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Internal Control Assurance

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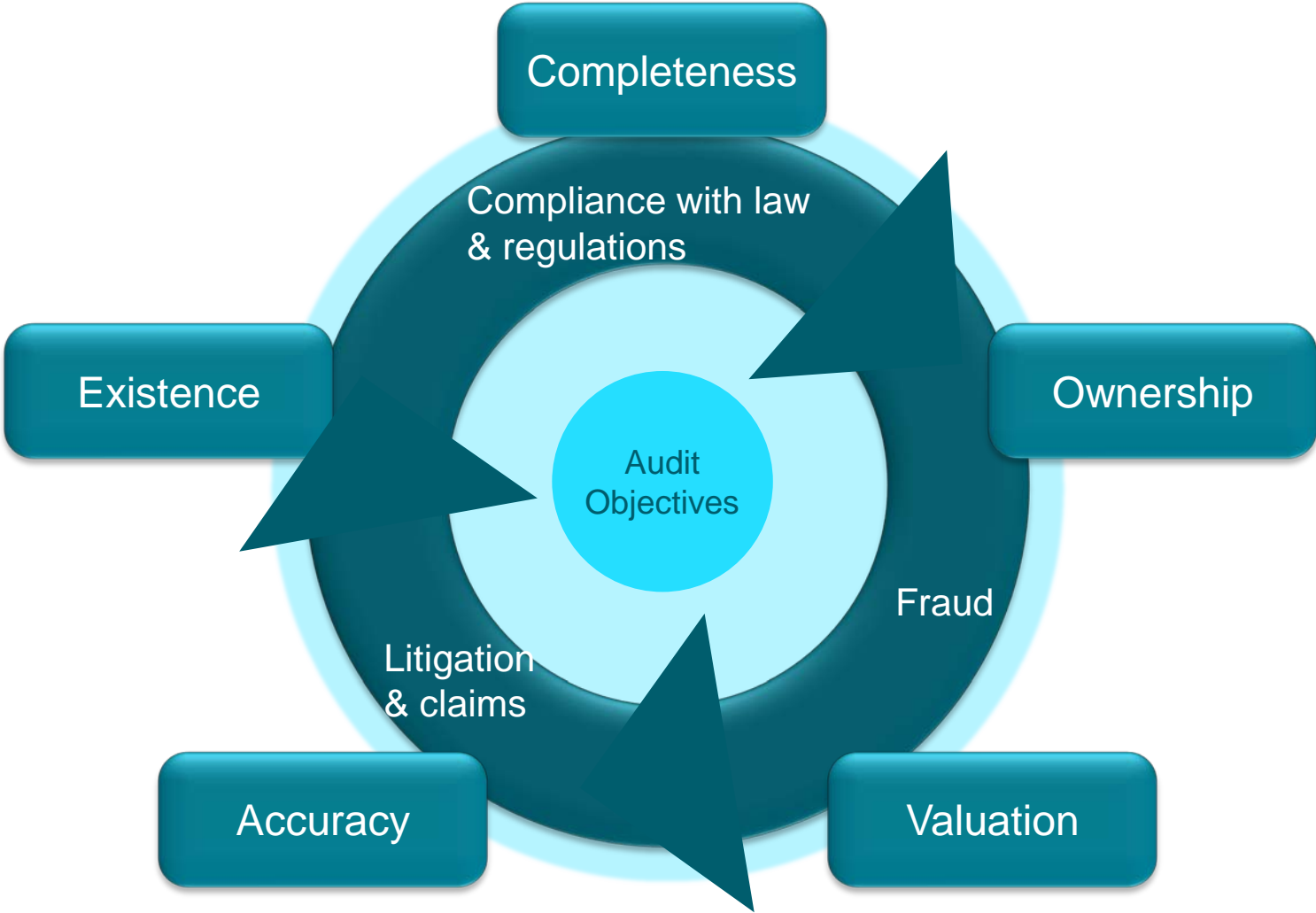
January 2012

A key element of the audit work on the final accounts is gaining assurance around the internal controls

