AUDIT SCOTLAND

North East Scotland Pension Funds

2014/15 Audit

Annual Audit Report to the Members of Aberdeen City Council Pensions Committee and the Controller of Audit

August 2015

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)

The Accounts Commission has appointed Stephen Boyle as the external auditor of North East Scotland Pension Funds for the period 2012/13 to 2015/16.

This report has been prepared for the use of Aberdeen City Council as administering authority for North East Scotland Pension Funds 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 Aberdeen City Council Pensions Committee. 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.

Key contacts

Stephen Boyle, Assistant Director
sboyle@audit-scotland.gov.uk

Anne MacDonald, Senior Audit Manager
amacdonald@audit-scotland.gov.uk

Deirdre Sim, Auditor
dsim@audit-scotland.gov.uk

Audit Scotland
Business Hub 11, 2nd Floor West
Marischal College, Broad Street
Aberdeen

AB10 1AB

Telephone: 0131 625 1500

Website: www.audit-scotland.gov.uk

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Key messages

Audit of financial statements	• The independent auditor's report on the 2014/15 financial statements of the North East Scotland Pension Fund (the main fund) and the Aberdeen City Council Transport Fund (the transport fund) is unqualified. • A satisfactory approach was applied by the funds' to disclose fund management expenses in accordance with CIFPA's guidance on accounting for local government pension scheme management costs.
Financial management and sustainability	• A good financial management framework is in place but there is scope to improve the frequency of budget monitoring reports to members. • The main fund and the transport fund were considered to be funded at a similar level, around 94%, following the 2014 triennial actuarial valuation. However the funds' positions have deteriorated to 82% and 86% respectively as at 31 March 2015. • A transport fund de-risking strategy was implemented during the year. This is expected to provide more certainty about its funding position as the liabilities of the fund mature. • With regular triennial valuations, the funds' financial position is secure for the next few years.
Governance and transparency	• The fund was well prepared for the introduction of the new Local Government Pension Scheme from 1 April 2015. This changed the basis for calculating benefits from final salary to career average revalued earnings. • A revised governance structure was approved in October 2014. It implemented a Pensions Committee with wider membership than the previous pensions panel and it will consider the performance of all fund activities. This should provide an opportunity for more effective scrutiny of the funds. • Systems of internal control operated effectively and there are sound anti-fraud arrangements in place.

Best Value	• The main fund was slightly behind benchmark over the year but it was in line with the benchmark over the 5 year period. • The transport fund marginally underperformed against each of the benchmarks but it is showing signs of improvement and this should continue with the implementation of a derisking strategy.
Outlook	• In accordance with regulations, a Pensions Board was appointed and sat with the Pensions Committee for the first time in June 2015. It will take time for the new governance arrangements to bed in alongside the recently formed pensions committee.

Introduction

1. North East Scotland Pension Funds (NESPF) consists of two funds, the North East Scotland Pension Fund (the main fund) and the Aberdeen City Council Transport Fund (the transport fund). Both funds are part of the Local Government Pension Scheme.

2. This report is a summary of our findings arising from the 2014/15 audit of North East Scotland Pension Funds. The report is divided into sections which reflect our public sector audit model.

3. The management of Aberdeen City Council, as administering authority for the Pension Funds, is responsible for:
   - preparing financial statements which give a true and fair view
   - implementing appropriate internal control systems
   - putting in place proper arrangements for the conduct of its affairs
   - ensuring that the financial position is soundly based.

4. Our responsibility, as the external auditor of North East Scotland Pension Funds, is to undertake our audit in accordance with International Standards on Auditing, the principles contained in the Code of Audit Practice issued by Audit Scotland in May 2011 and the ethical standards issued by the Auditing Practices Board.

5. An audit of financial statements is not designed to identify all matters that may be relevant to those charged with governance. It is the auditor's responsibility to form and express an opinion on the financial statements; but this does not relieve management of their responsibility for the preparation of financial statements which give a true and fair view.

6. **Appendix II** is an action plan setting out our recommendations to address the high level risks we identified during the course of the audit. Officers have considered the issues and agreed to take the specific steps in the column headed "Management action/response". We recognise that not all risks can be eliminated or even minimised. What is important is that the North East Scotland Pension Funds understand their risks and have arrangements in place to manage these risks. The council, as administering authority, and the Head of Finance as the Proper Officer should ensure that they are satisfied with proposed action and have a mechanism in place to assess progress and monitor outcomes.

7. We have included in this report only those matters that have come to our attention as a result of our normal audit procedures; consequently, our comments should not be regarded as a comprehensive record of all deficiencies that may exist or improvements that could be made.

8. We are grateful for the cooperation and assistance we received during the course of the audit.

Audit of the 2014/15 financial statements

Audit opinion	We have completed our audit and issued an unqualified independent auditor’s report.
Going concern	As the funding position is calculated every three years by the actuary, the financial statements of the Pension Funds have been prepared on the going concern basis. We are unaware of any other events or conditions that may cast significant doubt on the pension funds’ ability to continue as a going concern.
Other information	We review and report on other information published with the financial statements, including the management commentary, annual governance statement and governance compliance statement. We have nothing to report in respect of these statements.

Submission of financial statements for audit

9. We received the unaudited financial statements on 9 June 2015, in accordance with the agreed timetable. The working papers were of a good standard and staff were effective support to the audit team which assisted the delivery of the audit to deadline.

Overview of the scope of the audit of the financial statements

10. Information on the integrity and objectivity of the appointed auditor and audit staff, and the nature and scope of the audit, were outlined in our Annual Audit Plan presented to the Pensions Committee on 9 March 2015.

11. As part of the requirement to provide full and fair disclosure of matters relating to our independence, we can confirm that we have not undertaken non-audit related services. As such, the 2014/15 agreed fee for the audit was set out in the Annual Audit Plan and remains unchanged.

12. The concept of audit risk is of central importance to our audit approach. During the planning stage of our audit we identified a number of key audit risks which involved the highest level of judgement and impact on the financial statements and consequently had the greatest effect on the audit strategy, resources and effort. We set out in our Annual Audit Plan the audit work we proposed to undertake to secure appropriate levels of assurance. **Appendix I** sets out the significant audit risks identified during the course of the audit and how we addressed each risk in arriving at our opinion on the financial statements.

13. Our audit involved obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error.

Materiality

14. 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, an item contrary to law).

15. 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.

16. We summarised our approach to materiality in our Annual Audit Plan. Based on our knowledge and understanding of North East Scotland Pension Fund, we set our planning materiality at

- for the main fund, £1.088m for the fund account (FA) and £28.336m for the net assets statement (NAS) and

- for the transport fund, £35,000 for the fund account and £798,000 for the net assets statement.

