

**Deloitte.**



**Shetland  
Islands  
Council**



# **Shetland Islands Council Pension Fund**

Planning report to the Audit Committee  
on the 2016/17 audit

9 February 2017

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# Director introduction

## The key messages in this report

Audit quality is our number one priority. We plan our audit to focus on audit quality and have set the following audit quality objectives for this audit:

A robust challenge of the key judgements taken in the preparation of the financial statements.

A strong understanding of your internal control environment.

A well planned and delivered audit that raises findings early with the Audit Committee.

I have pleasure in presenting our planning report to the Audit Committee for the 2016/17 audit of the Shetland Islands Council Pension Fund ("the Pension Fund"). I would like to draw your attention to the key messages of this paper:

### **Pension Fund changes**

Following discussions with the Pension Fund's finance team we have not identified any significant changes to the Pension Fund itself during the year. We will continue to liaise with the finance team to identify any changes between the date of this report and the Pension Fund's year end, and will update our audit plan accordingly should any occur.

The Code of Practice on Local Authority Accounting in the UK ("the 2016/17 Code") has been amended for pension fund audits from financial year 2016/17, and requires additional disclosures to be included in the financial statements. As such we have identified this as an other area of audit focus below, with further details outlined on page 16.

### **Significant audit risk**

We have identified management override of controls as our significant audit risk. Auditing Standards require us to assume that management override of controls is an audit risk for all of our audits.

Further details of this significant risk, including our proposed testing can be found on page 13.

### **Other areas of audit focus**

The following areas of focus have not been identified as significant audit risks but will be considered as part of our audit:

1. Accuracy of contributions payable to the Pension Fund;
2. Valuation of investments; and
3. Compliance of the financial statements with the amendments made by the 2016/17 Code.

Further details of the other areas of audit focus, including our proposed testing are outlined on pages 14 to 16.

# Director introduction (continued)

## The key messages in this report (continued)

Audit quality is our number one priority. We plan our audit to focus on audit quality and have set the following audit quality objectives for this audit:

A robust challenge of the key judgements taken in the preparation of the financial statements.

A strong understanding of your internal control environment.

A well planned and delivered audit that raises findings early with the Audit Committee.

### **Audit Dimensions**

- The 2016 Code of Audit Practice sets out four audit dimensions which set a common framework for all public sector audits in Scotland. Our audit work will consider how the Pension Fund is addressing these and we will report our conclusions in our annual report to the Audit Committee in September 2017. In particular, our work will focus on:
  - **Financial sustainability** – we will monitor the Pension Fund’s actions in respect of its short, medium and longer term financial plan to assess whether short term financial balance can be achieved, whether there is a long-term financial strategy and if the investment strategy is effective.
  - **Financial management** – we will review the budget and monitoring reports of the Pension Fund during the year to assess whether financial management and budget setting is effective.
  - **Governance and transparency** – from our review of the Pension Fund’s papers and attendance at Audit Committee meetings we will assess the effectiveness and scrutiny of governance arrangements. We will also share best practice examples, where it is deemed appropriate.
  - **Value for money** – we will gain an understanding of the Pension Fund’s self-evaluation arrangements to assess how it demonstrated value for money in the use of resources and the linkage between money spent and outputs and outcomes delivered.

**Pat Kenny**  
**Audit Director**

# Responsibilities of the Audit Committee

## Helping you fulfil your responsibilities

The primary purpose of the Auditor's interaction with the Audit Committee is set out as follows:

