

Pensions Committee

2.00 p.m., Tuesday, 15 March 2016

External Audit - Annual Audit Plan 2015-16

Item number	5.3
Report number	
Executive/routine	
Wards	All

Executive summary

Audit Scotland, the external auditor to the Lothian Pension Fund, the Lothian Buses Pension Fund and the Scottish Homes Pension Fund, has detailed its planned programme of work to support the statutory audit 2015/16. This is shown at Appendix 1 - "Audit Scotland Annual Audit Plan 2015-16".

Stephen O'Hagan, Senior Audit Manager, Audit Scotland, will present the Annual Audit Plan 2015-16 to Committee.

Progress against the Plan will be reported to future meetings of the Pensions Audit Sub-Committee and thereafter the Pensions Committee.

The proposed audit fee for 2015/16 is £47,660, which is the same as the previous year's fee.

Links

Coalition pledges

Council outcomes

[CO26](#)

Single Outcome Agreement

External Audit - Annual Audit Plan 2015-16

Recommendations

- 1.1 That Committee invites the Pension Board to raise any relevant matters or concerns which the Committee should consider.
- 1.2 Note the formal reliance placed on the work of Internal Audit;
- 1.3 Note that suitable provision has been made in the approved budget 2015-16 for the audit fee; and
- 1.4 Note that progress against the Annual Audit Plan 2015-16 will be reported to future meetings of the Pensions Audit Sub-Committee and the Pensions Committee.

Background

- 2.1 The Audit Plan is reported annually to Pensions Committee by the external auditor, Audit Scotland.

Main report

- 3.1 Audit Scotland, the external auditor to the Lothian Pension Fund, the Lothian Buses Pension Fund and the Scottish Homes Pension Fund, has detailed its planned programme of work to support the statutory audit 2015/16. This is shown at Appendix 1 - "Audit Scotland Annual Audit Plan 2015-16".

Measures of success

- 4.1 Progress against the Annual Audit Plan 2015-16 will be reported to future meetings of the Pensions Audit Sub-Committee and thereafter the Pensions Committee. The prime objective is to ensure an unqualified audit opinion of the Annual Report 2015-16. This will be determined in due course.

Financial impact

- 5.1 The proposed audit fee for 2015/16 is £47,660, which is the same as the previous year's fee. Suitable provision has been made in the budget for 2015/16.

Risk, policy, compliance and governance impact

6.1 External audit is a critical part of the governance of the pension funds.

Equalities impact

7.1 There are no adverse equalities impacts arising from this report.

Sustainability impact

8.1 There are no adverse sustainability impacts arising from this report.

Consultation and engagement

9.1 The Pension Board, comprising employer and member representatives, is integral to the governance of the Funds.

Background reading/external references

The responsibilities of Audit Scotland, as independent auditor, are established by the Local Government (Scotland) Act 1973 and the Code of Audit Practice, as approved by the Auditor General for Scotland and the Accounts Commission. Appropriate cognisance is also taken of ethical guidance of the auditing profession.

Hugh Dunn

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Links

Coalition pledges

Council outcomes CO26 - The Council engages with stakeholders and works in partnerships to improve services and deliver agreed

Single Outcome Agreement

Appendices Appendix 1 - Audit Scotland Annual Audit Plan 2015-16



Lothian Pension Funds

Annual Audit Plan

2015/16

Prepared for Members of Pensions Committee

March 2016



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The Accounts Commission is a statutory body which appoints external auditors to Scottish local government bodies (www.audit-scotland.gov.uk/about/ac/). Audit Scotland is a statutory body which provides audit services to the Accounts Commission and the Auditor General (www.audit-scotland.gov.uk/about/).

The Accounts Commission has appointed David McConnell as the external auditor of Lothian Pension Fund for the period 2011/12 to 2015/16.

This report has been prepared for the use of Lothian Pension Fund and no responsibility to any member or officer in their individual capacity or any third party is accepted.

This report will be published on our website after it has been considered by the council. The information in this report may be used for the Accounts Commission's annual overview report on local authority audits published on its website and presented to the Local Government and Regeneration Committee of the Scottish Parliament.

