

Annual governance report

London Borough of Lewisham Pension Fund

Audit 2010/11



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Key messages

This draft report summarises the findings to date from my 2010/11 audit which is not yet complete. It summarises the messages arising from my audit of your pension fund financial statements.

Audit opinion and financial statements

This report summarises the findings from my 2010/11 pension fund audit to date. It identifies the key issues arising that you should consider before I will be in a position to issue my audit opinion on the Council's financial statements.

The Council provided the pension fund financial statements earlier than the main council financial statements, on 7 June 2011. I found that the draft pension fund financial statements contained four material errors, three material omissions in the notes, and several non trivial and trivial errors. There were also two material disclosures missing that related to the transition to International Financial Reporting Standards. The errors found from my audit work to date are summarised in Appendix 2.

A complete set of working papers to support the financial statements was not available at the start of the audit. Subsequent requests for further supporting information were not always provided in a timely manner and in some cases, did not provide sufficient evidence to support the audit query being raised. Due to these issues and the fact that the main contact left during the audit, the audit is currently ongoing.

Subject to the remaining items detailed on page 5, and the completion of review procedures I plan to issue an audit report on the Council's financial statements that includes an unqualified opinion on the pension fund financial statements. Appendix 1 (a separate attachment) contains a draft format of the audit opinion on the pension fund annual report.

Before I complete my audit

I confirm to you

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 on the Council's pension fund during 2010/11.

Due to the errors that I have found during the audit to date and the delays in providing timely and accurate supporting working papers I am in the process of agreeing an additional fee for the pension fund with the Director of Resources.

I ask you to confirm to me

I ask the Audit Panel to:

- consider the matters raised in this report before the Council approves the financial statements (page 5);
 - take note of the adjustments to the financial statements which are set out in this report (Appendix 2);
 - approve the letter of representation on behalf of the Council and before I issue my opinion (a separate attachment- Appendix 6);
 - agree your response to the attached action plan (Appendix 5); and
 - report its findings and recommendations when the Council approves its financial statements.
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Financial statements

Subject to the remaining items noted below I plan to issue an audit report on the Council's financial statements that includes an unqualified opinion on the pension fund financial statements

Opinion on the pension fund financial statements

Subject to satisfactory clearance of outstanding matters below, I plan to issue an audit report including an unqualified opinion on the financial statements of the pension fund. Appendix 1 (to follow) contains a copy of my draft report. My work on the financial statements is not yet complete. The following items are outstanding.

- Accounting policy for two investments.
- Audited accounts from the investment manager to confirm the price of the Investec fund 31 March 2011.
- Reconciliations: from AXISE (pension administration system) to the general ledger and from payroll to the general ledger for March 2011.
- Supporting information for the testing of receipts and payments in April.
- Reconciliation to support the year end cash balance.
- Reconciliation between the purchases and sales in the accounts and the information from the investment manager.

I have received some responses to queries raised however I have not yet completed my testing on:

- review of the annual report (not yet received);
- contributions and benefits testing;
- review of the investments disclosure and agreement to external confirmations (new note to be provided by the council).

Subject to the receipt and review of further working papers and further internal reviews, my team may raise further audit queries.

Errors in the financial statements

The financial statements submitted for audit were incomplete. The Council had not disclosed an analysis of the Financial Instruments nor the opening net asset Statement for 2009 which are two material disclosures required by the transition to International Financial Reporting Standards (IFRS) in 2010/11.

My audit to date has identified the following errors which management has agreed to adjust (refer to Appendix 2). There are four material amendments to date within the net asset statement.

- There were two material classification errors within the investment categories on the net asset statement in 2010/11.
- The derivatives were shown on a gross basis on the net asset statement, instead of disclosing only the profit/loss.
- There was one material amendment made to the prior year classification of private equity, to ensure consistency between years.

None of these errors had an impact on the overall position of the fund account or the total net assets. There were three material disclosure omissions in the notes:

- There was no collateral disclosed (£11million), nor related stock lending (£10.2million).
- The Council had not disclosed the value of the commitments relating to private equity (£26.2million).

There were also several trivial and non trivial disclosure errors. The Council has agreed to adjust for all of the errors found to date (Appendix 2).

Recommendation

R1 Ensure that a full quality review is undertaken before the accounts are submitted for audit.

Financial statements

The Pension Fund financial statements are important means by which the Council accounts for its stewardship of public funds. The Council has final responsibility for these statements. It is important that you consider my findings before the Council adopts the financial statements.