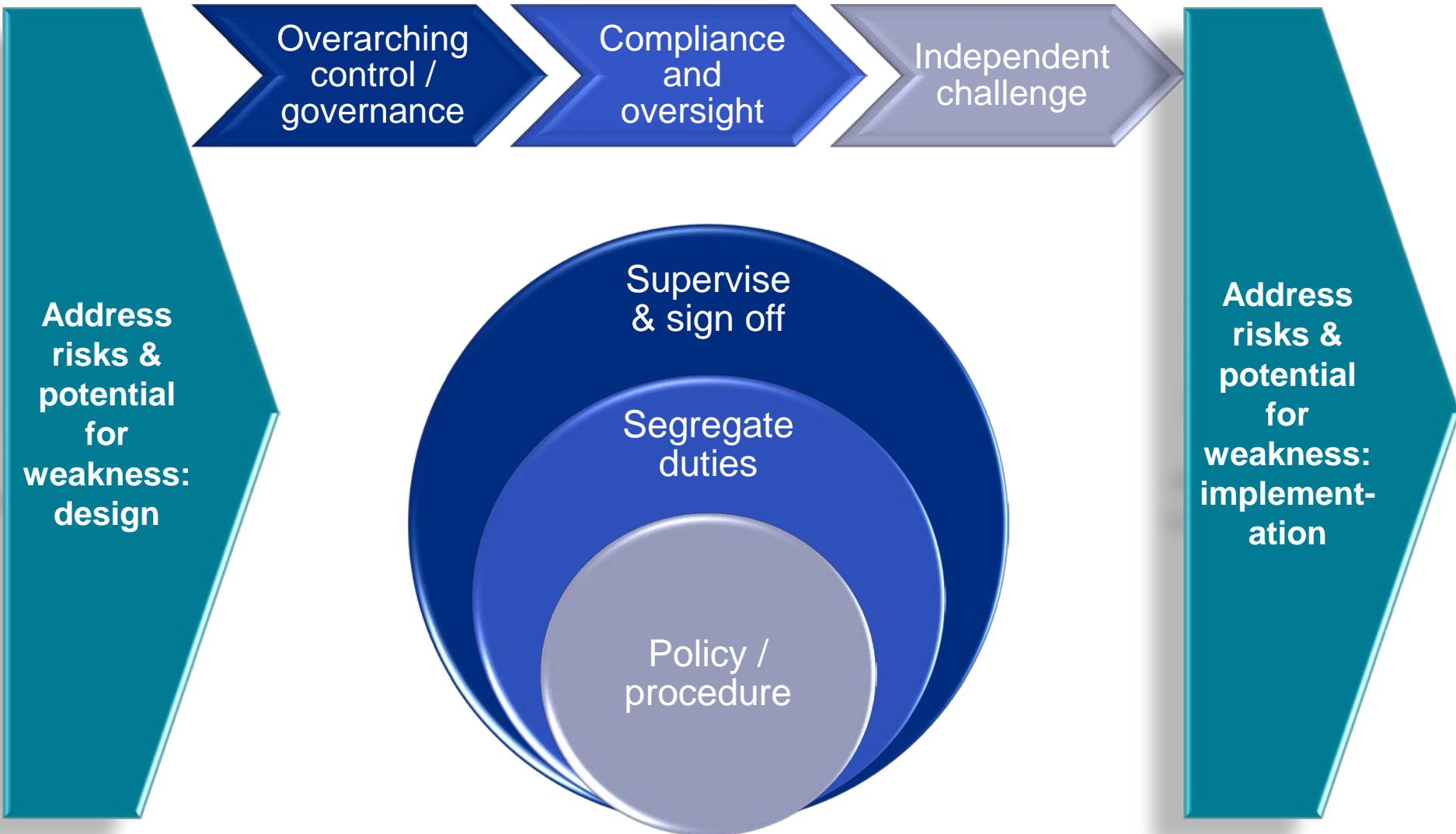
Agenda

- **Audit and Internal Controls Framework**
- **Internal Control Reports Provided by Third Parties**
- **Controls in Dealings with Members**
- **Challenges in Investment Controls**

