis on which reasonable ranges for assumptions had been determined by the auditor's actuary, and why they were appropriate for these schemes; and
- The specific checks and procedures that had been completed by the auditor's actuary in the course of their work.

As the reporting did not fully reflect the work performed by the actuarial expert, it was difficult to understand how the audit team had fully evaluated the adequacy of the actuary's work and whether it was sufficient under auditing standards.

3.1.3 Evidence to support key actuarial assumptions

The estimation of the value of the defined benefit obligation is heavily reliant upon a number of key assumptions about the future and may be susceptible to management bias. Management and their actuaries use significant judgement to set the assumptions used to value the pension scheme liabilities. The valuation can also be sensitive to these key assumptions.

On the audits that we reviewed, the key assumptions used to estimate the defined benefit obligation were discount rates, inflation rates and mortality rates. In most cases, the auditor assessed each of the key assumptions against an independent estimate and/or acceptable range for that assumption. In most cases the auditor considered whether the assumptions were within the acceptable range and assessed whether they were at the optimistic or pessimistic end of this range. If the assumptions were outside the range, the auditor would be required to challenge management to bring their assumptions within the range.

For each key assumption, it is important that the auditor obtains sufficient audit evidence to demonstrate how their independent estimate or acceptable range has been reached, and therefore how the auditor has concluded that management's assumptions are appropriate. It is important for the auditor to understand where assumptions sit on the acceptable range and to consider whether this is appropriate to the entity's circumstances. They also need to consider the sensitivities to assess the impact on the financial statements of changes in any of these key assumptions. This is therefore an important area where auditors should clearly evidence the audit work performed, showing how they have exercised professional scepticism and challenged management's judgments.

For the discount rate, the most common approach was for the audit team to develop an independent estimate or acceptable range for their expected discount rate. In some cases, this was determined centrally by the firm's valuations team and then made available to be used on each audit. We noted five cases where the derivation of the independent estimate and the acceptable range by the valuations team could have been more clearly evidenced.

The mortality rate assumptions (how long pension scheme members are expected to live following retirement) have two main components: a) the base mortality table, reflecting current mortality rates and which may be based on a mortality study of the scheme members and b) the allowance for future mortality improvements, which is generally determined using a mortality projection model. In general, audit teams, or their experts, assessed the appropriateness of the mortality assumptions by benchmarking the expectation of life at age 65 across the firm's other audit clients, and checked if the assumption used was consistent with that used in the prior valuation. On benchmarking, on some audits we saw evidence of recognition that mortality experience varies across many factors such as occupation and socio-economic groups and there was consideration of where in the benchmarking of expectation of life an individual entity's experience would be expected to be.

Where the auditor's expert determined an acceptable range, we noted instances where they did not set out in their report in sufficient detail the basis for determining the range or why that range was appropriate for that particular scheme. For example, we saw a number of cases where the actuary used 'traffic light coloured' ranges (green, amber and red) to represent the reasonable ranges calculated for each assumption. This style of reporting did not provide sufficient information on how wide or narrow each range was, and did not indicate which of the assumptions were the most significant. In some cases, the independent estimates appeared to be drawn from benchmarking exercises performed by the firm's actuaries pulling together assumptions from models that each of the main actuarial consultants were recommending to their clients. Where this approach was adopted, the evidence to support the estimate or range was not evidenced.

CASE STUDY EXAMPLE C

There was insufficient evidence to support the basis of conclusions for the following key assumptions reviewed by the audit team's actuaries, and insufficient evidence that the audit team had followed these matters up:

- ***Discount rate*** – The actuary noted that the discount rate was at the upper end of the range but was reasonable based on additional independent analysis performed. However, there were no details of the independent analysis performed, such as evidence of the underlying yield curves used.
- ***Salary increases*** – There was no justification why an assumed long-term real decrease in salaries was deemed appropriate.
- ***Mortality rates*** – The actuaries concluded that the scaling factors applied to the mortality rates were at the optimistic end of their reasonable ranges but acceptable. There was insufficient consideration of why the scaling factors were appropriate and how these were applicable for the population demographics for each scheme.
- ***Cash commutation*** – There were no calculations or analysis to support the actuaries' conclusion that the prudent assumption of no commutations would be offset by other optimistic assumptions.

