

# North East Scotland Pension Funds

## Annual report on the 2012/13 audit



Prepared for the Members of Aberdeen City Council's Pensions Panel  
and the Controller of Audit  
October 2013

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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

## 2012/13 audit findings

This report sets out our main findings from the 2012/13 audit of North East Scotland Pension Funds and provides an outlook for the period ahead. We audited the financial statements and having considered the key strategic and financial risks faced by the funds, we examined aspects of governance, use of resources and performance.

## Financial Statements

We have given an unqualified opinion that the financial statements for 2012/13 give a true and fair view of the state of the financial transactions of the funds during the year and of the amount and disposition of their assets and liabilities at the year end.

## Financial Position/Funding level

A triennial funding valuation was carried out by the scheme actuaries as at March 2011 and showed the extent to which scheme assets met its liabilities. Updated estimates at 31 March 2013 show that the North East Scotland Pension Fund (NESPF) and the Transport Fund were 74% and 91% funded respectively. In both cases this is a reduction from the positions identified by the triennial valuation due to a significant increase in liabilities arising from a fall in discount rates used to calculate future payments. NESPF currently has one of the lowest funding levels amongst Scottish Local Government Pension Schemes (LGPSs).

## Funding levels

	North East Scotland Pension Fund			Aberdeen City Council Transport Fund	
	2011 £m	2012 £m	2013 £m	2011 £m	2013 £m
<b>Assets</b>	2,218	2,270	2,568	68	80
<b>Liabilities</b>	2,512	3,067	3,489	72	88
<b>Net Liability</b>	294	791	921	4	8
<b>Funding Level</b>	88%	74%	74%	95%	91%
<b>Discount Rate</b>	5.5%	4.9%	4.2%	5.5%	4.2%

## Governance

As the administering authority, Aberdeen City Council has statutory responsibility for the administration of the funds, however this is delegated to the Pensions Panel.

From October 2012, the Pensions Panel has been formally recognised as the body charged with governance in respect of the pension funds. While the type and frequency of reports considered by the Panel was reviewed, there is scope to strengthen financial reporting. However, an important piece of work was completed to implement a risk register for the funds which will be kept under review by the Panel.

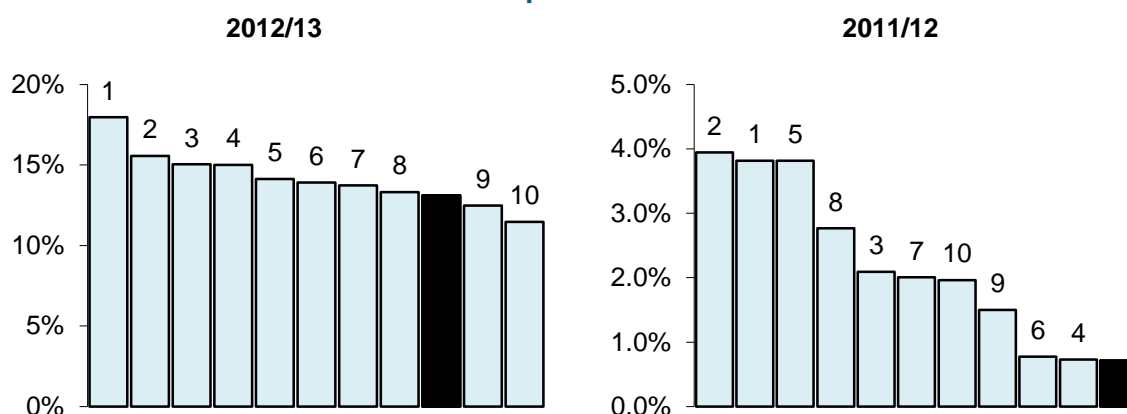
The Joint Investment Advisory Committee (JIAC) is responsible for monitoring the performance of fund managers and making recommendations to the Panel. This relationship should be strengthened by implementing a requirement for the JIAC to provide assurances to the Pensions Panel on a quarterly basis following each scrutiny session of a fund manager's performance. This will increase the overall accountability for the funds.

Internal cover arrangements for the management of the pension funds have been in place for more than 12 months. However, the Panel should not lose sight of reaching a permanent solution which provides sufficient capacity to deliver priorities. Senior staff responsible for the pension funds should work for the benefit of the funds in the long term, and in our opinion, continued reliance on temporary cover may not deliver the most effective outcome.

## Performance

For 2012/13, the NESPF achieved an annual return of 12.89% which was below both its scheme specific benchmark of 14.64% and a national benchmark of 13.3%. When compared with other Scottish LGPSs as shown below, its net return continues to be at the lower end of the scale. However, the Transport Fund achieved an annual return of 13.49% against its scheme specific benchmark of 13.27%.

### NESPF Net return on investments compared with other Scottish LGPSs



Different investment strategies operate in respect of each north east fund. NESPF is a maturing fund with a growing number of pensioners compared to contributing members. However, as auto-enrolment is implemented by all fund employers in the next few years, this may help increase the number of members and contributions to the fund. The Transport Fund is a closed fund and in a cash negative position. In both cases, there is an increased dependence on investment returns to ensure that the funds can meet their liabilities in the long term. Improving investment returns and performance against benchmark are therefore critical. In addition, NESPF needs to look at its position relative to other funds and consider options to improve its performance in the sector.