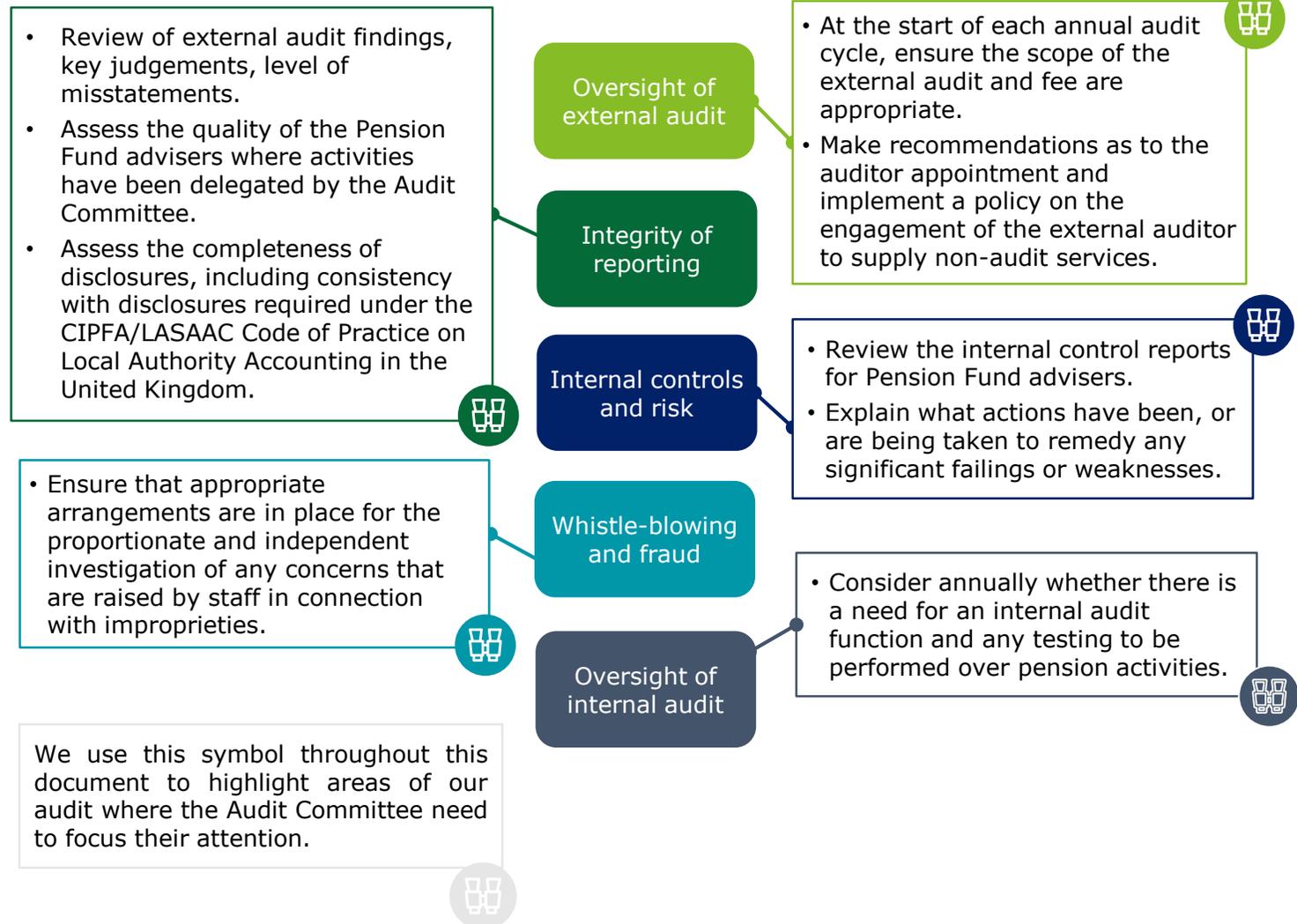
Clearly communicate the planned scope of the financial statements audit.

Provide timely observations arising from the audit that are significant and relevant to your responsibility to oversee the financial reporting process.

In addition, we seek to provide the Audit Committee with additional information to help them fulfil their broader responsibilities.

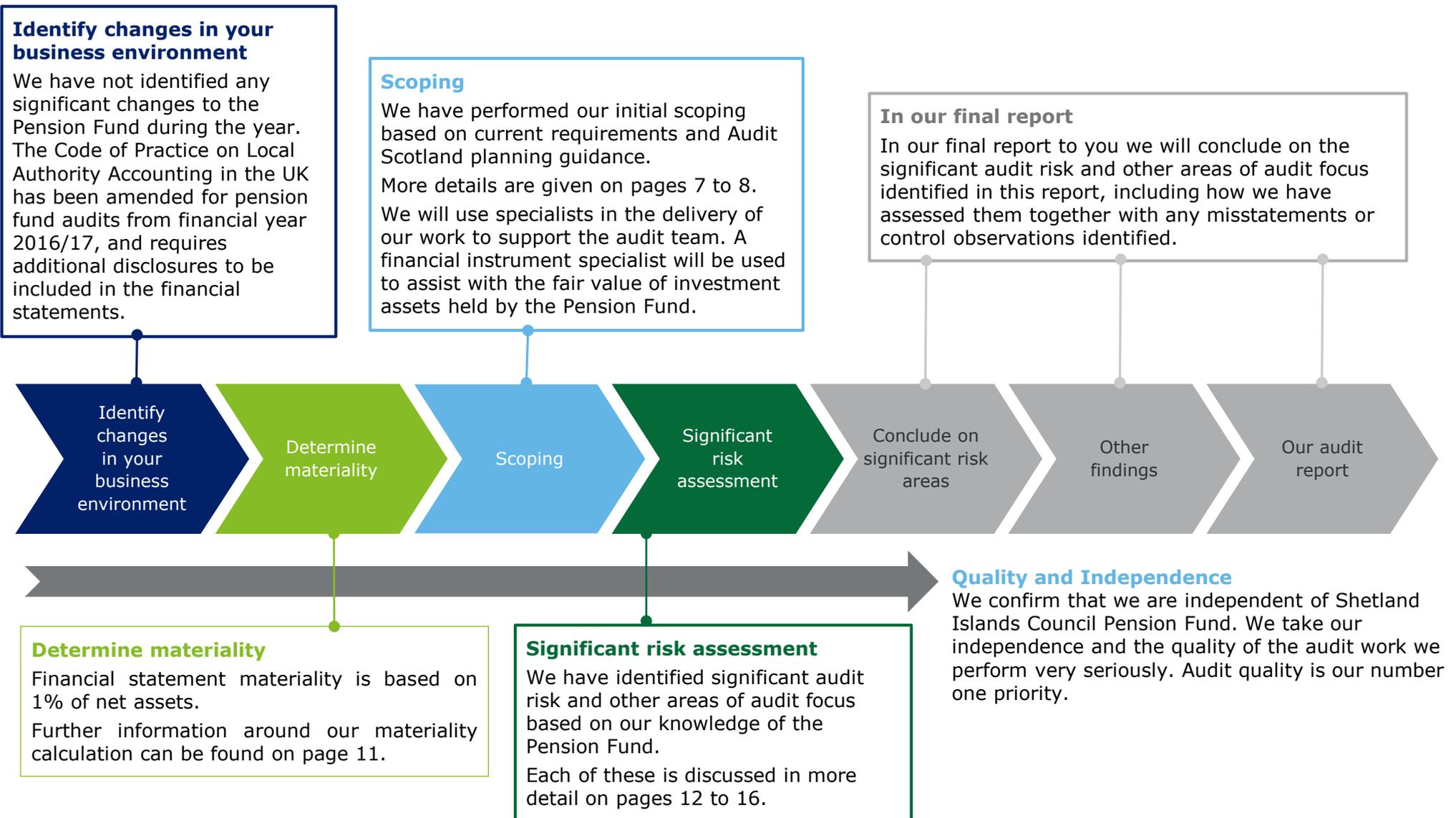
Provide assurance over the financial statements and compliance with the Pension Fund's Funding Strategy Statement.