In a small number of cases, we found little evidence of consideration of the potential financial impact of the compounding effect of key assumptions where they had been assessed as being at the optimistic or pessimistic end of the acceptable range. In addition, it is important that this financial impact is communicated to the Audit Committee to assist them in concluding as to whether assumptions had been set at a reasonable level.

CASE STUDY EXAMPLE D

The audit team's actuaries reviewed each assumption individually and compared them to their central assumptions. They concluded that two of the assumptions (life expectancy and discount rate) were slightly optimistic, and that one of the assumptions (RPI inflation) was optimistic and on the outer limit of the acceptable range. The actuaries concluded that the combined effect of the three optimistic assumptions, when compared to the actuary's central assumptions, was acceptable. The audit team did not articulate why they concluded that the combined effect of the three optimistic assumptions taken together was acceptable and did not indicate a potential material misstatement, when compared to their actuary's central assumptions.

In a small number of cases, there was little evidence of the application of an appropriate level of scepticism being applied in the consideration of the reasonableness of the economic assumptions. In particular, in these cases we noted a lack of consideration of the broader environment in which the audited entity was operating and whether it was appropriate to adopt optimistic or pessimistic assumptions in all areas.

3.1.4 Testing of source data provided to the actuary

In calculating the defined benefit obligation at the year end, the entity's actuary relies on the accuracy of the source data provided to it by the entity and the pension scheme administrators. In most cases the entity's actuary states in their report to management that they have not verified the accuracy of the source data provided to them. In addition, the work of the audit team's actuarial expert rarely included a review of the data underpinning the calculation of the defined benefit obligation.

In a quarter of the audits that we reviewed, the audit team could have more clearly evidenced their work on the completeness and accuracy of certain aspects of the source data provided to the actuary, for example verification of current employee payroll data and the contributions paid over to the scheme and of the benefits paid by testing a sample of benefits paid to supporting documentation.

In evaluating the accuracy of the defined benefit obligation calculation, the auditor should consider whether the source data on which the calculation is based is materially accurate and complete and perform appropriate audit procedures to be satisfied that a material misstatement is unlikely to arise.

3.1.5 Testing of 'roll forward' approach

Pension schemes trustees are required to obtain triennial funding valuations. The valuation of the defined benefit obligations in the company's financial statements are usually determined using a roll-forward of data and assumptions from the latest triennial scheme funding valuation, adjusted for IAS 19 assumptions and methodologies and allowing for changes in experience and assumptions since then. On a quarter of the audits we reviewed, where the auditor's actuary was responsible for reviewing this roll forward, there was no evidence of the actual review they had completed, simply an assertion that it had been checked, with a limited explanation of the roll-forward methodology and how the methodology had been applied.

GOOD PRACTICE EXAMPLES

Testing of roll-forward approach

We saw an example of good practice at one firm where evidence was provided that the auditor's actuary had replicated the roll-forward independently. In another audit the movement was split into its component parts and the movements validated. For example, the impact of changes in assumptions was split by assumption.

As this is an important element of the estimation of the valuation of the defined benefit obligation, we would expect all audits to set out clear evidence of the work done on the roll forward and how the conclusions had been reached. Whilst we are not suggesting that this approach is the only approach, we would expect to see a review of the roll-forward calculation and that this review be clearly evidenced.

3.2 Pension scheme assets

Pension scheme assets are significant balances and even small changes can have a material effect on the financial statements. Whilst a number of pension scheme asset types are easy to value, pension schemes have increasingly invested in harder to value assets to reduce risk and/or provide greater returns.

It is important that auditors develop appropriate audit procedures for the different investment types to obtain assurance over the existence, ownership and valuation of pension assets which are managed by external entities.

3.2.1 Testing of asset valuations

The structuring of a pension scheme's investment asset portfolios can be complex with:

- a number of different investment managers responsible for varying types of investment assets,
- custodians with responsibility for all or part of the investments held, and
- a range of investments from those that are easy to value (e.g. quoted equities) to harder to value assets (e.g. longevity swaps).