In planning my audit I identified specific risks and areas of judgement that I have considered as part of my audit.

Key audit risk and findings

Key audit risk	Finding
<p>1. Separate bank accounts required for the Fund</p> <p>Under revisions to legislation, the Fund must from 1 April 2011 have a separate and dedicated bank account rather than have its funds within the Council's banking arrangements. This increases the risk particularly with the year-end closing cash balance that will become the opening balance within a separate bank account.</p>	<p>The Council confirmed that a new bank account has been open from 1 April 2011. However the Council has not yet used this bank account for the pension fund transactions in the 2011/12 year and hence the pension fund monies are not yet clearly ring-fenced from other monies held by the Council. The Council has confirmed that this will now be undertaken as soon as possible.</p>
<p>2. International Financial Reporting Standards (IFRS)</p> <p>Some presentational and classification changes will be required due to the implementation of IFRS.</p>	<p>I have reviewed the disclosures required under IFRS. The Council had correctly included the present value of funded benefits which is a new requirement in 2010/11 under International Accounting Standard (IAS)26.</p> <p>However I found that the Council had not disclosed the net asset statement for 2009 which is a requirement under the transition to IFRS.</p> <p>The Council also updated the accounts during the audit to include an analysis of financial instruments required under the international financial reporting standards, (along with related disclosures).</p>

Key audit risk

3. Unquoted investments

The valuation of unquoted investments is potentially a very complex area. The pension fund has a material amount of unquoted investments. There are risks around accurate valuation at year end.

4. Preparation of the financial statements

The Council is planning to produce the Pension fund financial statements and working papers one month earlier than last year by producing them on the 27 May 2011. The Council needs to obtain all relevant information to avoid subsequent amendments for example in 2009/10 the Custodian provided late information causing material adjustments to the financial statements. There is a risk that the audit is not complete before the main contact leaves the council.

5. Fair value disclosure of the investments

There is an inherent risk that investments disclosed in the net asset statement are not at disclosed fair value.

Finding

I reviewed the unquoted investments disclosed in the accounts. I found:

- Harbourvest private equity investments. The 31 March 2011 valuation had not been used to prepare the accounts. Due to timing, the report used by the custodian was prior to March 2011 and therefore I found a discrepancy between the accounts and the confirmation I received from the investment manager of £2.16 million.
- M&G: The custodian had used the valuation from the 31 December 2010 and this meant that the investments were disclosed at cost rather than fair value. The difference is trivial for 2010/11 (£5k) but the Council should ensure the investments are disclosed at market value for next year.

The Council provided the statements for audit on 7 June 2011, 11 days later than the date agreed. The working papers were not ready with the accounts and there were subsequent delays in starting the audit and with audit progress. This was mainly due to the fact that the key contact left during the audit.

The Council has worked hard to provide responses to audit queries raised since the key contact left and I will work with the Council to complete the audit as soon as possible before the deadline.

During the audit I obtained external confirmation for the value of investments disclosed in the net asset statement. I have the following issues to report.

- I found that the investments disclosed were materially correct however I found two discrepancies between the net asset statement and the external confirmation from the fund manager (£65k for RCM investments and £246k for Schroders investments). The Council confirmed that in some cases the prices differ slightly due to various factors including pricing sources and methods.

Key audit risk

Finding

- I also found that the external investment manager confirmation I received from Schroder contained a valuation for one investment as at 31 December 2010 instead of 31 March 2011. As a result I have no external support for the valuation of this investment (£7.1million) in the accounts as at 31 March, other than the custodian's confirmation. The difference between the December and the March price was non trivial (£178k).
 - I tested the price of equities held in HarbourVest Private Equity Group against publicly available information (prices held on external websites). There was a discrepancy of £187k (due to different pricing sources).
 - As part of my testing I took a sample of purchases, sales disclosed in the accounts. I found the following discrepancies between the values disclosed in the accounts and the fund manager:
 - Alliance Bernstein: Sales £294k, Purchases £489k
 - Schroders: Purchases £275kVarious differences between the custodian and the fund manager reports are due to timing and pricing sources used, and therefore no amendments have been made for these differences. I have requested management representation to confirm that the values in the accounts are fairly stated.
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Financial statements

Significant weaknesses in internal control

I reported one weakness in my audit opinion plan that was presented to the Pensions Investment Committee and I have repeated this weakness below. 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.