17. We report all misstatements greater than £27,000 for the main fund and £1,000 for the transport fund. Performance materiality is calculated to reduce to an acceptable level the probability of uncorrected and undetected audit differences exceeding our planning materiality level. For 2014/15, these were calculated as:
    - for the main fund, £544,000 for the fund account and £14.168m for the net assets statement
    - for the transport fund, £17,000 for the fund account and £399,000 for the net assets statement.

18. On receipt of the financial statements and following completion of audit testing we reviewed our materiality levels and concluded that they remained appropriate and no change was required to our original calculations. Fund materiality levels are summarised in Exhibit 1.

Evaluation of misstatements

19. All misstatements identified during the audit, which exceeded our misstatement threshold, have been discussed with officers and amended in the financial statements. The main adjustment is an increase of £9.443m in the value of private equity investments. The draft accounts included an estimate but this was revised when actual information became available to the fund during the period of the audit. Both the fund account and net assets statement were increased accordingly. This matter is explained further at item 2 on page 11.

Exhibit 1: Materiality levels

	Materiality £'000	Performance Materiality £'000	Clearly Trivial £'000
Main Fund	1.088 (FA) 28,336 (NAS)	544 (FA) 14,168 (NAS)	27 (FA) 100 (NAS)
Transport Fund	35 (FA) 798 (NAS)	17 (FA) 399 (NAS)	1(FA) 20 (NAS)

20. International Standard on Auditing 260 requires us to communicate to you significant findings from the audit, including:
    - the auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures
    - significant difficulties encountered during the audit
    - significant matters arising from the audit that were discussed, or subject to correspondence with management
    - written representations requested by the auditor
    - other matters which in the auditor's professional judgment, are significant to the oversight of the financial reporting process.

Significant findings from the audit

21. During the course of the audit we identified the following significant issues that, in our view, require to be communicated to you.

Issue	Resolution
1. Investment Management Expenses – The Code of Practice on Local Authority Accounting requires that administrative expenses should be presented on the face of the Fund Account. In recognition of the fact that this is a complex area, CIPFA issued guidance on accounting for local government pension scheme management costs which is recommended practice from 2014/15. This sets out a framework for consistent disclosure of administrative expenses analysed across Administration Expenses, Oversight and Governance Expenses and Investment Management Expenses. The common areas of uncertainly include performance related fees, pooled fund management fees, private equity and hedge funds fees. Exhibit 11 later in the report provides a comparison of management fees across Scottish pension funds as disclosed in the 2014/15 unaudited accounts. The fund contacted private equity managers to obtain the necessary information for both the current and previous years. This required the previous year's figures to be restated to reflect additional management costs of £3.151m in the fund account. While the draft accounts presented for audit showed amended figures for the previous year, in order to comply with the Code, an accounting policy and a fuller note explaining the prior year adjustment were required. Our review of the accounts identified that managers' transactions costs and direct operating expenses for the fund's property portfolio totalling £2.852m (2013/14 £2.894m) were separately accounted for when they should have formed part of the investment management expenses disclosures. Otherwise we concluded that a satisfactory approach had been adopted by the funds to identify and account for relevant management expenses in accordance with the Code.	The revised accounts were amended to include an accounting policy and explanatory note in relation to the restatement of prior year figures in respect of management fees. Along with final adjustments of for fees in respect of private equity investments, transaction costs and property operating costs of £2.852m (2013/14 £2.894m) were added to management expenses.

Issue	Resolution
2. Private Equity Investments - Included in the Net Assets Statement for the main fund is £146m representing private equity investments held at 31 March 2015. These have largely been valued by the fund managers, Standard Life and HarbourVest, in accordance with the International Private Equity and Venture Capital Valuation Guidelines. The valuations involved estimates and judgements based on an expert view of fair values. Consequently, we have taken assurance from the fund managers' valuations which is in accordance with ISA500, *audit evidence*. In common with previous years, the amount included in the accounts at 31 March was based on valuations carried out at 31 December which were the best and most up to date estimates available to officers when preparing the annual accounts. Valuations at 31 March 2015 were received by the pension fund in July 2015 and showed that the amount in the accounts was understated by £9.443 million.	The revised accounts were amended to reflect the year end valuation.
3. Impairment Losses – Included within sundry debtors is an amount of £0.173 million representing outstanding strain on the fund contributions due to the pension fund from Oakbank School Trust, a former admitted body. As these invoices are now more than two years old and the contributions have remained unpaid, we proposed that it would be prudent to include a provision for non-collection in the accounts. In addition, there is a larger debt of £2.6m due to the pension fund from the former admitted body. The main element represents the amount due following a termination valuation carried out by the actuary. While this debt has been included as a potential impairment loss in Note 26 to the accounts, the pension fund has been pursuing recovery action for several years. There have been a number of technical issues to resolve along the way, most recently, implementing an alternative arrangement to ensure that pensioners of the former school continue to receive their retirement benefits once the Trust has been legally wound up. We understand that the new arrangement will take the form of an annuity and once this is in place, the Trust will clear its liability with the pension fund and trustees will take steps to wind up the Trust.	Officers do not propose to adjust the accounts in respect of £0.173m as they do not think it is material. We have accepted this treatment and the amount is treated as a non-adjusted misstatement. As the outstanding debt has been identified within the provision for impairment losses, there are no concerns about the misstatement of amounts in the accounts. However, as this is a significant debt which has been outstanding for some time, we have continued to monitor the action taken by the pension fund to recover the amount due. ***Refer recommendation 1***

Issue	Resolution
4. Local Government Pension Scheme (Scotland) (2015) - The Local Authority Accounts (Scotland) Regulations 2014 require a Management Commentary and a wider governance statement in the financial statements. Local Government Finance Circular 6/2015 replaced Circular 1/2011 and set out the revised requirements for the content of Pension Fund Annual Reports. Guidance was more detailed than had been anticipated and came late in the closedown timetable leaving little time for officers to absorb and implement the requirements. The draft annual report included a management commentary but it retained an explanatory foreword to the financial statements which is no longer required. A wider governance statement was included alongside the governance compliance statement but there is scope to make the statement more pension fund specific to the activities of the North East Scotland Pension Funds.	The explanatory foreword has been removed from the revised annual report and the annual governance statement was updated to place more emphasis on the pension funds' arrangements.

Future accounting and auditing developments

Revisions to the Code of Practice

22. The financial statements of the Funds are prepared in accordance with the Code of Practice on Local Authority Accounting in the United Kingdom (the Code) which interprets and adapts International Financial Reporting Standards (IFRS) to the local authority context. There are no significant changes to accounting requirements introduced by the 2015/16 Code which impact on Pension Fund accounts.

