

Strathclyde Pension Fund

Annual report on the 2010/11 audit



Prepared for Those Charged with Governance 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

This report covers the 2010/11 audit of the Strathclyde Pension Fund. This 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 annual report includes 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 Strathclyde Pension Fund (the fund). Our audit work included both Fund No. 1 and the sub-fund, Fund No. 3. 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 Strathclyde 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.

As the administering authority, Glasgow City Council has statutory responsibility for the administration of the fund with responsibility for the overall strategic direction of the fund delegated to the Strathclyde Pension Fund Committee (the committee).

As a result of the new requirement for a separate audit, the committee has taken on additional responsibilities in relation to the audit of the fund's financial statements with the annual audit plan, governance report, ISA260 letter and draft audit certificate all reported to the committee. It would be considered appropriate for the terms of reference for the committee to be reviewed and expanded to include these wider responsibilities.

Investment performance is reported to the pension fund committee and the Investment Advisory Panel on a quarterly basis. At the year end, an annual report on overall performance is produced and reported to committee. During 2010/11 No. 1 Fund achieved an annual return of 7.7% against its scheme specific benchmark of 8.5% while No 3. Fund achieved an annual return of 8.8% against its scheme specific benchmark of 7.5%.

The fund's administration strategy for 2010/11 was approved by committee in March 2010. It contains the standards which are required of the participating employers to ensure that the fund meets its statutory obligations and is able to deliver services efficiently. The strategy contains a variety of performance measures against which the fund and the participating employers are assessed with performance being reported to the committee on a quarterly basis. Administration performance has been strong in 2010/11 despite a number of challenges including office relocation, reductions in staff levels and the significant increase in workload caused by early retirement schemes across the fund's participating employers.

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 will continue to affect the value of fund assets.

There are a number of developments emerging in the public sector pension environment which will have an impact on the Local Government Pension Scheme (LGPS) and public sector pension schemes in general. The effect of the proposed changes and the potential impact on the fund is largely unclear at this time.

A triennial funding valuation is being carried out by the scheme actuaries which will report the funding position as at March 2011. The valuation will establish the extent to which, based on future assumptions, the scheme assets currently meet its liabilities. The results of the valuation will determine the employer contribution rates required over the next three year period to attain the objective of a fully funded scheme at a set future date. The results of this will be published in early 2012.

An Administration Strategy was implemented for the first time in 2010/11. This sets out the standards required of participating employers to enable the efficient administration of the pension fund. Performance in a number of areas fell short of the targets required. Compliance with the strategy will be encouraged by officers.

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 Strathclyde Pension Fund. The fund comprises No. 1 Fund and a sub-fund, No. 3 Fund. Both of these together are referred to as '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 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 the 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 Governance Compliance Statement. 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 Strathclyde 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 Executive Director of Financial Services has confirmed that, to the best of her 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.

Governance Compliance Statement

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

Annual Report

12. The Scottish Government Guidance requires that the annual report for the pension fund incorporates the following:
 - the financial statements
 - 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.
13. We are satisfied that the report complies with Scottish Government guidance and that the other sections are consistent with the audited accounts. However the format of the financial statements could be further improved by clarifying the accountability arrangements for the fund by inclusion of a statement of responsibilities. The board should consider this for its 2011/12 statements.

Accounting issues

14. 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 financial statements have been prepared in accordance with the 2010 Code.

Accounts submission

15. The fund's unaudited financial statements were submitted to the controller of audit by the deadline of 30 June 2011. The other sections of the Annual Report were available by 30 September 2011. This enabled us to conclude the audit and certify the financial statements by the target date 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

16. In line with International Standards on Auditing 260 *Communication of audit matters to those charged with governance*, we reported to the Pension Fund Committee on 31 October 2011 that there were two errors identified during the financial statements audit. Both of these were corrected in the signed financial statements.

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 fund as none of the IFRS changes affected the preparation of its accounts.

Outlook

Audit appointment for 2011/12

18. 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 Strathclyde Pension Fund, although the engagement lead and a number of the core audit team will change. We look forward to continuing the good working relationships that exist with officers.

