External Audit Progress Report 2020/21

East Hampshire District Council

—

September 2021

Introduction

To the Audit Committee of East Hampshire District Council

We are pleased to have the opportunity to meet with you on 14 September 2021 to provide an update on our external audit of the financial statements of East Hampshire District Council as at and for the year ended 31 March 2021.

We are providing this report in advance of our meeting to enable you to consider our findings and hence enhance the quality of our discussions. This report should be read in conjunction with our audit plan and strategy report, presented in March 2021. We will be pleased to elaborate on the matters covered in this report when we meet.

As of the time of drafting this report, we have not been able to complete our review of the draft statement of accounts in order to sign off the audit report. Due to a number of factors, there has been delays in the progress of the audit.

The authority produced a draft statement of accounts by the 31 July deadline but unfortunately, due to technical issues, the was not uploaded to the website until nine days later.

We have been working closely with the Finance team to make every effort to progress the audit. Our central actuarial team have completed their review of the valuation of the pension liability. A summary of their findings is attached in appendix 1.

We draw your attention to the important notices on pages 3 and 4 of this report, which explains:

- The purpose of this report;
- Limitations on work performed; and
- Restrictions on distribution of this report.

Yours faithfully,

Andrew Cardoza
Director, KPMG LLP
14 September 2021

How we have delivered audit quality

Audit quality is at the core of everything we do at KPMG and we believe that it is not just about reaching the right opinion, but how we reach that opinion. We consider risks to the quality of our audit in our engagement risk assessment and planning discussions.

We define ‘audit quality’ as being the outcome when audits are:

— Executed consistently, in line with the requirements and intent of applicable professional standards within a strong system of quality controls and

— All of our related activities are undertaken in an environment of the utmost level of objectivity, independence, ethics and integrity.

Some of the ways in which we drive audit quality are demonstrated throughout our report and include:

Contents

Summary of progress

Scepticism Challenge

Purpose of this report

This Report has been prepared in connection with our audit of the 2020/21 financial statements of East Hampshire District Council, prepared in accordance with the Code of Practice on Local Authority Accounting in the United Kingdom 2020/21, supported by International Financial Reporting Standards (IFRS), as at and for the year ended 31 March 2021.

This report summarises the key issues identified during our audit but does not repeat matters we have previously communicated to you.

Limitations on work performed

This Report is separate from our audit report and does not provide an additional opinion on the Authority's financial statements, nor does it add to or extend or alter our duties and responsibilities as auditors. We have not designed or performed procedures outside those required of us as auditors for the purpose of identifying or communicating any of the matters covered by this Report.

The matters reported are based on the knowledge gained as a result of being your auditors. We have not verified the accuracy or completeness of any such information other than in connection with and to the extent required for the purposes of our audit.

Status of our audit

As of the time of drafting this report, we have not been able to complete our review of the draft statement of accounts in order to sign off the audit report. We have still to receive one supporting note, and a full set of supporting documentation to support the figures in the draft statement of accounts, which would enable us to complete the audit. We have been working closely with the finance team to make every effort to progress the audit and have make good progress on areas such as valuation of the pension liability, review of the property valuations by our valuation specialist and the audit of East Hampshire Commercial Services Ltd.

We have maintained regular contact with officers throughout our planned final audit visit, including daily meetings with Finance staff to discuss progress and chase outstanding information. We contacted the Chief Finance Officer on 23 July 2021 to express our concerns over the impact of the delays on our likely audit timetable. Following a further discussion on 13 August 2021,

it was agreed that we would put our audit on hold until officers were able to produce a full set of financial statements and were confident that all information to support the figures was available. We will recommence the audit later in the year, but it will not be possible to complete the work in time to meet the statutory deadline for publishing audited accounts of 30 September 2021.

The following page shows a high level summary of the timeline of the audit so far.

Summary of progress

Scepticism Challenge

2020/21 external audit timeline	Output/s
Week commencing 11 January 2021:	Planning and risk assessment
Week commencing 1 March 2021:	Interim audit
Week commencing 12 July 2021:	Initially agreed date of final audit visit
Week commencing 26 July 2021:	Rescheduled date of final audit visit at request of management
Thursday 29 July 2021:	First draft statement of accounts received. These were missing the Collection Fund, Cash Flow Statement and a number of Notes.
Saturday 31 July 2021:	Statutory deadline for publishing draft financial statements on the Council's website. The Council did not meet this deadline and, as at the time of drafting this report, has not published a notice to explain why.
Tuesday 3 August 2021:	Second draft statement of accounts received. These were still missing the Collection Fund, Cash Flow Statement and a number of Notes
Week commencing 23 August 2021:	End of our planned final 2020/21 external audit visit.

Restrictions on distribution

The report is provided on the basis that it is only for the information of the Audit Committee of the Authority; that it will not be quoted or referred to, in whole or in part, without our prior written consent; and that we accept no responsibility to any third party in relation to it.

