

Dumfries and Galloway Council Pension Fund

Annual report on the 2010/11 audit



Prepared for Members and the Controller of Audit
November 2011

Audit Scotland is a statutory body set up in April 2000 under the Public Finance and Accountability (Scotland) Act 2000. It provides services to the Auditor General for Scotland and the Accounts Commission. Together they ensure that the Scottish Government and public sector bodies in Scotland are held to account for the proper, efficient and effective use of public funds.

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Key messages

2010/11 is the first year in which Scottish Government regulations require local government pension funds to prepare an annual report separate from the administering authority's own statutory accounts. The report is required to include separate pension fund financial statements which require a separate audit certificate.

During 2010/11 we looked at the key strategic and financial risks faced by Dumfries and Galloway Council Pension Fund (the fund). We audited the financial statements and looked at aspects of governance, use of resources and performance. This report sets out our main findings, summarising key outcomes from the 2010/11 audit and the outlook for the period ahead.

We have given an unqualified opinion that the financial statements of Dumfries and Galloway Council Pension Fund for 2010/11 give a true and fair view of the state of the affairs of the pension fund as at 31 March 2011 and of the income and expenditure for the year then ended.

During 2010/11 there were no material weaknesses in the pension fund's accounting and internal control systems. While the committee structures in place during the year provided adequate governance arrangements and gave those charged with governance appropriate arrangements to carry out their role, the council has taken the positive step of agreeing new committee arrangements for the pension fund with a view to enhancing governance even further.

Outlook

Looking ahead, it is clear that the outlook for public spending for the period 2012/13 to 2014/15 remains very challenging, while volatility on the financial markets continue to affect the value of fund assets.

The triennial funding valuation was carried out by the scheme actuaries as at March 2011 and the results of this will shortly be published. It establishes to what extent, on future assumptions, the scheme assets currently meet the liabilities, and is expected to show a drop in the previous funding level of 88%. This could potentially mean a phased rise in employer contribution rates to attain the objective of a fully funded scheme at a set future date, which would put additional pressure on employers at an already difficult time financially.

The recent Scottish Spending Review has not compulsorily passed on the member contribution increases imposed in England and in other public sector pension schemes in Scotland such as police, fire and health, however if not met by increased members' contributions, any shortfall in funding will have to be found by other means.

Introduction

1. This report is the summary of our findings arising from the 2010/11 audit of Dumfries and Galloway Council Pension Fund ("the fund"). The purpose of the annual audit report is to set out concisely the scope, nature and extent of the audit, and to summarise the auditor's opinions (i.e. on the financial statements) and conclusions and any significant issues arising. The report is divided into sections which reflect the extent of our public sector audit model.
2. Appendix A provides details of our reports issued during 2010/11. We do not repeat all of the findings in this report, but instead we focus on the financial statements and any significant findings from our wider review of the fund.
3. Appendix B is an action plan setting out the high level risks we have identified from the audit. Officers have considered the issues and agreed to take the specific steps in the column headed "planned management action". We do not expect all risks to be eliminated or even minimised. What we expect is that those charged with governance understand the risks and have arrangements in place to manage these risks. The fund should ensure that those charged with governance are satisfied with the proposed management action and have a mechanism in place to assess progress.
4. This report is addressed to members and the Controller of Audit. It should be made available to the public and other stakeholders. Audit is an essential element of accountability and the process of public reporting. This report will be published on our website after consideration by the council.
5. The management of the audited body is responsible for preparing financial statements that show a true and fair view and for implementing appropriate internal control systems. Weaknesses or risks identified by auditors are only those which have come to their attention during their normal audit work, and may not be all that exist. Communication by auditors of matters arising from the audit of the financial statements or of risks or weaknesses does not absolve management from its responsibility to address the issues raised and to maintain an adequate system of control.

Financial statements

6. Audited bodies' financial statements are an essential part of accounting for their stewardship of the resources made available to them and their performance in the use of those resources.
7. Auditors are required to audit financial statements in accordance with the timescales set by Audit Scotland, which may be shorter than statutory requirements, and give an opinion on:
 - whether they give a true and fair view of the financial position of audited bodies and their expenditure and income
 - whether they have been properly prepared in accordance with relevant legislation, the applicable accounting framework and other reporting requirements.
8. Auditors review and report on, as appropriate, other information published with the financial statements, including the explanatory foreword and, statement on the systems of internal financial control. This section summarises the results of our audit of the financial statements.