As a result of regulatory change in recent years, the role of the Audit Committee has significantly expanded. We set out here a summary of the core areas of responsibility to provide a reference in respect of these broader responsibilities and highlight throughout the document where there is key information which helps the Audit Committee in fulfilling its remit.



# Our audit explained

We tailor our audit to your business and your strategy



# Scoping

## Our key areas of responsibility under the Code of Audit Practice



### Core audit

Our core audit work as defined by Audit Scotland comprises:

- providing the **Independent Auditor's Report** on the annual accounts;
- providing the **annual report** on the audit addressed to the Pension Fund Audit Committee;
- communicating **audit plans** to the Audit Committee;
- providing **reports to management**, as appropriate, in respect of the auditor's responsibilities in the Code;
- preparing and submitting **fraud returns**, including nil returns, to Audit Scotland where appropriate;
- identifying significant matters arising from the audit, alert the Controller of Audit and support Audit Scotland in producing statutory reports as required; and
- undertaking work requested by Audit Scotland or local performance audit work.

### Wider scope requirements

The Code of Audit Practice sets out four audit dimensions which set a common framework for all public sector audits in Scotland:

- **Financial sustainability** – looking forward to the medium and longer term to consider whether the body is planning effectively to continue to deliver its services or the way in which they should be delivered.
- **Financial management** – financial capacity, sound budgetary processes and whether the control environment and internal controls are operating effectively.
- **Governance and transparency** – the effectiveness of scrutiny and governance arrangements, leadership and decision making, and transparent reporting of financial and performance information.
- **Value for money** - using resources effectively and continually improving services.

# Scoping (continued)

## Our approach



### Liaison with internal audit

The Auditing Standards Board's version of ISA (UK and Ireland) 610 "Using the work of internal auditors" prohibits use of internal audit to provide "direct assistance" to the audit. Our approach to the use of the work of Internal Audit has been designed to be compatible with these requirements.

We will review reports prepared by internal audit and meet with them to discuss their work. We will also discuss the work where they have identified specific material deficiencies in the control environment and we will consider adjusting our testing so that the audit risk is covered by our work.

Using these discussions to inform our risk assessment, we will work together with internal audit to develop an approach that avoids inefficiencies and overlaps, therefore avoiding any unnecessary duplication of audit requirements on the Council's staff.

### Approach to controls testing

As set out in the "Briefing on Audit Matters" circulated separately to this document, our risk assessment procedures will include obtaining an understanding of controls considered to be 'relevant to the audit'. This involves evaluating the design of the controls and determining whether they have been implemented ("D & I").

We will consider the results of our procedures in respect of the Pension Fund's controls and the extent of any impact our findings have on our substantive audit procedures.

Obtain an understanding of the Pension Fund and its environment including the identification of relevant controls.

Identify risks and controls that address those risks.

Carry out "design and implementation" work on relevant controls.

If considered necessary, test the operating effectiveness of selected controls

Design and perform a combination of substantive analytical procedures and tests of details that are most responsive to the assessed risks.