Appendices

Contents

Appendix 1

Financial statements audit - judgements - LGPS - (continued)

Level of prudence compared to KPMG central assumptions

Outside normally acceptable range | *Cautious* | *Balanced* | *Optimistic* | *Outside normally acceptable range*

Acceptable range

Overall assessment of assumptions of LGPS for IAS 19 for audit consideration							
The overall assumptions adopted by the Authority are considered to be Optimistic relative to our central rates but within our normally acceptable range overall						*Optimistic*	
Underlying review of individual assumptions	Methodology	Consistent methodology to prior year?	Compliant methodology with IAS 19?	Authority	KPMG central	Assessment vs KPMG central	Significant assumptions
Discount rate	Aon Single Agency AA Curve	No, see page 7	✓	2.10%	2.00%		✓
CPI inflation	Aon UK Government RPI curve with a deduction to reflect an inflation risk premium, and a further deduction to reflect differences between RPI and CPI	No, see page 8	✓	2.70%	2.82%		✓
Salary increases	Employer best estimate	✓	✓	CPI plus 1%	In line with long-term remuneration policy		✓
Pension increases	In line with CPI	✓	✓	2.70%	2.82%		✓
Mortality – Base tables	In line with 2019 Fund valuation	✓	✓	90%/85% (males/females) of the SAPS Series 2 Normal tables	In line with best-estimate Fund experience		✓
Mortality – Future improvements	In line with 2019 Fund valuation	✓	✓	CMI 2018 projections model with a 1.5% long-term trend rate, smoothing parameter of 7.5 and default initial addition parameter	CMI 2020 projections model with a 1.25% long-term trend rate and default smoothing, initial addition and 2020 weight parameters		
Other demographics	In line with 2019 fund valuation	✓	✓	70% of maximum tax-free cash	In line with Fund experience		

Financial statements audit - judgements - LGPS - (continued)

Scepticism Challenge

Area	Comment
Change of approach to setting discount rate	At 31 March 2021, the methodology for calculating the discount rate has changed from Aon's Select curve to their Single Agency curve. There has been a change in the Company's assessment of what constitutes a high-quality corporate bond for the purposes of establishing the discount rate under IAS 19.83. Corporate bonds where only one of the rating agencies consider them to be AA-rated (or equivalent) are now included in the assessment of the discount rate. We view the change in approach as being compliant with IAS 19. The impact of this change in methodology has been estimated by the actuary to be an increase in the unrounded discount rate of c. 2bps. We are aware that Aon round their discount rates to the nearest 10 bps – therefore the change in methodology will not impact the DBO in some cases. We understand from conversations between our central assumptions team and Aon that at durations of 19 to 26 years the rounded discount rates under the Single Agency and Select curves would have been the same at 31 March 2021, and therefore we are satisfied that the DBO would not be different had the discount rate methodology been kept the same as at 31 March 2020. The assumption is still within our normally acceptable range.
Mortality	Consistent with last year, the Employer has retained the mortality base table assumptions adopted at the most recent Fund valuation as at 31 March 2019. In conversation with the Fund Actuary, our central team has confirmed that the mortality assumptions adopted for the Fund valuation as at 31 March 2019 can be considered be a best estimate assumption, consistent with the requirements of IAS 19.81. This is because margins for prudence are all captured in the funding valuation discount rate. We challenged each of the LGPS Fund Actuaries to provide copies of the underlying evidence supporting this assessment, but they have confirmed that this evidence is not able to be shared with us. Our central team have discussed the approach taken with each of the LGPS Fund Actuaries, and have concluded that, while each firm's methodology to confirm the assumptions was different, each was attempting to obtain a Fund-wide best-estimate base table. While the assumption should really be focused on the Employer's membership only, the Fund Actuary has considered the Fund as a whole. It is reasonable to assume that most LGPS Employers in a region would be expected to have similar demographic characteristics, and therefore there is unlikely to be a better-evidenced assumption for the Employer. We therefore consider this to meet the requirement of the standard, although note that we would prefer to see the evidence of the underlying assessment. Additionally, the allowance for future improvements has been maintained in line with the most recent Fund valuation as at 31 March 2019, consistent with the prior year end. The proposed assumption for future mortality improvements can therefore be considered to be a best estimate assumption, consistent with the requirements of IAS 19.81.
Other demographic assumptions	The Employer has maintained all other demographic assumptions in line with the most recent Fund valuation as at 31 March 2019. In conversation with the Fund Actuary, our central team has confirmed that the other demographic assumptions can be considered best estimate assumptions because margins for prudence are all captured in the funding valuation discount rate.
Salary Changes	We have confirmed that the Authority's salary increase assumptions represents management's best estimate long-term assumption for salary increase for the active membership of the Fund.