## Outlook

It is clear that these are challenging times for pension fund management. With the global economic outlook and increased levels of volatility in the financial markets, there are particular problems for investment management and strategy. With investment performance key to the funding position of the LGPS, this may impact on employer contributions following the next triennial valuation at March 2014.

It is against this backdrop that the new Public Service Pensions Bill was published. The UK Government announced its intention to move to career average pay and an automatic link between normal retirement and state pension age with effect from 2015. In preparation for this date, the Scottish Local Government Pensions Advisory Group has recently set out the agreement reached on the content and operation of a new scheme for Scotland.

Proposed changes to the LGPS will impact on administrative workloads going forward as will any further severance activity and restructuring by employers. Additionally auto enrolment will continue to have implications for the fund in terms of information requirements and administration arrangements. Aberdeen City Council implemented auto-enrolment from April 2013 while other scheduled bodies in the fund have taken advantage of the option to defer implementation until 2017.

From April 2013, police and fire services transferred to new single bodies. At present there is no change to the pension administration arrangements for staff who are members of local government pension schemes. New arrangements are likely to be implemented by April 2016.

# Introduction

1. This report is the summary of our findings arising from the 2012/13 audit of the North East Scotland Pension Funds. The funds comprise of the North East Scotland Pension Fund (NESPF) and the Aberdeen City Council Transport Fund. Both of these together are referred to as '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. A number of charts have been used in the report to reflect the performance of the fund in a national context. While other funds are not named, they have been numbered in the charts and the numbering is used consistently throughout the report.
3. Appendix A provides details of our reports issued during 2012/13. 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 funds.
4. 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. Members of the Pensions Panel should ensure that they are satisfied with the proposed management action and have a mechanism in place to assess progress.
5. This report is addressed to Members of Aberdeen City Council Pensions Panel and the Controller of Audit. It should be made available to the public and other stakeholders as soon as possible after the formal completion of the audit of North East Scotland Pension Funds' financial statements. Audit is an essential element of accountability and the process of public reporting. This report will be published on our website after consideration by those charged with governance.
6. Management of the pension funds 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.
7. The co-operation and assistance given to us by members of the Pensions Panel and officers and staff responsible for the management of North East Scotland Pension Funds is gratefully acknowledged.

# Financial statements

8. 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.
9. 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 transactions of the funds during the year ended 31 March 2013 and of the amount and disposition at that date of their assets and liabilities
  - whether they have been properly prepared in accordance with relevant legislation, the applicable accounting framework and other reporting requirements.
10. Auditors review and report on, as appropriate, other information published with the financial statements including the Explanatory Foreword, Governance Compliance Statement and Statement on the System of Internal Financial Control. This section summarises the results of our audit on the financial statements.

## Audit opinion

11. We have given an unqualified opinion that the 2012/13 financial statements of North East Scotland Pension Funds give a true and fair view of the financial transactions of the fund during the year and of the amount and disposition of their assets and liabilities.

## Legality

12. Through our planned audit work we consider the legality of the pension funds' financial transactions. In addition the Chief Accountant has confirmed that, to the best of his 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.

## Statement on the System of Internal Financial Control

13. As part of our annual audit, we review the disclosures in the Statement on the System of Internal Financial Control and the process of obtaining sufficient assurances to inform the content of the statement. Overall we were satisfied with the processes put in place to obtain the necessary assurances.
14. As we highlighted in our 2011/12 Annual Report, internal audit provided assurances to Aberdeen City Council on the financial controls in place within the administering authority. While specific internal audit work may be undertaken on investments and pensions, it is done so as part of the financial landscape of Aberdeen City Council. In response to our recommendation last year, initial steps have now been taken to submit relevant internal audit plans and reports to the Pensions Panel for consideration.



## Governance Compliance Statement

15. We are satisfied that the Governance Compliance Statement covers the areas and levels of compliance required by the Scottish Government's guidance.

## Annual Report

16. The Scottish Government Guidance requires that the annual report for the pension fund incorporates the following:
  - the financial statements
  - 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
  - the 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.
17. We are satisfied that the North East Scotland Pension Funds Annual Report complies with Scottish Government guidance and that the other sections are consistent with the audited accounts.

## Accounting issues

18. Local authority bodies in Scotland are required to follow the 2012/13 Code of Practice on Local Authority Accounting in the United Kingdom (the Code). We were satisfied that the financial statements have been prepared in accordance with the Code.
19. At 31 March 2013, the accounts included a provision for the potential non-collection of £2.6m from the Governors of Oakbank School Trust, a former admitted body of the pension fund. As a result of the closure of the school in 2009, the actuary calculated a termination valuation which represents a significant element of the amount due to the pension fund to cover liabilities in respect of future pension payments to former employees of the school.
20. This debt has been the subject of a longstanding dispute between the pension fund and the Trust. Initiation of legal action to pursue collection of the debt was approved by the Pensions Panel in March 2012. In June 2013, after little progress, the matter was referred to the council's external legal advisers. This matter has been ongoing for some time and needs to be effectively concluded prior to 31 March 2014.