# Wider scope requirements

## Audit dimensions

The Code of Audit Practice sets out four audit dimensions which set a common framework for all public sector audits in Scotland. We will consider how the Pension Fund addresses these areas, including any risks to their achievement, as part of our audit work as follows:

Audit dimension	Areas to be considered	Impact on the 2017 Audit
<p><b>Financial sustainability</b> looks forward to the medium and longer term to consider whether the Pension Fund is planning effectively to continue to deliver its services or the way in which they should be delivered.</p>	<ul style="list-style-type: none"><li>• The financial planning systems in place across the shorter and longer terms.</li><li>• The arrangements to address any identified funding gaps.</li><li>• The affordability and effectiveness of funding and investment decisions made.</li></ul>	<p>We will review the arrangements and financial planning systems in place by the Pension Fund to ensure that its services can continue to be delivered. This will include a review of the latest actuarial valuation of the Pension Fund and the plans in place to reduce the deficit over the shorter and medium term. In addition we will review the funding policy as set out in the Shetland Islands Council Pension Fund Investment Strategy 2014-2027, which aims to ensure the long-term solvency of the Pension Fund, so that there are sufficient funds available to meet all benefits as they fall due.</p>
<p><b>Financial management</b> is concerned with financial capacity, sound budgetary processes and whether the control environment and internal controls are operating effectively.</p>	<ul style="list-style-type: none"><li>• Systems of internal control.</li><li>• Budgetary control system.</li><li>• Financial capacity and skills.</li><li>• Arrangements for the prevention and detection of fraud.</li></ul>	<p>We will review the budget and monitoring reporting by the Pension Fund during the year to assess whether financial management and budget setting is effective.</p> <p>In addition we will also ensure that there is a proper officer and fund manager who have sufficient status to be able to deliver good financial management, that monitoring reports contain information linked to performance as well as financial data, and that members have the opportunity to provide a sufficient level of challenge around variances and under-performance.</p> <p>Our fraud responsibilities and representations are detailed on page 20.</p>

# Wider scope requirements (continued)

## Audit dimensions (continued)

Audit dimension	Areas to be considered	Impact on the 2017 Audit
<p><b>Governance and transparency</b> is concerned with the effectiveness of scrutiny and governance arrangements, leadership and decision making, and transparent reporting of financial and performance information.</p>	<ul style="list-style-type: none"><li>• Governance arrangements.</li><li>• Scrutiny, challenge and transparency on decision making and financial and performance reports.</li><li>• Quality and timeliness of financial and performance reporting.</li></ul>	<p>We will review the Pension Fund's papers and use our attendance at Audit Committee meetings to assess the effectiveness and scrutiny of governance arrangements.</p> <p>We will also review other aspects of governance around the Pension Fund including Codes of Conduct for officers and members, fraud and corruption arrangements, and arrangements for reporting regulatory breaches to the Pensions Regulator.</p> <p>In addition we will review the Annual Governance Statement and Governance Compliance Statement to confirm the governance arrangements observe the guidance issued by Scottish Ministers.</p>
<p><b>Value for money</b> is concerned with using resources effectively and continually improving services.</p>	<ul style="list-style-type: none"><li>• Value for money in the use of resources.</li><li>• Link between money spent and outputs and the outcomes delivered.</li><li>• Improvement of outcomes.</li><li>• Focus on and pace of improvement.</li></ul>	<p>We will gain an understanding of the Pension Fund's self-evaluation arrangements to assess how it demonstrates value for money in the use of resources and the linkage between money spent and outputs and outcomes delivered.</p> <p>We will also the scrutiny that is in place to challenge the Pension Fund's investment managers on fees and performance.</p>

# Materiality

## Approach to materiality



### Basis of materiality - benchmark



We set materiality for our opinion on the financial statements at 1% of net assets of the Pension Fund and performance materiality at 90% of materiality based on professional judgement, the requirements of auditing standards and the financial measures most relevant to users of the financial statements.

Using the 2015-16 Pension Fund Annual Report and Accounts, we estimate materiality to be £3.8m and performance materiality to be £3.4m.

We will update our materiality assessment following receipt of the draft 2016-17 financial statements and will communicate this to the Audit Committee in our final report.

The concept of materiality and its application to the audit approach are set out in our 'Briefing on audit matters' document which has been circulated separately to this report.

### Reporting to the Audit Committee

We report to the Audit Committee any unadjusted misstatements greater than 5% of materiality ("reporting threshold") and other adjustments we consider to be qualitatively material. Based on the 2015-16 Annual Report and Accounts, we estimate the reporting threshold ("RT") to be £188k.

We will report to you misstatements below this threshold if we consider them to be material in nature.

### Our audit report

The extent of our procedures is not based on materiality alone but also on the quality of systems and controls in preventing material misstatement in the financial statements, and the level at which known and likely misstatements are tolerated by you in the preparation of the financial statements.



Although materiality is the judgement of the audit director, the Audit Committee must satisfy themselves that the level of materiality chosen is appropriate for the scope of the audit.