Financial statements audit - judgements - LGPS - (continued)

Scepticism Challenge

Area	Comment
RPI inflation / CPI inflation	**Background** For UK DB pension schemes it is common to set long term RPI inflation based on long term gilt market-implied expectations (known as “break even RPI”), often less an inflation risk premium to allow for supply/demand factors, and for long term CPI inflation to be set with reference to RPI inflation less a “wedge” reflecting established differences in index construction, as there is no deep-market in CPI-linked instruments. The UK Government and the UK Statistics Authority (UKSA) ran a joint consultation during 2020 on the proposal to amend the flawed RPI index by aligning it with CPIH at a future date between 2025 and 2030. The government and the UKSA published their consultation response on 25 November 2020, confirming the UKSA’s intention (and legal and practical ability) to effect the proposed change from February 2030. The consultation response also confirmed that there would be no compensation payable to holders of index-linked gilts. **Implications** The consultation response confirms that RPI will be aligned with CPIH from 2030 onwards which suggests the RPI-CPI wedge applied when setting CPI assumptions should be close to zero post-2030. In light of the muted market reaction following the consultation response in November 2020, there is now strong evidence that gilt market-implied RPI inflation rates have been pricing in a substantial reduction in long-term RPI rates due to potential RPI reforms since Q3 2019; however, actuaries have generally been slower to reflect significant reductions in the long-term RPI-CPI wedge when setting CPI assumptions due to prevailing uncertainty before November 2020 on the extent to which the gilt market was pricing in the proposed reforms. This will mean that for many audited entities, CPI assumptions (and hence DBOs) will increase in order to reflect the proposed RPI reforms (even though the future changes to RPI will reduce pension benefits payable). Some uncertainty remains on the precise extent to which long-term gilt market-implied RPI inflation fully reflects a future transition to CPIH. We therefore anticipate some variability to persist in how corporate reporters of UK DB liabilities now set their RPI and CPI assumptions. **What has the Employer proposed?** • The Employer has proposed that RPI inflation is to be set in line with market break even expectations less an inflation risk premium (IRP). They have proposed a change to how the IRP is set, resulting in a reduction in post 2030 RPI compared with the prior year methodology of 40 basis points. • For CPI, the Fund Actuary has proposed reducing the long term gap between RPI and CPI, resulting in an increase in the resulting CPI assumption of 40 basis points post- 2030 compared with the prior year methodology to reflect increased clarity on the future of the RPI index. • The four LGPS Fund Actuaries have proposed different treatments, giving a range of CPI assumptions from 2.7% to 2.85% (with our central benchmark being around 2.80% (+/- 3bp) at all durations). In the LGPS, all inflationary increases are linked to CPI and as such the absolute value of the RPI assumption does not have a direct impact on the DBO, though it is used to derive the CPI assumption as described above. The method for calculating the RPI assumption (on which the CPI assumption is based) results in a reduction of between 4% and 6% in the DBO (i.e. between c£6,300k and c£9,500k). In addition, the change in calculating the CPI assumption results in an increase of between 4% and 6% in the DBO (i.e. between c£6,300k and c£9,500k). If these changes are considered material, we would recommend the impact be disclosed in the Company’s financial statements; whilst the change in RPI-CPI wedge is not necessarily considered a change in accounting estimate under IAS8.39, including a description of the reduction in assumed RPI-CPI wedge compared to the prior year would be considered best practice, given the high profile nature of the RPI reform consultation at this time. **What is our audit assessment?** There is a range of possible approaches for determining both the RPI and CPI inflation assumptions. As part of our audit methodology, we have modelled what we consider to be reasonable bookend RPI and CPI scenarios. This allows us to test whether the Company’s proposed assumptions are within a range of reasonable outcomes. In our view the Employer’s proposed CPI assumption is Optimistic relative to our central rates.

KPMG

The key contacts in relation to our audit are:

Andrew Cardoza
Director
T: +44 (0)7711 869957
E: andrew.cardoza@kpmg.co.uk

Duncan Laird
Senior Manager
T: +44 (0)7776 476430
E: duncan.laird@kpmg.co.uk

Ed Mills
Assistant Manager
T: +44 (0)7825 435919
E: edward.mills@kpmg.co.uk

kpmg.com/uk

This report is addressed to the Authority and has been prepared for the sole use of the Authority. We take no responsibility to any member of staff acting in their individual capacities, or to third parties.

External auditors do not act as a substitute for the audited body's own responsibility for putting in place proper arrangements to ensure that public business is conducted in accordance with the law and proper standards, and that public money is safeguarded and properly accounted for, and used economically, efficiently and effectively.

We are committed to providing you with a high quality service. If you have any concerns or are dissatisfied with any part of KPMG's work, in the first instance you should contact Rees Batley the engagement lead to the Authority, who will try to resolve your complaint.