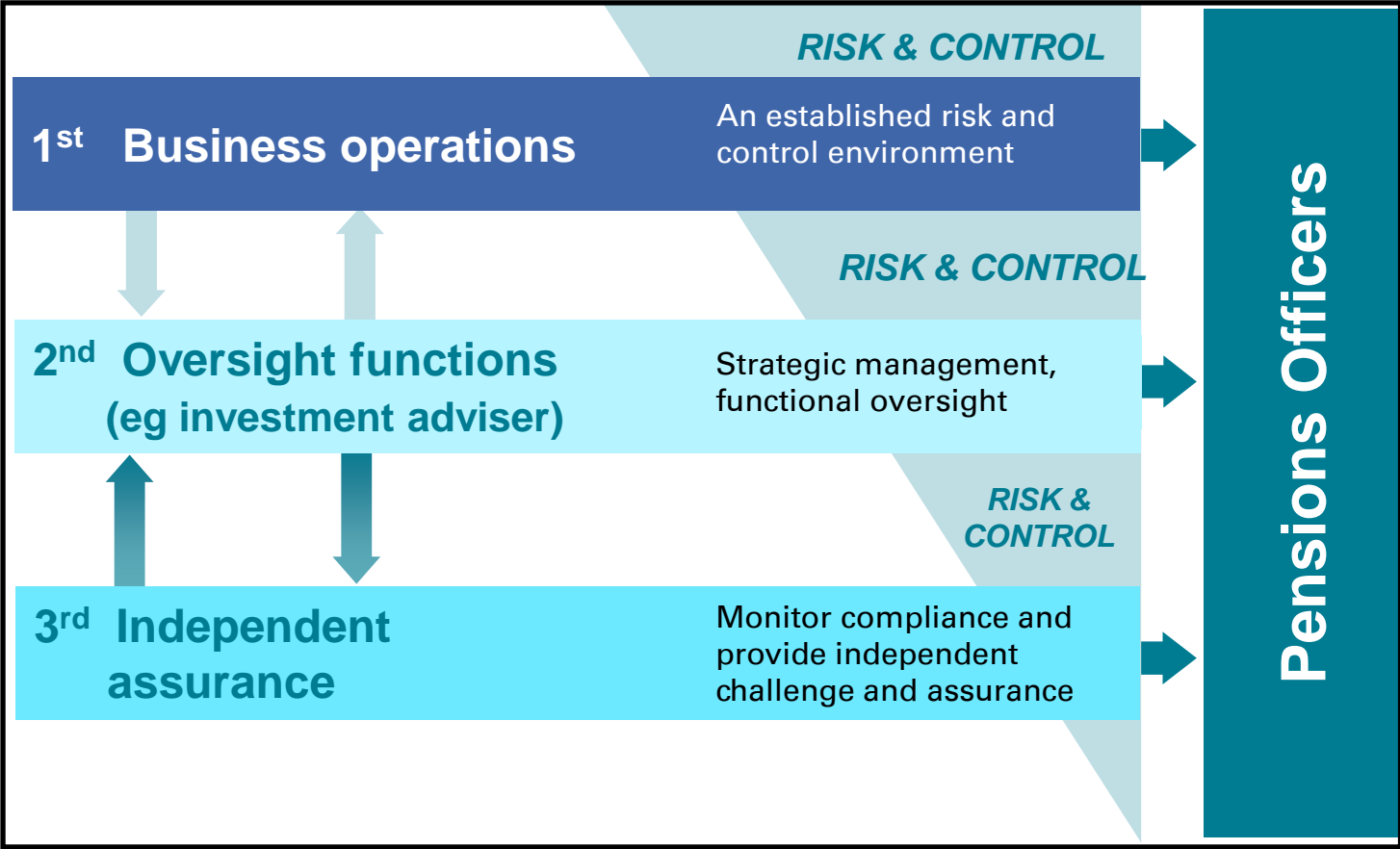
Audit Objectives



Internal controls for audit purposes



The Three Lines of Defence





**Internal Control
reports provided
by third parties**

Internal Controls Reports

Prepared by

Third party service organisations such as:

- administrators,
- custodians and
- fund managers

Guidance

AAF 01/06 (UK)

SSAE 16 (US, replaces SAS 70)

ISAE 3402 (international)

Changes

Changes driven by ISAE 3402 issued Dec 2009:

- SSAE 16 effective for periods ending on or after 15 June 2011
- AAF 01/06 introduced a new appendix in Nov 2010
- AAF 01/06 to be revised and updated

Internal Controls Reports

Watch points

- Narrower scope of SSAE 16 – financially focussed
- Lack of prescribed control objectives in SSAE 16, restricting comparability between reports
- Exceptions that need consideration