Financial management and sustainability

Combined dealings with employers and members - net income £2.1m

- Contribution income £121.0m
- Pension costs £118.9m

Combined returns on investments £365.5m

- Net income from investments £52.6m
- Capital growth £312.9m

Combined asset value increased 11.9%

- Main Fund investments up 11.9%
- Transport Fund investments up 12.3%

Funding Level at 31/03/15

- Main Fund 82%
- Transport Fund 86%

Financial management arrangements

23. As auditors, we need to consider whether the Pension Funds have established adequate financial management arrangements. We do this by considering a number of factors, including whether:

- the proper officer has sufficient status within the council to be able to deliver good financial management
- financial regulations are comprehensive, current and promoted within the council
- reports monitoring performance against budgets and benchmarks are accurate and provided regularly to members
- monitoring reports do not just contain financial data but are linked to information about performance
- members provide a good level of challenge and question the Pensions Manager on significant variances and underperformance.

24. The Head of Finance, as s95 officer, for the council and a member of the council's corporate management team has sufficient status to oversee the financial management of the Pension Fund.

25. The financial regulations of the administering authority, Aberdeen City Council, apply to the funds. These are revised annually and are available on the council's website. We reviewed the regulations and concluded they were comprehensive and current.

26. The fund submits three types of financial information to the Pensions Committee covering fund performance, funding position and budget monitoring.

27. Fund performance reports are submitted to the Pensions Committee on a quarterly basis. Reports are comprehensive, providing performance information at both a fund and individual manager level. However, there is scope for more clarity around performance against benchmarks. There are a number of different benchmarks used e.g. one year, five years etc and if not used consistently, the result may be confusing to the reader.

28. The funding positions for the funds are also reported quarterly as part of the governance report. While this is helpful, there is no comparison against the previous quarter nor any supporting commentary, which leaves little scope for comment and comparison when scrutinising the figures provided.

29. The fund prepares a budget for its administration costs and management fees and in accordance with the committee's remit, budget monitoring should be reported to the Pensions Committee twice a year. However, in 2014/15, there was no report presented until March 2015. Whilst monitoring reports are submitted to officer groups on a more regular basis, the absence of reporting to committee meant that members were unable to scrutinise this information until the end of the financial year.

Refer Recommendation 2

Conclusion on financial management

30. The funds' financial management arrangements are generally sound but as noted, there is scope to improve the frequency of the budget monitoring information that the Pensions Committee receives. There is also scope to review the quantity and frequency of reporting in light of the implementation of a pensions committee and a pensions board.

Financial performance and sustainability

31. In this section we comment on the funds', financial outcomes and assess their financial position.

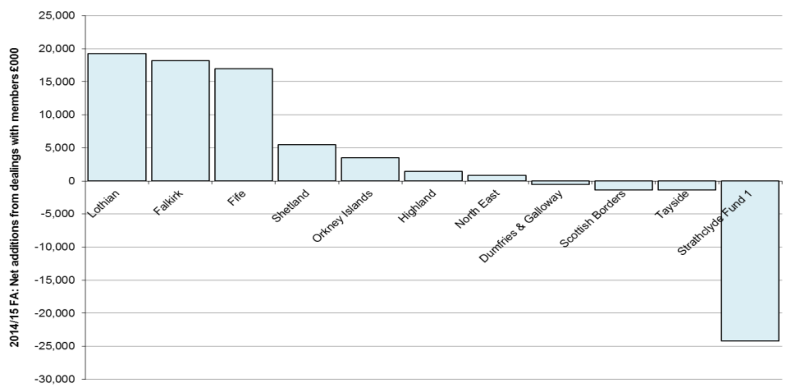
32. Although both funds benefit from shared governance and administrative arrangements, their assets and liabilities are accounted for separately. The main fund provides pensions for around 50 employer organisations and has more than 24,000 active members. The transport fund, which closed to new members on 31 March 1994, has only 78 active members compared with more than 400 pensioners.

33. Pension fund finances are independently assessed every three years by the funds' actuary, most recently as at 31 March 2014. Employer contribution rates are determined by the actuary and used by the council as administering authority to set an annual budget for the pension funds' expenditure and income.

Financial outcomes

34. The net assets of the main fund grew by £338m to £3,171m, an increase of 11.9% in the year. Only £2.7m of the increase came from dealings with members. Employer contributions included advance payments of £4m for deficit funding. However, this increase in income masks an increase in retirement benefits compared with the previous year. Had the advance contributions not been received, income from members in the year was not sufficient to meet pension benefits payments. This is a recurring pressure for the fund that is being addressed through the investment strategy with fund managers. Exhibit 2 shows the position for all pension funds.

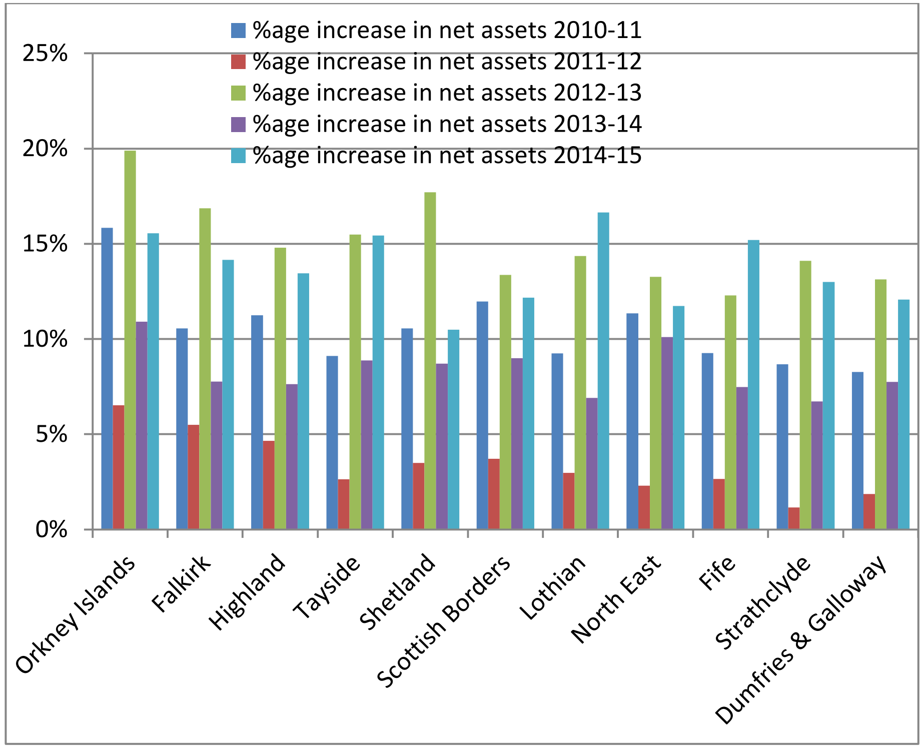
Exhibit 2 : Net additions from dealing with members