# Significant audit risks and other areas of audit focus

## Risk dashboard

Significant risk area	Risk Level	Fraud Risk	Approach to Controls Testing	Level of Judgement
<b>Management override of controls</b>			D&I	
Other area of audit focus	Risk Level	Fraud Risk	Approach to Controls Testing	Level of Judgement
<b>Accuracy of contributions</b>			D&I	
<b>Valuation of investments</b>			D&I	
<b>Compliance of the financial statements with the amendments made by the 2016/17 Code</b>			D&I	

	Low levels of management judgement/involvement		Not a Fraud Risk		Significant Audit Risk
	Medium levels of management judgement/involvement		Fraud Risk		Other Area of Focus
	High degree of management judgement/involvement	<b>D &amp; I</b>	Design and Implementation		

# Significant audit risk

## Management override of controls

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### Description

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In accordance with ISA 240 (UK and Ireland), management override of controls is always a significant risk for financial statement audits. 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.

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### Deloitte

### Response

In order to address this significant audit risk, we will perform the following audit procedures:

- Make enquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments;
  - Perform testing on the design and implementation of controls surrounding the financial reporting process and the controls over journal entries and other adjustments posted in the preparation of the financial statements;
  - Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements. As part of our work in this area, we will perform an analysis of journal entries which will enable us to focus on journals meeting specific pre-determined parameters determined during our audit planning;
  - Review the financial statements for any accounting estimates which could contain management bias, and assess the judgements taken against supporting evidence;
  - Ensure that there is an appropriate level of segregation of duties over processing journal entries to the financial statements throughout the year;
  - Obtain an understanding of the rationale of any significant transactions that we become aware of that are outside the normal course of the Pension Fund's operations or that otherwise appear to be unusual given our understanding of the Pension Fund and its environment; and
  - Make enquiries of management in relation to the identification of related party transactions.
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# Other areas of audit focus

## Accuracy of contributions

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### Description

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The correct deduction of contributions depends on systems-based processing of membership data and salary details, together with a robust internal control framework. Errors in processing contributions can lead to issues such as non-compliance with the Funding Strategy Statement and deducting incorrect amounts from active members' payroll which can be costly to rectify and cause reputational damage.

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### Deloitte

### Response

In order to address this area of audit focus we will perform the following audit procedures:

- Review the design and implementation of key controls over the contribution process;
  - Perform an analytical review of the employer and employee normal contributions received in the year, basing our expectation on the prior year audited balance, adjusted for the movement in active member numbers, contribution rate changes and any average pay rise awarded in the year;
  - For a sample of active members, we will recalculate individual contribution deductions to ensure that these are being calculated in accordance with the rates stipulated in the Local Government Pension Scheme (Benefits, Membership and Contributions) (Scotland) Regulations 2014 ("LGPS Regulations") for employee contributions and in the Funding Strategy Statement for employer contributions;
  - Test that the correct definition of pensionable salary is being used per the LGPS Regulations to calculate contribution deductions; and
  - Test the reconciliation of the total number of active members between the membership records and the employer payroll records.
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# Other areas of audit focus (continued)

## Valuation of investments

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### Description

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There is a risk that investments are not valued accurately in the Pension Fund's financial statements due to the levels of judgement involved in pricing such investments.

The Pension Fund holds investments primarily in pooled funds, pooled property unit trusts and fixed income unit trusts with a range of investment managers.

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### Deloitte

### Response

In order to address this area of audit focus, we will perform the following audit procedures:

- Review the design and implementation of key controls over the valuation of these investments by obtaining investment manager internal control reports and evaluating the implications for our audit of any exceptions noted;
  - Agree year end valuations, sales proceeds and purchases in the financial statements to the reports received directly from the investment managers;
  - Perform valuation testing by using a range of techniques depending on the type of investment. Where the investment held is directly quoted on an exchange, we will obtain an independent price of the investment asset using our own internal pricing systems e.g. Bloomberg. Where the investment is not directly quoted on an exchange we will confirm if it is registered on the Financial Conduct Authority website and obtain an independent price, or use sales transactions close to year end as an estimate of the price. Where none of these options are available we will obtain audited financial statements and roll forward the audited value to the year end using benchmark data and Pension Fund transactions where the audited accounts are not coterminous with the Pension Fund's year end; and
  - Engage our financial instrument specialists to review the audit work performed in relation to these assets.
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## Other areas of audit focus (continued)

### Compliance of the financial statements with the amendments made by the 2016/17 Code

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#### Description

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There is a risk that the Pension Fund's financial statements are not in compliance with the amendments made by the 2016/17 Code of Practice on Local Authority Accounting in the UK. These changes include:

- Amendments to the format of the accounts to be consistent with the new Financial Reports of Pension Schemes – A Statement of Recommended Practice 2015;
  - Additional disclosure requirements for investments measured at fair value e.g. fair value hierarchy;
  - Disclosure requirements in respect of investment management expenses; and
  - An annex that provides an overview of how the other sections of the Code apply to pension funds.
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#### Deloitte

