

The Highland Council

Pensions Committee and Pensions Board

24th September 2015

Agenda Item	5
Report No	PC/05/15

Internal Audit Reports - Matters Arising from the Statement on Internal Control 2014/15 and Pension Fund Investments

Report by the Head of Audit & Risk Management

Summary

This report refers to the audit work undertaken since the last report to the Board on 14th November 2014.

1. Internal Audit Reports

1.1 Each Internal Audit report contains an audit opinion based upon the work performed in respect of the subject under review. There are five audit opinions which can be provided:

- (i) **Full Assurance:** There is a sound system of control designed to achieve the system objectives and the controls are being consistently applied.
- (ii) **Substantial Assurance:** While there is a generally a sound system, there are minor areas of weakness which put some of the system objectives at risk, and/ or there is evidence that the level of non-compliance with some of the controls may put some of the system objectives at risk.
- (iii) **Reasonable Assurance:** Whilst the system is broadly reliable, areas of weakness have been identified which put some of the system objectives at risk, and/ or there is evidence that the level of non-compliance with some of the controls may put some of the system objectives at risk
- (iv) **Limited Assurance:** Weaknesses in the system of controls are such as to put the system objectives at risk, and/ or the level of non-compliance puts the system objectives at risk.
- (v) **No Assurance:** Control is generally weak, leaving the system open to significant error or abuse, and/ or significant non-compliance with basic controls leaves the system open to error or abuse.

1.2 Final Report – Matters arising from the Statement of Internal Control 2014/15

This report has an audit opinion of Substantial Assurance as the internal systems of control are considered to be reliable but there is one area that could be further improved. 1 medium grade recommendation was made with regard to the Fund's Risk Management Policy and Strategy. This has now been addressed with this document presented for approval as a separate agenda item.

1.3 Final Report – Pension Fund Investments

This report has an audit opinion of Full Assurance as the key controls are operating effectively and ensure that investments comply with relevant legislation and guidance. The majority of audit objectives were achieved and the issues identified

from the audit are minor in nature and do not affect the system of control. 2 low grade recommendations were made, both of which have been completed.

3. Implications

- 3.1 There are no Resource; Legal; Equalities; Climate Change/Carbon Clever; Risk and Gaelic and Rural implications arising from this report.

Recommendation

Members are invited to consider the content of the attached reports and the audit opinions provided, and to raise any relevant points with the Head of Audit & Risk Management.

Designation: Head of Audit & Risk Management

Date: 2nd September 2015

Author: Donna Sutherland, Audit & Risk Manager

Background Papers

CONFIDENTIAL

**INTERNAL AUDIT
FINAL REPORT**

PENSION FUND

MATTERS ARISING FROM THE STATEMENT
OF INTERNAL CONTROL 2014/15

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18/08/15
08/09/15

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1. INTRODUCTION

In order to inform the Head of Audit & Risk Management's annual Statement of Internal Control, work was undertaken to examine the systems of internal control operated within the Pension Fund. This consisted of:

- (i) A high level review of the system of internal control by way of an evidence-based checklist comprising six key areas:
 - Control environment.
 - Identification and evaluation of risk and control objectives.
 - Information and reporting.
 - Control processes.
 - Monitoring and corrective action.
 - Assessment of whether the key controls have been applied during the year.
- (ii) A review of the key controls operated within those financial systems which were not subject to a detailed audit review during the year. As separate audits of the General Ledger, Income and Payroll systems were undertaken for 2014/15 and have been reported separately, this audit consisted of a review of creditor payments. The areas examined included:
 - Financial procedures and guidance issued to staff;
 - Segregation of duties;
 - User access levels and appropriateness;
 - System backups and security of data.

A sample of transactions was also selected for detailed testing to verify that the controls were operating as expected. This sample covered the Council, Pension Fund and organisations which use some or all of the Council's financial systems (Assessor's Department, High Life Highland, NHS Highland and HITRANS).

- (iii) A follow-up review to ensure that the agreed actions arising from the previous audit report have been satisfactorily implemented by Management.