Source: Audit Scotland – Unaudited Pension Fund Annual Accounts Database

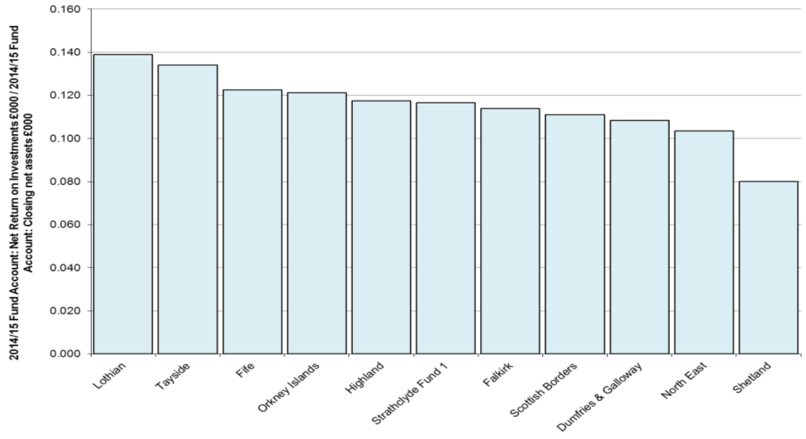
35. The growth in market value of the main fund was 11.9%. Compared with the in year returns shown in Exhibit 3, this was behind the majority of other Scottish Funds in 2014/15. The performance of the fund relative to other funds is also reflected in the net return on investments set out in Exhibit 4 for all funds. In this case, the main fund also had a lower return than most other funds.

Exhibit 3 – Year on year increases in net assets over time



Source: Audit Scotland – Unaudited Pension Fund Annual Accounts Database

Exhibit 4 : Net Return on Investments



Source: Audit Scotland – Unaudited Pension Fund Annual Accounts Database

36. While the continued growth of investment assets is encouraging, the overall funding position set out in Exhibit 5 is such that the main fund's assets do not cover its liabilities and if, in the unlikely event that the fund was wound up immediately, employers would be left with an estimated funding gap of around £865m based on estimates at 31 March 2015.

37. The triennial valuation carried out as at 31 March 2014 showed that the fund could cover 94% of its liabilities as set out in Exhibit 5. The roll forward position at 31 March 2015, however showed a worsening position with the fund now only being in a position to cover 82% of its liabilities. This change in financial position is linked to the fall in value of gilt yields which underpin the calculation for the fund's past service liabilities. The reduction in the funding level between 2014 and 2015 is consistent with similar falls in valuation

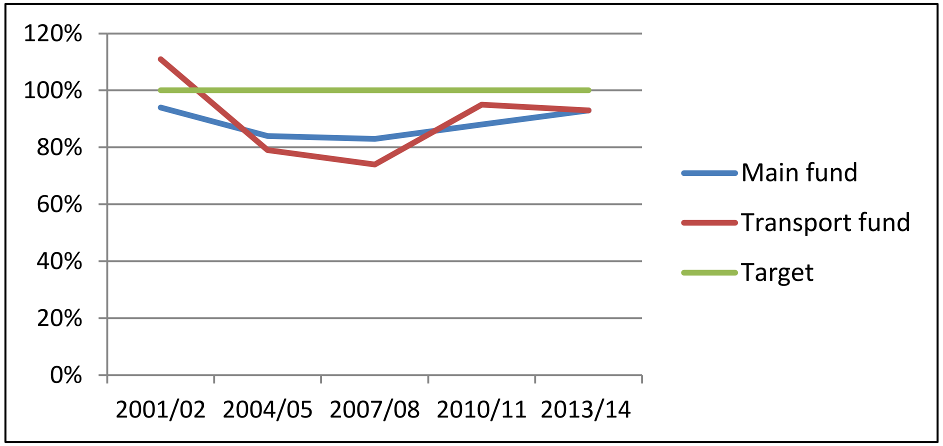
across other Scottish local government pension schemes. However, as the funding position is calculated every three years by an actuary, the fund is considered to be a going concern in the interim.

Exhibit 5: Snap-shot of assets and liabilities – Main Fund

	2014 Valuation £m	2015 Roll-forward estimate £m
Assets	2,834	3,162
Liabilities	3,025	3,874
Net surplus/(liability)	(191)	(865)
Funding Level	94%	82%

Source: NESPF Annual Accounts

Exhibit 6: Actuarial funding level of the two funds



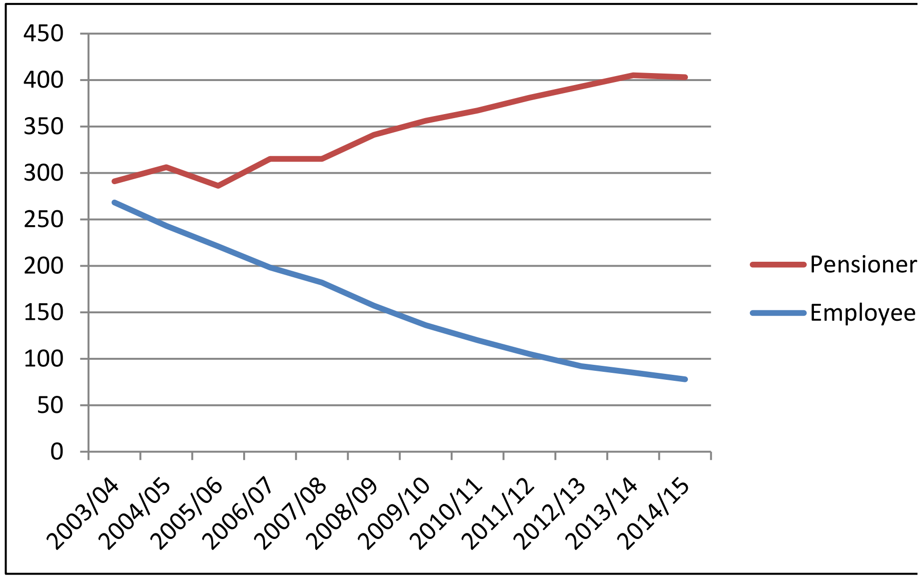
Source: Actuarial Valuation Reports

38. The 2014 valuation report stated that an employer's contribution rate of 14.9% could be set for the majority of employers but, due to volatility in the markets after the valuation date and a consequent deterioration in the funding position, it was decided that the rate should be maintained at the 2011 valuation level of 19.3%. Each employer, however, was offered the opportunity to pay the next three years deficit contributions upfront in return for a lower contribution rate. This option was taken up by 2 employers and represents the £4m deficit funding contributions referred to in paragraph 34.