Financial position

19. Audited bodies are responsible for conducting their affairs and for putting in place proper arrangements to ensure that their financial position is soundly based.
20. Auditors consider whether audited bodies have established adequate arrangements and examine:
 - financial performance in the period under audit
 - compliance with any statutory 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.
21. These are key areas in the current economic circumstances. This section summarises the financial position and outlook for the organisation.

Financial results

Budgetary control

22. Due to the nature of most of the fund's activities it is not considered appropriate to prepare a comprehensive annual budget for expenditure. However the fund does prepare an annual budget for its administration costs with monitoring reports presented to committee on a quarterly basis. Total net budgeted expenditure for 2010/11 was £4.279 million with a small underspend of £1,000 reported at the year end.
23. Cashflow monitoring reports are prepared monthly to ensure that sufficient cash balances are held to meet ongoing pension commitments, and that any excess balances are passed periodically to the fund's investment portfolios. These cashflow reports are also presented quarterly to committee. During 2010/11 excess cash balances of £50 million were transferred to the fund's global custodian for investment.

Funding position

24. At the last actuarial valuation at 31 March 2008, the No. 1 fund had assets of £9,493 million matched against liabilities of £9,979 million. The net liability of £486 million represents a funding level of 95%.
25. At the same point, the No. 3 fund had assets of £103 million matched against liabilities of £117 million. The net liability of £14 million represents a funding level of 88%.

Financial Position

26. The overall position at 31 March 2011 is that the No.1 fund has assets of £11,320 million. These are matched against an overall liability of £13,207 million. The No. 3 fund has assets of £127 million matched against an overall liability of £105 million
27. The liability on each fund is an estimate of the present value of the future liabilities of the funds, based on the actuary's assumptions regarding future discount rates, longevity of members and rate of inflation.

Outlook

2011/12 budget and cashflow

28. The 2010/11 annual budget for administration costs is £4.16 million, a reduction of £0.12 million from 2009/10. These savings have been made possible by reductions in staff costs resulting from the voluntary severance scheme offered to all council staff aged over 50 during 2009/10. The SPFO will lose 16 FTE staff over the period to 2012/13. Savings have also been made in property costs as a result of the completion of the move to new office accommodation for the SPFO.
29. The most recent administration budget monitoring report to committee, as at period 5, showed an underspend of £0.254 million.
30. Cashflow monitoring reports indicated that cash inflows from activities were exceeded by cash outflows by around £15 million at period 5. This leaves a cash balance of £59 million which is expected to reduce further to £54 million by the year end.

Financial forecasts beyond 2011/12

31. The fund's next triennial actuarial valuation, to be presented in March 2012, will determine the funding position as at 31 March 2011. This will inform the future funding strategy and will determine the levels of employer contributions required to meet the fund's objective of holding sufficient assets to meet the estimated current cost of providing members' past service benefits.
32. Currently the fund's monthly cash inflows exceed the required outflows, resulting in a surplus cash position throughout the year. As a result of widespread severance schemes and recruitment freezes across participating employer bodies, it is likely that the membership profile of the fund will change with a higher proportion of pensioner members compared to active members. At some point in the future this will result in monthly income not being sufficient to meet the fund's monthly commitments, requiring the use of investment income to pay pension benefits. This will be considered as part of the fund's review of its investment structure and strategy.

Refer Action Plan no. 1

33. Looking ahead, it is clear that the outlook for public spending for the period 2012/13 to 2014/15 remains very challenging. There are a number of ongoing developments in the public

sector pension environment that could have a significant impact on the operation of local government pension schemes.

Refer Action Plan no. 2

Governance and accountability

34. 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.
35. 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.
36. 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.
37. In this part of the report we comment on key areas of governance.

