

Annual governance report

Cheshire Pension Fund

Audit 2010/11



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Key messages

This report summarises the findings from my 2010/11 audit of the accounts of Cheshire Pension Fund (the Pension Fund) which is substantially complete. It includes the messages arising from my audit of your financial statements

Audit opinion and financial statements

Once a small number of outstanding issues are cleared, I intend to issue an unqualified opinion on the Pension Fund's annual accounts for 2010/11.

The Pension Fund provided me with a set of draft accounts by the statutory deadline. The draft accounts and associated working papers were of a good standard.

The Pension Fund addressed the adoption of International Financial Reporting standards (IFRS) effectively. The financial statements have been amended to include a Net Assets Statement and accompanying notes as at the transition date 1 April 2009.

The financial statements have also been amended to correct other, generally minor, errors identified during the audit. Most of these related to incorrect classifications or disclosures.

Before I complete my audit

I confirm to you my independence and the scope of my audit work.

My report includes only matters of governance interest that have come to my attention in performing my audit. My audit is not designed to identify all matters that might be relevant to you.

Independence

I can confirm that I have complied with the Auditing Practices Board's ethical standards for auditors, including ES 1 (revised) - Integrity, Objectivity and Independence. I can also confirm there were no relationships resulting in a threat to independence, objectivity and integrity.

The Audit Commission's Audit Practice has not undertaken any non-audit work for the Pension Fund during 2010/11.

I ask you to confirm to me that you have approved the accounts and agree the letter of representation.

I ask the Pension Fund Committee to:

- consider the matters raised in this report before recommending approval of the Pension Fund accounts to Cheshire West and Chester Council's (the Council's) Audit and Governance Committee (the AGC).
- take note of the adjustments to the Pension Fund's accounts which are set out in this report (Appendix 1); and
- recommend the approval of the letter of representation (Appendix 2) on behalf of the Pension Fund before I issue my opinion.

I ask the Audit and Governance Committee to:

- consider the matters raised in this report and the recommendations of the Pension Committee before it:
 - approves the Council's financial statements; and
 - approves the letter of representation (Appendix 2) before I issue my opinion and conclusion.
-

Financial statements

The Pension Fund's financial statements are an important means by which the Council accounts for its stewardship of the funds. As Council members you have final responsibility for these statements. It is important that you consider my findings before adopting the financial statements.

Opinion

The financial statements were prepared to a good standard and contained few errors.

Subject to satisfactory clearance of outstanding matters, I plan to issue an audit report including an unqualified opinion on the Pension Fund's accounts for inclusion in the Council's financial statements on 29 September. (Appendix 3).

Matters outstanding are:

- review of the Pension Fund's Annual Report;
- review of a final set of accounts including all the amendments agreed; and
- completion of elements of my testing, in particular on:
 - Contributions, and
 - Investments.

If any matters arise as a result of this work I will report this to you verbally at the AGC meeting on 28 September.

Subject to the findings of my review of the Pension Fund's Annual Report I plan to issue an audit report to be included within it (Appendix 3a).

Errors in the financial statements

In common with most local government pension funds, the accounts did not include a Net Assets Statement as at 1 April 2009. It is a requirement of IFRS 1 First time adoption of IFRS that bodies include a comparative Net Assets Statement and associated notes at the date of transition to IFRS. The Pension Fund has agreed to include a Net Assets Statement and accompanying notes as at the transition date of 1 April 2009.

I identified several other, mainly minor adjustments that were needed. I do not wish to draw your attention to any of these. However, I have provided a list of all the adjustments, for your information, at Appendix 1.

Financial statements

Audit risks

The key risks I identified were:

- First time application of International Financial Reporting Standards;
- Upgrade of the main financial system;
- Financial pressures – contributing employers;
- Differences between AXISe and general ledger;
- Valuation of investments;
- Accounting treatment of Compensatory added years (CAYs);
- Quality assurance arrangements; and
- Access to the general ledger.