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Summary

Introduction

1. Our audit is focused on the identification and assessment of the risks of material misstatement in Lothian Pension Fund, the Lothian Buses Pension Fund and the Scottish Homes Pension Fund financial statements (collectively referred to as the Funds).
 2. This report summarises the key challenges and risks facing the Funds and sets out the audit work that we propose to undertake in 2015/16. Our plan reflects:
 - the risks and priorities facing the Funds
 - current national risks that are relevant to local circumstances
 - the impact of changing international auditing and accounting standards
 - our responsibilities under the Code of Audit Practice as approved by the Auditor General for Scotland
 - issues brought forward from previous audit reports.
- they give a true and fair view of the financial transactions of the Funds and their group during the year ended 31 March 2016, and of the amount and disposition at that date of their assets and liabilities
 - the accounts have been properly prepared in accordance with the Local Government (Scotland) Act 1973 and the 2015/16 Code of Practice on Local Authority Accounting in the United Kingdom (the Code)
 - a review and assessment of the Funds' governance and performance arrangements in a number of key areas including a review of adequacy of internal audit, arrangements to support the annual governance statement and management commentary in the annual report.

Summary of planned audit activity

3. Our planned work in 2015/16 includes:
 - an audit of the financial statements and provision of an opinion on whether:

Responsibilities

4. The audit of the financial statements does not relieve management or the Pensions Committee, as the body charged with governance, of their responsibilities.

Responsibility of the appointed auditor

5. Our responsibilities, as independent auditor, are established by the Local Government (Scotland) Act 1973 and the Code of Audit Practice, and guided by the auditing profession's ethical guidance.
6. Auditors in the public sector give an independent opinion on the financial statements. We also review and report on the arrangements set in place by the audited body to ensure the proper conduct of its financial affairs and to manage its performance and use of resources. In doing this, we aim to support improvement and accountability.

Responsibility of the Pensions and Accounting Manager

7. It is the responsibility of the Pensions and Accounting Manager, as the appointed "proper officer", to prepare the financial statements in accordance with relevant legislation and the Code of Practice on Local Authority Accounting in the United Kingdom (the Code). This means:
 - maintaining proper accounting records

- preparing financial statements which give a true and fair view of the financial transactions of the Funds and their group during the year ended 31 March 2016, and of the amount and disposition at that date of their assets and liabilities for the year then ended.

Format of the accounts

8. The financial statements should be prepared in accordance with the Code, which constitutes proper accounting practice.

Audit Approach

Our approach

9. Our audit approach is based on an understanding of the characteristics, responsibilities, principal activities, risks and governance arrangements of the Funds and their group. We also consider the key audit risks and challenges in the local government sector generally. This approach includes:
 - understanding the business of the Funds and their group and the risk exposure which could impact on the financial statements
 - assessing the key systems of internal control, and considering how risks in these systems could impact on the financial statements
 - identifying major transaction streams, balances and areas of estimation and understanding how the Funds will include these in the financial statements
 - assessing and addressing the risk of material misstatement in the financial statements
 - determining the nature, timing and extent of the audit procedures necessary to provide us with sufficient audit evidence as to whether the financial statements give a true and fair view.
10. We have also considered and documented the sources of assurance which will make best use of our resources and allow us to focus audit testing on higher risk areas during the audit of the financial statements. The main areas of assurance for the audit come from planned management action and reliance on systems of internal control. Planned management action being relied on for 2015/16 includes:
 - comprehensive closedown procedures for the Funds and group financial statements accompanied by a timetable issued to all relevant staff
 - clear responsibilities for preparation of financial statements and the provision of supporting working papers
 - delivery of unaudited financial statements to agreed timescales with a comprehensive working papers package
 - completion of the internal audit programme for 2015/16.
11. Auditing standards require internal and external auditors to work closely together to make best use of available audit resources. Internal audit is provided on a co-sourced basis between PricewaterhouseCoopers (PwC) and the City of Edinburgh Council, the administering authority for the Funds.
12. We seek to rely on the work of internal audit wherever possible and as part of our planning process we carry out an early assessment of the internal audit function to determine whether it has sound documentation standards and reporting procedures in place and complies with the main requirements of the Public Sector Internal Audit Standards (PSIAS).