Internal control issues and findings

Description of weakness	Potential effect
<p>1. Year end reconciliation (pre statement audit finding)</p> <p>My audit work has identified that the Council is not regularly carrying out reconciliations between the general ledger and</p> <ul style="list-style-type: none">■ contributions (payroll system); or■ transfers in and out (pension system AXISe).	<p>There is a risk that the general ledger is not kept up to date if no reconciliations are completed between the systems.</p>
<p>2. Cash book reconciliation</p> <p>I found during the audit that there was no cash book to support the cash relating to the pension fund at year end. The Council provided a reconciliation during the audit but there remained a discrepancy of £73k. The Council is working to analyse this discrepancy.</p>	<p>The Council should ensure that it maintains records to support the cash balance. As the Council moves over to the new bank account this will remain important to ensure proper transfer and segregation between council and the pension fund monies.</p>
<p>3. Membership details</p> <p>There was no membership reconciliation to show the movement from opening number of members to the closing number of members. The AXISe report that I obtained as a working paper to support the note to the accounts at year end did not agree to the note due to timing (the original report printed to support the note had not been saved).</p>	<p>Keeping a reconciliation of members who join or leave the scheme provides additional control over the membership numbers.</p>

Recommendations

- R2** Ensure regular reconciliations are completed between the general ledger and the AXISe system/payroll system on a regular basis.
 - R3** Maintain detailed records to support the cash in the pension fund account and ensure that the new bank account is used for all pension fund transactions, in line with the regulations.
 - R4** Keep a full reconciliation of members in the pension fund, from the opening to the closing position at year end. Ensure that a working paper is provided to support the number of members at year end.
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Financial statements

Quality of your financial statements

I consider aspects of your accounting practices, accounting policies, accounting estimates and financial statements disclosures.

These are the issues I want to raise with you.

Accounting practices, policies, estimates and financial closures

Issue	Recommendations
<p>1. Agreement to the ledger</p> <p>The Statement of Accounts submitted for audit did not agree to the ledger. There was a discrepancy of £6.2 million due to timing. The Council has now agreed to amend the ledger to agree to the accounts.</p>	<p>R5 Ensure that the statement of accounts agrees to the ledger before submitting to the accounts for audit.</p>
<p>2. Working paper requirements</p> <p>The Council had not used the working paper requirements document that was agreed with the auditors to prepare working papers before the audit began. This resulted in substantial delays and material errors being identified during the audit.</p>	<p>R6 Use the working paper requirements document agreed with the auditors to prepare the working papers before the audit begins.</p>

Financial statements

Significant difficulties encountered during the audit

A complete set of working papers to support the financial statements was not available at the start of the audit. Subsequent requests for further supporting information were not always provided in a timely manner and in some cases, did not provide sufficient evidence to support the audit query being raised. I understand that the key contact preparing the pension fund left during the audit and this was the main reason for the significant delays. I do not expect the same issues to arise next year.

Letter of representation

Before I issue my opinion, auditing standards require me to ask the Audit Panel and management for written representations about the financial statements and governance arrangements (refer to Appendix 6 - a separate attachment).

Appendix 2 – 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.

Table 1: Amendments made to statement or note (value)

Adjusted mis-statement	Nature of adjustment	Value of amendment £000
Net Asset Statement: The equity tracker fund had been incorrectly reclassified as 'segregated equities' in 2010/11.	The Council reversed the reclassification made in 2010/11. This amendment has been made in the final version of the accounts.	125,633
Net Asset Statement: The index linked funds had been incorrectly reclassified as 'fixed income' in 2010/11.	The Council reversed the reclassification made in 2010/11. This amendment has been made in the final version of the accounts.	42,414
Net Asset Statement: The private equity investment has been correctly reclassified as 'other funds' in 2010/11, yet the prior year had not been adjusted to make this consistent between years.	The Council amended the prior year classification to recognise a prior period adjustment, and to ensure consistency between years.	23,681
Net Asset Statement: Derivatives. The Council had incorrectly accounted for the derivatives on a gross basis in the Net Asset Statement.	The Council amended the presentation on the net asset statement by showing only the profit or the loss of each derivative on the Net Asset Statement.	17,203 (assets)/17,283 (liabilities)