Audit opinion

9. We have given an unqualified opinion that the financial statements of Dumfries and Galloway Council Pension Fund for 2010/11 give a true and fair view of the state of the affairs of the fund as at 31 March 2011 and of the income and expenditure for the year then ended.

Legality

10. Through our planned audit work we consider the legality of the pension fund's financial transactions. In addition the proper officer has confirmed that, to the best of his knowledge and belief, the financial transactions of the pension fund were in accordance with relevant legislation and regulations. There are no legality issues arising from our audit which require to be brought to the attention of those charged with governance.

Statement on the system of internal financial control

11. We are satisfied with the disclosures made in the statement on the system of internal financial control and the adequacy of the process put in place by the pension fund to obtain assurances on the system of internal control.

Governance Compliance Statement

12. We are satisfied that this statement covers the areas and levels of compliance required by the Scottish Government's guidance.

Annual Report

13. The Scottish Government Guidance requires that the annual report for the pension fund incorporates the following:
 - the annual accounts
 - a report about the management and financial performance of the funds during the year, a report explaining the authority's investment policy and reviewing the performance during the year of the investments of each fund, and a report of the arrangements made during the year for the administration of the funds
 - a statement by the actuary of the level of funding disclosed by their valuation
 - the governance compliance statement, funding strategy statement, and statement of investment principles (or details of where these statements may be obtained)
 - the extent to which levels of performance set out in the pension administration strategy have been achieved
 - any other material which the authority considers appropriate.
14. We are satisfied that the report incorporates the above sections and that the other sections are consistent with the audited accounts.

Accounting issues

15. Local authority bodies in Scotland are required to follow the 2010 Code of Practice on Local Authority Accounting in the United Kingdom (the 2010 Code), including for the first time in 2010/11 the application of International Financial Reporting Standards (IFRS). We were satisfied that the pension fund prepared the accounts in accordance with the 2010 Code.

Accounts submission

16. The fund's unaudited financial statements were submitted to the Controller of Audit by the deadline of 30 June 2011. A comprehensive working papers package was also available by this date. The other sections of the Annual Report were available from mid September. This enabled us to conclude the audit and certify the financial statements in advance of the target of 30 November 2011. The annual report, incorporating the financial statements, is now available for presentation to members and for publication.

Presentational and monetary adjustments to the unaudited accounts

17. As reported to the Audit and Risk Management Committee via our report in line with International Standard on Auditing 260 '*communication of audit matters to those charged with governance*' there was only one minor audit adjustments required to the financial statements as a result of our audit findings.
18. Dumfries and Galloway Council Pension Fund draft financial statements did not have a note on the present value of future liabilities of the Pension Fund. This is a new disclosure required by the 2010/11 Code. This information has now been provided by the actuary and included in

the final version of the financial statements. The IAS 19 note gives information on the present value of future liabilities of the Pension Fund in respect of all members including admitted bodies at 31st March 2011 and a comparative figure at 31st March 2010. These figures are £594 million and £661 million respectively. The IAS 19 valuation of the pension fund liability at 31 March 2011 is greater than the closing value of the net assets of the Pension Fund which were £511 million at 31 March 2011. A number of presentational changes were identified and were corrected by the treasurer as appropriate.

Prior year adjustments

19. The 2010/11 financial statements have been prepared in accordance with the 2010 Code which is based on International Financial Reporting Standards (IFRS) instead of the previous practice of preparing financial statements under UK Generally Accepted Accounting Practice (GAAP). This transition did not require a prior year adjustment to the 2009/10 audited financial statements of Dumfries and Galloway Council Pension Fund as none of the IFRS changes affected the preparation of its accounts.

Outlook

Audit appointment for 2011/12

20. Audit appointments are made by the Accounts Commission, either to Audit Scotland staff or to private firms of accountants for a five year term. 2010/11 is the last year of the current audit appointment. The procurement process for the next five years was completed in May 2011. From next year (2011/12) the Accounts Commission have appointed a new audit team from PricewaterhouseCoopers to audit the pension fund.

