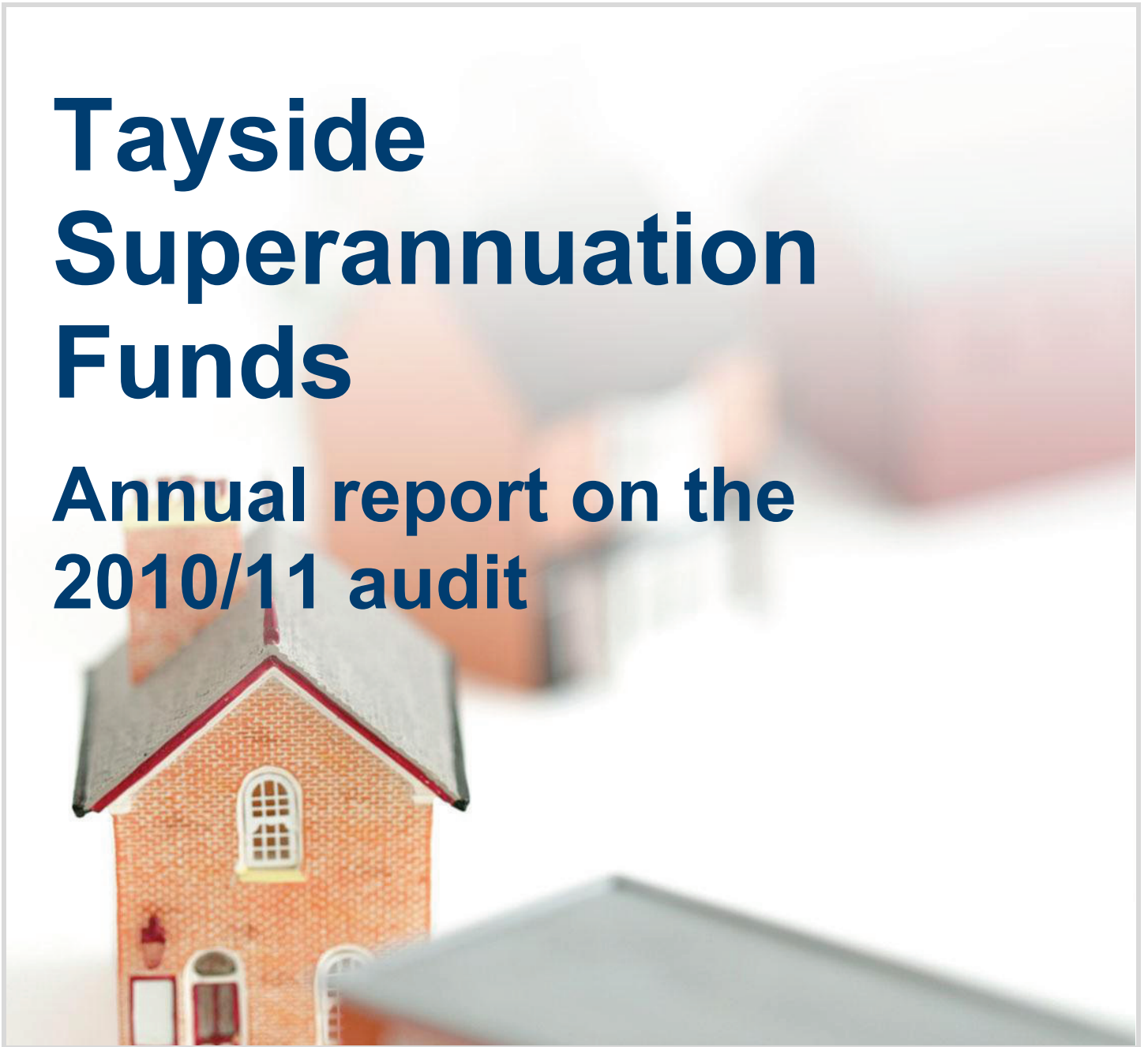


Tayside Superannuation Funds

Annual report on the 2010/11 audit



Prepared for Members of Dundee City Council as administering authority for the Tayside Superannuation Funds and the Controller of Audit

November 2011

Audit Scotland is a statutory body set up in April 2000 under the Public Finance and Accountability (Scotland) Act 2000. It provides services to the Auditor General for Scotland and the Accounts Commission. Together they ensure that the Scottish Government and public sector bodies in Scotland are held to account for the proper, efficient and effective use of public funds.