***Refer Action Plan no. 1***

21. Investment management expenses of £5.7m are included in the fund accounts and in accordance with the Code, fuller information is separately disclosed by way of a note to the accounts. Where private equity investments are involved however, it is not possible to separately identify management fees as they are reflected within the overall valuation of the investment. While this is not in accordance with the disclosures required by the Code, an explanation to this effect has been provided within a note to the accounts. This is a complex area, however consideration should be given to the disclosure requirements for management fees in order that the fund (together with other relevant pension funds) can determine how to comply with the Code in future.

**Refer Action Plan no. 2**

## Accounts submission

22. The unaudited financial statements were submitted to the Controller of Audit in advance of the statutory deadline of 30 June 2013. The working papers were of a good standard and staff provided effective support to the audit team. The financial statements were certified by the target date of 30 September 2013. The annual report, incorporating the financial statements, is now available for presentation to members and for publication.

## Presentational and monetary adjustments to the unaudited accounts

23. In line with International Standard on Auditing 260 *Communication of audit matters to those charged with governance*, we reported the conclusions of our audit to the Pensions Panel on 2 September 2013.
24. In our '*Report to those charged with governance on the 2012/13 audit*', we reported misstatements of £2.881m identified from the audit which were to be amended in the revised accounts. This related to the under-valuation of private equity investments. The unaudited accounts reflected valuations carried out at 31 December 2012 and were considered the best estimates available to officers when preparing the annual accounts. Valuations at 31 March 2013 were received in June 2013 and were of sufficient difference to merit amending the accounts. Officers amended Return on Investments (fund account) and Net Investments Assets (net assets statement) in the revised accounts by £2.996m rather than £2.881m. The difference of £0.115 m has therefore been added to the total for unadjusted misstatements recorded for the audit as stated in paragraph 25 below. A number of presentational amendments were also processed to improve the disclosures within the accounts.
25. Adjustments were not made for other misstatements identified during the audit. These misstatements, while more than clearly trivial, are immaterial to the accounts as a whole. Had an adjustment been made, the net impact of the misstatements would be a decrease in the Fund Account and Net Assets Statement of £0.196m. Following discussions with the Chief Accountant, we concurred with officers' proposals not to adjust the accounts for these amounts.

# Financial position

26. Audited bodies are responsible for conducting their affairs and for putting in place proper arrangements to ensure that their financial position is soundly based.
27. 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.
28. These are key areas in the current economic circumstances. This section summarises the financial position and outlook for the funds.

## Financial results

### Budgetary control

29. The funds have an annual budget for administration and external investment costs. In 2012/13, the overall budget of £9.9m was split between fund administration £1.9m and £8m in respect of estimated fees to external fund managers. The administering authority sets the budget for administration costs and for 2012/13, there was an overspend of around £60k representing increased costs of £210k associated with the implementation of the new payroll system, £150k additional recharges from the administering authority and unspent budget of £300k in respect of staff costs. Due to the under performance of the fund, fund managers' did not achieve performance targets and therefore £2.5m less fees were incurred than estimated.
30. Budget monitoring information is provided to the Pensions Panel as part of the quarterly investment and accounting report. It might however be more appropriate to provide this information within a separate report and agenda item so that revenue budget monitoring has higher prominence. This will increase the Panel's accountability for delivery of the budget to the council as the administering authority.

### Refer Action Plan no. 3

31. Cashflow monitoring reports are prepared by the funds on an ongoing basis to ensure that sufficient cash balances are held to meet pension commitments, and that any excess balances are passed periodically to the funds' investment portfolios. These cashflow reports are also presented quarterly to the Pensions Panel.

## Funding position

32. The triennial valuation determines employer contribution rates required over the next three year period. On a quarterly basis, the actuary provides an updated position. Table 1 sets out the estimated position at 31 March 2013 against the last triennial valuation results as at 31 March 2011. In respect of both funds there is an increase in the net liability and a reduction in the percentage funding level. The significant movement on NESPF in particular is due to the increased liabilities in both 2011/12 and 2012/13. In both years the corporate bond yields reduced significantly, resulting in a lower discount rate being used in the calculations for future payments which has produced a higher liability.