Use

- To answer specific queries and help address matters on risk register
- As a basis for further investigation and challenge

Appendices with control objectives for:

- Custody
- Investment management
- Pensions administration
- Property management
- Fund accounting
- Transfer agency
- Information technology
- **Private equity***
- **Investment administration***
- **Hedge fund management***

*added in 2009



Controls over Dealings with members

Contributions and benefits

Contributions

- Complexity / volume
- Recoverability

Early retirement augmentations

Income

Fund

Outflow

Pensions and Benefits

Payments to Leavers

Administration expenses

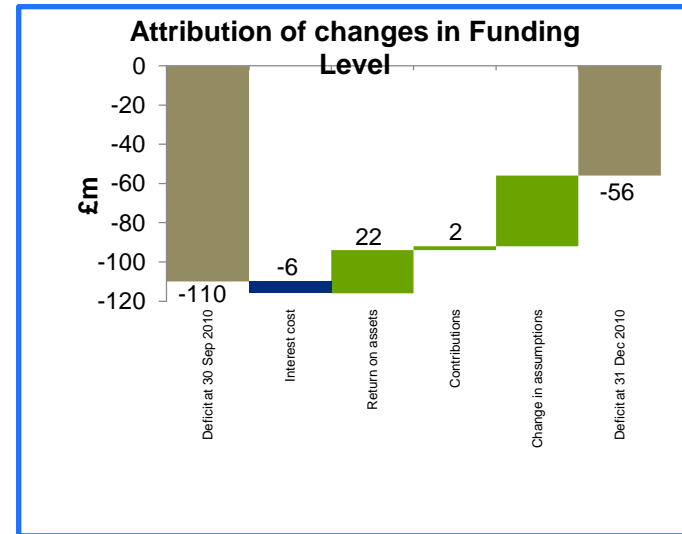


Data

- Quality of data and record keeping
- Data feeds
- Membership reconciliation
- IT systems and security of data held

Scheme Liabilities

- Basis of valuation
- Source data
- Assumptions used
- Movements





Challenges in investment controls

Investment areas

Valuation

- Pooled investment vehicles
- Harder to price investments
 - Private equity
 - Derivatives
- Property

Custody

- Sub-custody
- Manner of holding
- Pooled investment vehicles
- Property
- Cash / collateral

Sales & purchases

- Internal controls

Investment income & tax reclaims

- Stock-lending
- Rental income

Investment Pricing Hierarchy

Increasing due diligence

Level 1: "Easy to Price"
Readily observable unadjusted prices
Quoted prices
Active markets

Level 2: "Moderately Difficult to Price"
Inactive markets
Market observable or market derived inputs to
valuations significantly determine prices

Level 3: "Difficult to Price"
Valuations using models, judgments and estimates
rather than observable market data

Increasing transparency

Pooled investment vehicles

Issues

- Found across the hierarchy levels: Range from quoted PIVs to unquoted private equity funds
- Many funds cannot be independently priced by the global custodian
- Prices observed may be stale
- Internal controls can be difficult to assess
- Benchmarks used to monitor can be tricky to select

Internal controls – examples where custodian unable to obtain independent prices

- Understand structure
- Obtain information on/ composition of underlying assets
- Understand the pricing mechanism and validation process used by fund manager?
- Obtain accounts – do they support the fund value?
- Consider governance structure: manager / custodian / administrator and internal control reports
- Consider risk points for follow up and resolution – volatility in prices, stale markets, exceptions or going against market trends

Issues

- Generally level 2 or 3 in hierarchy
- Illiquid assets
- Valued using fund manager estimates or models

Internal controls – examples – vary depending on size and nature of investment

- Obtain accounts and other investor information. Review for audit opinion and accounting policies. Understand and challenge adjustments made.
- Discussions with investment manager
- Consider reasonableness against sector results
- Ongoing due diligence over any valuation models used and inputs
- Consider specialists depending on size and risk

Nature of Derivative

- Exchange traded derivatives eg
 - Futures
 - Some options
 - Margin accounts
- Over the counter derivatives eg
 - Swaps
 - Options
 - Collateral arrangements

Issues for OTC derivative valuations

- Valuation models

Internal Controls – examples

- Ongoing due diligence over models and inputs
- Understand quality control exercised by valuer
- Periodic independent valuation
- Monitor exposures and commitments

Thank you



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