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Key messages

2010/11

2010/11 is the first year in which Scottish Government regulations require local government pension funds to prepare an annual report separate from the administering authority's own statutory accounts. The report is required to include separate pension fund financial statements which require a separate audit certificate.

During 2010/11 we looked at the key strategic and financial and strategic risks faced by the Tayside Superannuation Funds (the funds). We audited the financial statements and assessed aspects of governance, use of resources and performance. This report sets out our main findings, summarising key outcomes from the 2010/11 audit and the outlook for the period ahead.

We have given an unqualified opinion that the financial statements of the funds for 2010/11 give a true and fair view of the state of the affairs of the funds as at 31 March 2011 and of the income and expenditure for the year then ended.

Our review of the funds governance arrangements identified some areas where further development is required to allow the administration of the funds to meet best practice and have made recommendations both here and in our Governance Report issued earlier in the year. We were satisfied that the disclosures in the Governance Compliance Statement contained within the funds' financial statements were in accordance with Scottish Government guidance.

Outlook

Looking ahead, it is clear that the outlook for public spending for the period 2012/13 to 2014/15 remains very challenging, while volatility on the financial markets continue to affect the value of fund assets.

The triennial funding valuation as at 31 March 2011 was carried out by the funds' actuaries and the results will shortly be published. It will establish the extent to which, on future assumptions, scheme assets cover scheme liabilities. At this stage, it is uncertain whether the funding level will drop from the 2008 level of 97.6% (main fund) and 92.3% (transport fund). Demographic changes and turmoil on the financial markets will impact adversely on all defined benefit occupational pension schemes.

The recent Scottish Spending Review has not required compulsory contribution increases, unlike the situation in England and in other Scottish public sector pension schemes such as police, fire and health. However, public sector pension provision will continue to be under review and a range of options will be considered to improve funding and reduce liabilities, including increased contribution rates, lowered accrual rates and extended retirement ages.

Introduction

1. This report is the summary of our findings arising from the 2010/11 audit of the funds. The purpose of the annual audit report is to set out concisely the scope, nature and extent of the audit, and to summarise the auditor's opinions (i.e. on the financial statements) and conclusions and any significant issues arising. The report is divided into sections which reflect the extent of our public sector audit model.
2. Appendix A provides details of our reports issued during 2010/11. We do not repeat all of the findings in this report, but instead we focus on the financial statements and any significant findings from our wider review of the administering authority's arrangements for management of the funds.
3. Appendix B is an action plan setting out the high level risks we have identified from the audit. Officers have considered the issues and agreed to take the specific steps in the column headed "planned management action". We do not expect all risks to be eliminated or even minimised. What we expect is that those charged with governance understand the risks and have arrangements in place to manage these risks. The fund should ensure that those charged with governance are satisfied with the proposed management action and have a mechanism in place to assess progress.
4. This report is addressed to those charged with governance and the controller of audit. It should be made available to the public and other stakeholders. Audit is an essential element of accountability and the process of public reporting. This report will be published on our website after consideration by the those charged with governance.
5. Management is responsible for preparing financial statements that show a true and fair view and for implementing appropriate internal control systems. Weaknesses or risks identified by auditors are only those which have come to their attention during their normal audit work, and may not be all that exist. Communication by auditors of matters arising from the audit of the financial statements or of risks or weaknesses does not absolve management from its responsibility to address the issues raised and to maintain an adequate system of control.
6. The co-operation and assistance given to us by officers is gratefully acknowledged.

Financial statements

7. Audited bodies' financial statements are an essential part of accounting for their stewardship of the resources made available to them and their performance in the use of those resources.
8. Auditors are required to audit financial statements in accordance with the timescales set by Audit Scotland, which may be shorter than statutory requirements, and give an opinion on:
 - whether they give a true and fair view of the financial position of audited bodies and their expenditure and income
 - whether they have been properly prepared in accordance with relevant legislation, the applicable accounting framework and other reporting requirements.
9. Auditors review and report on, as appropriate, other information published with the financial statements, including the foreword, and the governance compliance statement. This section summarises the results of our audit of the financial statements.

