

SURREY COUNTY COUNCIL AUDIT REPORT

6

Pension Fund Investment

2014/15

Prepared for: Sheila Little, Director of Finance
Phil Triggs, Strategic Manager, Pensions and Treasury

Prepared by: Tasneem Ali, Lead Auditor

Sue Lewry-Jones
Chief Internal Auditor
Surrey County Council
County Hall
Kingston upon Thames
Surrey
KT1 2EA

January 2015

Additional circulation list:

External Audit	Grant Thornton LLP UK
Service Finance Manager	Susan Smyth
Strategic Director	Julie Fisher
Risk and Governance Manager	Cath Edwards
Audit and Governance Committee	All
Cabinet Member & Chairman of the Surrey Pension Fund Board	Denise Le Gal

Glossary:

LGPS –Local Government Pension Scheme

Audit opinions:

Effective	Controls evaluated are adequate, appropriate, and effective to provide reasonable assurance that risks are being managed and objectives should be met.
Some Improvement Needed	A few specific control weaknesses were noted; generally however, controls evaluated are adequate, appropriate, and effective to provide reasonable assurance that risks are being managed and objectives should be met.
Significant Improvement Needed	Numerous specific control weaknesses were noted. Controls evaluated are unlikely to provide reasonable assurance that risks are being managed and objectives should be met.
Unsatisfactory	Controls evaluated are not adequate, appropriate, or effective to provide reasonable assurance that risks are being managed and objectives should be met.

Pension Fund Investment - 2014/15

1. INTRODUCTION

- 1.1 The Local Government Pension Scheme (LGPS) is a funded scheme, which operates distinctly from the non-funded public sector schemes and has its own regulatory framework. The funds received through employer and employee contributions are invested and administered at individual pension fund authority level with the agreement of elected members who are accountable to the local council taxpayers. In Surrey, the Surrey Pension Fund (SPF) is the channel through which the pension contributions are invested and administered by external investment managers on behalf of its members. At 31st March 2014 the Surrey Pension Fund had net assets valued at £2,808m with 32,530 employees, 21,598 pensioners and 30,639 deferred pensioners. A Surrey Pensions Board was established in April 2013 and meets quarterly to ensure the proper governance of the fund. The Board includes SCC Councillors, representation from admitted bodies and an employer and employee union representative.
- 1.2 A review of the Pension Fund Investment was included as part of the 2014/15 Annual Audit Plan and was undertaken following agreement of the Terms of Reference included at Annex A. This report sets out the findings and recommendations of the review. The completed Management Action Plan accompanies this report as Annex B.

2. WORK UNDERTAKEN

- 2.1 The purpose of the audit was to ascertain whether adequate controls are in place to ensure that:
- purchases and sales of stocks and shares are properly accounted for;
 - all income due to the fund is received and properly recorded;
 - fund managers are properly appointed and governed by appropriate arrangements with regard to the custody of assets;
 - investment strategy is approved by the Pension Fund Board and is monitored effectively and independently;
 - governance arrangements are appropriate;
 - adequate separation of duties exists;

Discussions were held with key personnel in the Council to document any changes to relevant systems and processes, which have taken place since the last audit review in 2012/13. The accounts of Fund Managers and Northern Trust were reviewed as well as the reconciliations to Council records and SAP reports. Testing was performed to confirm that signed contractual agreements were in place and that independent monitoring of performance of investment managers was regularly undertaken.

3. OVERALL AUDIT OPINION AND RECOMMENDATIONS SUMMARY

- 3.1 The overall audit opinion following this audit is Some Improvement Needed. A few specific control weaknesses were noted; generally however, controls evaluated are adequate, appropriate, and effective to provide reasonable assurance that risks are being managed and objectives should be met.
- 3.2 **Recommendations analysis:**

Rating	Definition	No.	Para. Ref.
High	Major control weakness requiring immediate implementation of recommendation	1	5.1.6
Medium	Existing procedures have a negative impact on internal control or the efficient use of resources		

Pension Fund Investment - 2014/15

Low	Recommendation represents good practice but its implementation is not fundamental to internal control	7	5.2.5
			5.3.6
			5.3.7
			5.4.4
			5.5.4
			5.6.4
	Total number of audit recommendations		8