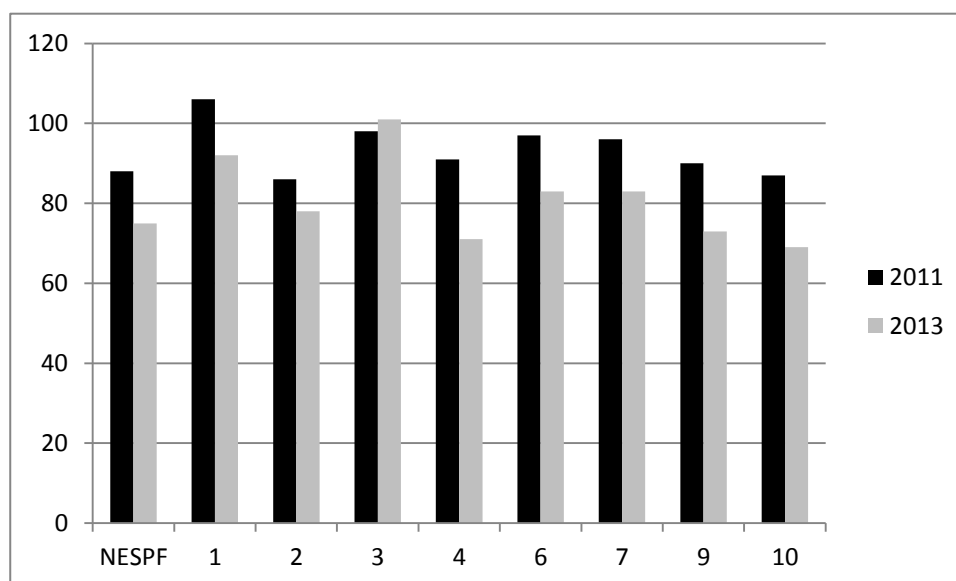
**Table 1: Funding levels**

	North East Scotland Pension Fund			Aberdeen City Council Transport Fund	
	2011 £m	2012 £m	2013 £m	2011 £m	2013 £m
<b>Assets</b>	2,218	2,270	2,568	68	80
<b>Liabilities</b>	2,512	3,067	3,489	72	88
<b>Net Liability</b>	294	791	921	4	8
<b>Funding Level</b>	88%	74%	74%	95%	91%
<b>Discount Rate</b>	5.5%	4.9%	4.2%	5.5%	4.2%

Source: Actuarial Valuation at 31 March 2011 and updates at 31 March 2012 and 31 March 2013

33. Exhibit 1 shows NESPF's funding level relative to other Scottish LGPSs. In each case, the results of the triennial valuations at 31 March 2011 are compared with actuarial updates at 31 March 2013. With one exception, the funding level has fallen for each fund since 2011. However, NESPF currently has one of the lowest funding levels.
34. In respect of NESPF, a common employer contribution rate of 19.3% was held for the period 2012-2015 despite the triennial valuation suggesting a lower rate of 17.9%. The actuary had reported a worsening position during 2011/12 due to the impact of the recession on global markets, and therefore the higher rate of 19.3% was held. For similar reasons, it was necessary to increase the 27% contribution rate for the Transport Fund applicable in 2012/13 and 2013/14 to 33% in 2014/15.

### Exhibit 1 : NESPF Funding levels relative to other Scottish LGPSs



Source: Pension Fund Annual Reports 2012/13

### Financial forecasts beyond 2013/14

35. During 2012/13, the number of employees in the NESPF increased by 508. There was a further increase from April 2013, through the implementation of auto-enrolment. (Refer paragraphs 38 – 39). Table 2 also shows that there was a greater increase in the number of pensioners. It increased by 704, while the number of deferred pensioners increased by 451. The fund has experienced an increasing trend of rising pensioner numbers relative to employee members.

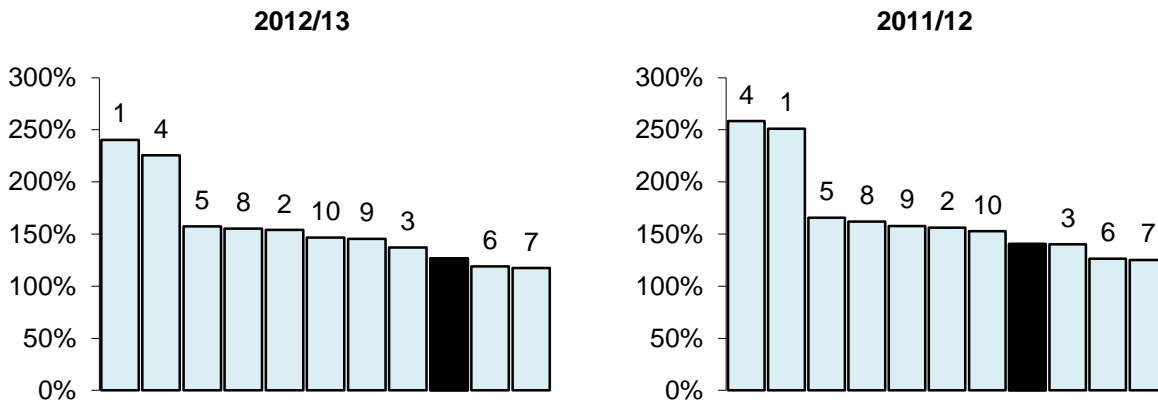
**Table 2: Movement in members and pensioners**

North East Scotland Pension Fund			
	2012/13 Number	2011/12 number	Increase/ (decrease) 2012/13
<b>Active members</b>	20,869	20,361	508
<b>Pensioners</b>	16,472	15,768	704
<b>Deferred pensioners</b>	16,876	16,425	451