Audit opinion

10. We have given an unqualified opinion that the financial statements of the funds for 2010/11 give a true and fair view of the financial transactions of the funds during the year ended as at 31 March 2011 and of the amount and disposition at that date of their assets and liabilities.

Legality

11. Through our planned audit work we consider the legality of the funds' financial transactions. In addition the Director of Finance of Dundee City Council has confirmed that, to the best of her knowledge and belief, the financial transactions of the pension funds were in accordance with relevant legislation and regulations. There are no legality issues arising from our audit which require to be brought to the attention of those charged with governance.

Governance Compliance Statement

12. Regulation 27 of the Local Government Pension Scheme (Administration) (Scotland) Regulations 2008 (SSI 2008/228) requires that the administering authority formulate a governance compliance statement stating where their arrangements complied with Scottish Ministers guidance, and where they did not. Although the regulations allow for this statement to be referred to in the annual report, the funds took the decision to include the full statement.
13. We are satisfied that this statement covers the areas and levels of compliance required by the Scottish Government's guidance.

Annual Report

14. An amendment to the Local Government Pension Scheme (Administration) (Scotland) regulations (SSI 2010/234) required administering authorities to publish a pension fund annual

report for the first time in 2010/11, with a publishing deadline of 31 December 2011. The funds have been producing a separate annual report for several years.

15. The Scottish Government Guidance requires that the annual report for the pension fund incorporates the following:
 - the annual accounts
 - a report about the management and financial performance of the funds during the year, a report explaining the authority's investment policy and reviewing the performance during the year of the investments of each fund, and a report of the arrangements made during the year for the administration of the funds
 - a statement by the actuary of the level of funding disclosed by their valuation
 - a governance compliance statement, funding strategy statement, and statement of investment principles (or details of where these statements may be obtained)
 - the extent to which levels of performance set out in the pension administration strategy have been achieved;
 - any other material which the authority considers appropriate.
16. We are satisfied that the report incorporates the above sections and that the other sections are consistent with the audited accounts.

Accounting issues

17. Local authority bodies in Scotland are required to follow the 2010 Code of Practice on Local Authority Accounting in the United Kingdom (the 2010 Code), including for the first time in 2010/11 the application of International Financial Reporting Standards (IFRS). We were satisfied that the pension fund prepared the accounts in accordance with the 2010 Code.

Accounts submission

18. The funds unaudited financial statements were submitted to the controller of audit by the deadline of 30 June 2011. A comprehensive working papers package was also available by this date. This enabled us to conclude the audit and certify the financial statements before the target date of 30 November 2011. The annual report, incorporating the financial statements, is now available for presentation to members and for publication.
19. The target date of 30 November 2011 was a transitional date set to assist administering authorities in the first year of new requirements. In future years the certification date for the financial statements will be 30 September in line with other local authority bodies. Administering authorities will need to plan their approach to the preparation of the annual report to ensure that all necessary third party information is available to meet this deadline.

Refer Action Plan no. 1

Presentational and monetary adjustments to the unaudited accounts

20. As reported in line with International Standard on Auditing 260 *communication of audit matters to those charged with governance* there were a number of audit adjustments required to the financial statements as a result of our audit findings. These were corrected as appropriate, with one exception.
21. Due to the double counting of pending investment sale and purchase transactions in 2009/10 the net assets of the main fund were overstated by £4.797 million and the transport fund understated by £0.065 million as at 31 March 2010. As a result the 2010/11 change in market value was overstated by £4.797 million for the main fund and understated by £0.065 million for the transport fund. The Director of Finance of Dundee City Council has decided not to change this on the basis that it is not material to the financial statements and we are content with this.

Prior year adjustments

22. The 2010/11 financial statements have been prepared in accordance with the 2010 Code which is based on International Financial Reporting Standards (IFRS) instead of the previous practice of preparing financial statements under UK Generally Accepted Accounting Practice (GAAP). This transition did not require a prior year adjustment to the 2009/10 audited financial statements of the funds there were no material IFRS changes which affected the preparation of their accounts.