4. MANAGEMENT SUMMARY

- 4.1 The Surrey Pension Fund has an established investment strategy in place which is reviewed and managed by members of the Surrey Pension Fund Board who are responsible for the stewardship of the Fund. The Auditor concluded that the Surrey Pension Fund Board had an effective process in place to monitor the investment strategy. This is evident from review of the minutes which demonstrate the quality of membership of the Board and the quality of the level of scrutiny provided.
- 4.2 Whilst performing the audit, the Auditor obtained the Independent Service Auditors report for the Global Custodian which confirmed that the control objectives of the Custody and Fund Services system were suitably designed to provide reasonable assurance that the control objectives were achieved and operating effectively.
- 4.3 There are adequate measures in place to collect pension contributions and a Business Plan and Governance Compliance statement have been approved which enables compliance with statutory regulations and scheme rules.
- 4.4 During the period under review the Auditor also examined the processes in place for the:
- appointment of new fund managers;
 - termination of fund managers; and the
 - closure of employer bodies.
- The auditor established that there was adequate consideration given by the Board, Senior managers and the independent advisers to ensure appropriate outcomes.
- 4.5 At the time of this audit, it was also identified that the reconciliation of the Global Custodian bank account to SAP had not been completed. This will be evaluated further in our findings below.
- 4.6 The Auditor also carried out substantive sample testing, which has resulted in one high level and 7 low level recommendations.
- 4.7 In view of the above findings, set out in more detail in section 5 below, the overall audit opinion is **Some Improvement needed**.

5. FINDINGS AND RECOMENDATIONS**5.1 Reconciliation of Northern Trust to SAP**Finding

- 5.1.1 During audit testing of fund manager and private equity drawdown requests it was found that quarterly reconciliations to the Northern Trust (NT) account had not been completed. This process is identified as a key control which accounts for movements on NT to be incorporated into SAP through a journal entry. These movements included income, purchases, sales, funding, tax, contributions between accounts and related transactions.
- 5.1.2 In order to identify whether any compensating controls were in place the Auditor enquired whether any other procedures were being performed to identify or account for movements on the NT account.

Pension Fund Investment - 2014/15

- 5.1.3 From enquiry with the senior accountant and review of the second quarter report it was ascertained that although a reconciliation to SAP had not been completed, the movements on the Northern Trust account, such as income from investments, purchases, sales, funding, contributions between accounts, and fees paid to fund managers which were pertinent to the reporting requirements of the board had been incorporated into the fund manager valuation report, and were completed monthly and presented to the Board.
- 5.1.4 Review of minutes and meeting notes presented to the Board, also confirmed that the Pensions team together with Board members met regularly with fund managers which further demonstrated that there was adequate review of movements on the NT account. The auditor does not however have assurance that the transactions for the year have been correctly accounted for in SAP which represents the main financial reporting framework.

Risk

- 5.1.5 Failure to complete reconciliations on time could potentially result in omission of pertinent data for financial reporting purposes.

Recommendation

- 5.1.6 Quarterly reconciliations to the Northern Trust account should be completed in a timely manner to ensure that SAP accurately reflects the true financial position of the Pension Fund and enables any reports presented to the Board to be a reflection of data available on SAP.

5.2 **Drawdown requests**

Finding

- 5.2.1 For the period April to September 2014 total drawdown requests amounted to £10,750m. The auditor performed a walkthrough of the drawdown process. The highest value drawdown request was selected for testing and it was found that the actual amount paid to the fund manager exceeded the amount requested by £3m. The error was a result of the misinterpretation of the amount in the drawdown request by both officers responsible for the transaction. Although the investment fund manager notified the Pension Fund Senior Accountant of the overpayment, and the funds were subsequently withdrawn within two days, the potential exists for similar errors to occur.
- 5.2.2 Further analysis of the error confirmed that the payment made in error to the global custodian did not represent a financial risk to the funds, as in essence it was a movement between the funds bank accounts. At no point did the Pension Fund lose custody of the funds that were deposited in error into the global custodian account as it functions as an intermediate account. The potential consequence of this error would be that the fund manager's return on investment would have been distorted by the additional funds invested or the Fund would have lost out on the interest potential of the £3m.
- 5.2.3 As a result of the above error the auditor tested the remaining £8,750m drawdown requests and verified that for each request made, the amount paid agreed to the drawdown request and was within commitment levels.

Risk

- 5.2.4 The Pension Fund could incur financial loss through the loss of interest income on the excess amount paid or alternatively the performance results of the investment could be distorted based on the difference between the value of funds actually

Pension Fund Investment - 2014/15

invested compared to the value of funds requested for the investment.

Recommendation

- 5.2.5 Fund drawdown requests should be accurately actioned.

