

Scottish Borders Council 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

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 Scottish Borders 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 Scottish Borders Council Pension Fund for 2010/11 give a true and fair view of the state of the affairs of the board as at 31 March 2011 and of the income and expenditure for the year then ended.

Our review of the Fund's governance arrangements found that overall they were reasonably robust however there are a number of areas where the Fund is still developing the governance arrangements to ensure best practice is followed.

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 the extent to which, on future assumptions, the scheme assets currently meet the liabilities, and is expected to show a drop in the previous funding level of 96.5%. The council and other employers will need to review their financial strategies to ensure the future liabilities of the Fund can be met.

The recent Scottish Spending Review has not compulsorily passed on the member contribution increases imposed in England and some other unfunded public sector pension schemes in Scotland, such as police, fire and health. Discussions are ongoing at a national level as to what alternative options are available to address any potential shortfall in funding resulting from this.

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 Scottish Borders 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 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 explanatory foreword, statement on the systems of internal financial control and the remuneration report. Where required, auditors also review and report on the Whole of Government Accounts return. 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 Scottish Borders 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 Fund's financial transactions. In addition the proper officer has confirmed that, to the best of her knowledge and belief, the financial transactions of the 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 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 pension funds 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 appropriately incorporates this information 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. This is to be addressed by the Fund and the development of a pension administration strategy, against which performance can be measured, is an action point in the Governance Report.

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 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 by 30 September 2011, well before the transitional target date of 30 November in this first year of the separate audit. 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 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 adjustment required to the financial statements as a result of our audit findings.

Prior year adjustments

18. 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 Scottish Borders Council Pension Fund as none of the IFRS changes affected the preparation of its 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) the Accounts Commission have appointed a new audit team from KPMG to audit the Fund.

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 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.

Financial position

24. The overall position at 31 March 2011 is that the Fund has asset valued at £379m. As a result of the IAS26 actuarial calculations for the final accounts, the comparison between the fair value of the scheme assets and the present value of the funded obligations results in a net liability for the Fund of £92.5m. 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.

2011/12 reporting

25. It has been agreed that a budget would be established for 2012/13 and that budget monitoring would be introduced for the new financial year.

Outlook

26. The triennial review by the scheme actuary will be important in determining future contribution rates for employers. The full extent of the recommendations made in the Hutton review, and how they will impact upon schemes in Scotland remains uncertain. If contribution rates are increased as a result of this, there is a risk of member drop-out from the schemes. In addition, the financial markets look set to remain volatile over the coming year. This will affect the value of scheme assets and investment income going forward.
27. The Fund will have to remain vigilant and keep assessing exposure to risk. Continuing to work, and communicating effectively with employers and the actuary will be even more critical going forward.

Governance and accountability

28. 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.
29. 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.
30. 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.
31. In this part of the report we comment on key areas of governance.

Corporate governance

Processes and committees

32. Scottish Borders Council Pension Fund's governance arrangements run alongside the governance structures of the administering authority, Scottish Borders Council. The current arrangements are that the Pension Fund Sub Committee deals with all pension fund issues and is a sub committee of Scottish Borders Council.
33. The Pension Fund 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.
34. The Pension Fund reports to the Council's main Audit Committee as the body "charged with overseeing the governance" for the Pension Fund as the scale of the Pension Fund does not currently warrant a separate committee. The annual plan, governance report, ISA260 letter and draft audit certificate were all reported to this committee and this report is also being submitted to it.

35. 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.
36. Scottish Borders Council Pension Scheme demonstrated compliance in most areas but identified that it was not yet compliant in the following area:

- training/facility time/expenses: there is no formally documented training policy framework for the Pension Fund and there are no annual training plans or training logs for committee members;

and recorded only partial compliance in the area of:

- selection and role of lay members/access: observers are not currently provided with the private session papers in advance

The pension fund has given an indication of how these areas are being addressed in their compliance statement.

Refer Action Plan no.2

37. As part of our assessment of existing governance arrangements we noted that there was currently no separate risk register for the SBC Pension Fund. Maintaining a separate risk register would enable committee members to focus on the issues facing the pension fund as distinct from those facing the council. This has been recorded as a high priority action in our Governance report.