Transport Fund

39. The Transport Fund is a closed fund and as the number of active members decreases, the number of pensioners and longer term liabilities increases. Exhibit 7 shows the membership profile of the transport fund. Currently, the proportion of active employees represents only 12% of the membership (2013/14 13%).

Exhibit 7 : Transport fund : trends in membership



Source: NESPF Annual Accounts

40. In recognition of this, and following discussions between the fund, Scheme Actuary and the employer First Aberdeen, the Pensions Committee approved a derisking strategy for the fund in September 2014. The aim of this is to reduce the risk associated with existing equity investments by replacing them with lower risk bonds and pooled investments. The strategy aims to provide more certainty over investment values and easier access to funds to meet liabilities as the fund matures. We agree that this is an appropriate response given the fund's profile.

41. The net assets of the transport fund increased by £9.8m (12.3%) to £89.6m and this was only a fraction short of the benchmark (13.72%). This is a significant improvement on the previous financial year when assets fell by £0.9m. The annual cost of pensions and benefits is around £0.7m more than contributions received from members. This position has been worsening in recent years with an increase in pensioners and a decline in contributing members since the closure of the fund.

42. The triennial valuation showed that the funding level was 93% as at 31 March 2014. With the worsening market conditions, this was estimated to have reduced to 86% at 31 March 2015 as set out in Exhibit 8. In March 2015, the pension committee implemented the de-risking strategy designed to ensure the fund is better placed to meet its future liabilities as they mature.

Exhibit 8: Snap-shot of assets and liabilities – Transport Fund

	2014 Valuation £m	2015 Roll-forward estimate £m
Assets	79.8	89.6
Liabilities	86.2	103.8
Net surplus/(liability)	(6.4)	(14.2)
Funding Level	93%	86%

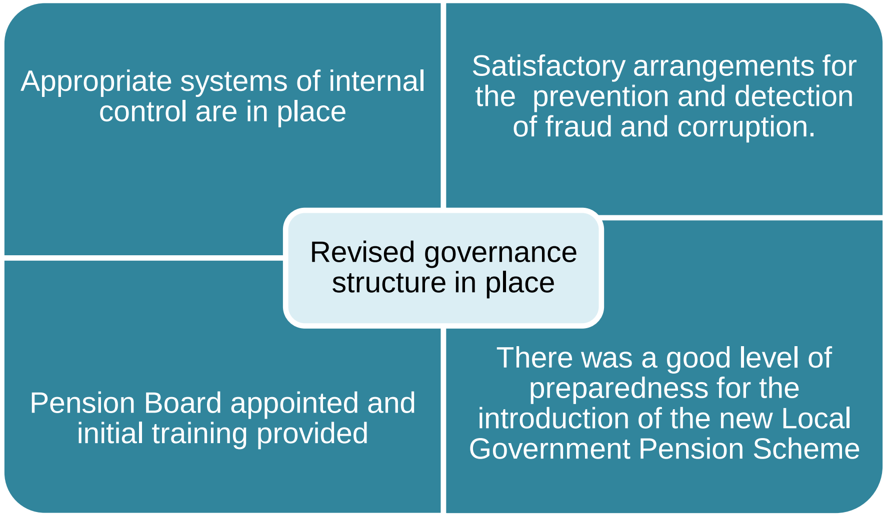
Source: NESPF Annual Accounts

Outlook

43. Both funds continue to have a growing number of pensioners, as a percentage of overall members. This typically increases pressure on a pension fund's financial outlook. More widely, there is uncertainly around local government funding in the medium term and in balancing future budgets, a further staff reduction will be a potential option for services. In turn, this places added demands on pension funds both in terms of additional administration and the impact on funding.

44. The Pensions Committee approved a revised investment strategy in June 2015 which is aimed at alleviating the pressures on the funds. Its implementation will require to be closely monitored by the pensions committee and further action taken as appropriate.

Governance and transparency



45. Members of Aberdeen City Council as administering authority, and the Head of Finance as the Proper Officer are responsible for establishing arrangements for ensuring the proper conduct of the affairs of the North East Scotland Pension Funds and for monitoring the adequacy and effectiveness of these arrangements.

Corporate governance

46. The corporate governance framework of the funds is determined by the council, as administering authority. In August 2014, Aberdeen City Council approved changes to their committee structure with effect from October 2014. As a consequence, the Pensions Committee replaced the previous pensions panel and increased the membership from 5 to 9 members. The committee continued to have delegated responsibility for the overall strategic direction of the funds. In previous years, we challenged the panel's ability to scrutinise effectively when attendance was low. With this increase in membership, a real opportunity is created for more effective scrutiny by the committee.

47. Following the committee restructure, the operation and remit of the Joint Investment Advisory Committee (JIAC) was also reviewed. It previously monitored and scrutinised fund managers' performance on behalf of the panel. In March 2015, the committee decided to disband the JIAC. Investment management performance is now undertaken by the Pension Committee. We support this decision as it should allow for improved scrutiny by the committee given it will have oversight for all the funds' business.

48. Based on our observations from attendance at committee meetings, there is engagement from members but often a range of papers are noted or approved with little or no comment. A contributing factor in this has been the late distribution of papers to members giving little time for the volume of information to be considered in advance of meetings. The council has taken steps to revise the timetable for distribution of agenda papers which should support improvement. There is also scope to review the content of committee agendas to ensure that the range of business is conducted as effectively as possible.

Refer Recommendation 3

Revised governance arrangements

49. From 1 April 2015, the Local Government Pension Scheme (Scotland) Regulations 2014 (2014 Regulations) changed the basis for calculating pension benefits from final salary to Career Average Revalued Earnings, known as the CARE scheme.

Exhibit 9 : CARE scheme

Benefits from 1 April 2015 will build up on a career average basis at the rate of 1/49th of annual pensionable earnings

Normal Pension Age will be aligned with each member's own State Pension Age

Source: Local Government Pension Scheme (Scotland) Regulations 2014

50. During the year, pension administration staff continued to build on work commenced in 2013/14 in preparation for the introduction of the new CARE scheme including:

- between December 2014 and February 2015, testing of the Pensions Administration system, Altair, continued in preparation for the go-live date for the new CARE scheme update in early March 2015
- there were 18 employer briefing sessions and 43 presentations to members of the scheme in the run up to 1 April 2015
- training was given to the pension fund team in January 2015 which was supported by further fortnightly sessions from February 2015
- scheme documentation was updated
- quarterly updates were provided to meetings of the Pensions Panel/Committee.