5.3 **Conflict of interest**

Finding

- 5.3.1 From a review of attendee names the Auditor identified that an independent adviser to the Pension Fund, had recently been appointed as a Director of a Global Investment company. Although this in itself does not pose a conflict of interest, it does present a perceived conflict of interest.
- 5.3.2 Enquiry with the Pensions Manager, confirmed that advice on fund manager matters is provided by Mercer, a firm of investment advisers who are FCA registered, and another independent adviser acting in his own capacity, who is not FCA registered. The role of the latter is to challenge the information provided by Mercer and advise the Pension Fund Board to ensure that the best investment decisions are made. The adviser is not responsible for making any decisions.
- 5.3.3 As a result, the letter of engagement of the independent adviser is being redrafted to reflect this and if in the future the Global investment company was used as fund manager, the adviser will be excluded from any discussions.
- 5.3.4 Further review of the Financial Conduct Authority (FCA) compliance requirements for independent advisers, effective January 2013, identified that the independent adviser could potentially be in breach of the Retail Distribution Review (RDR) rules. These rules state that 'to offer financial advice an individual must represent or be an appointed representative of a firm registered with the FCA'. Where this is not the case the financial adviser should obtain an annual Statement of Professional Standing, which confirms that they are suitably qualified and they subscribe to a code of ethics and that they have kept their knowledge up-to-date through continuing professional development.

Risk

- 5.3.5 There could be a risk that the investment advisers may provide conflicting advice to the Pension Fund Board. It could also result in the appointment of an investment adviser who does not comply with FCA guidance, therefore risking the value of the Pension Fund investments

Recommendation

- 5.3.6 The Pension Fund Board should ensure that any potential conflict of interest is managed appropriately in relation to the use of independent advisers. An independent adviser must also be perceived to be free of any potential interest in relation to decisions taken by the Pension Fund Board.
- 5.3.7 The Pension Fund Board should also ensure that independent advisers comply with FCA guidance, in particular the RDR rules.

5.4 **Risk register**

Finding

- 5.4.1 Review of the minutes identified that the risk register was evaluated and reviewed at each Pension Fund Board meeting. The risk register reflects the current risks that the Pension Fund is exposed to, the impact of these risks and the mitigating actions in place to overcome these risks.
- 5.4.2 Detailed review of the risk register established that the following risks could also be considered by the Pension Fund Board: -
- loss of funds through fraud or misappropriation;

Pension Fund Investment - 2014/15

- failure to hold personal data securely;
- failure to keep pensions data up to date;
- failure to collect and account for contributions from employers and employees on time;
- insufficient funds to meet liabilities as they fall due;
- lack of expertise on Pension Fund Board;
- failure of global custodian;
- over reliance on key officers; and
- incorrect funds sent to fund managers.

Risk

- 5.4.3 The Pension Fund Board should consider all the relevant risks that it could be exposed to.

Recommendation

- 5.4.4 The Pension Fund Board could consider the Pension Funds exposure to the additional risks highlighted above in order to present a comprehensive assessment of potential risks.

5.5 Fund manager payments

Finding

- 5.5.1 The auditor identified 22 fund manager fee payments for the period under review. A sample of 5 fund manager fee payments was tested to determine whether fund manager payments had been accounted for in the correct financial period. Of the 5 payments tested, the Auditor identified that 3 payments totalling £743,281 related to the 2014/15 year. One payment valued at £84,642 related to the 2013/14 year which was correctly accrued for in 2013/14, and one payment valued at £887,643 which was a recalculation/clawback for previous years, related to the 2011/12, 2012/13 and 2013/14 years collectively. Further scrutiny of the invoice confirmed that the invoice was received in November 2013 and had not been accrued for in the 2013/14 year.
- 5.5.2 Fund managers often use incentives in order to retain investments. The Pensions team should address the accounting treatment of incentives in order to more accurately match investment returns with fund manager fees.

Risk

- 5.5.3 Inaccurate matching of fund manager fees annually with investment returns could result in inaccurate financial data being presented for management purposes and for monitoring of the Pension Fund Investment strategy.

Recommendation

- 5.5.4 Fund manager payments should be accounted for in the correct financial period in order to appropriately match expenditure with returns on investment. The Pensions Team should also provide for clawbacks in their accounting treatment where this arrangement has been negotiated. This would enable better matching of income with expenditure.

5.6 Fund Manager assurance statements

Finding

- 5.6.1 The Surrey Pension Fund utilises the services of 10 fund managers to invest their funds. Results of testing indicate that Surrey Pension Fund have obtained independent controls assurance for eight fund managers which represents 88.5 percent of its investment. Therefore no assurance has been obtained for the remaining two fund managers who represent 11.5 percent of the funds invested. Controls assurance statements provide reasonable assurance on the adequacy of

Pension Fund Investment - 2014/15

the control environment of the fund manager thus fulfilling the Pension Fund Boards responsibility for safeguarding the funds.