2. SCOPE, METHOD AND COVERAGE

Details of the procedures in operation were ascertained by enquiry of officers within the Pension Fund and review of documents published on their website.

The audit testing covered the financial year 01/04/14 – 31/03/15.

3. MAIN FINDINGS

The main finding of the review was that the systems of internal control were reliable. However there were some matters identified where action could be taken by management to improve the internal controls as follows:

3.1 Internal Control Checklist

This work undertaken did not identify any control issues. However, there is scope to further enhance the Fund's risk management arrangements as outlined below.

- 3.1.1 A risk register for the Pension Fund was prepared and presented to the Pensions Committee on 14/08/14. However, as detailed at 3.3 below, the agreed action that a risk policy and risk strategy would be prepared has not been completed.

3.2 Review of Key Controls

The key controls were found to be operating satisfactorily.

From a sample of 30 creditor invoices examined, two related to the Pension Fund. These consisted of a quarterly payment amounting to £168,056 for the provision of portfolio management services. A formal agreement was formed for this service. The remaining transaction related to a quarterly payment of £4,530 for investment fund advice. A formal contract had been arranged for the provision of this service. In both cases, the correct procedures as set out in Financial Regulations had been followed.

3.3 Follow-up of management agreed actions

The Pension Fund Matters Arising from the Statement of Internal Control, 2013/14 report was issued on 01/09/14, the agreed actions are summarised below. Details of these recommendations and progress in implementing the management agreed actions are provided in Table 1 below.

Table 1

Recommendation	Management agreed action/ (implementation target date)	Progress
<p>In order to ensure that the Pension Fund's risk management arrangements comply with best practice it is recommended that:</p> <ul style="list-style-type: none"> • A risk policy is produced and communicated to all stakeholders. • A risk management strategy is produced in line with the risk policy. • The risk register is finalised and reported to the next meeting of the Pensions Committee as planned. In addition, review of the risk register should be a standing agenda item with focus on the highest risk areas and/ or those where the position has changed since the last review. 	<ul style="list-style-type: none"> • The Fund will develop a risk policy and strategy. (31/12/14) • Risk Register is being reported to Pensions Committee on 14/08/14. 	<p>Still outstanding</p> <p>Completed 14/08/14</p>
<p>For regular monthly amounts of income, the efficient use of direct debit collection should be considered rather than issue invoices.</p>	<p>Consideration will be given to the feasibility of using direct debit as a method of collecting regular income although fluctuations in amounts may make this impractical. (31/12/14)</p>	<p>Completed 31/12/14</p>

4. CONCLUSION

This review has concluded that the Pension Fund's system of internal control is reliable. However, as detailed in the main findings above, there is one area that could be further improved. As such, there is 1 medium recommendation in this report. The recommendation has been accepted by management, with the agreed action to be completed by 24/09/15.

5. **AUDIT OPINION**

The opinion is based upon, and limited to, the work performed in respect of the subject under review. Internal Audit cannot provide total assurance that control weaknesses or irregularities do not exist. It is the opinion that **Substantial Assurance** can be given in that while there is a generally a sound system, there are areas of weakness which put some of the system objectives at risk, and/ or there is evidence that the level of non-compliance with some of the controls may put some of the system objectives at risk.

6. ACTION PLAN

The Action Plan contains **1** recommendation as follows:

Description	Priority	Number
Major issues that managers need to address as a matter of urgency.	High	0
Important issues that managers should address and will benefit the Organisation if implemented.	Medium	1
Minor issues that are not critical but managers should address.	Low	0
Total recommendations		1

REPORT REF.	GRADE	FINDING	RECOMMENDATION	MANAGEMENT AGREED ACTION	IMPLEMENTATION	
					RESPONSIBLE OFFICER	TARGET DATE
3.1.1	Medium	One of the agreed management actions from the 2013/14 Pension Fund Matters Arising from the Statement of Internal Control report to prepare a risk policy and strategy by 31/12/14 has not been completed.	<p>In order to ensure that the Pension Fund's risk management arrangements comply with best practice it is recommended that:</p> <ul style="list-style-type: none"> • A risk policy is produced and communicated to all stakeholders. • A risk management strategy is produced in line with the risk policy. 	A risk management strategy (including policy statement) will be presented to the Pensions Committee on 24/09/15.	Head of Corporate Finance	24/09/15