GOOD PRACTICE EXAMPLES

Effective pension asset testing

In one case we considered the audit team's risk assessment set out very clearly the nature of the investment assets, how the investment managers were remunerated and whether there was a recent audit opinion for the investment fund. In another case, the audit team performed effective procedures over the allocation of the assets in a multi-employer retirement benefit scheme arrangement and over the valuation of harder to value scheme assets.

In a number of audits that we reviewed, we identified areas where aspects of the testing of asset valuations could be improved. In a number of cases, auditors did not fully explain whether they were adopting a controls-based or substantive approach to the audit of investments, or whether their audit approach was suitably tailored to address the specific risks that different types of investment might present.

Controls reports

A number of audit teams sought to obtain investment manager controls reports to obtain evidence over the valuation of investments. Not all investment managers prepare these reports and, in some cases, particularly for harder to value assets, no alternative procedures were performed other than to obtain a valuation report directly from the investment manager. Where the investment manager is the sole provider of the valuation for the investment, an investment manager valuation report does not provide any additional evidence and further audit procedures should be performed.

CASE STUDY EXAMPLE E

The audit team obtained assurance from their review of investment manager controls reports for four of the six schemes' managers. For the other two managers, in one case the controls report was received too late to be considered and the other manager did not produce a controls report. Additional valuation testing should have been performed in the two cases where controls reports were not available.

Investment manager control reports are often not coterminous with the entity's year end. In a number of audits that we reviewed, the audit team obtained "bridging letters" to the year end. Where such letters were not obtained, though, no additional audit procedures were performed to cover the intervening period.

In some cases, we noted that audit teams sought both to obtain controls reports to obtain evidence over the valuation of the investments and also obtained independent valuation reports and performed detailed valuation substantive testing. In these cases, it was not clear from the audit file whether the audit team were taking a controls-based approach or a substantive approach to the audit.

It is important for the audit team to be clear about the approach that they are planning to take to the audit of pension scheme assets so that they can determine what sources of evidence they need to obtain and from whom.

Materiality for testing assets

Pension scheme assets are often a significant balance. The audit team needs to set an appropriate level of performance materiality[6] to obtain sufficient and appropriate audit evidence and to identify any potential material misstatements in the financial statements in relation to the pension assets.

6 The auditor uses performance materiality to assess the risks of material misstatement and determine the nature, timing and extent of audit procedures. Performance materiality is a percentage of overall materiality.

In order to minimise the risk of the aggregate of uncorrected misstatements being material, auditors set 'performance materiality' thresholds as a basis for planning and performing their work. The auditor also uses performance materiality to determine the nature, timing and extent of audit procedures. In two audits that we inspected, the firm's methodology allowed the audit team to use an "acceptable error rate" for testing the valuation of pension scheme assets of between 20 and 30 times performance materiality. As a consequence, the sample sizes calculated for testing the valuation of assets were reduced. Whilst the audit teams in both cases increased the calculated sample sizes by 30%, it was not clear that the sample sizes were adequate to test the underlying pension assets in order to be able to conclude that the asset valuations were not materially mis-stated.

Investment types

Some audit teams did not clearly set out their audit approach to the pension scheme assets and sought to obtain the same audit evidence regardless of the ease with which each investment type could be valued or the proportion of those assets held. In a number of cases, investments were not stratified by the auditor according to valuation risk to plan an appropriate audit approach, and samples for testing were spread across categories of investments based on asset values in each category rather than the risk.

CASE STUDY EXAMPLE F

Approximately 80% of the scheme investments were straightforward to value (equity, fixed income and cash). The audit team identified that the remaining 20% of investment were held in "hard-to-value" categories (property, private equity and derivatives) with a higher valuation risk. The audit team selected the sample of investment holdings for testing on a pro-rata basis based on the relative value of each investment category. Insufficient procedures were performed to respond to the higher valuation risk for the hard-to-value assets.

CASE STUDY EXAMPLE G

In one audit, the entity operated more than ten different pension schemes. The audit team opted only to perform valuation testing for half of the schemes, although the firm's guidance suggested sampling from each portfolio. The audit team did not explain how this approach gave sufficient evidence across all scheme managers, given that each manager was responsible for different asset types and had different systems and controls.