51. The funds were well prepared for the implementation of the new CARE scheme from 1 April 2015. While there have been no major issues arising since April, officers have plans are in place to review the effectiveness of the implementation.

52. The Local Government Pension Scheme (Governance) (Scotland) Regulations 2015 (2015 Regulations) set out new governance arrangements required from 1 April 2015. At a national level, this established a Scheme Advisory Board to provide advice to:

- Scottish Ministers on proposed changes to the LGPS (Scotland)
- scheme managers or the scheme’s pension boards on the effective and efficient administration of the scheme and any funds within the scheme.

Exhibit 10 : 2015 governance requirements

The LGPS will have a national Advisory Board and local pension boards.

Powers extended to the Pensions Regulator to cover standards of governance and administraton fothe LGPS in Scotland.

Source: Local Government Pension Scheme (Governance) (Scotland) Regulations 2015

53. The 2015 regulations also introduced the requirement for pension funds to set up a Pensions Board which would be responsible for assisting the administering authority in complying with scheme regulations and the requirements of the Pensions Regulator.

54. The inaugural meeting of the North East Pensions Board was held on 23 April 2015 and the first joint meeting with the Pensions Committee on 15 June 2015. It is therefore too early to assess its effectiveness.

55. The requirement to establish and implement a Pensions Board with an interest in all scheme issues was a further factor in the pension committee's decision to disband the JIAC and bring all matters onto its own agenda.

56. The Pensions Board, in line with a model constitution issued by Scottish Ministers, was determined to consist of equal numbers of scheme employer representatives and trade unions (4 from each side). Appointments, with the exception of those from Aberdeen City Council, were made by early February 2015. An initial joint training session was also held in February 2015 to which Pensions Committee members were also invited.

Internal control

57. The funds' financial systems are provided by the administering authority. We were able to take assurance from our audit of the council that high level financial controls that impact on the pension funds' financial statements operated effectively during the year.

58. We also reviewed controls relating to the pension investment and administration transaction systems. Our overall conclusion was that the North East Scotland Pension Funds had appropriate systems of internal control in place during 2014/15.

Internal audit

59. Internal audit provides members and the Head of Finance with independent assurance on the overall risk management, internal control and corporate governance processes for the funds. Internal audit provided an internal audit plan to the council's Audit, Risk and Scrutiny Committee which included coverage of pension fund financial systems. While the 2014/15 plan was not submitted to the Pensions Committee, internal audit reported their findings to the committee in June 2015 in respect of audits undertaken on the pension payroll and pension fund financial controls. Overall, positive assurances were provided with only a few minor improvements recommended.

60. Generally, we seek to rely on the work of internal audit wherever possible and, as part of our 2014/15 planning process, we concluded that the internal audit service provided by PricewaterhouseCoopers operated in accordance with relevant Public Sector Internal Audit Standards (PSIAS). This enabled us to take assurance from their documentation and reporting procedures.

Arrangements for the prevention and detection of fraud

61. The pension funds complied with the relevant fraud and irregularity policies of Aberdeen City Council during 2014/15. Following a review of the council's arrangements, there are no matters we need to draw to members' attention.

Arrangements for maintaining standards of conduct and the prevention and detection of corruption

62. The funds' arrangements for the prevention and detection of corruption are satisfactory and we are not aware of any specific issues that need to be recorded in this report.

Transparency

63. Following the replacement of the Pensions Panel with a Pensions Committee, plans are being progressed to bring the administration of the committee into line with the practices for other council committees, for example, arrangements for pre-meeting agendas and distribution of papers. While agenda packs are available on the council's website, they have not always been placed there in advance of meetings. However, packs have included detailed information about all aspects of the operation of the funds with the majority of those papers being included as public papers. In addition, the pension fund has its own website (www.nespf.org.uk) and while this provides an important mechanism for sharing operational information securely with the 50+ scheme employers, a range of scheme documents and news updates are also publicly available.

Management costs

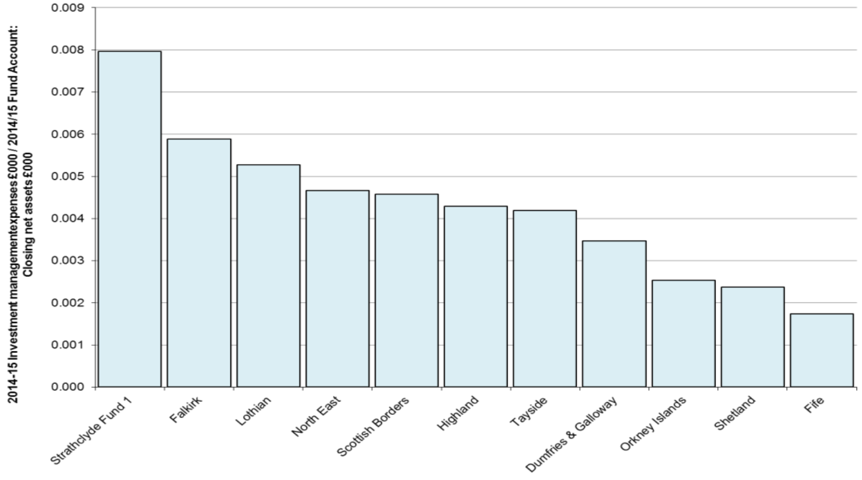
64. The cost of administering pension funds has come under increasing scrutiny in recent years. In order to enable the sector to consider the effectiveness of pensions administration, there was a need to improve the transparency of reporting through better data comparison and more complete reporting of costs.

65. In response, CIPFA's new guidance on accounting for local government pension scheme management costs set out a common methodology for the classification and accounting of management costs. This included guidance for dealing with the more complex investment areas where fees had been hidden in the past. For example, fees in fund of funds were previously included within the value of the asset rather than being separately identified in the fund account.

66. The guidance was applied from 2014/15 and should provide a framework for better data comparison. Exhibit 11 sets outs a comparison of management fees across the Scottish funds as set out in their 2014/15 unaudited accounts. This will provide a useful trigger for further discussion as it will take time to resolve the technical aspects which invariably only come to light when new guidance is first applied in practice.

67. We concluded at paragraph 21 that we were satisfied with the funds' approach in applying the new CIPFA guidance this year.