Source: NESPF Annual Report 2012/13

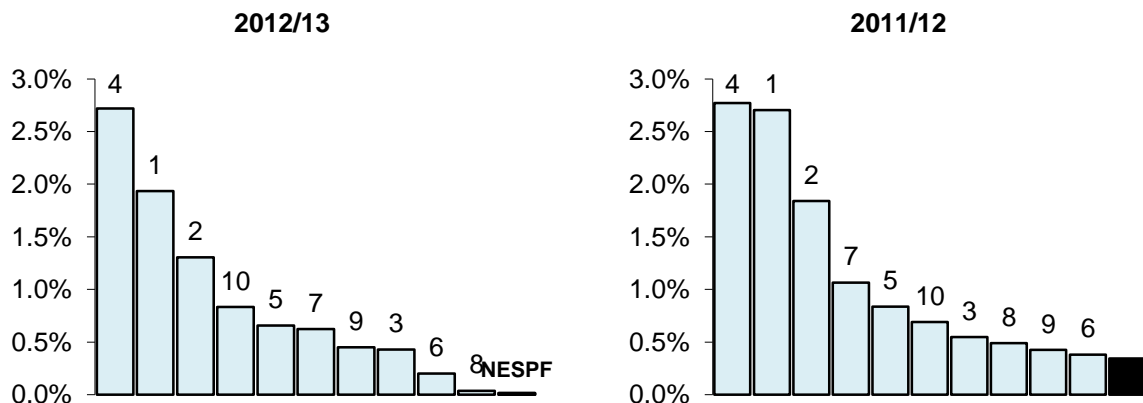
36. Exhibit 2 shows that NESPF has one of the lowest levels of *Active Members as a percentage of Total Pensioners in comparison with the other Scottish pension funds*. The Net Additions from Dealing with Members (i.e. contributions received less pensions and allowances paid) was £0.361m in 2012/13 which represents only 0.34% of total contributions received in the year. Exhibit 3 shows the *Net Additions from dealing with members as a percentage of the Opening Net Assets* of the fund for the year was the lowest when compared with all Scottish pension funds. Currently the funds' cash inflows exceed the required outflows, resulting in a positive cashflow position for the year. The actuary has projected that this will remain the case for around 5 years.

**Exhibit 2 : NESPF Active Members**



Source: Pension Fund Annual Reports 2012/13

**Exhibit 3 : NESPF Net dealings with fund members**



Source: Pension Fund Annual Reports 2012/13

37. Taking the impact of the low level of active members and the reducing net contributions position however, demonstrates an increasing reliance on strong investment returns. The fund investment strategy was reviewed in 2013 and there is recognition by members and officers that the investment profile of the fund will need to change in line with the maturity of the fund. In the meantime, this is an area of significant risk for the Pensions Panel to manage in the short and longer term when setting and monitoring funding and investment strategies.

***Refer Action Plan no. 4***

### **Auto-enrolment**

38. On a more positive note, the Pensions Act 2011 introduced measures which aimed to reform workplace pensions and enable individuals to save more for their retirement. The majority of the Act does not impact on the LGPS, however one key provision was auto-enrolment which placed new responsibilities on employers and the administering authority. All employers are required to enrol their workers into 'a qualifying workplace scheme' if they are not already in one by prescribed staging dates. The principal responsibilities fall on the scheme employers, however the fund will be impacted in the following areas:
- detailed records to be kept on membership and opt outs of the LGPS
  - issuing auto-enrolled members with opt out forms following employer auto-enrolment
  - supporting employers through the introduction of auto-enrolment
  - providing regular communication to employers on the requirements of auto-enrolment.
39. While the main scheduled bodies in the NESPF had staging dates between April and July 2013, there was an option to defer implementation until 2017. With the exception of Aberdeen City Council, this option was taken by other scheduled bodies in the fund. Aberdeen City Council introduced auto-enrolment with effect from 1 April 2013. Early indications are that more staff have chosen to remain in the fund than had been anticipated which will provide additional members and contributions for the fund. In September 2013, 880 staff had been enrolled in respect of Aberdeen with 340 opting out.

### **Outlook**

40. Looking ahead, it is clear that the outlook for public spending remains challenging. The UK government announced its intention to reform public service pension schemes several years ago, with changes to include a move to career average pay and an automatic link between normal retirement and state pension age.
41. While discussions for the LGPS reforms, which are due to take effect from 2015, were more advanced in England and Wales, a 'Heads of Agreement' document issued in September 2013 sets out the terms agreed by the Scottish Local Government Pensions Advisory Group (SLOPAG) on the operation of a new scheme for Scotland. The next stage for the Advisory Group is to discuss the proposed timetable set out by Scottish Ministers which requires implementation of the new arrangements by August 2015.

42. With effect from 1 April 2013, the new police and fire authorities took responsibility for their respective single services. At this stage, there has been no change to the arrangements for pension fund assets and accrued pension liabilities in respect of police and fire staff who are currently members of different local government pension funds. Consultation has taken place on options for implementation of new arrangements by April 2016.



# Governance and accountability

43. 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.
44. Through its chief executive or accountable officer, each body is responsible for establishing arrangements for ensuring the proper conduct of its 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 (including audit committees or similar groups) in monitoring these arrangements.
45. Consistent with the wider scope of public audit, auditors have a responsibility to review and report on audited bodies' 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.
46. In this part of the report we comment on key areas of governance.