- 5.6.2 Whilst assurance reports provide the Board with a degree of comfort, Board members should also take time to consider the scope of the independent reviews and investigate whether any limitations have been identified by the reporting accountant in their report, including any action taken by the fund manager to rectify material control failures.

Risk

- 5.6.3 This may have an impact on the ability of the fund manager to safeguard the investments of the Pension Fund and could potentially result in losses to the Pension Fund.

Recommendation

- 5.6.4 The Pension Fund Board should review all controls assurance statements received from fund managers in order to consider any limitations identified in the report. This should be presented to the Pension Fund Board annually.

6. ACKNOWLEDGEMENT

- 6.1 The assistance and co-operation of all the staff involved was greatly appreciated.

TERMS OF REFERENCE

Pension Fund Investment 2014/15

BACKGROUND

The Local Government Pension Scheme (LGPS) is a funded scheme, which operates distinctively from the non-funded public sector schemes and has its own regulatory framework. The funds received through employer and employee contributions are invested and administered at individual pension fund authority level with the agreement of elected members who are accountable to the local council taxpayers. In Surrey, the Surrey Pension Fund is the channel through which the pension contributions are invested and administered by external investment managers on behalf of its members. A Surrey Pensions Board was established in April 2013 and meets quarterly to ensure the proper governance of the fund. The Board includes SCC Councillors, representation from admitted bodies and an employer and employee union representative.

PURPOSE OF THE AUDIT

The Surrey Pension Fund (SPF) covers around 80 scheduled bodies, which include, in the main, employees of the County Council (excluding teachers and fire fighters who have their own pension schemes), District and Borough Councils and admitted bodies which were previously closely associated with local government. This equates to a combined membership in excess of 80,000 individuals. Northern Trust continues to be the Global Custodian of the funds since its appointment in January 2004.

The latest triennial actuarial valuation of the fund as at 31 March 2013 reported assets of £2,559m against liabilities of £3,538m resulting in a deficit of £980m.

The auditor has discussed the key risks associated with the SPF with the relevant officers and examined the programme risk register. These discussions identified the following specific risks as areas where the provision of additional assurance over the effectiveness of controls would be useful to the Service.

- Investment Managers fail to achieve performance targets.
- Inadequate monitoring and review of the long term investment strategy;
- employer bodies transferring out of the pension fund or deterioration in the financial health of an employer body.

Internal Audit's work is focused on assessing the effectiveness of controls in place to manage risks that are operating throughout the year. The Pensions Fund is subject to a separate annual external audit which examined the financial performance of the fund and other matters. External Audit's activity may take account of the findings of this work.

WORK TO BE UNDERTAKEN

The purpose of the audit is to ascertain whether adequate controls are in place to ensure that:

- purchases and sales of stocks and shares are properly accounted for;
- all income due to the fund is received and properly recorded;
- fund managers are properly appointed and governed by appropriate arrangements with regard to the custody of assets;
- investment strategy is approved by the Pension Fund Board and is monitored effectively and independently;

- governance arrangements are appropriate;
- adequate separation of duties exists;

Discussions will be held with key personnel in the Council to document any changes to relevant systems and processes, which have taken place since the last audit review in 2012/13. The accounts of Fund Managers and Northern Trust will be reviewed as well as the reconciliations to Council records and SAP reports. Testing will seek to confirm that signed contractual agreements are in place and that independent monitoring of performance of investment managers is regularly undertaken.

OUTCOMES

The findings of this review will form a report to Surrey County Council management, with an overall audit opinion on the effectiveness of arrangements in place and recommendations for improvement if required. Subject to the availability of resources, and the agreement of the auditee, the audit will also seek to obtain an overview of arrangements in place for:

- Data quality and security;
- Equality and diversity;
- Value for Money, and
- Business continuity.

The outcome of any work undertaken will be used to inform our future audit planning processes and also contribute to an overall opinion on the adequacy of arrangements across the Council in these areas.

REPORT ARRANGEMENTS

Auditor:	Tasneem Ali
Supervisor:	Simon White
Reporting to:	Phil Triggs
Audit Ref:	KF 21/ 2014/15

MANAGEMENT ACTION PLAN

Directorate:	Business Services
Audit report:	Pension Fund Investment
Dated:	

PRIORITY RATINGS

Priority High (H) - major control weakness requiring immediate implementation of recommendation

Priority Medium (M) - existing procedures have a negative impact on internal control or the efficient use of resources

Priority Low (L) - recommendation represents good practice but its implementation is not fundamental to internal control

I agree to the actions below and accept overall accountability for their timely completion. I will inform Internal Audit if timescales are likely to be missed.