13. Overall, we concluded that the internal audit service operates in accordance with Public Sector Internal Audit Standards (PSIAS) and has sound documentation standards and reporting procedures in place.
14. We plan to place formal reliance on aspects of the work of internal audit in the following areas, to support our audit opinion on the financial statements:
 - immediate payments to pensioners
 - externally managed investments
 - compliance arrangements.

Materiality

15. Materiality can be defined as the maximum amount by which auditors believe the financial statements could be misstated and still not be expected to affect the decisions of users of financial statements. A misstatement or omission, which would not normally be regarded as material by amount, may be important for other reasons (for example, the failure to achieve a statutory requirement or, an item contrary to law). In the event of such an item arising, its materiality has to be viewed in a narrower context; such matters would normally fall to be covered in an explanatory paragraph in the independent auditor's report.
16. We consider materiality and its relationship with audit risk when planning the nature, timing and extent of our audit and conducting our audit programme. Specifically with regard to the financial statements, we assess the materiality of uncorrected misstatements both individually and collectively.
17. Based on our knowledge and understanding of the Funds we have set our overall planning materiality at 0.5% of net assets for each separate Fund. We set a lower level, known as performance materiality, when defining our audit procedures. This level depends on professional judgement and is informed by a number of factors including:
 - extent of estimation and judgement within the financial statements
 - nature and extent of prior year misstatements
 - extent of audit testing coverage.
18. As the net assets of the Funds are significantly more than the income and expenditure streams, we set separate planning materiality levels for income and expenditure through the fund accounts. These levels are based on 1% of total contributions received for each Fund. We also set separate performance materiality levels for these areas.
19. **Exhibit 1** summarises the materiality levels applied across the financial statements areas.

Exhibit 1: Materiality levels

Financial statements area	Planning materiality £000s	Performance materiality £000s
Main fund – net assets statement	25,535	19,375
Main fund – fund account	1,910	1,435
Lothian Buses – net assets statement	1,930	1,450
Lothian Buses – fund account	95	70
Scottish Homes – net assets statement	775	580
Scottish Homes – fund account	8	6

20. Subject to the comments in the paragraph 21, we will report to those charged with governance all individual misstatements over the following thresholds:
- Main fund - £100,000
 - Lothian Buses – £20,000
 - Scottish Homes - £10,000.
21. In addition, an inaccuracy which would not normally be regarded as material in terms of monetary value may be important for other reasons (for example the failure to achieve a statutory requirement,

or an item contrary to law). In the event of such an item arising, its materiality has to be viewed in a narrower context; such matters would normally fall to be covered in an explanatory paragraph in the independent auditor's report.

Reporting arrangements

22. The Local Authority Accounts (Scotland) Regulations 2014 require that the unaudited annual accounts are submitted to the appointed external auditor no later than 30 June each year. The Pensions Committee is required to consider the unaudited annual accounts at a meeting by 31 August 2016.
23. The Funds must publish the unaudited accounts on their websites and give public notice of the inspection period.
24. The 2014 regulations require the Pensions Committee to meet by 30 September to consider whether to approve the audited annual accounts for signature. Immediately after approval, the annual accounts require to be signed and dated by specified members and officers and then provided to the auditor. The Controller of Audit requires audit completion and issue of an independent auditor's report (opinion) by 30 September each year.
25. The Funds are required to publish on their website their signed audited annual accounts, and the audit certificate, by 31 October 2016. The local authority is also required to publish a copy of the accounts of its subsidiaries. The annual audit report is required to be published on the website by 31 December 2016.

26. A proposed timetable for the audit of the 2015/16 financial statements is included at [Exhibit 2](#) below which takes account of submission requirements and planned Pension Committee dates.