Corporate governance

Processes and committees

38. As the administering authority, Glasgow City Council has statutory responsibility for the administration of the fund. Its functions are carried out in accordance with the Local Government Pension Scheme (Scotland) Regulations 1998 and the Superannuation Act 1972.
39. Responsibility for the overall strategic direction of the fund is delegated by the council to the Strathclyde Pension Fund Committee (the committee) which is comprised of elected members of the council. Day to day administration of the fund is carried out by the Strathclyde Pension Fund Office (SPFO) which is a division of the council's financial services department.
40. The committee meets quarterly 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.
41. The pension fund does not have its own audit committee. After discussion with officers it was agreed that for 2010/11 it would be appropriate for the members of the committee to be considered as 'those charged with governance'. The annual audit plan, governance report, ISA260 letter and draft audit certificate were all reported to this committee and this report is also being submitted to it.

42. As a result of the new requirement for a separate audit the committee has taken on additional responsibilities in relation to the audit of the fund's financial statements. It would be considered appropriate for the terms of reference for the committee to be reviewed and expanded to include these wider responsibilities.

Refer Action Plan no. 3

43. The Representative Forum is the main mechanism for engagement with the fund's stakeholders and enables their involvement in the decision-making process. The forum meets quarterly on the same cycle as the committee.
44. There was a new requirement in 2010/11 for pension funds to produce a governance compliance statement, setting out areas where 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. The governance compliance statement produced by the fund meets the requirements of this guidance.
45. Given the complex nature of pensions and investments, it is important that the committee receive continuous training and support to enable effective scrutiny. There are likely to be many legislative and regulatory changes over the coming years, so it is essential that members receive sufficient training to keep them up to date with current events. This will be particularly important next year as membership of the committee may change as a result of the Scottish Local elections in May 2012.

Internal control

46. 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.
47. The 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.
48. As part of our work, we took assurance from key controls within the fund's systems, with some controls being tested by internal audit. The results of our review were reported to the committee in September 2011. No significant control weaknesses were identified during this work.

Outlook

49. As highlighted in paragraph 42 above, given there are now separate audit and reporting arrangements for the pension fund, it would be timely for the committee to review its remit and to formally acknowledge the change in its responsibilities.

Use of resources and performance

50. Audited bodies have a specific responsibility to ensure that arrangements have been made to secure Best Value.
51. 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.
52. 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.
53. Auditors may also consider the use of resources in services or functions, where the need for this is identified through local audit risk assessments.
54. 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.
55. 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

56. 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. A Best Value 2 audit of Glasgow City Council has been scheduled for 2013/14.

Investment Performance

57. Investment advice and support is provided to the fund by its Investment Advisory Panel (IAP) which is comprised of investment advisers, actuarial consultants and senior officers. The role of the IAP includes the development of investment strategy and the monitoring of performance of the fund's investments.

58. Performance against benchmark targets is reported to the pension fund committee and the IAP on a quarterly basis. During the year fund managers are required to present to the panel on their performance. At the year end, an annual report on overall performance is produced and reported to committee.

Administration Performance

59. The fund's administration strategy for 2010/11 was approved by committee in March 2010. It contains the standards which are required of the participating employers to ensure that the fund meets its statutory obligations and is able to deliver services efficiently. The strategy contains a variety of performance measures against which the fund and the participating employers are assessed with performance being reported to the committee on a quarterly basis.
60. In accordance with Regulation 60A of the LGPS (Administration) (Scotland) Regulations 2008, the fund's annual report discloses performance against the measures detailed in the administration strategy.

Overview of performance in 2010/11

The fund's performance measurement outcomes

61. Investment performance was mixed during 2010/11.

Fund No. 1

62. During 2010/11 the fund achieved an annual return of 7.7% against its scheme specific benchmark of 8.5%. This underperformance has resulted in the main from poor returns on the fund's property portfolio and underperformance from a number of individual managers. Of the fund's 17 investment managers, 9 underperformed against the benchmarks applied to them.
63. The fund achieved a 10 year annualised return of 5.7% which is below the benchmark of 5.9% and the actuarial assumed rate of return of 6.1%.

Fund No. 3

64. During 2010/11 the fund achieved an annual return of 8.8% against its scheme specific benchmark of 7.5%. All managers outperformed their respective benchmarks.
65. The fund achieved a 10 year annualised return of 7.0% which is above the benchmark of 5.8%.
66. Once the results of the triennial actuarial valuation are known the fund's Investment Strategy Working Group will develop a revised investment structure and strategy which will take into account the funding position at 31 March 2011 and the new funding strategy statement.