#### Response

In order to address this area of audit focus, we will perform the following audit procedures:

- Assess the design and implementation of key controls over the financial reporting process and, in particular, in relation to the implementation of the provisions of the revised Code;
  - Agree the classification of the investment assets within the fair value hierarchy to independently received investment manager reports and the reconciliation of those reports as prepared by the finance team;
  - Confirm that the recommended disclosures in respect of investment management expenses comply with the requirements of the Code; and
  - Obtain a copy of the annex to confirm that the other sections of the Code have been considered where they apply to the Pension Fund.
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# Audit quality

## Our commitment to audit quality

Our objective is to deliver a distinctive, quality audit to you. Every member of the engagement team will contribute, to achieve the highest standard of professional excellence.

In particular, for your audit, we consider that the following steps will contribute to the overall quality:

- We will apply professional scepticism on the material issues and significant judgements identified, by using our expertise in the local government sector and elsewhere to provide robust challenge to management;
- We will obtain a deep understanding of your Pension Fund, its environment and of your processes in key areas – such as contributions, benefits and investments - enabling us to develop a risk-focused approach tailored to the Pension Fund;
- Our engagement team is selected to ensure that we have the right subject matter expertise and industry knowledge. The audit team for the Pension Fund will be made up of pensions specialist from our Pensions Audit Centre of Excellence, incorporating managers who have in depth experience of Local Government Pension Schemes, leading to high quality understanding and challenge; and
- In order to deliver a quality audit to you, each member of the core audit team has received tailored training to develop their expertise in audit skills which includes Local Government and Pensions Engagement Team Based Learning. This is a director led programme encouraging teams from across our practice to engage and discuss current sector and audit issues, sharing best practice and expertise.

### Engagement Quality Control Review

We have developed a tailored Engagement Quality Control approach. Our dedicated Professional Standards Review (PSR) function will provide a 'hot' review before any audit or other opinion is signed. PSR is operationally independent of the audit team, and supports our high standards of professional scepticism and audit quality by providing a rigorous independent challenge.

# 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 Committee discharge its 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 our audit plan, key audit judgements and the planned scope of our work.

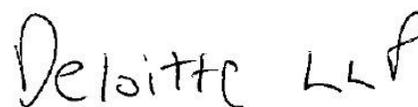
### What we don't report

- As you will be aware, our audit is not designed to identify all matters that may be relevant to the Audit Committee.
- Also, there will be further information you need to discharge your governance responsibilities, such as matters reported on by management or by other specialist advisers.
- Finally, the views on internal controls and business risk assessment in our final report should not be taken as comprehensive or as an opinion on effectiveness since they will be based solely on the audit procedures performed in the audit of the financial statements and the other procedures performed in fulfilling our audit plan.

### Other relevant communications

- This report should be read alongside the supplementary "Briefing on audit matters" circulated separately on 30 January 2017.
- We will update you if there are any significant changes to the audit plan.

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



**Deloitte LLP**

Chartered Accountants

Glasgow

30 January 2017

This report has been prepared for the Audit 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.

# Appendices

# Fraud responsibilities and representations

## Our responsibilities explained



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### Your Responsibilities

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The primary responsibility for the prevention and detection of fraud rests with management and the Audit Committee, and includes establishing and maintaining internal controls over the reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations.

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### Our Responsibilities

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We are required to obtain representations from the Audit Committee regarding internal controls, assessment of risk and any known or suspected fraud or misstatement. As the Pension Fund's auditor, 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. As set out in the significant risk section of this document, we have identified management override of controls as a significant audit risk for your Pension Fund.

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### Fraud Characteristics

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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 auditor – misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets.

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### We will request the following to be stated in the representation letter signed on behalf of the Audit Committee:

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- We acknowledge our responsibilities for the design, implementation and maintenance of internal controls to prevent and detect fraud and error.
  - 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.
  - We are not aware of any fraud or suspected fraud / We have disclosed to you all information in relation to fraud or suspected fraud that we are aware of and that affects the Pension Fund and involves:
    - (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.
  - We have disclosed to you all information in relation to allegations of fraud, or suspected fraud, affecting the Pension Fund's financial statements communicated by employees, former employees, analysts, regulators or others.
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# Your audit team and timetable

