

Highland Council Pension Fund

Annual report on the 2010/11 audit



Prepared for the members of the Highland Council Pension Fund 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

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 Highland 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 Highland 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.

Following a review of committee governance arrangements a new pension committee is to be established. This committee will be responsible for managing the affairs of the fund and may want to consider policies and procedures in place to ensure these meet business need.

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 continues 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 be published by the end of the financial year. This establishes the extent to which, on future assumptions, the scheme assets currently meet the liabilities. Although a small reduction is expected on the previous funding level of 98%, the overall position on employers' contributions is expected to be relatively positive.

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 the shortfall in funding will have to be found from other means, if not by increased members' contributions.

The co-operation and assistance given to us by officers is gratefully acknowledged.

Introduction

1. This report is the summary of our findings arising from the 2010/11 audit of Highland 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 the fund understand the risks and has arrangements in place to manage these. Members should ensure that they are satisfied with the proposed management action and have a mechanism in place to assess progress.
4. This report is addressed to those charged with governance 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 those charged with governance.
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 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 Highland 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 Director of Finance 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, with the exception that there is no statement regarding performance against a pension administration strategy.

Refer Action Plan no. 1

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 fund prepared the accounts in accordance with the 2010 Code.

Accounts submission

16. The fund's unaudited financial statements and annual report 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. This enabled us to conclude the audit and certify the financial statements by 30 November 2011. The annual report, incorporating the financial statements, is now available for presentation to members and for publication.

Prior year adjustments

17. 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 The Highland Council Pension Fund as none of the IFRS changes affected the preparation of its accounts.

Presentational and monetary adjustments to the unaudited accounts

18. There were no changes required to the figures in the financial statements as a result of our audit findings, other than corrections to typographical errors. A number of presentational

changes were identified and were corrected as appropriate which resulted in additional notes to the accounts.

Outlook

Audit appointment for 2011/12

19. 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) Audit Scotland will again be the appointed auditor for the Highland Council Pension Fund, but a different audit team will be in place. We look forward to continuing the good working relationships that exist.

Financial position

20. Audited bodies are responsible for conducting their affairs and for putting in place proper arrangements to ensure that their financial position is soundly based.
21. 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.
22. These are key areas in the current economic circumstances. This section summarises the financial position and outlook for the organisation.

Financial results

Budgetary control

23. 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 contributions, paying pensions, investing activities), 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 set a budget for these elements, perhaps along with expected costs for the other items.
24. In our controls report issued to the pension fund in June 2011 we highlighted the risk that performance issues, for example, cost overruns or inaccurate contributions may not be discovered timeously as there was no separate pension fund budget. This was to be considered as part of an overall review of governance arrangements for the pension fund by September 2011. The timescale for this has slipped and we have been advised that this will now be taken forward in conjunction with the establishment of the new Pension Committee (see paragraph 35).

Financial position

25. The overall position at 31 March 2011 is that the fund has assets of £987 million. These are matched against an overall liability of £1,247 million, giving a net liability of £279 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.

Outlook

2011/12 budget

26. The triennial funding valuation was carried out by the scheme actuaries as at March 2011. This establishes the extent to which, on future assumptions, the scheme assets currently meet the liabilities. The triennial review by the scheme actuary will be important in determining future levels of employer contributions.
27. The interim figures from the actuary for the Highland Council Pension Fund indicate that there is likely to be a small reduction in the funding level from 98% to 97% and this is not expected to result in a significant increase in employers contributions in the short term. The final report from the actuary will not be available until the end of the 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 high level figures for Scotland that were announced in the UK Comprehensive Spending Review indicate that significant budget reductions will be required in these years. This will impact on contributions received and benefits payable where scheduled and admitted bodies reduce staffing numbers.

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 its board, chief executive and/or accountable/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. Highland Council Pension Fund's governance arrangements run alongside the governance structures of the administering authority, The Highland Council. The current arrangements are that the Resources Committee deals with all pension fund issues and this committee has delegated investment matters to a working group - the Investment Advisory Group (IAG).
34. The Investment Advisory Group 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.
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 & Scrutiny Committee and the annual audit plan and governance report were reported to this committee. This report is also being submitted to it. As part of an overall review of governance arrangements during the year, we have been advised that a new pension committee, responsible for pension investments and administration, will be established with effect from 28 February 2012 and the IAG will be replaced by an investment sub-committee.