Refer Action Plan no.3

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. However, 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 we suggested in our governance report 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. We note that several policies have already been adopted by the Pension Fund Sub Committee.

Outlook

41. As highlighted in paragraph 35 above, given there are now separate audit and reporting arrangements for the pension fund, in order to make the committee governance arrangements absolutely clear the Audit Committee's remit within the Scheme of Administration should formally acknowledge its responsibilities in relation to the Pension Fund.

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 (Aon Hewitt) and managed by a several specialised fund managers. Performance against benchmark targets is reported to the Pension Fund Sub Committee at each meeting. The pension fund also utilises the performance reporting services of WM Company to provide independent fund reporting, analysis and benchmarking information.

50. An annual performance report is also presented to the Pension Fund Sub Committee.

Administration Performance

51. A number of KPIs for administration such as speed of various processes and the unit cost per scheme member/pensioner are compared against benchmarks. These results have however not been reported to the Pension Fund Sub Committee. It is recommended that this information is reported to committee and publicised via the fund's section of the council website and sent to pension scheme members as part of their annual benefits statement. This has already been agreed as part of the governance report and will be incorporated into the work involved in developing and implementing a Pensions Administration Strategy.

Refer Action Plan no. 1

Overview of performance in 2010/11

The Pension Fund's performance measurement outcomes

52. In 2010/11 the pension fund investments performed 1.6% above the benchmark at 10.4%. The returns against the three year benchmark are now 7.1% against a benchmark of 6.1%.
53. As outlined above, there is no material on the performance of pension administration in the annual report. As part of the proposals to develop and implement a Pensions Administration Strategy there will action taken the introduction of performance reporting to the Sub Committee.

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. Scottish Borders Council Pension Fund already has a passive currency hedge in place, and is in the process of reviewing these arrangements to ensure they continue to meet the objectives for the management of currency risk. In addition the pension fund is in the process of commissioning two new mandates for fund managers to further diversify the portfolio.

National performance reports

55. 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 overleaf:

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

56. We encourage officers to continue to review national performance reports as they become available and consider any findings which impact on 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 Audit Committee
Annual audit plan	11 March 2011	21 March 2011
Review of the internal control system and governance	25 August 2011	26 September 2011
Report on financial statements to those charged with governance	22 September 2011	26 September 2011
Audit opinion on the 2010/11 financial statements	22 September 2011	26 September 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	14	<p>The pension fund does not have a documented pension administration strategy and consequently has not included a statement on performance against the strategy in its annual report.</p> <p><i>Risk</i></p> <p><i>The pension fund is not complying with Scottish Government guidance.</i></p>	<p>The Pension Administration Strategy will be developed and as part of this process, key service standards will be defined including those in relation to customer satisfaction, and benchmarks.</p> <p>Following the approval of the Strategy, the monitoring of performance against the standards will be included in the annual reporting process.</p>	<p>Ian Angus HR Shared Services Manager</p> <p>Ian Angus HR Shared Services Manager</p>	<p>31 March 2012</p> <p>Annual Report 2012/13</p> <p>30 June 2013</p>
2	36	<p>The pension fund does not have formalised arrangements in place for the development of the committee role in relation to member training.</p> <p><i>Risk</i></p> <p><i>If this is not addressed there is a risk of that good practice on governance is not being achieved.</i></p>	<p>Develop and Implement a Skills and Knowledge framework. Target date based on introducing new membership to Pension Fund Sub Committee post the May elections.</p>	L Mirley Treasury & Capital Manager	30 September 2012
3.	38.	<p>The pension fund does not have a separate risk register</p> <p><i>Risk</i></p> <p><i>Risks specific to the</i></p>	<p>Development of a Risk Register has been identified as an action to be undertaken as part of the Business</p>	<p>L Mirley Treasury & Capital Manager</p> <p>Ian Angus</p>	31 December 2011

Action Point	Refer Para No	Risk Identified	Planned Management Action	Responsible Officer	Target Date
		<i>pension fund may not be given sufficient prominence</i>	Plan. This will be taken to PFSC for agreement in December.	HR Shared Services Manager	