Outlook

Audit appointment for 2011/12

23. Audit appointments are made by the Accounts Commission, either to Audit Scotland staff or to private firms of accountants for a five year term. 2010/11 is the last year of the current audit appointment. The procurement process for the next five years was completed in May 2011. From next year (2011/12) the auditor for the funds will be KPMG LLP. We will be meeting with the incoming external auditors KPMG LLP as part of a managed changeover process.
24. As this is the last year of our appointment, we would like to take the opportunity to thank the officers and staff of Dundee City Council for their assistance during the past year.

Financial position

25. Audited bodies are responsible for conducting their affairs and for putting in place proper arrangements to ensure that their financial position is soundly based.
26. Auditors consider whether audited bodies have established adequate arrangements and examine:
 - financial performance in the period under audit
 - compliance with any statutory financial requirements and financial targets
 - ability to meet known or contingent, statutory and other financial obligations
 - responses to developments which may have an impact on the financial position
 - financial plans for future periods.
27. These are key areas in the current economic circumstances. This section summarises the financial position and outlook for the organisation.

Financial results

Budgetary control

28. The pension fund does not set a budget for its activities or report on progress through the year. This has been mainly due to the fact that, for most of its activities (receiving contributions, paying pensions, investing activities), it does not have control over the value of the transactions at any one time. There are, however some elements (administration costs, investment manager expenses and other overheads) where it does have some control and would be helpful to set a budget for such areas of expenditure.

Refer Action Plan no. 2

Financial position

29. The overall position at 31 March 2011 set out in the net assets statement is that the main fund has assets of £1,909 million. The financial statements do not take account of the obligations to pay pensions and other benefits which fall due after the end of the year. The actuarial position of the scheme, which does take account of such obligations is disclosed in the Notes to the Accounts.
30. The actuarial value of promised retirement benefits at the accounting date has been estimated by the Funds Actuary as £2,396 million. This gives an estimated net liability of £487.5 million as at 31 March 2011. The liability is an estimate of the present value of the future liabilities of the funds, based on the funds actuary's assumptions regarding the future discount rate, longevity of members and rate of inflation. This figure is used by the pension fund for statutory accounting purposes and is not relevant for funding purposes and setting contributions payable to the fund.

31. The value of the pension fund liability at 31 March 2011 has reduced from the 31 March 2010 value of £927.6 million. The principal reason for this reduction has been the change in the basis for indexing the value of pension payments from RPI (retail price index) to CPI (consumer price index). In effect this now means that future pension increases are now linked to the consumer price index and are expected to rise at a lower rate than when previously linked to the retail price index. This will reduce payments to pensioners and thus reduce the future liabilities of the funds.

Outlook

31 March 2011 actuarial funding review

32. At the last triennial full actuarial valuation of the funds (as at 31 March 2008), the actuary reported that the main fund had a funding level of 97.6% (a funding shortfall of £37.6 million) and calculated that an employer contribution rate of 18.5% of pay would be required to meet this shortfall over a 12 year period. For the Transport Superannuation Fund the actuary reports a funding level of 92.3% at 31 March 2008. This was revised to 89% at November 2008 due to market conditions and the annual contributable amounts calculated on that basis.
33. The triennial review by the funds actuary as at 31 March 2011 will be important in determining future levels of employer contributions. The final report from the actuary will be available in early 2012.

The picture beyond 2011/12

34. The full extent of the recommendations made in the Hutton report and how they impact upon pension schemes in Scotland remains uncertain. Increasing the funding burden on employees through higher contributions whilst at the same time reducing end benefits will impact on the desirability of pension schemes increasing the risk of member drop out.
35. Looking ahead it is clear that the outlook for public spending for the period 2012/13 to 2014/15 remains very challenging. The high level figures for Scotland announced in the UK Comprehensive Spending Review indicate that significant budget reductions will be required in these years. This will impact on contributions received and benefits payable where scheduled and admitted bodies reduce staffing levels. The financial constraints also increase the risk of delayed payment of contributions or, in the worst case scenario, employer default by smaller bodies.
36. The funds will have to remain vigilant and keep assessing their exposure to risk. Continuing to work, and communicating effectively with employers and the actuary will be even more critical going forward.