Exhibit 11: Management fees

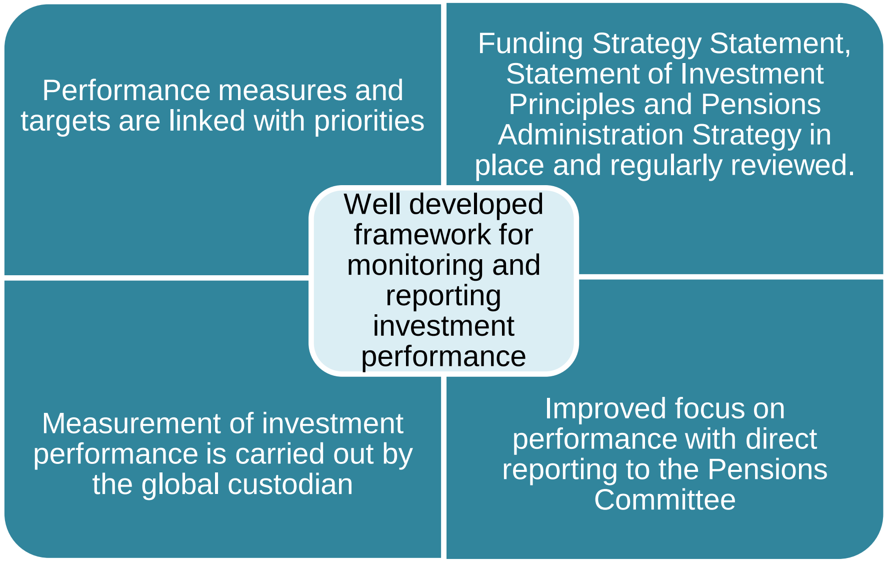


Source: Audit Scotland – Unaudited Pension Fund Annual Accounts Database

Outlook

68. Meeting the requirements of the new regulations has been a significant workload for pension fund staff. With a new scheme in place, a new Pensions Committee and a Pensions Board, there is an opportunity to now review implementation and make any necessary changes. The governance framework has been strengthened but to operate effectively, it needs to become embedded and include appropriate challenge from management and members.

Best Value



69. Administering authorities have a specific responsibility to ensure arrangements have been made to deliver best value in the services they provide. This requires continuous improvement while maintaining a balance between quality and cost and having regard to value for money, equal opportunities and sustainability. There is also the duty to report performance publicly so that local people and other stakeholders know what quality of service is being delivered and what they can expect in the future.

70. North East Scotland Pension Funds has a Pensions Administration Strategy which includes targets for the measurement of service performance. From April 2014, workflow systems have been used to report performance with a summary presented quarterly to the Pensions Panel and now the Pensions Committee.

71. Over the last 2 years, the funds have implemented online systems enabling employers to electronically transfer data on an ongoing basis. Almost 40% of employers have signed up and in most cases, the data returned to the funds is of a good quality. This means that pension fund systems are updated regularly, amendments are processed on a more timely basis and reconciliations of contributions received are easier because information is more accurate and up-to-date as a matter of routine. The continued uptake of these systems by employers will encourage them to notify the funds more promptly of staff changes and in turn, this should improve their performance against the different employers' targets set out in the Pension Administration Strategy which are regularly reported to committee.

72. The fund also has a Funding Strategy Statement which is supported by the Statement of Investment Principles and the Investment Policy. These documents link investment strategy to long term funding needs and define performance criteria.

Investment performance

73. Nine external fund managers provide quarterly updates on their performance, and these are summarised for presentation to committee. A variety of benchmarks are used depending on the mandate of the fund manager, and an overall composite benchmark to assess their performance is calculated by the global custodian who acts on behalf of the pension funds.

74. Performance against benchmark targets is regularly reported to the Pensions Committee. Exhibits 12 and 13 show the one, three and five year rolling average results against benchmark for the main fund and the transport fund.

Exhibit 12: Main fund performance – rolling average

	In-year	3-Year	5- year
Main fund	11.6	11.69	9.26
Benchmark	12.43	12.02	9.26

Source: NESPF Annual Accounts

75. Exhibit 12 shows that growth in market value of the fund was 11.6% last year, below the 12.4% benchmark. Investment performance over a 3 year period was also marginally below the benchmark. However, over the 5 year period, the fund's performance met the benchmark.

76. The funds' performance reports as submitted to the JIAC/Pensions Committee over the last year confirmed that most managers outperformed against their benchmark on some or all of the quarters. One manager with a global equity mandate has however consistently underperformed over the short and long term. The committee heard from the relevant manager in June 2015 and following appropriate challenge of the manager's view of the market and performance, it decided to retain the services of the manager for a further period.

Exhibit 13: Transport fund performance – rolling average

	In-year	3-Year	5- year
Transport fund	13.33	8.8	8.86
Benchmark	13.72	9.93	9.26

Source: NESPF Annual Accounts

77. Exhibit 13 shows the performance of the transport fund and while it falls behind benchmark both over the short, medium and long term, the implementation of the derisking strategy should reduce the level of uncertainty and provide the required improvement in the fund.

Appendix I – Significant audit risks

The table below sets out the financial statement audit risks we identified during the course of the audit and how we addressed each risk in arriving at our opinion on the financial statements.

Audit Risk	Assurance procedure	Results and conclusions
Financial Statements Opinion Risks		
Local Authority Accounts (Scotland) Regulations 2014 (2014 regulations) The 2014 regulations introduce a number of key changes with regard to the processes for approval and publication of both the unaudited and audited annual accounts. In addition, the 2014 regulations require the inclusion of a wider governance statement in the financial statements. There is a risk that the fund does not comply with the regulations and the date for sign off of the annual accounts is not met.	• Regular discussions with Pension Fund staff • Agreed timetable for delivery of unaudited accounts.	We met with officers early in the 2014/15 audit to agree a joint timetable for delivery of audited accounts to meet the requirements of the regulations. Regular discussions have been held throughout the audit to ensure that plans were proceeding as expected.

<table>
<tr><th>Audit Risk</th><th>Assurance procedure</th><th>Results and conclusions</th></tr>
<tr>
<td>Income

North East Scotland Pension Funds receive a significant amount of income from employer and employee contributions and investment income. The extent and complexity of income means there is an inherent risk of fraud in accordance with ISA 240.

There is a risk that fund income per the annual accounts is materially misstated.</td>
<td>Contributions

• Focused year end testing of contribution reconciliations
• Verification that contributions have been properly deducted on employer payrolls and transferred to the fund.

Investment Income

• Review of controls in place
• Focused year end substantive testing of investment income.</td>
<td>Contributions

We reviewed the fund’s contribution database spreadsheet and confirmed that it
• reconciled with the ledger and
• there were no significant variances between actual contributions paid and the fund’s reasonableness checks based on pensionable pay.