## Corporate governance

### Pension committees

47. As the administering authority, Aberdeen City Council has statutory responsibility for the administration of the funds. Its functions are carried out in accordance with the Local Government Pension Scheme (Scotland) Regulations 1998 and the Superannuation Act 1972. Responsibility for the overall strategic direction of the funds is delegated by the council to the Pensions Panel.
48. From October 2012, the Pensions Panel formally became the body charged with governance as defined by International Standard on Auditing (ISA) 260: *'Communication of audit matters to those charged with governance'*. Relevant responsibilities were transferred from the council's Audit and Risk Committee and the Panel's remit was amended accordingly. All reporting by auditors in respect of the pension funds is now made to the Pensions Panel rather than to the council's Audit and Risk Committee.
49. The Pensions Panel meets quarterly to consider reports on governance, investment strategy and pension administration matters. It has four members who are all Aberdeen City Council elected members, one from each of the major political groups. The Panel has a minimum quorum of two members. While the Panel was quorate, attendance was low during 2011/12. There has been improvement in attendance in 2012/13 and from 1 April 2013, there was one change in membership.

50. A revised training policy for elected members was approved by the Pensions Panel in March 2012. Training is provided through a combination of personal review of key policy documents, online training and attendance at courses and seminars. The whole area of members' training has been highlighted as a key risk within the recently developed risk register for the pension funds. We concurred with officers that pensions administration is a complex area and that suitable training opportunities are essential.
51. Appropriate training should enable members in their role as trustees of the funds to have sufficient understanding to challenge fund managers and to be guided by fund advisors. Recognising the importance of scrutiny in this area, the Hutton review made recommendations about the membership of committees both in terms of size and quorum. As part of our 2011/12 audit, we recommended that the Panel consider if its number and quorum were sufficient to effectively scrutinise proposals. We reminded members in September 2013 that this recommendation had still to be acted upon.
52. The Joint Investment Advisory Committee (JIAC or the committee) has twelve members representing scheduled and admitted bodies. It advises and makes recommendations to the Pensions Panel regarding the investment management and performance of the funds. We would highlight the following matters to strengthen the operation of the committee:
- In September 2012, following an internal review of papers provided to the Panel, it was agreed that the quarterly governance report would explicitly include a section for recommendations from JIAC. It would be helpful if this was extended to provide assurances to the Panel following each meeting of JIAC. The committee has the remit for monitoring and scrutinising fund managers' performance, and as part of this role received presentations from the various fund managers. We have not yet observed this committee as part of the audit process but from a review of minutes we noted that, in general they simply recorded that presentations had taken place. From an accountability perspective, it is important that the committee gives assurances to the Panel following each meeting and confirms its conclusion on performance following scrutiny and challenge of relevant fund managers.
  - While the JIAC is effectively a sub-committee of the Pensions Panel, it operates outwith the formality of other council committees and therefore minutes and agenda papers are not as easily accessible. We would suggest JIAC is brought within the remit of Committee Services to reflect its importance and to ensure common practices are applied around meeting administration.

***Refer Action Plan no. 5***

## Pension management

53. Following a period of absence, the Head of Finance ceased employment by mutual consent with Aberdeen City Council on 31 August 2013. The council acted promptly in June 2013 to approve the chief accountant as an interim proper accounting officer in terms of S95 of the Local Government (Scotland) Act 1973. We obtained management assurances that there were no irregularities which would impact on the pension funds' financial position at 31 March 2013 or its overall governance arrangements.

54. Day to day management of all aspects of the pension funds is delegated to the Pensions Manager who reports directly to the Chief Accountant (and formerly the Head of Finance). Following unsuccessful attempts in 2012 to appoint a permanent pensions manager due to a limited pool of potential candidates and the geographical location, internal cover arrangements were put in place. An experienced pensions officer is currently covering the Pensions Manager role in an acting capacity supported by a Pensions Analyst who provides support on an ad hoc basis.
55. Having identified an absence of succession planning in the management of the pension funds, there has been an internal review of the team's structure. Additional budget was identified for 2012/13 to fund the appointment of an assistant pensions manager, however no action has yet been taken to fill this post.
56. The existing cover arrangements have been in place for more than 12 months. While we acknowledge the difficulties which have been experienced in trying to secure a suitably qualified and experienced pensions manager, it is important that a permanent solution is found. It is appropriate that senior staff responsible for the pension funds are well placed to work for the benefit of the pension fund in the long term, and, in our opinion, continued reliance on temporary cover may not deliver the most effective outcome. Action needs to be taken to complete a review of existing structures with a view to enhancing the arrangements to support improved performance of the funds.

***Refer Action Plan no. 6***

## Internal control

57. 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.
58. International Standards on Auditing (ISAs) require evaluation of critical financial systems and testing of key controls on an annual basis. In reaching conclusions, audit work should be based on controls and transactions across the financial year.
59. No material weaknesses in the accounting and internal control systems were identified during the audit which could adversely affect the ability to record, process, summarise and report financial and other relevant data so as to result in a material misstatement in the financial statements.

## Prevention and detection of fraud and irregularities

60. Audited bodies are responsible for establishing arrangements to prevent and detect fraud and other irregularity. Auditors review and report on these arrangements.
61. In general, the pension funds adopt the fraud and corruption prevention arrangements put in place by Aberdeen City Council. We consider the arrangements in place to be satisfactory.

## NFI in Scotland

62. Audit Scotland has coordinated another major counter-fraud exercise working together with a range of Scottish public bodies, external auditors and the Audit Commission to identify fraud and error. These exercises, known as the National Fraud Initiative in Scotland (NFI), are undertaken every two years as part of the statutory audits of the participating bodies. The current exercise commenced in October 2012 and will be reported upon in May 2014.