Governance and accountability

37. The three fundamental principles of corporate governance – openness, integrity and accountability – apply to all audited bodies, whether their members are elected or appointed, or whether they comprise groups of people or an individual accountable officer.
38. Through its board, chief executive and/or accountable officer, each administering authority is responsible for establishing arrangements for ensuring the proper conduct of pension fund affairs including the legality of activities and transactions, and for monitoring the adequacy and effectiveness of these arrangements. Audited bodies usually involve those charged with governance in monitoring these arrangements.
39. Consistent with the wider scope of public audit, auditors have a responsibility to review and report on an administering authority's corporate governance arrangements as they relate to:
 - corporate governance and systems of internal control
 - the prevention and detection of fraud and irregularity
 - standards of conduct and arrangements for the prevention and detection of corruption.
40. In this part of the report we comment on key areas of governance.

Corporate governance

Processes and committees

41. The funds' governance arrangements run alongside the governance structures of the administering authority, Dundee City Council. The Superannuation Investment Sub-Committee, a sub-committee of the Policy & Resources committee of Dundee City Council, deals with pension fund investment issues and monitors investment manager performance.
42. The remit of the sub-committee is mainly concerned with pension investment arrangements and is silent on fund income and expenditure and administration. We are advised that this falls within the remit of the council's policy and resources committee, however, this would benefit from being clearly documented. We note that there is little evidence of the Policy and Resources Committee routinely and actively considering Pension Fund related matters.

Refer Action Plan no. 3

43. The sub-committee met four times in 2010/11 to consider reports on the performance of investments, the investment approach of individual fund managers and changes in the portfolio of fund managers.
44. The sub-committee membership is comprised of 6 elected members of Dundee City Council who hold all the voting rights. Provision is made for three observer employee representatives who do not have voting rights. Pensioners and employers are not directly represented. The

Governance Compliance Statement included within the financial statements recognises this as an area of non-compliance, however, it is noted that representatives are consulted and included in communications.

Internal control

45. While auditors concentrate on significant systems and key controls in support of the opinion on the financial statements, their wider responsibilities require them to consider the financial systems and controls of audited bodies as a whole. However, the extent of this work should also be informed by their assessment of risk and the activities of internal audit. We note that there is currently no programme of internal audit work specifically targeted at the funds and there has been no internal audit activity in this area for 2010/11. We have therefore been unable to place any reliance on internal audit work during 2010/11.

Refer Action Plan no. 4

46. The funds have procured the services of six fund managers and a custodian to provide specialist fund management services for their investment portfolio of £1.9 billion. Statement on Auditing Standard 70 *Service Organisations* (replaced by International Standard on Auditing 402 *Audit considerations relating to an entity using a service organisation* for accounting periods ending on or after 15 June 2011) reports are issued annually by auditors independent of the fund managers to those relying upon their services. The reports provide assurance that adequate controls are in operation over funds placed with the fund managers and that identified weaknesses are appropriately addressed. We note however that these reports are not subject to formal review and that action plans are not monitored.
47. The funds financial transactions are processed through the corporate financial systems of Dundee City Council under a service level agreement. As the external auditors of the council we have been able to take assurance from our work on these systems.
48. We have also sought and received assurances from the auditors of Perth and Kinross Council, Angus Council as significant scheduled bodies, that these organisations have adequate systems of control in place over the calculation of contributions due and their payment to the funds.
49. The funds' own financial systems run alongside those of the administering authority. There are specific systems and lines of responsibility for pension administration and for investment transactions. Our review of these financial systems did not identify significant issues.
50. At 31 March 2011 the funds' investment managers held cash balances of £49.8 million. In 2010/11 transactions in excess of £1.2 billion were processed through these cash accounts. However, we noted that accounting arrangements for the investment managers' cash accounts could be strengthened. While we are satisfied that cash balances held by investment managers are fairly stated, the Exchequer Officer should reconcile opening and closing cash positions. Such reconciliations would greatly reduce the risk that investment transactions recorded are in complete or incorrect.