36. There was a new requirement in 2010/11 for pension funds to produce a governance compliance statement setting out where it does/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.
37. The Highland Council Pension Scheme was not compliant in the following two areas:
- Structure - representatives of participating LGPS employers are members of either the main or secondary committee. There are currently no pensioner or deferred members on the IAG or Resources Committee. This is expected to be addressed with the establishment of the new pension committee.
 - Representation - all key stakeholders are afforded the opportunity to be on the main or secondary committee. Resource Committee members are selected from the council. This is also expected to be addressed with the establishment of the new pension committee.
38. Partial compliance was achieved in:
- Meeting frequency - providing a forum outside of formal governance arrangements by which the interests of key stakeholders can be represented. Meetings are held with trade union representatives prior to each IAG meeting.

Refer Action Plan no. 2

Internal control

39. 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. However, the extent of this work should also be informed by their assessment of risk and the activities of internal audit.
40. 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.

Outlook

41. As highlighted in paragraph 35 above, following a review of committee governance arrangements a new pension committee is to be established. This committee will be "those charged with governance" for the pension fund and will be responsible for managing the affairs of the fund. The new committee may want to consider policies and procedures in place given the new requirement for a separate audit opinion to ensure these meet business need and we will monitor any developments next year.

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

Best Value

48. The pension fund has not been subject to a best value review, however it is covered by the overall best value arrangements of the administering authority.

Investment Performance

49. The main way the pension fund measures performance is through the performance of its investments, overseen by independent investment advisor (Hymans Robertson) and managed by a several specialised fund managers. Performance against benchmark targets is reported to each meeting of the IAG. An annual performance report is also presented to the IAG.

Administration Performance

50. The Highland Council has a local performance indicator measuring the unit cost per scheme member (measured against average scheme membership). There are no performance indicators, for example, to measure speed of processing, unit costs per pensioner or, member satisfaction levels.

Refer Action Plan no. 3

Overview of performance in 2010/11

51. In 2010/11 the pension fund investments performed 1.48% above the benchmark, at 8.34%, largely as a result of the out-performance of equity funds by one fund manager. The returns against the three year benchmark of 5.59% to the end of March 2011 showed a slight underperformance (5.45%), however, a report to the September IAG meeting highlighted that the three year performance was now 6.93% against a benchmark of 6.24%. Overall the fund is performing well under challenging market conditions.

National performance reports

52. 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 |
|---|--|

Source: www.audit-scotland.gov.uk

53. Whilst the administering authority currently has a system in place to ensure national performance reports are reviewed as they become available, the new pension committee should also consider any findings which impact on the pension fund.

Outlook

54. 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 including hedging against currency fluctuations. We note that the fund is currently considering various options to diversify such as global property and infrastructure assets. A private equity manager was recently appointed and tendering is underway for a global equity manager.

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 Audit Committee |
|---|------------------|---------------------------------------|
| Annual audit plan | 14 March 2011 | 7 April 2011 |
| Review of the internal control system and governance | 15 June 2011 | 30 November 2011 |
| Report on financial statements to those charged with governance | 10 November 2011 | 30 November 2011 (for information) |
| Audit opinion on the 2010/11 financial statements | 15 November 2011 | 30 November 2011 (for information) |

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 | 14 | <p>The pension fund has not included a statement on performance against an administration strategy in its annual report.</p> <p>Risk: The pension fund is not complying with Scottish Government guidance.</p> | <p>Investment performance is reported quarterly to the IAG. Benchmarking is undertaken against Administration activities. The timing of contributions from employers was recently reported to the Resources Committee. With the establishment of the new Pension Committee consideration will be given to future reporting requirements.</p> | <p>Head of Accounting & Budgeting and Head of Exchequer & Revenues</p> | <p>September 2012</p> |

| Action Point | Refer Para No | Risk Identified | Planned Management Action | Responsible Officer | Target Date |
|--------------|---------------|--|---|---|----------------|
| 2 | 37 | <p>There were a few areas where the pension fund has reported non or partial compliance with Scottish Government guidance on governance.</p> <p>Risk: If non compliance is not addressed there is a risk of that good practice on governance is not being achieved.</p> | <p>The establishment of a Pensions Committee will over time allow the Pension Fund to achieve full compliance with the SG guidance</p> | Head of Accounting & Budgeting | September 2012 |
| 3 | 53 | <p>The pension fund has limited performance measures in place.</p> <p>Risk: Members do not have the opportunity to identify performance issues in the pension administration function.</p> | <p>Investment performance is reported quarterly to the IAG.</p> <p>Benchmarking is undertaken against Administration activities. The timing of contributions from employers was recently reported to the Resources Committee.</p> <p>With the establishment of the new Pension Committee consideration will be given to future reporting requirements</p> | Head of Accounting & Budgeting and Head of Exchequer & Revenues | September 2012 |