Exhibit 2: Financial statements audit timetable

Key stage	Date
Testing and review of internal control systems and transactions	By 31 March 2016
Meetings with officers to clarify expectations of working papers and financial system reports	By 31 March 2016
Consideration of unaudited financial statements by those charged with governance	27 June 2016
Latest submission date of unaudited council financial statements with complete working papers package	13 June 2016
Progress meetings with lead officers on emerging issues	As required
Latest date for final clearance meeting with Pensions and Accounting Manager	9 Sept 2016
Agreement of audited unsigned financial statements, and issue of Annual Audit Report which includes the ISA 260 report to those charged with governance	30 Sept 2016
Independent auditor's report signed	30 Sept 2016

27. Matters arising from our audit will be reported on a timely basis and will include agreed action plans. Draft management reports will be issued to the Pensions and Accounting Manager to confirm factual accuracy. Responses to draft reports are expected within two weeks of submission. A copy of all final agreed reports will be sent to the Executive Director of Resources, Investment and Pensions Services Manager, Pensions and Accounting Manager (as Proper Officer), Internal Audit and Audit Scotland's Performance Audit and Best Value Group. In addition key findings will be submitted to the Pensions Audit Sub-Committee and Pensions Committee for their consideration.
28. We will provide an independent auditor's report to the Funds and the Accounts Commission that the audit of the financial statements has been completed in accordance with applicable statutory requirements. The combined ISA 260 and Annual Audit Report will be issued by 30 September 2016.
29. All annual audit reports produced are published on Audit Scotland's website: (www.audit-scotland.gov.uk).
30. Planned outputs for 2015/16 are summarised at [Appendix 1](#).

Quality control

31. International Standard on Quality Control (UK and Ireland) 1 (ISQC1) requires that a system of quality control is established as part of financial audit procedures. This is to provide reasonable assurance that those professional standards and regulatory and legal requirements are being complied with and that the independent

auditor's report or opinion is appropriate in the circumstances. The foundation of our quality framework is our Audit Guide, which incorporates the application of professional auditing, quality and ethical standards and the Code of Audit Practice issued by Audit Scotland and approved by the Accounts Commission. To ensure that we achieve the required quality standards, Audit Scotland conducts peer reviews and internal quality reviews and has been subject to a programme of external reviews by the Institute of Chartered Accountants of Scotland (ICAS).

32. As part of our commitment to quality and continuous improvement, Audit Scotland will periodically seek your views on the quality of our service provision. We do, however, welcome feedback at any time and this may be directed to the engagement lead, David McConnell, Assistant Director.

Independence and objectivity

33. Auditors appointed by the Accounts Commission must comply with the Code of Audit Practice. When auditing the financial statements, auditors must also comply with professional standards issued by the Financial Reporting Council (FRC) and those of the professional accountancy bodies. These standards impose stringent rules to ensure the independence and objectivity of auditors. Audit Scotland has in place robust arrangements to ensure compliance with these standards including an annual "fit and proper" declaration for all members of staff. The arrangements are overseen by the Assistant Auditor General, who serves as Audit Scotland's Ethics Partner.

34. Auditing and ethical standards require the appointed auditor to communicate any relationships that may affect the independence and objectivity of audit staff.
35. Audit Scotland is an admitted body within Lothian Pension Fund, and represents around 1% of fund membership. Staff involved in the audit are members of the fund. While this merits disclosure, it is not considered to represent a conflict of interest for the organisation or individuals involved. We are not aware of any other relationships pertaining to the audit of the Funds.

Audit issues and risks

Audit issues and risks

36. Based on our discussions with staff, attendance at committee meetings and a review of supporting information we have identified the following main risk areas for the Funds. We have categorised these risks into financial risks and wider dimension risks. The financial statements issues and risks, which require specific audit testing, are summarised below and detail contained in [Appendix 2](#).

Financial statement issues and risks

37. **Management override of controls:** Auditing standards (ISA 240 *The auditor's responsibility to consider fraud in an audit of financial statements*) highlights the unique position of management to influence the financial statements by overriding controls that otherwise operate effectively.
38. The ability to override these controls exists in all entities and therefore represents a significant financial statements risk. We will undertake focused substantive testing of journal entries, accounting estimates and significant transactions outside the course of normal business.
39. **Group Accounting:** The Pensions Committee, and subsequently City of Edinburgh Council, agreed in October 2014 to the creation of two special purpose vehicles wholly owned and controlled by the council. One company was established in May 2015 for directly

employing certain key staff associated with the Funds investment function to minimise the risk of not retaining staff and has an impact on the 2015/16 financial statements. The Funds have recently signed off on the revised terms and conditions of service for transferred staff. The second company can only become operational once the Funds receive Financial Conduct Authority (FCA) authorisation. It is anticipated this will happen during 2016/17. The impact of these changes have been discussed in detail with Funds' officers in relation to accounting for these special purpose vehicles in such areas as group accounting and any potential changes to accounts presentation.