## Standards of conduct

63. Audited bodies are responsible for ensuring that their affairs are managed in accordance with proper standards of conduct and that they have proper arrangements in place for implementing and monitoring compliance with standards and codes of conduct, standing orders and financial instructions. Auditors consider whether bodies have adequate arrangements in place. We have concluded that the arrangements in the North East Scotland Pension Funds are satisfactory and we are not aware of any specific issues that we need to identify in this report.

# Best Value, use of resources and performance

64. Audited bodies have a specific responsibility to ensure that arrangements have been made to secure Best Value.
65. 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.
66. Auditors may also consider the use of resources in services or functions, where the need for this is identified through local audit risk assessments.
67. 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.
68. This section includes a commentary on Best Value and the performance management arrangements for the pension funds.

## Management arrangements

### Best Value

69. The pension 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

70. Performance against benchmark targets is reported to the Pensions Panel at a summary level and to the Joint Investment Advisory Committee at a detailed level on a quarterly basis. The advisory committee received investment presentations from fund managers.
71. At the year end, a report on overall performance forms part of the Pension Fund Annual Report along with the annual accounts. This complies with the Scottish Government guidance on the content of annual reports referred to earlier in paragraph 16.

## Administration Performance

72. The fund implemented its overdue administration strategy from April 2013 which contains the standards required of the participating employers to ensure that the funds meet statutory obligations and are able to deliver services efficiently. The strategy contains a variety of performance measures against which the funds and the participating employers will be assessed.

## The funds' performance measurement outcomes

### North East Scotland Pension Fund

73. During 2012/13, the fund achieved an annual return of 12.89% which was below the specific benchmark of 14.64% as shown in Table 3. In 2011/12, the fund achieved an annual return of 0.9% against its scheme specific benchmark of 2.2%. The annual return achieved in the year was 88% of the benchmark (2011/12: 41%). While the fund had increased its return for the year due to an overall improvement in the markets, the overall position is one of continued underperformance against benchmarks and against the national picture.

**Table 3: Investment Performance – NESPF**

	1 Year %	3 Years %	5 Years %
Fund	12.89	8.05	6.72
Benchmark	14.64	8.29	6.85

Source: North East Scotland Pension Funds Annual Report 2012/13

74. Table 4 compares the investment performance of NESPF for the year against the average for 9 of the 10 other Scottish LGPSs. While NESPF have a more challenging benchmark, actual performance is below both the average return and average benchmark achieved by other Scottish funds.

**Table 4: Investment Performance – comparison against the Scottish average**

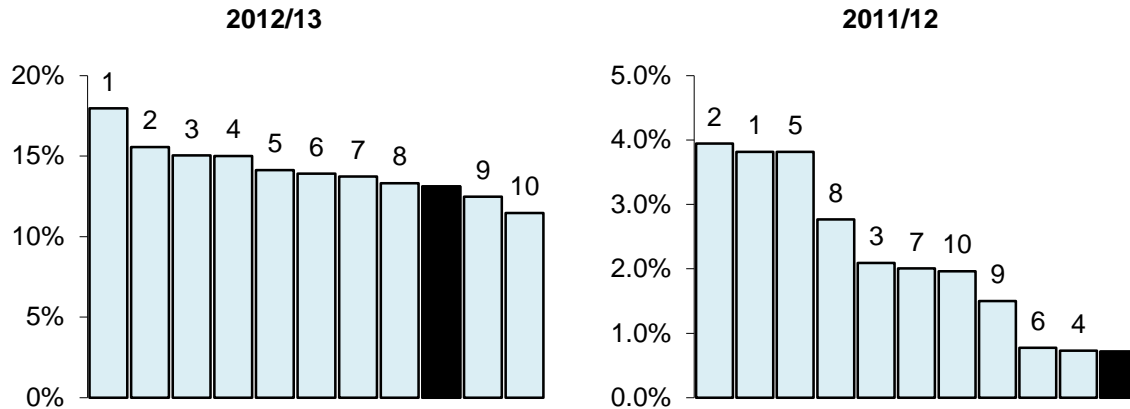
	NESPF %	Scottish Average %
Fund	12.89	14.5
Benchmark	14.64	13.3
% Benchmark achieved	88.4	109.0

Source: Pension Fund Annual Reports 2012/13 (where information was provided)

75. The net return on investments for 2012/13 has been calculated by taking the *net return on investments for the year as a percentage of the opening balance of the funds*. Exhibit 4 shows that NESPF increased its net return substantially but relative to other pension funds, while it has improved its position, it continues to perform at the lower end of the scale.

**Refer Action Plan no. 4**

#### Exhibit 4: NESPF Net return on investments



Source: Pension Fund Annual Reports 2012/13

#### Aberdeen City Council Transport Fund

76. For 2012/13, retirement pensions and other benefits paid amounted to £3.5m compared with only £2.4m received in contributions from continuing employees. The investment strategy needs to deliver sufficient return each year to meet this ongoing shortfall.
77. The results for 2012/13 show that the fund achieved an annual return of 13.49%, which is slightly ahead of the benchmark of 13.27%. Table 5 shows that the fund has been marginally outperforming the specific benchmark over a 5 year period.
78. In recognition of the fact that the fund is closed and maturing, there has been a recent change in investment strategy. The fund has reduced equities and increased bonds which is a lower risk strategy but one which is aimed at generating sufficient returns to meet long term liabilities.