The auditor agrees that the actions set out below are satisfactory.

Lead Responsible Officer (HOS): Phil Triggs, Strategic Manager Pensions and Treasury

Auditor

Tasneem Ali

Date 02 December 2014

Date

02 December 2014

Para Ref	Recommendation	Priority Rating	Management Action Proposed	Timescale for Action	Officer Responsible	Audit Agree?
5.1.6	Quarterly reconciliations to the Northern Trust account should be completed in a timely manner to ensure that SAP accurately reflects the true financial position of the Pension Fund and enables any reports presented to the Board to be a reflection of data available on SAP.	High	Reconciliations for the year are currently up to date. Financial portfolio and investment performance information provided to the Pension Fund Board was not affected. The team will ensure that quarterly custodian and fund manager report reconciliations are completed within one month of the requisite custodial and fund manager reports becoming available.	Ongoing	Phil Triggs	Yes

MANAGEMENT ACTION PLAN

Para Ref	Recommendation	Priority Rating	Management Action Proposed	Timescale for Action	Officer Responsible	Audit Agree?
5.2.5	Fund drawdown requests should be accurately actioned	Low	The manager is satisfied as to the presence of internal controls specific to checking and authorisation of transactions. Officers have been advised as to future scrutiny required in future processing of transactions.	Ongoing	Phil Triggs	Yes
5.3.6	The Pension Fund Board should ensure that any potential conflict of interest is managed appropriately in relation to the use of independent advisers. An independent adviser must also be perceived to be free of any potential interest in relation to decisions taken by the Pension Fund Board.	Low	The letter of engagement with the independent advisor has been redrafted to address and manage this potential conflict of interest and ensure that the independent advisor will not be involved in decisions where there is a possible conflict of interest with regard to external interests. The redraft is currently with Legal for approval.	February 2015	Phil Triggs	Yes
5.3.7	The Pension Fund Board should ensure that independent advisers comply with FCA guidance, in particular the RDR rules.	Low	The Fund's independent investment advisor is not required to be FCA registered as the advice offered does not fall within the scope of the 'regulated activity, advising on investments' under The Financial Services & Markets Act 2000, as per Section 2.7.15, 2.7.16 and 10.4 of the FCA Perimeter Guidance Manual.	n/a	Phil Triggs	No- Review of PERG 2.7.15/16, PERG 10.4, PERG 8.2 implies that limitations would need to be included in engagement letter. Pension Fund Board would need to be clear

MANAGEMENT ACTION PLAN

Para Ref	Recommendation	Priority Rating	Management Action Proposed	Timescale for Action	Officer Responsible	Audit Agree?
						on limitation of advice.
5.4.4	The Pension Fund Board could also consider the Pension Funds exposure to the additional risks highlighted in paragraph 5.4.2 in order to present a comprehensive assessment of potential risks.	Low	The Pension Fund risk register includes all but two of the suggested additional risks. The two were removed following a specific recommendation made by the Pension Fund Board to streamline/reduce the number of entries within the risk register and focus upon only the most significant risks. The number of risk entries was reduced from 36 to 26 as a result.	February 2015	Phil Triggs	Yes –Updated Risk register presented at Nov 14 Pension Fund Board Meeting.
5.5.4	Fund manager payments should be accounted for in the correct financial period in order to appropriately match expenditure with returns on investment.	Low	The additional invoice in question was received by e-mail but was not transacted in the final accounts process. Systems have been improved to prevent reoccurrence.	April 2015	Alex Moylan	Yes
5.5.4	The Pensions Team should provide for clawbacks in their accounting treatment of returns on investment. This would enable better matching of income with expenditure.	Low	The provision for recovered investment fee discounts will be assessed at year end with a view to potentially including within the statement of accounts.	April 2015	Phil Triggs	Yes
5.6.4	The Pension Fund Board should review all controls assurance statements received from fund managers in order to consider any limitations identified in the report. This should be presented to the	Low	A summary report will be taken to the Pension Fund Board on an annual basis to coincide with statement of accounts.	September 2015	Phil Triggs	Yes

ANNEX B

MANAGEMENT ACTION PLAN

Para Ref	Recommendation	Priority Rating	Management Action Proposed	Timescale for Action	Officer Responsible	Audit Agree?
	Pension Fund Board annually.					