For example, where the value in a category held is small and the valuation risk is low, a reasonableness check against market data may provide sufficient evidence. However, where the value held in a category is significant and the valuation risk is high, independent valuation testing should be performed, or the adequacy of the controls used by the investment manager to perform the valuation should be assessed using control reports.

3.2.2 Split of assets for multi-employer schemes

Some company groups are contributors to multi-employer schemes where several employers make contributions which are based on the liabilities apportioned to their employees and the share of the total assets allocated to them. Our reviews covered a small number of groups that participated in these types of scheme. In two cases, we identified that the audit team did not obtain sufficient evidence over the liabilities and assets allocated to the schemes. For example:

- In one case, no independent confirmation was obtained from the custodian of the asset split and the asset split was not reconciled to the latest audited accounts of the total scheme which disclosed the allocation to each participant.
- In another audit, the audit team explained that, for one entity, the entity had an immaterial participation in a multi-employer scheme so it was accounted for as a defined contribution scheme. The audit file did not contain any details or assessment of the obligations and contributions relating to the entity's participation to the scheme to confirm that it was immaterial and that it was appropriate to treat it as a defined contribution scheme.

3.3 Pension disclosures

The financial statements provide important information to users of the financial statements and complete and accurate disclosures help investors make their investment decisions. Information about the pension scheme can have a significant impact on investors decisions.

Our review highlighted some cases where audit of the disclosures in the financial statements relating to pensions could be improved. None of these represented a material misstatement in the financial statements, but they should have been identified and reported to Audit Committees.

- In one case the entity disclosed the end of service benefit as an area of critical accounting estimate and judgement. This was however a simple calculation which is not very sensitive to changes in significant assumptions and therefore should not have been included in this disclosure.
- One entity participated in a multi-employer scheme which was accounted for as a defined contribution scheme. However, the audit team did not identify that the financial statements did not disclose that the entity was a participant within this scheme.
- The pensions' note in the financial statements did not include disclosures of the assets held in each asset category reflecting their valuation hierarchy. The audit team should have requested management to enhance these disclosures.

- In another case the audit team obtained confirmations for certain scheme assets, however, this was not broken into the different classes of scheme assets which were disclosed in the financial statements. It was not clear how the audit work provided sufficient assurance over the disclosure of the classification of scheme assets.
- The work performed by the audit team in relation to disclosures did not detect a netting off of a surplus in one scheme with deficits in others.
- There was insufficient evidence on file to demonstrate the audit team's communication to the Audit Committee of their findings relating to the required re-presentation of the split of quoted and unquoted assets in the retirement benefit note, a key matter relating to financial statement disclosures. This matter was identified after the final Audit Committee report had been issued and should have been communicated formally as an addendum to the report.

3.4 Audit report disclosures

The auditor's report provides important information to users of the financial statements of the key matters considered by the auditor during their work. The auditor's report should accurately describe the auditor's risk assessment and the procedures performed in response so that users of the financial statements can clearly understand the nature and extent of the audit work performed and the basis for conclusions drawn.

In a third of the audits reviewed, the auditor reported on the work that they had performed in relation to the pension balances. In most cases, these were included where the auditor had identified a significant risk in the valuation of the pension balances. We were pleased to note three audits where the valuation of the pension balances was not identified as a significant risk but the auditor determined that they should nevertheless refer to the work performed in this area within their audit report. In the majority of cases the information provided by the auditor in their report was informative.

However, in three audits, where the valuation of the pension balances had been assessed as being a significant risk, the auditor made no mention in its audit report as to the nature of the risk or the audit procedures performed to address this risk. Whilst the auditor does not need to make reference in its audit report for all the significant risks identified, in one of these audits the pension assumptions were at the low end of the auditor's acceptable range and, given the risk that management may have had an incentive to reduce the liability, we would have expected for this to have been included in the auditor's report.

We also noted one audit where the auditor had incorrectly reported that the pensions balances had been identified as a significant risk, potentially overstating the extent of the work performed in this area to respond to this risk.

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