Financial position

21. Audited bodies are responsible for conducting their affairs and for putting in place proper arrangements to ensure that their financial position is soundly based.
22. Auditors consider whether audited bodies have established adequate arrangements and examine:
 - financial performance in the period under audit
 - compliance with any statutory financial requirements and financial targets
 - ability to meet known or contingent, statutory and other financial obligations
 - responses to developments which may have an impact on the financial position
 - financial plans for future periods.
23. These are key areas in the current economic circumstances. This section summarises the financial position and outlook for the pension fund.

Financial results

Budgetary control

24. The pension fund does not set a budget for its activities or report on progress through the year. This has been mainly due to the fact that for most of its activities (receiving pension contributions, paying pensions, investing activities etc) it does not have control over the value of the transactions at any one time. There are however some elements (administration costs, investment manager expenses and other overheads) where it does have some control and it would be helpful to prepare budgets for such areas of expenditure.

Financial position

25. The overall position at 31 March 2011 is that the pension fund has assets of £511 million. These are matched against an overall liability of £594 million, giving a net liability of £83 million. The liability is an estimate of the present value of the future liabilities of the fund, based on the fund actuary's assumptions regarding the future discount rate, longevity of members and rate of inflation. It is important to note that this is a snapshot at a point in time and that even slight variations in the actuary's assumptions can have a significant impact on estimated liability values.
26. The value of the pension fund liability at 31 March 2011 has reduced from the previous year. The main reason for this is due to the change in the basis of indexing the value of pension payments from retail price index to consumer price index and its effect of reducing future liabilities. In effect this means that future pension increases are now linked to the consumer price index, which is expected to rise at a lower rate than the previous retail price index (on average 0.8% lower according to the actuary's estimates), giving lower payments to pensioners and hence less future liabilities for the pension fund.

Outlook

2011/12 budget reporting

27. There is currently no reporting on the 2011/12 budgeted figures. It has been agreed that this will be introduced by March 2012 for the new financial year.

Financial forecasts beyond 2011/12

28. Looking ahead, it is clear that the outlook for public spending for the period 2012/13 to 2014/15 remains very challenging. The full extent of the recommendations made in the Hutton review, and how it will impact upon schemes in Scotland remains uncertain. The Pension Fund will have to remain vigilant and keep assessing their exposure to risk. Continuing to work, and communicate effectively with employers, and the actuary will be even more critical going forward.

Governance and accountability

29. The three fundamental principles of corporate governance – openness, integrity and accountability – apply to all audited bodies, whether their members are elected or appointed, or whether they comprise groups of people or an individual accountable officer.
30. Through members, chief executive and proper officer, each body is responsible for establishing arrangements for ensuring the proper conduct of its affairs including the legality of activities and transactions, and for monitoring the adequacy and effectiveness of these arrangements. Audited bodies usually involve those charged with governance (including audit committees or similar groups) in monitoring these arrangements.
31. Consistent with the wider scope of public audit, auditors have a responsibility to review and report on audited bodies' corporate governance arrangements as they relate to:
 - corporate governance and systems of internal control
 - the prevention and detection of fraud and irregularity
 - standards of conduct and arrangements for the prevention and detection of corruption.
32. In this part of the report we comment on key areas of governance.

Corporate governance

Processes and committees

33. Dumfries and Galloway Council Pension Fund's governance arrangements run alongside the governance structures of the administering authority, Dumfries and Galloway Council. The current arrangements are that pension investment matters are considered by a Pension Fund Investment Sub Committee, powers delegated from the Policy and Resources Committee. Any matters regarding pension administration are dealt with by the Policy and Resources Committee itself, although in practice this committee has discussed very little regarding pension matters.
34. The Pension Fund Investment Sub Committee met quarterly in 2010/11 to consider reports on the performance of investments, the investment approach of individual fund managers and changes in the portfolio of fund managers. The committee's membership consists of experienced senior councillors and meetings are generally well attended.
35. The pension fund does not have its own audit committee so after discussion with officers it was decided that for 2010/11 "those charged with governance" should be the council's Audit and Risk Management Committee. Our annual audit plan, governance report, ISA260 letter and draft audit certificate were all reported to this committee. To enhance governance the council has recently approved a change to the committee arrangements for the pension fund.

These will become operational from December 2011 and their effectiveness should be kept under review.

