

REPORT TO: SCRUTINY COMMITTEE - 14 DECEMBER 2011

REPORT ON: EXTERNAL AUDIT REPORT- TAYSIDE SUPERANNUATION FUNDS CORPORATE GOVERNANCE ARRANGEMENTS

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REPORT NO: 540-2011

1 PURPOSE OF REPORT

- 1.1 To submit to Members of the Scrutiny Committee the External Audit Report on Tayside Superannuation Funds Corporate Governance Arrangements

2 RECOMMENDATIONS

- 2.1 Members of the Committee are asked to consider the report and to note the agreed action plan.

3 BACKGROUND

- 3.1 Dundee City Council administers the Tayside Superannuation and Tayside Transport Superannuation Funds on behalf of employees and employers. Jointly the funds cover approximately 39,000 members and, as at 31 March 2010 had combined net assets of £1.8 billion.
- 3.2 An amendment to the Local Government Pension Scheme (Administration) (Scotland) Regulations 2008 required the administering authority to publish a pension fund annual report from 2010/11 and consequently, auditors are required to provide a separate audit opinion on the financial statements within the annual report. As part of this work we have conducted a review of the Council's corporate governance arrangements as the administering authority. The report summarises the findings from that review.
- 3.2 The report identifies that the Council has many of elements of good practice in place. Particularly through the existence of a dedicated sub-committee to scrutinise investments, and the use of external fund managers with appropriate expertise to manage investments.
- 3.3 The report also highlights the findings of our review of internal controls in operation over the key financial systems used in the administration of the funds noting that we found a good level of control to be in place.

Alasdair Craik
Senior Audit Manager

29 November 2011

Tayside Superannuation Funds

Corporate Governance 2010/11

August 2011

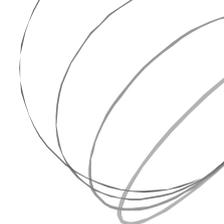


 AUDIT SCOTLAND

Contents

Corporate governance	1	Appendix A – Risk summary and action plan	6
Introduction	1		
Governance arrangements	1	Appendix B	10
Internal control systems	4		

Corporate governance



Introduction

1. The Local Government Pension Scheme (LGPS) is a common scheme throughout Scotland, administered by 11 individual pension funds. Between these funds manage assets of around £20bn on behalf of members of the scheme in Scotland
2. Dundee City Council administers the Tayside Superannuation Fund on behalf of its own employees and some 47 other admitted and scheduled bodies. The council also administers the Tayside Transport Superannuation Fund on behalf of the employees of the former Tayside Public Transport Company. Local government pension schemes are administered by local authorities but adhere to the nationally determined regulations of the LGPS. Jointly the funds cover approximately 39,000 members with c18,500 contributing members and c11,650 pensioners and as at 31 March 2010 had combined net assets of £1.791 billion.
3. Although those entrusted to make statutory decisions under the LGPS are, in many ways, required to act in the same way as trustees in terms of their duty of care, they are subject to a different legal framework, which derives from public law. In particular, members of LGPS pension committees are subject to all the normal duties and responsibilities that come with their office. However, they are not trustees in the strict legal sense of that word.
4. The LGPS also differs from most private sector schemes in terms of the management of risk to members' accrued benefits. In private sector schemes, accrued benefits payable to members are always subject to risk of fund/scheme under-performance or even failure meaning that a degree of risk of underperformance is shared with scheme members. By contrast, the accrued benefits paid by local authorities are established and payable by statute and underpinned from local authority revenue. In effect, the pension fund exists to defray the pension costs incurred by the local authority. Therefore, it is the local authority itself and, ultimately, the council tax payers who bear the financial and investment risks, rather than scheme members.,
5. Our 2010/11 Annual Audit Plan highlighted that we would undertake a review of the funds' governance arrangements in a number of key areas. This report summarises our findings from the review of corporate governance arrangements and from the testing of high level controls upon which we plan to place reliance for our audit of the financial statements.

Governance arrangements

6. Governance is about how local government bodies ensure that they do the right things, in the right way, for the right people, in a timely, inclusive, open, honest and accountable manner. It comprises the systems and processes, culture and values by which local government bodies are directed and



controlled and through which they account to, engage with and, where appropriate, lead their community.

7. Elected members have legal responsibilities for the prudent and effective stewardship of LGPS funds and in more general terms, have a clear fiduciary duty in the performance of their functions. However, the scheme beneficiaries have an interest in the beneficial title to the assets and the legal right to require that assets are held and managed on their behalf in accordance with the LGPS regulations. In this regard elected members have a duty of care that goes beyond the strict fiduciary duty to employers and tax payers.
8. The Council exercises its responsibility for the administration of the funds through powers delegated to the Superannuation Investment Sub-Committee (the sub-committee). The sub-committee comprises of six elected members from Dundee City Council with provision made for 3 employee representatives to attend as observers.
9. The remit of the sub-committee and the governance framework are detailed in the Governance Compliance Statement approved by the sub-committee in May 2009. We note, however, that the remit is mainly concerned with pension investment arrangements and is silent on fund income and expenditure and administration. In particular, no mention is made of transactions with members, such as payments made to members and contributions received from members and participating employers. It is unclear where the responsibility for governance of these areas lies within the current framework.