**INTERNAL AUDIT
FINAL REPORT**

FINANCE SERVICE

PENSION FUND INVESTMENTS

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1. INTRODUCTION

The purpose of this report is to record the findings of a recently completed audit review of the Council's Pension Fund investment arrangements, including compliance with relevant legislation and guidance.

The market value of the Fund's net investment assets as at 31st March 2015 was £1.447bn, compared to £1.275bn at 31st March 2014 with an asset allocation of:

- 67.3% - Equities
- 19.7% - Fixed Income
- 10.4% - Property Funds
- 2.6% - Private Equity

The Fund's assets are managed by 6 appointed Fund Managers and a Global Custodian is contracted to oversee the Fund Manager's activities to ensure that investments are managed efficiently and securely. An Investment Advisor provides specialist advice on areas such as investment strategy and performance.

2. REVIEW OBJECTIVES

The objectives of the review were to ensure that:

- (iv) The Fund's investments are made in accordance with its statutory requirements and relevant policies.
- (v) All Fund investments, acquisitions and disposals are properly controlled and recorded.
- (vi) All Pension Fund income is received in full, on time and is accurately recorded.
- (vii) There are appropriate arrangements in place for the monitoring and appraisal for the performance of the Fund's investments.

3. SCOPE, METHOD & COVERAGE

The audit reviewed the key controls surrounding the Council's Pension Fund investment arrangements, including compliance with relevant legislation and guidance. A sample of transactions, in respect of the financial year 2014/15, was examined to ensure that the above objectives could be achieved.

The audit was undertaken as part of the 2015/16 audit plan and external audit will look to place reliance on the work carried out.

4. MAIN FINDINGS

The main findings of the review, referenced to the above review objectives, are as follows:

- 4.1 This objective was fully achieved. The Council's Scheme of Delegation delegates responsibility for the determination of investment policies to the Investment Sub-Committee. It also requires that any policies comply with all relevant legislation and that the arrangements accord with best practice. As required by Local Government Pension Scheme (LGPS) Regulations, the Council's Pension Fund policy is set out in the Funding Strategy Statement (FSS) and the Statement of Investment Principles (SIP).

The most recent Fund Managers were appointed in accordance with the Council's Contract Standing Orders and the Procurement Unit has been involved in the process. A procurement exercise is taking place to appoint a commercial real estate debt manager but has not yet been completed.

LGPS Investment Regulations prescribe limits on the amount the Fund can invest in certain legal structures. Each of the Fund Managers is made aware of these limits and the Investment Advisor monitors them against these. An in-house retrospective check is also carried out.

4.2 This objective was substantially achieved. Each Fund Manager operates within their own mandate to buy and sell stocks which accounts for the majority of transactions. However, there are occasions where monies require to be transferred out of the Pension Fund to facilitate a capital call notice from Global Partners. In such cases, the cash transaction documentation is prepared by one of the Treasury Team and is then approved by an authorised signatory both on the CHAPS (Clearing House Automated Payment System) form and through the online banking. At least 3 officers are involved in each transaction. 2 capital call notice transactions were examined and in both cases appropriately authorised documentation had been retained on file.

4.2.1 There are 'Capital Call Process Notes' which the Treasury Team follow when completing capital call transactions. These notes state that payment instructions to the Custodian should be authorised by the Service Finance Manager (Corporate Budgeting, Treasury and Taxation) or the Head of Corporate Finance. However, this does not accord with the officers who are approved to authorise banking and related financial transactions (the Director of Finance, Head of Corporate Finance, Head of Audit and Risk Management and Head of Revenues and Business Support).