Refer Action Plan no. 1

36. It was a new requirement for 2010/11 that pension funds have to produce a governance compliance statement which sets out the areas that it does and does not comply with guidance issued by the Scottish Government on committee governance arrangements. The guidance covers membership of the pension committee, frequency of meetings, training of members and several other areas. Dumfries and Galloway Council Pension Scheme recorded on the governance compliance statement with regard to 2010/11, only partial compliance in the areas of:
- structure: administration and investment do not both sit with the same committee and representatives of scheduled or admitted bodies are not invited to committee
 - representation: there is no representative from the scheduled or admitted bodies on the committee
 - selection and role of lay members: a review of members training requirements is being carried out and training will be in place by May 2012.
37. The pension fund has given an indication of how these areas of partial non compliance are being addressed.

Refer Action Plan no. 2

Internal control

38. While auditors concentrate on significant systems and key controls in support of the opinion on the financial statements, their wider responsibilities require them to consider the financial systems and controls of audited bodies as a whole. The extent of this work should also be informed by their assessment of risk and the activities of internal audit.
39. The pension fund's financial systems run alongside those of the administering authority and its financial ledger and payroll system are used to process transactions. There are specific systems and lines of responsibility for pension administration and for investment transactions. Our review of these financial systems did not identify significant issues.
40. Our review of the fund's internal management policies found that in many cases it did not have specific policies and the expectation was that it would simply refer back to the council's own policies. For clarity and transparency it is suggested that the pension fund consider which council policies it wants to adopt and for which areas it needs to have its own specific policies. These policies are an essential part of the internal control system and should be kept up to date to reflect changes in the internal and external environment.

Outlook

41. Proposals to create one sub committee to cover all aspects of the pension fund were discussed and agreed by full council on 13 October 2011, with the first proposed meeting of the new committee due on 2 December 2011. The council is not planning to set up an

additional Pension Fund Audit Committee and those charged with governance would be the members of the Pensions Sub Committee itself.

Use of resources and performance

42. Audited bodies have a specific responsibility to ensure that arrangements have been made to secure Best Value.
43. Auditors of local government bodies also have a responsibility to review and report on the arrangements that specified audited bodies have made to prepare and publish performance information in accordance with directions issued by the Accounts Commission.
44. As part of their statutory responsibilities, the Accounts Commission may procure, through Audit Scotland, examinations of the use of resources by audited bodies and publish reports or guidance. Auditors may be requested from time to time to participate in:
 - a performance audit which may result in the publication of a national report
 - an examination of the implications of a particular topic or performance audit for an audited body at local level
 - a review of a body's response to national recommendations.
45. Auditors may also consider the use of resources in services or functions, where the need for this is identified through local audit risk assessments.
46. During the course of their audit appointment auditors should also consider and report on progress made by audited bodies in implementing the recommendations arising from reviews in earlier years.
47. This section includes a commentary on the Best Value and performance management arrangements within the pension fund. We also note any headline performance measures used by members and comment on any relevant national reports.

Management arrangements

Investment Performance

48. The main way the pension fund measures performance is through the performance of its investments, overseen by independent investment advisor (Hymans) and managed by a portfolio of specialised fund managers. Performance against benchmark targets is reported to the Pension Fund Investment Sub Committee at each meeting.
49. The Pensions Fund Investment Committee receives quarterly performance reports covering the previous three month, one year and three year performance periods. There is no separate annual performance report.

Administration Performance

50. The pension fund was included as part of a national review of pensions administration by the Improvement Service and as such customers participated in an online survey about customer experience. Approximately 1000 respondents were involved in providing information about customer experience and provided valuable information upon which to assess and improve performance where necessary. The aim is to incorporate a user survey on a continuous basis going forward.
51. A number of KPIs for administration such as speed of various processes and the unit cost per scheme member/pensioner are compared against the benchmark of another high performing fund. These results have been reported to the Policy and Resources Committee in the past but not for 2010/11. It is recommended that this information is publicised via the fund's section of the council website and sent to pension fund members as part of their annual benefits statement.