I included a number of significant audit risks in my audit plan agreed with you. Following this I identified a further significant risk. This relates to controls over access to the Council's main financial system (ORACLE).

| Key audit risk | Findings |
|---|---|
| <p>First time application of International Financial Reporting Standards</p> <p>The transition to IFRS is complex requiring reconsideration of previous accounting disclosures and presenting a significant amount of new information in a new format. Failures to implement the requirements could lead to material misstatement in the financial statements.</p> | <p>The Finance team prepared well for the implementation of IFRS. Appropriate procedures and controls were implemented to enable the transition to be achieved in a timely and effective way.</p> <p>We found one material error in the Pension Funds application of IFRS – in common with most local government pension funds the accounts did not include a transitional Net Asset Statement. The Pension Fund has agreed to update the accounts to include a transitional Net Assets Statement.</p> |
| <p>Upgrade of the main financial system</p> <p>Oracle is the core financial system used by Cheshire West and Chester Council to maintain the financial records for Cheshire Pension Fund. The Council upgraded to a new version, Oracle R12, in January 2011. I identified some key audit risks for the Pension Fund:</p> <ul style="list-style-type: none"> • potential loss / corruption of data during the upgrade; • changes to the operation of key controls; and • backlog in data processing leading to loss of information. | <p>As part of my IT risk assessment I reviewed the Council's controls over the upgrade. I found that change management is generally well controlled and there are no weaknesses - compared to best practice. Officers put in place a wide range of procedures and controls to mitigate the risk around the upgrade, including:</p> <ul style="list-style-type: none"> • a Programme Board receiving weekly reports; • appointing a test co-ordinator to manage end to end testing; • four stages of user acceptance testing; and • an Internal Audit review of the testing arrangements and the results of the tests. <p>I reviewed and tested these controls. I found the risks reduced to an appropriately low level.</p> <p>The information held in the ledger itself was unaffected by the upgrade. I tested this assertion by comparing the closing trial balance for the old version of Oracle with the opening trail balance for Oracle R12. I did not identify any variances.</p> |

Financial pressures – contributing employers

We are aware that contributing bodies to the pension fund are under financial pressure and in many cases are offering voluntary early retirement, voluntary redundancy and possibly may need to make compulsory redundancies in the near future. This may place additional workload on the Pensions team in dealing with the large volume of severance arrangements

I did not find evidence of any backlog in the administration of pensions as a result of an increase in workload from increased numbers of severance cases in contributing bodies.

Differences between AXISe and ledger

The Pension Fund did not carry out reconciliations between the values in AXISe Pensions Payroll and membership administration systems to those in the general ledger in 2009/10. These are essential procedures which are intended to give the Pension Fund assurance that transactions in the fund account are correctly stated as well as providing controls assurance over receipts and payments in key areas.

The Pension Fund has improved the controls over receipts and payments in key areas by undertaking regular reconciliations between AXISe and the general ledger throughout the year.

Valuation of investments

The Pension Fund holds a diverse portfolio of investments. It is important that it uses the most appropriate approach to valuing each type of investment.

I tested the valuation of a sample of the Pension Fund's investments. I did not identify any errors in the valuation of investments.

Accounting treatment of Compensatory added years (CAYs).

The Pension Fund's receipts and payments were overstated by £5.5m in 2009/10 due to the incorrect inclusion of compensatory added years (CAYs). CAYs are awarded under the Local Government Regulations 2000 and therefore fall outside of the LGPS. The LGPS (Misc) Regulations 2009 now permit employers to convert CAYs into pension service, however there has to be a resolution by the employing authority.

The Pension Fund has received resolutions from employing authorities to convert CAYs into pension service. It is therefore correct for the accounts for 2010/11 and the associated comparatives for 2009/10 to include CAYs.

Quality assurance arrangements

In 2009/10 we recommended that management improve the quality assurance arrangements for the Pension Fund accounts including ensuring a reconciliation between the Net Assets Statement and the general ledger is performed.

The Pension Fund management have improved their year end accounts preparation procedures by including a reconciliation of the entries in the Net Assets Statement and the general ledger as at 31 March 2011.

Access to the general ledger

I found weaknesses with access security controls during my IT risk assessment. Similar control issues were identified by Internal Audit in their IT health check. The main weaknesses relate to non-council staff, for example, agency staff and consultants being able to access the general ledger without having effective controls being in place. This creates a risk of unauthorised entries being made in the general ledger and other key financial systems. It could lead to a material misstatement of the Pension Fund's accounts.

This finding was discussed with officers during the course of the audit. The Director of Resources has set out other key controls which are in place to help prevent and identify any incorrect or inappropriate entries to the ledger. Internal Audit have also done a review of Oracle user access processes and controls including detailed testing. The testing was designed to gain assurance that transactions undertaken by selected users were appropriately authorised and in accordance with Financial Procedure Rules.