Key risk area 1

10. CIPFA's report *Delivering good governance in local government funds* (2009) highlights that LGPS funds have many stakeholders including beneficiaries (pensioners), contributors (employees) employers and council tax payers. It is therefore essential that there are appropriate arrangements for ensuring that the legitimate interests of all stakeholders are properly represented within the structures chosen for the management of funds.
11. Under section 57 of the Local Government (Scotland) Act 1973, it is for the appointing council to decide upon the number of members of a committee and their terms of office. They may include committee members who are not members of the appointing council. Such members may be given voting rights by virtue of section 14 of the Local Government and Housing Act 1989. On this basis it is open to pension committees to include representatives from employing authorities, scheme members and other lay member representatives, with or without voting rights, provided that they are eligible to be committee members.
12. At present the sub-committee membership is comprised of 6 elected members of Dundee City Council with rights. Provision is made for three observer employee representatives who do not have voting rights.. Pensioners and employers are not directly represented.



Key risk area 2

13. The council communicates with active members through annual statements and newsletters and holds regular meetings and training events with participating employers. However, we understand that there is no regular communication with pensioners on cost grounds.
14. Pension scheme rules and investments are complex. Effective oversight of pension funds requires a robust understanding of complicated rules, investment types and transactions. Although provision is made for regular training of sub-committee members, attendance at these training events is voluntary and there has been no formal assessment of specific pension related training needs for relevant elected members.

Key risk area 3

15. At its meeting on 21 February 2011, the sub-committee approved the first risk register for the funds. Sub-committee members should ensure that they are satisfied with risk assessments and current risk control measures and should obtain assurances that sound controls are in place and operating effectively. We welcome this development and will keep a watching brief to ensure that risk management is embedded in the operation of the funds.
16. Internal audit is an appraisal activity established by or provided as a service to the entity. The objectives of the internal audit function are determined by management and, where applicable, those charged with governance. Its functions include, amongst other things, examining, evaluating and monitoring the adequacy and effectiveness of internal control.
17. The funds' Governance Policy Statement records that Dundee City Council provides an internal audit service which covers pension investment and administration at regular intervals. However, the council's internal audit service has not reviewed pension scheme-related systems and controls for some time and no pension fund work was undertaken in 2010/11.
18. We also note that there is no formal agreement between the council and the pension funds as to the provision of an internal audit service and that the sub-committee does not approve an annual programme of work or consider reports, including a year end statement of assurance on the effectiveness of the system of internal control.
19. This increases the risk that assurances over the adequacy and effectiveness of internal controls are not available to underpin effective governance and support the governance compliance statement.

Key risk area 4

20. The funds use 6 investment managers and a custodian to provide professional fund management services for their £1.8 billion investment portfolio. SAS70 reports (Service Organisations – replaced by ISA 402 for accounting periods ending on or after 15 June 2011) are issued annually by reporting



accountants who are independent to investment managers and custodian. These reports provide assurances to those charged with governance that controls in operation at investment managers operate satisfactorily. As well as an overall opinion, they give details of tests performed and weaknesses identified. However, we understand that these reports are not subject to formal review and that available assurance or weaknesses identified are not reported to members.

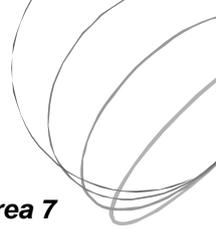
Key risk area 5

21. Given the magnitude of funds under management and the importance of exerting adequate control over the operations of outsourced services, it is essential that robust and up-to-date contracts are in place with firms providing outsourced services. However, we found weaknesses in the funds' contracts arrangements. Generally, there is a need for the Sub-Committee to ensure that it has up-to-date agreements for all outsourced professional services. We found one investment manager for whom no contract was in place. Two contracts were extended during 2010/11, however, member approval for these extensions was only obtained after the event.

Key risk area 6

Internal control systems

22. Internal control systems are the means by which management manages the risks inherent in key financial systems. In the period to April 2011, we carried out audit testing focussing on the high level controls in place within key internal control systems relevant to the funds, namely:
 - Investments
 - Pensions administration
 - Payroll
 - Cash management
23. In general, we found a good level of control to be in place although some risks were noted.
24. Sub-committee members receive quarterly reports on investment market values, transactions and performance. We have reviewed the underlying data used to report to members and have a number of observations, mainly in relation to derivatives (futures) and the benchmarks used for performance measurement.
25. We understand that some of the funds' investment managers use derivatives in the management of their portfolios. For example, we found that one manager's exposure to derivatives was around 50% of the value of its portfolio. However, the funds' exposure to derivatives and offsetting cash holdings are not reported to members. It is essential that members appreciate the financial techniques used by their appointed investment managers and the risks associated with financial instruments.