40. Where a group arrangement exists, the Code requires both single-entity financial statements and group financial statements to be produced. Officers have elected to use a columnar approach to show the single entity and group within one single fund account and net asset statement rather than produce two separate sets of financial statements. We will review this area through the course of our audit and will provide an update in our annual audit report.
41. **Changes to LGPS:** The Public Service Pension Act 2013 and associated regulations has replaced the final salary scheme with a career average revalued earnings (CARE) scheme from 1 April 2015. These arrangements introduce an increased complexity of pension benefit calculations and an increased workload of the funds administration. This may result in an increased risk of pension administration errors as well as possible regulatory breaches if members are not able to retrieve up to date information timeously. We plan to assess the funds' arrangements to address the

increased workload and undertake focused substantive testing of members calculations during the financial statements and will provide an update in our annual audit report.

- 42. Annual governance statement:** The Code was amended in 2014/15 to include both an annual governance statement and an annual compliance statement within the annual report and accounts. However, our review of the 2014/15 Annual Governance Statement noted that it has been based primarily on the content of the City of Edinburgh Council's Annual Governance Statement. Whilst some of the content within the council's statement is pertinent to the Funds, there are aspects which are of less relevance. Officers have indicated their intention for producing a more specific pension fund annual governance statement. We will review the disclosure as part of the financial statements audit and will provide an update in our annual audit report.
- 43. ICT infrastructure:** The Funds rely on internal and third party hosted IT systems. In relation to the internal infrastructure, the council's ICT services contract is due to transfer from BT to the new supplier CGI on 1 April 2016. Officers report regularly to committee on progress in implementing the project. However, there remains a risk over business continuity management in the interim and as a result the Funds require to manage the adverse effect that any outage may have on internal business operations. We plan to review project updates to committee, discuss the ongoing risk with management and will provide an update in our annual audit report.
- 44. Section 95 officer responsibility:** In previous years, the Pension and Investment Manager reported to Executive Director level within the City of Edinburgh Council. The Section 95 responsibility for the Funds has been delegated to the Pensions and Accounting Manager. Following a revision to the council's organisation structure in December 2015, the Pension and Investment Manager now reports to the Head of Finance at the City of Edinburgh Council. The Section 95 responsibility continues to be delegated to the Pensions and Accounting Manager.
- 45.** Following this change in line management, the Funds should consider whether the current governance and Section 95 reporting arrangements in place remain appropriate. We will consider this area prior to expressing our opinion of the audit and will provide an update in our annual audit report.
- 46. Breach in Regulation – Scottish Homes investment limits:** The statutory regulations set out limits for the proportion of a pension fund invested in certain types of investment. It was highlighted in the Pension Compliance Internal Audit report in November 2015 that a single insurance contract should not exceed 25% of the total value of existing investments. However, approximately 59% of the total value of the Scottish Homes pensions Fund investments, under an insurance contract, are managed by one provider. The Scottish Homes Pension Fund has agreed to restructure the current contract to ensure compliance with LGPS investment regulations. We will monitor progress in this area through the course of our audit and will provide an update in our annual audit report.

Fees and resources

Audit fee

47. Over the past four years, Audit Scotland has reduced audit fees by 24% in real terms, exceeding our 20% target. Due to further refinement of our audit approach we have been able to maintain audit fees for 2015/16 at the same level as last year. This represents an additional real term fee reduction of 1.6%.
48. In determining the audit fee we have taken account of the risk exposure of the Funds, the planned management assurances in place, and the level of reliance we plan to take from the work of internal audit. We have assumed receipt of a complete set of unaudited financial statements and comprehensive working papers package by 13 June 2016.
49. The proposed audit fee for the 2015/16 audit of the Funds is £47,660. Our fee covers:
 - the costs of planning, delivering and reporting the annual audit including auditor's attendance at committees
 - a contribution towards functions that support the local audit process (e.g. technical support and coordination of the National Fraud Initiative), support costs and auditors' travel and subsistence expenses.
50. Where our audit cannot proceed as planned through, for example, late receipt of unaudited financial statements or being unable to take

planned reliance from the work of internal audit, a supplementary fee may be levied. An additional fee may also be required in relation to any work or other significant exercises outwith our planned audit activity.