Financial statements

Other issues identified in planning the audit

I identified the following other issues in my audit plan:

- the Triennial Actuarial Valuation as at 31 March 2010;
- lack of Internal Audit focus on pension fund risks in 2009/10;
- implementation of the revised Governance arrangements; and
- the Council has engaged the actuary to provide strategic investment advice to the Pension Fund with the key objective of performing a full investment strategy review.

I included a number of other issues in my audit plan agreed with you.

| Issue | Findings |
|---|---|
| The Triennial Actuarial Valuation as at 31 March 2010 | <p>Following work carried out by PwC I concluded that I could place reliance on the work of the actuary.</p> <p>The Pension Fund has reached agreement with all Fund employers on the contribution rates to be paid to the Fund over the next three years. 17 employers have agreed to make deficit recovery payments via lump sum cash payments.</p> |
| Lack of Internal Audit focus on Pension Fund risks in 2009/10 | <p>The focus on Pension Fund risks has improved. We are continuing to work with Internal Audit to ensure the effective use of combined audit resources.</p> |
| Implementation of revised governance arrangements | <p>The Pension Fund has strengthened its governance arrangements with the creation of an Investment Sub Committee to support the Pension Fund Committee.</p> <p>These arrangements are in place for 2011/12.</p> |
| The Council has engaged the actuary to provide strategic investment advice to the Pension Fund with the key objective of performing a full investment strategy review | <p>The main body of the investment strategy review has been completed and implemented with the Committee ratifying the following key outcomes:</p> <ul style="list-style-type: none"> ■ To reduce the Fund's exposure to equities; ■ To move to managing UK equities on a passive basis; ■ To allocate 15% of Fund assets into an absolute return mandate; and ■ The appointment of four new managers: <p>These outcomes have been implemented. The Committee at the August 2011 meeting ratified the appointment of the new managers.</p> <p>A few remaining strands of the review are still under consideration by the Committee.</p> |

Financial statements

Weaknesses in internal control

I identified control weaknesses over access to the general ledger.

These weaknesses are only those I identified during the course of the audit that are relevant to preparing the financial statements. I am not expressing an opinion on the overall effectiveness of internal control.

| Description of weakness: | Potential effect: | Management action: |
|---|---|---|
| <p>General ledger access controls</p> <p>Non-council staff have access to the general ledger without effective controls being in place.</p> <p>Non council staff includes agency staff and system development consultants.</p> | <p>Increases the risk of unauthorised and inappropriate entries being made in the general ledger and other key financial systems.</p> | <p>Internal Audit undertook a review of procedures and controls and performed detailed testing of selected users. They concluded that there was no fraudulent or unauthorised access to Oracle in 2010/11. I have reviewed Internal Audit's work and have gained the assurance I need for my audit purposes. A joint officer working group has been set up by the Council and Cheshire East Council to identify the actions required to improve controls.</p> |

Financial statements

Quality of your financial statements

The quality of the Pension Fund's accounts is good

The quality of the Pension Fund's financial statements is good. However, I have asked for a small number of changes to be made. Apart from the omission of a transitional Net Assets Statement these other changes are mostly minor and presentational. I have included them in Appendix 1 for your information.

Other matters

Letter of representation

Before I issue my opinion, auditing standards require me to ask you and management for written representations about your financial statements and governance arrangements. The draft letter of representation is at appendix 2.

Appendix 1 – Amendments to the draft financial statements

I identified the following misstatements during my audit and management have adjusted the financial statements. I bring them to your attention to aid you in fulfilling your governance responsibilities.

| | | Funds Statement | | Net Asset Statement | |
|--|--|-----------------|----------|---------------------|----------|
| Adjusted misstatement | Nature of adjustment | Dr £000s | Cr £000s | Dr £000s | Cr £000s |
| Transitional IFRS net asset statement omitted | Include net assets statement as at 1 April 2009 | | | | |
| Cash balances overstated by £300k | Reduce cash balance | 300 | | | 300 |
| Long term debtors not discounted | Reduce debtors to reflect the change in the value of debts over time | 527 | | | |
| Lack of correlation between the fair value of investments in the fund account (£226m) and in note 7 (£194m). | Amend entries in note 7 to agree with fund account. | | | | |

I also identified the following disclosure errors which the Pension Fund has agreed to amend:

- Reanalysis of the Global Tactical Asset Allocation (GTAA) as a pooled investment;
- A small number of arithmetic errors and internal inconsistencies,
- Standard Life investments described as equity rather than money market funds;
- Inclusion of liabilities in relation to derivative contracts in the analysis of change in market value of investments;
- Reanalysis of M&G secured loans as pooled investments;
- Reanalysis of rental income debtor from debtors to investment debtors;
- Settlement in relation to the movement of the Magistrates Court pensions to the Civil Service shown as income not a contractual commitment;
- Note 35 actuarial present value of promised retirement benefits to refer to the actuarial calculation only and not include the figures; and
- Accounting policies expanded to refer to policy on:
 - costs of acquisition of investments
 - estimation uncertainty and significant judgments

Appendix 2 – Letter of representation

Judith Tench
District Auditor
Audit Commission
2nd Floor, Aspinall House
Aspinall Close
Middlebrook, Horwich
Bolton, BL66QQ

Cheshire Pension Fund - Audit for the year ended 31 March 2011

I confirm to the best of my knowledge and belief, having made appropriate enquiries of other directors and officers of the Cheshire Pension Fund (the Fund), the following representations given to you in connection with your audit of the Fund's financial statements for the year ended 31 March 2011.

Compliance with the statutory authorities

I have fulfilled my responsibility under the relevant statutory authorities for preparing the financial statements in accordance with the Code of Practice for Local Authority Accounting in the United Kingdom which give a true and fair view of the financial position and financial performance of the Fund for the completeness of the information provided to you, and for making accurate representations to you.

Supporting records

All relevant information and access to persons within the entity has been made available to you for the purpose of your audit, and all the transactions undertaken by the Fund have been properly reflected and recorded in the financial statements.

Irregularities

I acknowledge my responsibility for the design, implementation and maintenance of internal control to prevent and detect fraud or error.

I also confirm that I have disclosed:

- my knowledge of fraud, or suspected fraud, involving either management, employees who have significant roles in internal control or others where fraud could have a material effect on the financial statements;
- my knowledge of any allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others; and
- the results of our assessment of the risk that the financial statements may be materially misstated as a result of fraud.

Law, regulations, contractual arrangements and codes of practice

I have disclosed to you all known instances of non-compliance, or suspected non-compliance with laws, regulations and codes of practice, whose effects should be considered when preparing financial statements.

Transactions and events have been carried out in accordance with law, regulation or other authority. The Fund has complied with all aspects of contractual arrangements that could have a material effect on the financial statements in the event of non-compliance.

All known actual or possible litigation and claims, whose effects should be considered when preparing the financial statements, have been disclosed to the auditor and accounted for and disclosed in accordance with the applicable financial reporting framework.

Accounting estimates including fair values

I confirm the reasonableness of the significant assumptions used in making the accounting estimates, including those measured at fair value.

Related party transactions

I confirm that I have disclosed the identity of the Fund's related parties and all the related party relationships and transactions of which I am aware. I have appropriately accounted for and disclosed such relationships and transactions in accordance with the requirement of the framework.

Subsequent events

All events subsequent to the date of the financial statements, which would require additional adjustment or disclosure in the financial statements, have been adjusted or disclosed.

Signed on behalf of Cheshire west and Chester Council

I confirm that this letter has been discussed and agreed by the Audit and Governance Committee on behalf of the Council on 28 September 2011.

Julie Gill

Director of Resources

September 2011.

Appendix 3 - Draft auditor's report for the Council's financial statements

Draft independent auditor's report to the members of Cheshire West and Chester Council

Opinion on the pension fund accounting statements

I have audited the pension fund accounting statements for the year ended 31 March 2011 under the Audit Commission Act 1998. The pension fund accounting statements comprise the Fund Account, the Net Assets Statement and the related notes. These accounting statements have been prepared under the accounting policies set out in the Statement of Accounting Policies.

This report is made solely to the members of Cheshire West and Chester Council in accordance with Part II of the Audit Commission Act 1998 and for no other purpose, as set out in paragraph 48 of the Statement of Responsibilities of Auditors and Audited Bodies published by the Audit Commission in March 2010.

Respective responsibilities of the Director of Resources and auditor

As explained more fully in the Statement of the Director of Resource's Responsibilities, the Director of Resources is responsible for the preparation of the pension fund's Statement of Accounts in accordance with proper practices as set out in the CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom. My responsibility is to audit the accounting statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require me to comply with the Auditing Practices Board's Ethical Standards for Auditors.

Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the accounting statements sufficient to give reasonable assurance that the accounting statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the fund's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the fund; and the overall presentation of the accounting statements. I read all the information in the explanatory foreword and the pension fund annual report to identify material inconsistencies with the audited accounting statements. If I become aware of any apparent material misstatements or inconsistencies I consider the implications for my report.