## We have a highly experienced audit team

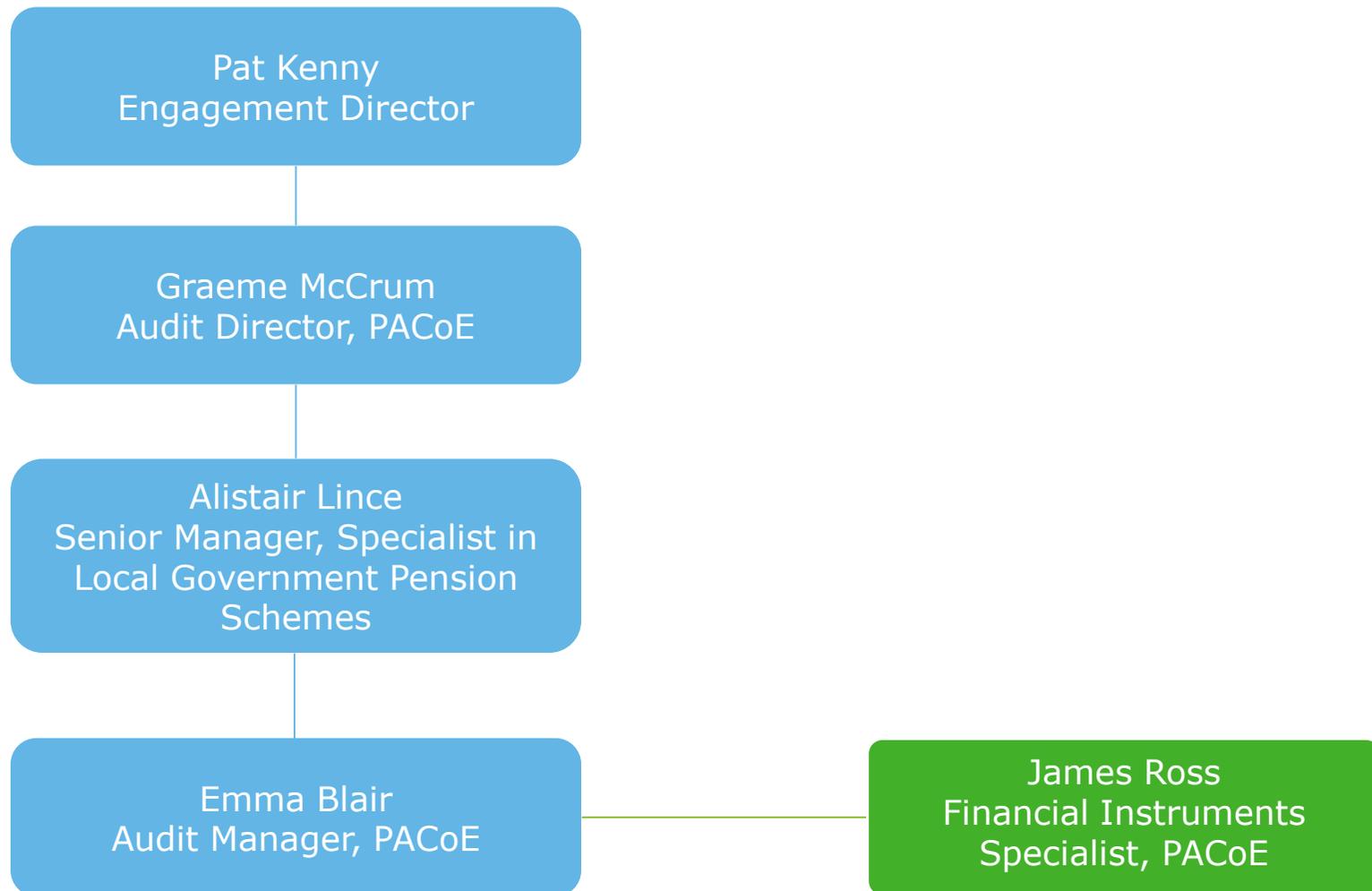
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### Your audit team

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We set out below our audit engagement team, which includes pensions specialists from our Pensions Audit Centre of Excellence ("PACoE").