Refer Action Plan no. 3

Overview of performance in 2010/11

The Pension Fund's performance measurement outcomes

52. In 2010/11 the pension fund investments performed 1% below the benchmark at 7.1%. The returns against the three year benchmark are now 4.5% against a benchmark of 6.1%. Steps are being taken to address the underperformance of some fund managers however these activities are long term and no hasty decisions will be taken.
53. The pension fund's administration function's performance is set out in several KPIs in the annual report. It benchmarks against Lothian Pension Fund and in most respects equals or betters it.
54. Given the increasing complexity of pension fund investment management issues, increasing governance requirements and an increase in overall numbers in the scheme (coupled with the freezing or reduction in investment management and administration budgets) there is a potential risk that performance may suffer.

Refer Action Plan no. 4

Outlook

55. The pension fund sets its investment performance targets based on advice from the investment advisor about market performance and standard industry benchmarks. The current volatility in the stock market makes it important for pension funds to have a wide range of investment vehicles. Dumfries and Galloway Council Pension Fund has recently commissioned several new mandates for fund managers in areas such as currency investments and property to diversify the portfolio. It has also reduced reliability on UK equities.

National performance reports

56. Audit Scotland carries out a national performance audit programme on behalf of the Accounts Commission and the Auditor General for Scotland. Reports in the last year of interest are detailed in Exhibit 1:

Exhibit 1: A selection of national performance reports 2010/11

- | | |
|---|--|
| <ul style="list-style-type: none">• The cost of public sector pensions in Scotland• Scotland's public finances: responding to the challenges | <ul style="list-style-type: none">• An overview of local government in Scotland 2010 |
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Source: www.audit-scotland.gov.uk

57. Officers should review national performance reports as they become available and consider the impact of the findings for the pension fund.

Appendix A: audit reports

External audit reports and audit opinions issued for 2010/11

Title of report or opinion	Date of issue	Date presented to Committee
Annual audit plan	February 2011	March 2011
Review of the internal control system and governance	May 2011	September 2011
Report on financial statements to those charged with governance	August 2011	September 2011
Final Report to Members	November 2011	December 2011

Appendix B: action plan

Key Risk Areas and Planned Management Action

Action Point	Refer Para No	Risk Identified	Planned Management Action	Responsible Officer	Target Date
1	35	<p>New committee arrangements have recently been set up to enhance the governance of the pension fund. These will become fully operational in December 2011.</p> <p>There is a risk that:</p> <p>The revised committee arrangements do not further enhance governance of the pension fund and the effectiveness of the new approach is not kept under review. .</p>	<p>A review of the effectiveness of the new Committee / Governance arrangements will be undertaken after six and twelve months.</p>	Head of Finance & Technology	<p>June 2012 (interim review)</p> <p>December 2012 (full review)</p>
2	37	<p>The pension fund is addressing areas of non compliance with Scottish Government guidance on governance.</p> <p>There is a risk that:</p> <p>If non compliance is not addressed there is a risk of poor governance.</p>	<p>A review of compliance will be undertaken as part of the reviews referred to at Action Point 1 above.</p>	Head of Finance & Technology	<p>June 2012 (interim review)</p> <p>December 2012 (full review)</p>

Action Point	Refer Para No	Risk Identified	Planned Management Action	Responsible Officer	Target Date
3	51	<p>A number of key performance indicators relating to pension administration activities were not reported to members in 2010/11 and not publically reported.</p> <p>There is a risk that:</p> <p>The reporting on the performance of the pension fund does not cover all relevant areas of activity and is not publically available for review by the members of the pension fund.</p>	<p>A conscious decision was taken to delay the publication of key performance indicators for 2010/11 and to present these to the first meeting of the newly established Pension Sub Committee. The 2010/11 key performance indicators will be reported to the Pensions Sub Committee on 2 December 2011.</p>	HR Relations Manager	December 2011
4	54	<p>Performance of the investment management and administration functions against key benchmarks could be strained due to increased demands and greater pressures being placed on resources.</p> <p>There is a risk that:</p> <p>The investment management and pension administration functions' performance against comparators and key performance indicators could deteriorate.</p>	<p>The Investment Management and Pensions Administration functions are undergoing reviews as part of the Chief Executive's Refocusing exercise. These reviews, which will be completed in March 2012, will consider the resources issues and risks faced by these functions.</p>	Head of Finance & Technology / Head of Organisational Development & HR	April 2012 and ongoing.