Key risk area 7

26. Performance benchmarks set vary between investment managers and may even vary for the same type of asset. However, benchmarks reported to members do not always take this into account, occasionally resulting in incorrect performance assessment. In some cases, benchmarks are not reported, which may make performance data less meaningful..

Key risk area 8

27. Admitted and scheduled bodies are responsible for the collection and timeous transfer to the fund of contributions from both employer and employees. If the sums due to be transferred are incorrectly calculated there is a risk that pension benefits will be incorrectly. We noted a lack of controls to ensure that employers contributions received are complete and accurate. While steps are taken to monitor the levels of employee contributions by employer month by month, this does not extend to confirming the employers' contributions.

Key risk area 9

28. Consideration should also be given to addressing the findings highlighted in Appendix B to further improve the control environment.
29. The issues identified in preparing this report are only those which have come to our attention during the course of the review and are not necessarily, therefore, all the risk areas that may exist. It remains the responsibility of management to determine the extent of the internal control system appropriate to Dundee City Council. We would stress, however, that an effective system of internal control is an essential part of the efficient management of any organisation.
30. The assistance and co-operation we received during the course of our work is gratefully acknowledged.

Appendix A – Risk summary and action plan

No	Risk	Responsible officer	Response and agreed action	Target date
Governance arrangements				
1.	<p>The remit of the sub-committee and the governance framework are detailed in the Governance Compliance Statement approved by the sub-committee in May 2009. We note, however, that the remit is mainly concerned with pension investment arrangements and is silent on fund income and expenditure and administration. In particular, no mention is made of transactions with members, such as payments made to members and contributions received from members and participating employers. It is unclear where the responsibility for the governance of these areas lies in the current framework.</p> <p>Risk: governance arrangements in relation to the administration of the funds and their transactions with stakeholders are weak and do not represent good practice.</p>	Exchequer Officer	<p>Revised compliance statement is being prepared for August Sub-committee</p> <p>The remit of Sub-Committee will continue to focus on investments.</p> <p>Financial Regulation 24.5 confirms the Director of Finance's responsibility for income and expenditure and there is delegated authority for administering the Local Government Pension Scheme.</p>	August 2011
2.	<p>Representatives of participating LGPS employers, admitted bodies and scheme members (including pensioners) should be represented on the committee established to govern the fund. At present the sub-committee membership is comprised of 6 elected members of Dundee City Council who hold all the voting rights. Provision is made for 3 observer employee representatives. Pensioners and employers are not directly represented.</p> <p>Risk: the views of key stakeholders may not be adequately represented in the management of the funds.</p>	Head of Financial Services	<p>Legal position needs to be clarified at a national level.</p> <p>Representatives are consulted and included in communications regularly.</p>	March 2012

No	Risk	Responsible officer	Response and agreed action	Target date
3.	<p>Pension scheme rules and investments are complex. Effective oversight of pension funds requires a robust understanding of complex rules and investment types and transactions. Although provision is made for regular training of Sub-Committee members, attendance at these training events is voluntary and there has been no formal assessment of specific pension – related training needs for Sub-Committee members.</p> <p>Risk: Sub-committee members may have unidentified training needs and may lack the knowledge and skills to fulfil their roles effectively.</p>	Head of Financial Services	<p>Training of current members will be reviewed but preparation will also be made for potential change in membership next year.</p> <p>This will include discussions with other Scottish Local Authority Funds regarding delivering nationwide training.</p>	May 2012
4.	<p>The funds' Governance Policy Statement records that Dundee City Council provides an internal audit service which covers pension investment and administration at regular intervals. However, the council's internal audit service has not reviewed pension scheme-related systems and controls for some time and no pension fund work was undertaken in 2010/11.</p> <p>We also note that there is no formal agreement between the council and the pension funds as to the provision of an internal audit service and that the sub-committee does not approve an annual programme of work or consider reports, including a year end statement of assurance on the effectiveness of the system of internal control.</p> <p>Risks: assurances over the adequacy and effectiveness over the system of internal controls are not available to underpin effective governance and support the governance compliance statement.</p>	Head of Financial Services	<p>Please note that the reference to Internal Audit originates from the Fund's risk register.</p> <p>As Dundee City Council administers the Pension Fund any planned audit work and subsequent reports will be taken to the Scrutiny Committee.</p> <p>An item is included in the 2011/12 Audit Plan.</p>	N/A