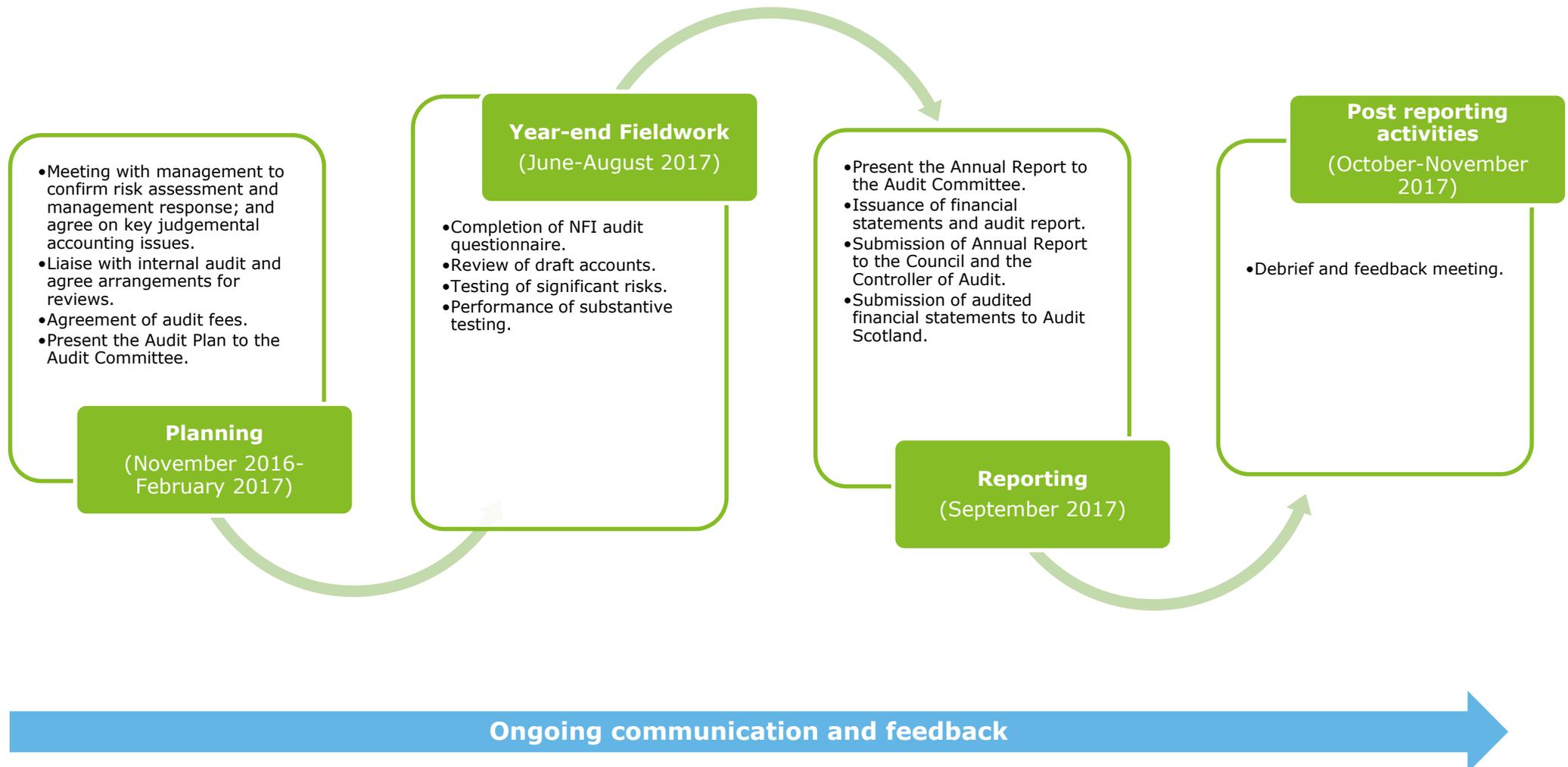
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# Your audit team and timetable (continued)

## Audit Timetable

Set out below is the approximate expected timing of our reporting and communication with Shetland Islands Council Pension Fund and Audit Scotland.



# 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 we are independent of the Shetland Islands Council Pension Fund and will reconfirm our independence and objectivity to the Audit Committee for the year ending 31 March 2017 in our final report to the Audit Committee.

## Fees

The total audit fee for 2016/17, in line with the fee range provided by Audit Scotland in its letter of 12 December 2016, is £30,238, as analysed below. As agreed with management, we have applied a 10% increase to the auditor remuneration in 2016/17 to reflect the higher input required in year 1 of our appointment, which will be offset by reduced fees in future years on a like for like basis, as illustrated below. The average fee is a 14% reduction on the 2015/16 fee.

		For Illustrative purposes				
	<b>+10%</b>	<b>+5%</b>	<b>-</b>	<b>-5%</b>	<b>-10%</b>	
	<b>2016/17</b>	<b>2018/19</b>	<b>2019/20</b>	<b>2020/21</b>	<b>2021/22</b>	<b>Average</b>
Auditor remuneration	26,678	25,494	24,280	23,066	21,852	24,280
Audit Scotland fixed charges:						
Pooled costs	2,110	2,110	2,110	2,110	2,110	2,110
Audit support costs	1,450	1,450	1,450	1,450	1,450	1,450
<b>Total Fee</b>	<b>30,238</b>	<b>29,054</b>	<b>27,840</b>	<b>26,626</b>	<b>25,412</b>	<b>27,840</b>

Details of all non-audit services fees for the period will be presented in our final report.

## Non-audit services

In our opinion there are no inconsistencies between APB Ethical Standards for Auditors and the company's policy for the supply of non-audit services or 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 otherwise advise as necessary.



Other than as stated below, this document is confidential and prepared solely for your information and that of other beneficiaries of our advice listed in our engagement letter. Therefore you should not, refer to or use our name or this document for any other purpose, disclose them or refer to them in any prospectus or other document, or make them available or communicate them to any other party. If this document contains details of an arrangement that could result in a tax or National Insurance saving, no such conditions of confidentiality apply to the details of that arrangement (for example, for the purpose of discussion with tax authorities). In any event, no other party is entitled to rely on our document for any purpose whatsoever and thus we accept no liability to any other party who is shown or gains access to this document.

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