The Treasury Team undertake monthly reconciliations between the reports provided by the Custodian and the individual Fund Managers to ensure that the Custodian's records are complete and accurate. Once this has been verified, any financial changes are processed into the financial ledger. 2 monthly reconciliations for each of the 6 Fund Managers were selected for review. All reconciliations had been completed by a Principal Accounting Technician or the Treasury Officer, and were checked by the Treasury Accountant. This was shown clearly on the reconciliation along with the date that it was prepared and checked and this was also noted on the checklist. Where a variance had been identified an adequate explanation had been provided.

4.2.2 The reconciliations are based on the market value of investments with an additional reconciliation carried out on a book cost valuation basis for 2 Fund Managers. All investments are stated in the financial ledger and subsequently reported in the annual accounts at market value. Therefore, the value of undertaking the additional book cost reconciliations is questioned.

4.3 This objective was fully achieved. The Custodian is responsible for ensuring that all due income is received and this is specified in section 2.3 of the Custody Agreement. A monthly report is received from the Custodian detailing all income for the period. The Treasury Accountant also carries out checks to ensure that the correct amount has been received where a distribution payment is due from Global Partners.

4.4 This objective was fully achieved. Performance benchmarks are agreed by the Investment Sub-Committee and ratified by the Pension Committee. There is an Investment Management Agreement in place with each Fund Manager which sets out the agreed performance benchmarks. On a quarterly basis a performance report, prepared by the Fund's appointed Investment Advisor, is put to the Investment Sub-Committee. The reports analyse overall Fund and individual Fund Manager's performance against benchmark for the quarter, 1 year, 3 year and 5 year periods. Fund Managers also make formal presentations to the Investment Sub-Committee on a rotational basis (each Fund Manager presents to Committee roughly once a year). These presentations cover investment performance.

5. CONCLUSION

The key controls for the Council's Pension Fund investments are operating effectively and ensure that investments comply with relevant legislation and guidance. The majority of audit objectives were achieved and the issues identified from the audit are minor in nature and do not affect the system of control.

There are a total of 2 low grade recommendations in this report, both of which have been completed.

6. AUDIT OPINION

The opinion is based upon, and limited to, the work performed in respect of the subject under review. Internal Audit cannot provide total assurance that control weaknesses or irregularities do not exist. It is the opinion that **Full Assurance** can be given in that there is a sound system of control designed to achieve the system objectives and the controls are being consistently applied.

7. ACTION PLAN

The Action Plan contains 2 recommendations as follows:

Description	Priority	Number
Major issues that managers need to address as a matter of urgency.	High	0
Important issues that managers should address and will benefit the Organisation if implemented.	Medium	0
Minor issues that are not critical but managers should address.	Low	<u>2</u>
Total recommendations		<u>2</u>

REPORT REF.	GRADE	FINDING	RECOMMENDATION	MANAGEMENT AGREED ACTION	IMPLEMENTATION	
					RESPONSIBLE OFFICER	TARGET DATE
4.2.1	Low	The payment instruction sent to the Custodian for a payment of €12.8m on 08/12/14 was authorised by the Head of Audit & Risk Management and the Head of Revenues & Business Support. Whilst both officers are approved to authorise such transactions, this does not accord with the 'Capital Call Process Notes' which state that payment instructions to the Custodian should be authorised by the SFM (Corporate Budgeting, Treasury & Taxation) or the Head of Corporate Finance.	The 'Capital Call Process Notes' should be updated to reflect that any of the bank authorised signatories can authorise a payment instruction to the Custodian.	Agreed. Process notes have been amended.	Treasury Accountant	Complete
4.2.2	Low	Reconciliations are based on the market value of investments for all Fund Managers, with an additional reconciliation carried out on a book cost valuation basis for 2 Fund Managers; Baillie Gifford and Pyrford. All investments are reported in the annual accounts at market value. Therefore, the value of undertaking the additional book cost reconciliations is questioned.	The present practice of reconciling the investments held by 2 Fund Managers at book cost should be investigated to establish if this is necessary. If not, then this practice should be ceased.	Agreed. From July month-end book cost reconciliations will not be completed.	Treasury Accountant	Complete