No	Risk	Responsible officer	Response and agreed action	Target date
5.	<p>The funds use 6 investment managers and a custodian to provide professional fund management services for their £1.8 billion investment portfolio. SAS70 reports (Service Organisations – replaced by ISA 402 for accounting periods ending on or after 15 June 2011) are issued annually by reporting accountants who are independent to investment managers and custodian. These reports provide assurances to those charged with governance that controls in operation at investment managers operate satisfactorily. As well as an overall opinion, they give details of tests performed and weaknesses identified. However, we understand that these reports are not subject to formal review and that available assurance or weaknesses identified are not reported to members.</p> <p><i>Risk: the sub-committee does not have adequate assurance as to the effectiveness of controls in operation at outsourced service providers responsible for the management of significant fund assets.</i></p>	Exchequer Officer	There have been no significant issues to report to committee but it is agreed it would be good practice to provide an annual report to the committee based on latest reports.	November 2011
6.	<p>Given the magnitude of funds under management and the importance of exerting adequate control over the operations of outsourced services, it is essential that robust and up-to-date contracts are in place with firms providing outsourced services. However, we found weaknesses in the funds' contracts arrangements. Generally, there is a need for the Sub-Committee to ensure that it has up-to-date agreements for all outsourced professional services. We found one investment manager for whom no contract was in place. Two contracts were extended during 2010/1, however member approval for these extensions was only obtained after the event.</p> <p><i>Risk: up-to-date agreements may not be in place for all outsourced service providers, leading to potential financial or reputational loss to the funds.</i></p>	Exchequer Officer	There have been no issues regarding contracts but a register will be maintained of latest versions and amendments.	December 2011



No	Risk	Responsible officer	Response and agreed action	Target date
Internal control systems				
7.	<p>We understand that a couple of investment managers use derivatives (futures) in the management of their portfolios. For example, we found that one manager's exposure to derivatives was around 50% of the value of its portfolio. However, the funds' exposure to derivatives and offsetting cash holdings are not reported to members. It is essential that members appreciate the financial techniques used by their appointed investment managers and the risks associated with financial instruments.</p> <p>Risk: Sub-Committee members are unaware of exposure to derivatives and related risks to the funds.</p>	Head of Financial Services	Additional training will be provided for members and additional information will be provided on a quarterly basis.	May 2012
8.	<p>Performance benchmarks set vary between investment managers and may even vary for the same type of asset. However, benchmarks reported to members do not always take this into account, occasionally resulting in incorrect performance assessment. In some cases, benchmarks are not reported, which may make performance data less meaningful.</p> <p>Risk: sub-committee members may be using incorrect or incomplete data when assessing investment performance.</p>		For practical purposes the summarised information presented to committee does not always fully differentiate between the individual benchmarks. However the Northern Trust reports which are considered every quarter cover the full detail of these.	N/A
9.	<p>We noted a lack of controls to ensure that employers contributions received are complete and accurate. While steps are taken to monitor the levels of employee contributions by employer month by month, this does not extend to employers' contributions.</p> <p>Risk: contributions received may be incomplete, inaccurate, or received late.</p>	Exchequer Accountant	The separate bank account and new coding structure make any discrepancies more obvious. A monthly checklist will be kept.	August 2011

Appendix B

Findings from 20010/11 audit testing of internal control systems

Investments

1. The Council appointed Northern Trust as custodian and also to monitor investment performance. However, we found that the investment performance reported to members did not originate from Northern Trust reports in all cases.
2. The Council uses Northern Trust reports for investment accounting and reporting. While officers agree most investment holdings between custodian and investment managers, derivatives and cash investments are not reconciled between custodian and investment managers' records.
3. It is not clear why the property portfolio (managed by Schroders) is reported separately and in so much detail. This portfolio makes up less than 10% of the total fund.

Cash

4. The pension bank account is reconciled monthly between the bank balance and cashbook balance. However, officers do agree the cashbook balance per the bank reconciliation to the ledger. There is therefore a risk that ledger figures, which are used for reporting purposes, are incomplete and inaccurate.
5. We noted that recharges due to the funds from Dundee City Council amounted to around £3 million by 31 March 2011. We understand that this represents monies due to the fund from the council and which had accumulated over a number of months. This recharge would typically be for contributions payable by the Council to the pension fund, less amounts paid by the Council on behalf of the fund. The Council should ensure that monies due to the funds are promptly paid over. Contributions collected must be paid over to pension funds not later than the 19th of the month following deduction.

Pension's administration

6. Membership reconciliations are not carried out by fund administrators. Members reconciliations provide comfort to trustees and auditors that movements in membership numbers (by category) can be fully explained and provides some assurance that the membership data is reliable. Robust membership data is essential as important actuarial decisions are based on this information.