Audit team

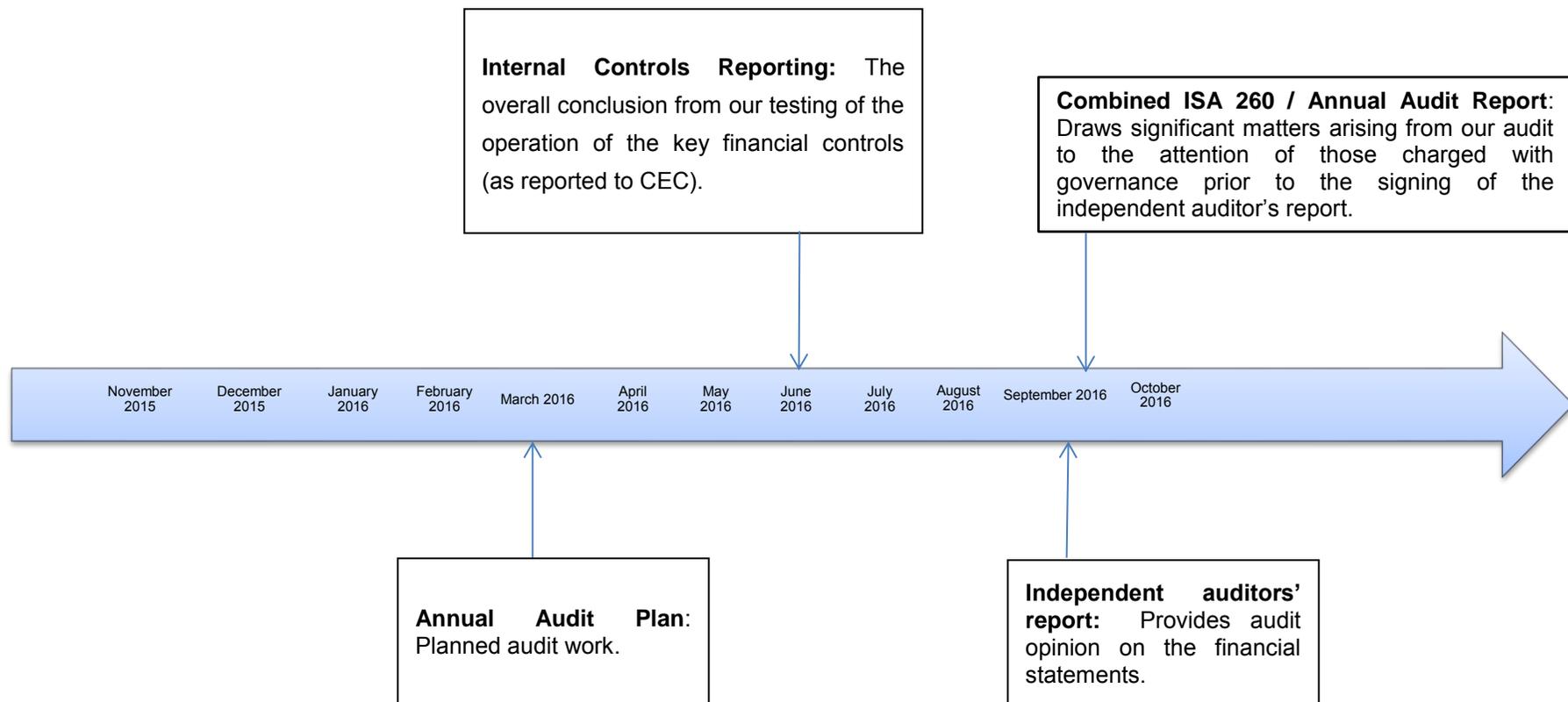
51. David McConnell, Assistant Director, Audit Services is your appointed auditor. The local audit team will be managed by Stephen O'Hagan and supported by Neil Reid who will be responsible for the day to day management of the audit and who will be your primary contact. Details of the experience and skills of our team are provided in **Exhibit 3**. The core team will call on other specialist and support staff as necessary.