Refer Action Plan no. 4

Administration performance

67. Administration performance has been strong in 2010/11 despite a number of challenges including office relocation, reductions in staff levels and the significant increase in workload caused by early retirement schemes across the fund's participating employers.
68. Performance has been above target in a number of areas including turnaround times for various pension processes and levels of positive customer feedback. Areas where performance has not been achieved include the supply of compliance certificates, year end data returns and employer responses to SPFO queries.
69. Employers are required to submit compliance certificates verifying compliance with a range of SPFO and regulatory requirements in relation to pension administration. As at 31 March 2011, 80% of certificates had been submitted. By October 2011 this had increased to 89%.
70. Employers are also required to submit year end contribution returns by 20 May for the preceding 31 March year end. By 21 May 2011, approximately 45% of returns had been received. By August 2011 information had been received from all employers.
71. Officers will continue to encourage employers to assist in the efficient running of the fund through compliance with the newly developed Administration Strategy.

Refer Action Plan no. 5

National performance reports

72. 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 which are of interest to the fund are detailed in Exhibit 1:

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

- The cost of public sector pensions in Scotland
- Scotland's public finances: responding to the challenges
- An overview of local government in Scotland 2010

Source: www.audit-scotland.gov.uk

73. We suggest that officers review national performance reports as they become available and consider any findings which impact on the pension fund.

Outlook

74. Continuing to meet performance targets will become more challenging in the coming years. Investment targets are set based on advice from investment advisors and standard industry

benchmarks. The funds will have to remain vigilant, and ensure that they have the right diversification of funds to minimise exposure to risk whilst still delivering the required returns

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	15 February 2011	9 March 2011
Review of the internal control system and governance	25 August 2011	7 September 2011
Report on financial statements to those charged with governance	26 October 2011	31 October 2011
Audit opinion on the 2010/11 financial statements	17 November 2011	31 October 2011
Annual Report to Members	28 November 2011	7 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	32	<p>Cashflow monitoring</p> <p>Due to the changing profile of the fund's membership, monthly cash inflows are reducing and outflows are increasing.</p> <p>Risk - at some point in the future the fund will be in a cash negative position and will have to manage investment income to pay pension benefits.</p>	The Investment Strategy Working Group is undertaking a review of investment strategy and structure to ensure that the changing cashflow pattern can be managed.	Head of Pensions	31 March 2012
2	33	<p>Pension Reform</p> <p>There are a number of wide ranging developments in the public pension environment.</p> <p>Risk - the future structure of the LGPS is unknown, creating uncertainty for members.</p>	Officers will continue to monitor developments and communicate the impact on the fund to its members.	Head of Pensions	Ongoing
3	42	<p>Committee Remit</p> <p>Due to the changing responsibilities of the committee as a result of the new audit requirements it is appropriate to revise the remit of the committee.</p> <p>Risk - there is a lack of clarity around the responsibilities of the</p>	An amended committee remit is to be approved by council.	Executive Director of Corporate Services	31 March 2012

Action Point	Refer Para No	Risk Identified	Planned Management Action	Responsible Officer	Target Date
		committee in their role as 'those charged with governance'			
4	66	<p>Investment Performance</p> <p>Fund No. 1 has underperformed against its benchmark for 2010/11.</p> <p>Risk - continued underperformance will affect the fund's investment objectives</p>	<p>The Investment Strategy Working Group will consider this as part of the review of investment structure and strategy.</p> <p>The results of the triennial valuation will also determine the new funding strategy statement.</p>	Head of Pensions	31 March 2012
5	71	<p>Administration Strategy</p> <p>2010/11 saw the first year of implementation of the fund's administration strategy. Performance by employers in meeting targets was mixed.</p> <p>Risk - the effective administration of the fund is adversely affected by failure to meet the agreed standards in the strategy.</p>	<p>Officers will continue to encourage compliance with the strategy.</p> <p>Performance against certain measures will continue to be reported in quarterly reports to committee.</p>	Chief Pensions Officer (Operations)	31 March 2012