Opinion on accounting statements

In my opinion the pension fund's accounting statements:

- give a true and fair view of the financial transactions of the pension fund during the year ended 31 March 2011 and the amount and disposition of the fund's assets and liabilities as at 31 March 2011 other than liabilities to pay pensions and other benefits after the end of the scheme year and
- have been properly prepared in accordance with the CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom.

Opinion on other matters

In my opinion, the information given in the explanatory foreword and the content of the pension fund annual report for the financial year for which the accounting statements are prepared is consistent with the accounting statements.

Appendix 3a - Draft auditor's report for the Pension Fund Annual Report

Draft independent auditor's report to the members of Cheshire West and Chester Council

Opinion on the pension fund accounting statements

I have audited the pension fund accounting statements for the year ended 31 March 2011 under the Audit Commission Act 1998. The pension fund accounting statements comprise the Fund Account, the Net Assets Statement and the related notes. These accounting statements have been prepared under the accounting policies set out in the Statement of Accounting Policies.

This report is made solely to the members of Cheshire West and Chester Council in accordance with Part II of the Audit Commission Act 1998 and for no other purpose, as set out in paragraph 48 of the Statement of Responsibilities of Auditors and of Audited Bodies published by the Audit Commission in March 2010.

Respective responsibilities of the Director of Resources and auditor

As explained more fully in the Statement of Directors Responsibilities, the Director of Resources is responsible for the preparation of the pension fund's Statement of Accounts in accordance with proper practices as set out in the CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom. My responsibility is to audit the accounting statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require me to comply with the Auditing Practices Board's Ethical Standards for Auditors.

Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the accounting statements sufficient to give reasonable assurance that the accounting statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the fund's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the fund; and the overall presentation of the accounting statements. I read all the information in the annual report to identify material inconsistencies with the audited accounting statements. If I become aware of any apparent material misstatements or inconsistencies I consider the implications for my report.

Opinion on accounting statements

In my opinion the pension fund's accounting statements:

- give a true and fair view of the financial transactions of the pension fund during the year ended 31 March 2011 and the amount and disposition of the fund's assets and liabilities as at 31 March 2011 other than liabilities to pay pensions and other benefits after the end of the scheme year; and
- have been properly prepared in accordance with the CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom.

Opinion on other matters

In my opinion, the information given in the annual report for the financial year for which the accounting statements are prepared is consistent with the accounting statements.

Matters on which I report by exception

I have nothing to report in respect of the governance statement on which I report to you if, in my opinion the governance statement does not reflect compliance with the Local Government Pension Scheme (Administration) Regulations 2008 and related guidance.

Appendix 4 – Glossary

Annual governance statement

A statement of internal control prepared by an audited body and published with the financial statements.

Audit opinion

On completion of the audit of the financial statements, I must give my opinion on the financial statements, including:

- whether they give a true and fair view of the financial position of the audited body and its spending and income for the year in question; and
- whether they have been prepared properly, following the relevant accounting rules.

If I agree that the financial statements give a true and fair view, I issue an unqualified opinion. I issue a qualified opinion if:

- I find the statements do not give a true and fair view; or
- I cannot confirm that the statements give a true and fair view.

Materiality and significance

The Auditing Practices Board (APB) defines this concept as ‘an expression of the relative significance or importance of a particular matter for the financial statements as a whole. A matter is material if its omission would reasonably influence users of the financial statements, such as the addressees of the auditor’s report; also a misstatement is material if it would have a similar influence. Materiality may also be considered for any individual primary statement within the financial statements or of individual items included in them. We cannot define materiality mathematically, as it has both numerical and non-numerical aspects’.

The term ‘materiality’ applies only to the financial statements. Auditors appointed by the Commission have responsibilities and duties under statute, as well as their responsibility to give an opinion on the financial statements, which do not necessarily affect their opinion on the financial statements.

'Significance' applies to these wider responsibilities and auditors adopt a level of significance that may differ from the materiality level applied to their audit in relation to the financial statements. Significance has both qualitative and quantitative aspects.

Weaknesses in internal control

A weakness in internal control exists when:

- a control is designed, set up or used in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements quickly; or
- a control necessary to prevent, or detect and correct, misstatements in the financial statements quickly is missing.

An important weakness in internal control is a weakness, or a combination of weaknesses that, in my professional judgement, are important enough that I should report them to you

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September 2011