Adjusted mis-statement	Nature of adjustment	Value of amendment £000
Net Asset statement Unquoted Harbourvest investments. The investments had not been valued as at 31 March 2011 due to timing of the accounts preparation.	This amendment was subsequently made to the accounts, to show the value as at 31 March 2011.	2,163
Note 1 fund account: Admitted/scheduled body contributions. The Council incorrectly input the figure for admitted bodies under the line for scheduled bodies in the accounts.	This amendment was subsequently made in the accounts.	571
Note 14: Collateral disclosure. There was no collateral disclosed.	This amendment was subsequently made in the accounts.	10,996
Note 14: Stock Lending. There was no value disclosed for the stock lending.	This amendment was subsequently made in the accounts.	10,200
Private equity note. There was no value disclosed for the commitments relating to Private Equity.	This amendment was subsequently made in the accounts.	£26,200
Note 13: Cash held with the fund managers was incorrectly disclosed as being held with the custodian	The Council has amended the note to disclose the cash being held with the fund managers.	Various
Investments note: The Council incorrectly disclosed a change in value to the investments as 'purchases'.	This amendment was subsequently made in the accounts.	2,594
Stock lending income disclosure	The Council amended the note to correct the value of income arising from stock lending.	168
Investments note: The value of purchases disclosed for Harbourvest during the year did not agree to the fund manager report	The Council amended the note to agree to the external confirmation from the fund manager	378

Table 2: **Amendment made to statement or note (change to text or omission)**

Statement or note	Amendment made to the text or statement
Net Asset Statement	The Council omitted the 2009 Net Asset Statement which is a requirement under IFRS. The Council has agreed to amend this in the final version of the accounts.
Financial instruments	The Council had not disclosed an analysis of the type of financial instruments held within the pension fund, nor an analysis of the risks relating to the financial instruments. The Council has agreed to include this in the final version of the accounts.
Rounding errors	There were inconsistencies between the main statements and the notes, as some figures have been rounded and some had not been rounded (several discrepancies up to £146k). The Council has agreed to amend this in the final version of the accounts.
Accounting policies	There were no accounting policies disclosed for the measurement of two investments held: M&G and Investec. The Council has agreed to amend this in the final version of the accounts.

Appendix 3 – Unadjusted misstatements to the financial statements

I identified the following misstatements during my audit but management has not adjusted the financial statements. I bring them to your attention to help you in fulfilling your governance responsibilities and ask you to correct these misstatements. If you decide not to amend, please tell me why in the representation letter. If you believe the effect of the uncorrected errors, individually and collectively, is immaterial, please reflect this in the representation letter. Please attach a schedule of the uncorrected errors to the representation letter.

		Comprehensive income and expenditure statement		Balance sheet	
Unadjusted misstatement	Nature of required adjustment	Dr £000s	Cr £000s	Dr £000s	Cr £000s

There are no unadjusted misstatements to report.

Appendix 4 – Glossary

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.

Opinion

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.

A significant 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.

Appendix 5 – Action plan

Recommendations

Recommendation 1

Ensure that a full quality review is undertaken before the accounts are submitted for audit

Responsibility Selwyn Thompson – Group Manager, Budget Strategy

Priority High

Date January 2012

Comments This quality review will commence as soon as the position for the 2010/11 has been concluded, and we will review the accounts before submitted to audit for 2011/12

Recommendation 2

Ensure regular reconciliations are completed between the general ledger and the AXISe system/payroll system on a regular basis

Responsibility Carol Eldridge – Group Manager, Pensions

Priority High

Date January 2012

Comments To establish the process immediately, to be effective from January 2012 onwards. The process to be implemented in conjunction with officers from the Information Management and Technology Division

Recommendation 3

Maintain detailed records to support the cash in the pension fund account and ensure that the new bank account is used in line with the regulations

Responsibility	Selwyn Thompson – Group Manager, Budget Strategy
Priority	High
Date	December 2011
Comments	The new bank account has already been set up. The process is being reviewed for completion and implementation of the new approach by December 2011

Recommendation 4

Keep a full reconciliation of members in the pension fund, from the opening to the closing position at year end. Ensure that a working paper is provided to support the number of members at year end.

Responsibility	Carol Eldridge – Group Manager, Pensions
Priority	Low
Date	September 2011
Comments	This process for reconciliation of members already exists. The issue of working papers will be specifically addressed as part of the closing of accounts process for 2011/12

Recommendation 5

Ensure that the statement of accounts agrees to the ledger before submitting to the accounts for audit.

Responsibility	Selwyn Thompson – Group Manager, Budget Strategy
Priority	High
Date	May 2012
Comments	This will be specifically addressed in the closing of accounts timetable for 2011/12

Recommendation 6

Use the working paper requirements document agreed with the auditors to prepare the working papers before the audit begins

Responsibility	Selwyn Thompson – Group Manager, Budget Strategy
Priority	High
Date	May 2012

Comments

This will be in place for the commencement of the closing of accounts process for 2011/12

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