Refer Action Plan no. 5

Outlook

51. It is clear that there are some elements of good governance in place. Going forward, however, Dundee City Council, as the administering authority should take the opportunity review its existing arrangements with particular regard to clarifying roles and responsibilities of the relevant committees and improving member representation
52. With the Scottish Local Government elections due to be held in May 2012, it is likely that the membership of the administering authority will change. This provides an opportunity to review the membership of committees.
53. The management of pension funds is a complex and high profile area. It will be important for the council to ensure that any new members of the superannuation investment sub-committee and other relevant committees receive appropriate and adequate induction and training to effectively scrutinise the proposals that are brought before them.

Use of resources and performance

54. Audited bodies have a specific responsibility to ensure that arrangements have been made to secure Best Value.
55. Auditors of local government bodies also have a responsibility to review and report on the arrangements that specified audited bodies have made to prepare and publish performance information in accordance with directions issued by the Accounts Commission.
56. As part of their statutory responsibilities, the Accounts Commission may procure, through Audit Scotland, examinations of the use of resources by audited bodies and publish reports or guidance. Auditors may be requested from time to time to participate in:
 - a performance audit which may result in the publication of a national report
 - an examination of the implications of a particular topic or performance audit for an audited body at local level
 - a review of a body's response to national recommendations.
57. Auditors may also consider the use of resources in services or functions, where the need for this is identified through local audit risk assessments
58. During the course of their audit appointment auditors should also consider and report on progress made by audited bodies in implementing the recommendations arising from reviews in earlier years.
59. This section includes a commentary on the Best Value and performance management arrangements within the pension fund. We also note any headline performance measures used by members and comment on any relevant national reports.

Management arrangements

Best Value

60. The funds have not been subject to a Best Value review; however they are covered by the overall Best Value arrangements of the administering authority.

Investment performance

61. The main way the funds measure performance is through the performance of their investments, overseen by independent investment advisor (Hymans Robertson) and managed by several specialised fund managers.
62. Performance against benchmark targets is reported to the Superannuation Investment sub-committee quarterly. In our corporate governance report, we noted that performance benchmarks set vary between investment managers and may even vary for the same type of

asset. However, benchmarks reported to members do not always take this into account, occasionally resulting in incorrect performance assessment. In some cases, benchmarks are not reported, which may make performance data less meaningful.

Administration performance

63. A number of KPIs for administration such as speed of various processes and the unit cost per scheme member/pensioner are compared against benchmarks. These results have however not been reported to and reviewed by the Superannuation Investment sub-committee. Without monitoring, review and challenge these indicators may not be effective in supporting continuous improvement

Refer Action Plan no. 6

Reporting performance measurement outcomes

64. As outlined above, KPIs for administration are produced. It would be beneficial to present this information to fund members as part of the annual report.

Refer Action Plan no. 7

National performance reports

65. Audit Scotland carries out a national performance audit programme on behalf of the Accounts Commission and the Auditor General for Scotland. Reports in the last year of interest are detailed in Exhibit 1:

Exhibit 1: A selection of national performance reports 2010/11

- | | |
|--|--|
| <ul style="list-style-type: none"> • The cost of public sector pensions in Scotland • Scotland's public finances: responding to the challenges | <ul style="list-style-type: none"> • An overview of local government in Scotland 2010 |
|--|--|

Source: www.audit-scotland.gov.uk

66. Elected members may wish to consider relevant national reports as they become available and to review national findings in the particular context of the Tayside funds.

Outlook

67. The current volatility of financial markets and potential for changes in income from contributions and benefits payable greatly increase the funds exposure to risk. Whilst many of the risks faced may only crystallise in the longer term it is the identification of these risks and

their mitigation in the short term that will ensure that they can be successfully managed in the years to come. Robust monitoring of investment performance and administration of the funds will need to play a significant role if the funds are to achieve this.