Exhibit 3: Audit team

Name	Experience
David McConnell MA CPFA, Assistant Director	David has worked in public sector audit since 1981, firstly with the National Audit Office and since 1985, with the Accounts Commission/Audit Scotland. He therefore, has extensive experience of audit in Central Government, Local Government and the NHS. Dave is currently Audit Scotland's lead on financial management and impact reporting.
Stephen O'Hagan, CPFA Senior Audit Manager	Stephen has over 18 years experience of public sector audit with Audit Scotland, covering local government, central government, health and the education sector. Prior to joining Audit Scotland, Stephen worked in local government finance for 5 years.
Neil Reid CMIIA & QICA, Senior Auditor	Neil has over twenty five years public sector experience working across a mix of local government, police and central government bodies within internal and external audit. Neil's previous experience has also involved a secondment to Deloitte, as a manager, working in their Scottish and Northern Ireland public sector advisory and Enterprise Risk Services teams.
Inire Evong BA (Hons) CPFA Senior Auditor	Inire has worked in public sector audit for 8 years, building up her knowledge of audit across the 3 main sectors with the last 5 years spent in local government.
Euan Millar, Professional Trainee	Euan joined Audit Scotland as a Trainee Auditor in 2014 and is studying for his ICAS qualification.

Appendix 1: Planned audit outputs

The diagram below shows the key outputs planned for Lothian Pension Funds in 2015/16.



Appendix 2: Significant audit risks

The table below sets out the key audit risks, the related sources of assurance received and the audit work we propose to undertake to address the risks during our audit work.

#	Audit Risk	Source of assurance	Audit assurance procedure
Financial statement issues and risks			
1	<p>Management override of controls</p> <p>ISA 240 requires that audit work is planned to consider the risk of fraud, which is presumed to be a significant risk in any audit. This includes consideration of the risk of management override of controls in order to change the position disclosed in the financial statements.</p>	N/A	<ul style="list-style-type: none"> • Detailed testing of journal entries. • Review of accounting estimates for bias. • Evaluating significant transactions that are outside the normal course of business.
2	<p>Group Accounting</p> <p>Investment and other senior staff have been transferred to a new company created to provide the Funds more flexibility in the terms and conditions on which staff are recruited and investment transactions. There is a risk that transactions between the Funds and the newly established company may not be recorded and disclosed in accordance with the accounting requirements of 'The Code'.</p>	<ul style="list-style-type: none"> • Management's implementation of service level agreements and charging schedules. • Officers have put arrangements in place to ensure that the financial statements are consistent with the Companies Act and the applicable UK accounting framework. 	<ul style="list-style-type: none"> • Substantive testing of transaction between the Funds and the newly established company. • Review of the disclosures made in the Funds' 2015/16 financial statements concerning the relationship between the Funds and the company against the requirements of 'The Code' and sector specific guidance.

#	Audit Risk	Source of assurance	Audit assurance procedure
3	<p>Changes to LGPS</p> <p>The Public Service Pension Act 2013 and associated regulations replaced a final salary scheme with a career average revalued earnings (CARE) scheme from 1 April 2015. There is a risk of increased complexity of pension calculations and increased workload of the Funds Administration which may result in an increase in errors.</p>	<ul style="list-style-type: none"> • Various recruitment exercises have taken place during the year to ensure appropriate resources to cope with demands including formation of a Systems Data Quality Team. • Pensions administration software system has also been rigorously tested by the eleven administering authorities in Scotland. 	<ul style="list-style-type: none"> • Review of Funds performance reporting. • Substantive testing of pension calculations during financial statements audit.
4	<p>Annual governance statement</p> <p>The Funds Annual Governance Statement in the past has been based primarily on the content of the council's Annual Governance Statement. However, there is a risk that the disclosures are not focused on the governance arrangements of the Pension Funds.</p>	<ul style="list-style-type: none"> • Project planning and preparatory work is underway to ensure compliance with the regulations. • Officers have indicated their intention for producing a more specific pension fund annual governance statement. 	<ul style="list-style-type: none"> • Review of compliance as part of the detailed financial statements review for 2015/16.