**Refer Action Plan no. 4**

**Table 5: Investment Performance – Aberdeen City Council Transport Fund**

	1 Year %	3 Years %	5 Years %
Aberdeen City Council Transport Fund	13.49	10.44	9.2
Benchmark	13.27	8.91	8.98

Source: North East Scotland Pension Funds Annual Report 2012/13

## National performance reports

79. 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 which may be of interest to members and officers are detailed in Table 6.

**Table 6: A selection of National performance reports 2012/13**

- An overview of local government in Scotland - challenges and change in 2013
- The National Fraud Initiative in Scotland (2012)

Source: [www.audit-scotland.gov.uk](http://www.audit-scotland.gov.uk)

80. Such reports are generally available to members through the administering authority. Going forward they should form part of the personal development undertaken by members of the Pensions Panel through personal reading.

## Outlook

81. Meeting performance targets will continue to become more challenging in the coming years. Investment targets are set based on advice from investment advisors and standard industry benchmarks. The funds need to remain vigilant, and ensure that they have the right diversification of funds to minimise exposure to risk whilst still delivering the required returns. Failure to improve performance relative to benchmarks will impact on the next triennial valuation due to be carried out as at 31 March 2014. This may lead to increased employer contributions which will add to mounting financial pressures for councils and other employers.



# Appendix A: audit reports

## External audit reports and audit opinions issued for 2012/13

Title of report or opinion	Date of issue	Date Presented to Pensions Panel
Annual Audit Plan	February 2013	March 2013
Report to those charged with governance on the 2012/13 audit	August 2013	September 2013
Audit opinion on the 2012/13 financial statements	September 2013	N/A
Report to Members on the 2012/13 audit	October 2013	November 2013

# 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	20	<p>A significant debt in respect of a termination agreement due from a former admitted body has been the centre of a dispute for some time. This matter needs to be effectively concluded by 31 March 2014.</p> <p><b><i>Risk: the Fund is not effectively managing collection of outstanding debt.</i></b></p>	The Pension Fund has determined its options to secure payment and will proceed based on legal advice with the aim of achieving progress by the end of the financial year.	Head of Finance	31 March 2014
2	21	<p>Investment management fees in respect of private equity investments are reflected in the valuation of investments. The Code requires that management fees are separately accounted for.</p> <p><b><i>Risk: the Fund is not complying with the Code.</i></b></p>	The Pension Funds will consider the options it has to fully comply with the Code.	Pensions Manager	31 March 2014
3	30	<p>Budget monitoring information is contained within a quarterly investment and accounting report. To assist the Panel in meeting its budget monitoring obligations, a separate agenda item with fuller information would strengthen accountability.</p> <p><b><i>Risk: the budget set by the administering authority is not delivered.</i></b></p>	The council will look at the budget setting process for the Pension Funds and its monitoring arrangements to improve transparency and accountability.	Head of Finance; and Pension Manager	31 March 2014

Action Point	Refer Para No	Risk Identified	Planned Management Action	Responsible Officer	Target Date
4	37, 75 and 78	<p>As the fund matures there is a growing dependence on investment returns to ensure fund liabilities are met.</p> <p>The Pensions Panel needs to ensure:</p> <ul style="list-style-type: none"> <li>• it maintains close scrutiny on the performance of the investment strategy and takes alternative action when appropriate</li> <li>• fund performance is improved against benchmark</li> <li>• improved fund performance relative other LGPSs.</li> </ul> <p><b><i>Risk: in the longer term, poor returns may not provide sufficient funds to meet pension payments. In the shorter term, there may be increased demands on fund employers through additional contributions.</i></b></p>	The Pension Fund will consider the options available to improve performance management of the Pension Funds and report on this to the Pensions Panel.	Head of Finance; and Pensions Manager	30 June 2014
5	52	<p>To increase accountability, there should be assurances from JIAC to the Pensions Panel after each meeting and in terms of committee administration, the JIAC should be within the remit of Committee Services.</p> <p><b><i>Risk: accountability is weakened by the absence of clear assurances on performance. There should be a clear audit trail between performance reports considered and assurances provided.</i></b></p>	The Pension Funds will put in place suitable procedures to enable the assurance to be captured; and the Head of Finance will discuss with the Head of Legal & Democratic Services the impact and means by which the JIAC can be incorporated into the Committee support framework.	Pensions Manager  Head of Finance	30 June 2014

Action Point	Refer Para No	Risk Identified	Planned Management Action	Responsible Officer	Target Date
6	56	<p>The organisational structure for the pensions section should be reviewed to ensure it is fit for purpose and in accordance with the needs of the administering authority. In particular, action is required to ensure there is sufficient capacity and responsibility at senior level to act for the long term benefit of the funds.</p> <p><b><i>Risk: the long term governance of the fund is weakened by uncertain management arrangements.</i></b></p>	A report will be prepared for the Pensions Panel to consider the options and recommended action following a review.	Head of Finance	31 March 2014