Appendix A: audit reports

External audit reports and audit opinions issued for 2010/11

| Title of report or opinion | Date of issue | Date presented to Committee |
|---|------------------|-----------------------------|
| Annual audit plan | 21 April 2011 | |
| Corporate governance | 1 August 2011 | 14 December 2011 |
| Report to those charged with governance | 22 November 2011 | 9 January 2012 |
| Audit opinion on the 2010/11 financial statements | 23 November 2011 | 9 January 2012 |

Appendix B: action plan

Key Risk Areas and Planned Management Action

| Action Point | Refer Para No | Risk Identified | Planned Management Action | Responsible Officer | Target Date |
|--------------|---------------|---|---|---------------------|---------------|
| 1 | 19. | <p>In future years the certification date for the financial statements will be 30 September in line with other local authority bodies. Administering authorities will need to plan their approach to the preparation of the annual report to ensure that all necessary third party information is available to meet this deadline.</p> <p><i>Risk: insufficient or inadequate preparation means that the financial statements are not prepared and certified within the required timescale.</i></p> | <p>The 2010/11 unaudited accounts were submitted on 30 June 2011.</p> <p>We do not envisage any issues with achieving the certification date of 30 September 2012.</p> | Exchequer Officer | June 2012 |
| 2 | 28. | <p>The pension fund does not set a budget for its activities or report on progress through the year. There are, however some elements (administration costs, investment manager expenses and other overheads) where it does have some control and would be helpful to set a budget for such areas of expenditure.</p> <p><i>Risk: in the absence of</i></p> | <p>The pension fund will set budgets for 2011/12 for controllable areas.</p> <p>This will form part of the pension fund business plan which will be reported to committee in February 2012.</p> | Exchequer Officer | February 2012 |

| Action Point | Refer Para No | Risk Identified | Planned Management Action | Responsible Officer | Target Date |
|--------------|---------------|---|--|----------------------------|-------------|
| | | <i>robust budgetary control the administering authority may not be fully effective in controlling costs.</i> | | | |
| 3 | 42. | <p>We note that there is little evidence of the Policy and Resources Committee routinely and actively considering Pension Fund related matters.</p> <p><i>Risk: without adequate scrutiny and challenge the administering authority may fail to achieve best practice and to maximise performance of the funds.</i></p> | <p>The Policy and Resources has provided a clear remit to the Superannuation sub-committee and receives the minutes of its meetings.</p> | n/a | n/a |
| 4 | 45. | <p>We note that there is currently no programme of internal audit work specifically targeted at the funds and there has been no internal audit activity in this area for 2010/11. We have therefore been unable to place any reliance on internal audit work during 2010/11.</p> <p><i>Risk: in the absence of an internal audit function the administering authority may lack the assurance it needs to determine that all key controls are operating and effective.</i></p> | <p>As Dundee City Council administers the Pension Fund any planned audit work and subsequent reports will be taken to the Scrutiny Committee.</p> <p>An item is included in the 2011/12 Audit Plan</p> | Head of Financial Services | n/a |
| 5 | 50. | <p>At 31 March 2011 the funds' investment managers held cash balances of £49.8 million.</p> | <p>The Fund Managers currently provide quarterly cash reconciliations. We will</p> | Exchequer Officer | June 2012 |

| Action Point | Refer Para No | Risk Identified | Planned Management Action | Responsible Officer | Target Date |
|--------------|---------------|---|---|---------------------|---------------|
| | | <p>In 2010/11 transactions in excess of £1.2 billion were processed through these cash accounts. However, we noted that accounting arrangements for the investment managers' cash accounts could be strengthened. While we are satisfied that cash balances held by investment managers are fairly stated, the Exchequer Officer should reconcile opening and closing cash positions.</p> <p><i>Risks: investment transactions may be incorrectly or incompletely recorded.</i></p> | review annual cash reconciliations from each manager. | | |
| 6 | 63. | <p>A number of KPIs for administration such as speed of various processes and the unit cost per scheme member/pensioner are compared against benchmarks. These results have however not been reported to and reviewed by the Superannuation Investment sub-committee. .</p> <p><i>Risk: without monitoring, review and challenge these indicators may not be effective in supporting continuous improvement..</i></p> | KPIs will be reported as part of the updated Business Plan. | Pensions Manager | February 2012 |

| Action Point | Refer Para No | Risk Identified | Planned Management Action | Responsible Officer | Target Date |
|--------------|---------------|--|--|---------------------|-------------|
| 7 | 64. | <p>KPIs produced by the administering authority are not widely reported to fund members.</p> <p><i>Risk: fund members do not have the opportunity to monitor the performance of the pension administration function.</i></p> | KPIs will be included within the Annual Report and Accounts 2011/12. | Exchequer Officer | June 2012 |