We tested a sample of 38 employees from 5 scheduled and admitted bodies and confirmed their pensions contributions had been correctly calculated and paid across to the fund.

Contributions included advance payment of deficit funding by 2 employers in March 2015 amounting to £4m. These were verified as part of the audit process.

Investment Income

On a sample basis, we confirmed that monthly cash reconciliations for each fund manager are checked before posting the movements for the month, including investment income, to the ledger.

We tested a sample of 3 investment income balances (2 main fund, 1 transport) as part of debtors testing and found all had been accounted for correctly.

We tested a sample of 4 (2 main fund, 2 transport) pre- and one post year end (main fund) investment income transactions and confirmed that the correct cut off had been applied and amounts had been posted to the correct financial year.

No fraud concerns identified in respect of income.</td>
</tr>
</table>

Audit Risk	Assurance procedure	Results and conclusions
Management override of controls As stated in ISA 240, management is in a unique position to perpetrate fraud because of management's ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively.	• Detailed testing of journal entries • Review of accounting estimates for bias • Evaluating significant transactions that are outside the normal course of business.	• Journals - a sample of 10 journal entries (7 main, 3 transport) was tested as part of debtors and creditors testing, and a further 5 in respect of investment income. We found no evidence to suggest that management were overriding controls. • Estimates – based on testing of debtors, creditors, provisions/contingencies and private equity balances, we found no evidence of bias in accounting estimates. • Significant transactions – based on our work on the annual accounts, we did not find any evidence of transactions outwith the scope of the funds.
Private Equity Private equity investments are included in the net assets statement on the basis of the best estimate (i.e. valuations at 31 December). There is a risk that investments per the accounts are materially misstated.	• Review of client working papers • Reliance on an expert in accordance with ISA 620 – review of investment approach.	Private equity investment figures per the draft accounts were verified to supporting capital statements on a sample basis as at 31 December (initial estimates) and as at 31 March 2015 when they year end statements became available in July 2015. The accounts were adjusted by £9.443m to reflect the revised asset values. In order to enable us to draw assurances from fund managers' private equity valuations, a review in accordance with ISA620 was carried out. This included examining relevant documentation such as accounting policies per the accounts, fund manager internal control reports and audited financial statements of the private equity funds. We concluded that we could place reliance on the fund managers' valuations.

Audit Risk	Assurance procedure	Results and conclusions
Fund management costs CIPFA have issued best practice guidance on *Accounting for local government pension scheme management costs*. Guidance has been given for further analysis of costs and it also covers areas where historically, difficulty has been experienced in identifying all the management costs. *There is a risk the fund does not comply with best practice.*	• Review of management action to identify costs • Focused year end substantive testing of management costs • Comparison of disclosures with other local government pension funds.	Taking the CIPFA guidance into consideration, we identified the funds' approach to identifying management expenses. The main areas of uncertainty were: • performance fees – fees were separately invoiced and have been accrued up to 31 March 2015 • private equity – the fund contacted the manager to identify fees which are built into fund of fund valuations. Amounts were extracted and investment values adjusted accordingly. We confirmed the transfers on a sample basis • pooled funds –fees are traditionally deducted at source through the redemption of units. Evidence for one quarter demonstrated that the fee invoice equated to the disposal of units. We therefore confirmed there was no netting off in the figures. • property fees –from a review of the accounts, we identified that direct operational costs were incorrectly netted against property rentals. These were correctly brought within the management expenses note in the revised accounts. • Transaction costs arising from purchases and sales of investments – a review of the accounts identified that transaction costs were separately disclosed. These were correctly brought within the management expenses note in the revised accounts. • Otherwise management fees have been separately invoiced and accrued up to 31 March 2015. We are satisfied that the management expenses disclosures are in accordance with CIPFA guidance. The revised accounts were amended to include the additional fees identified.

Audit Risk	Assurance procedure	Results and conclusions
Provision for non-collection A significant debt in respect of a termination agreement due from an admitted body has been the centre of dispute for some time. There is a risk that debt collection is not being effectively managed.	• Review of management action.	We received regular updates on this matter from the Head of Finance. This debt has been the subject of legal proceedings for some time. The delay has been caused by the time taken to put arrangements in place for the ongoing enhancement element of payments to pensioners who were employees of the former school. Plans have now been put in place to secure annuities to fund the enhancements. When the annuities have been purchased and the documentation finalised, the trust will be in a position to clear its debt with the pension fund and be wound up. Conclusion of this matter is overdue and the Head of Finance now anticipates closure by 30 September 2015.
Wider Dimension Risks		
Scrutiny The role and operation of the JIAC is under review and consequently, the committee has not met since August 2014. There is a risk that until the outcome of the review is implemented, scrutiny and challenge processes are reduced.	• Review of agreed management actions • Consider the effectiveness of scrutiny undertaken on pension fund activities.	With the implementation of a Pensions Board from April 2015, the Pensions Committee opted to disband the JIAC and consequently bring all investment scrutiny direct to the committee. Given the level of change in recent months and the fact there has only been one meeting of the Pensions Committee with the Pensions Board, it is too early to assess the effectiveness of the new arrangements.

Audit Risk	Assurance procedure	Results and conclusions
Local Government Pension Scheme (Scotland) Regulations 2014 The Local Government Pension Scheme (Scotland) Regulations 2014 apply from 1 April 2015. This will see a move from a final salary scheme to a scheme based on career average revalued earnings (CARE). There is a risk that the fund's level of preparedness is not sufficient to have the scheme operational by the due date.	• Review of management actions.	Based on discussions with the Pensions Manager and quarterly updates to the Pensions Committee, we confirmed there was ongoing activity in preparation for the implementation of the new CARE scheme. There were a range of presentations to scheme employers and elected members, training and a range of documentation was prepared for employers and members of the scheme. Regular updates were posted on the funds' website in respect of activities taking place in the run up to the go-live date. Overall, we considered the funds' preparation to be well planned and resourced. .

Appendix II – Action Plan

No/ para	Issue/risk/Recommendation	Management action/response	Responsible officer	Target date
	Issue/ Risk / Recommendation			
1/21 (issue 3)	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. ***Risk: the fund is not effectively managing collection of outstanding debt.*** ***Recommendation:*** This matter needs to be effectively concluded.	Work has been continuing during 2014/15 to put arrangements in place to enable existing pensioners to continue to receive their benefits. Once this arrangement is concluded, the former admitted body can be wound up and outstanding liabilities paid across to the pension fund.	Head of Finance	30 September 2015
2/29	A finance monitoring report in respect of 2014/15 was not submitted to committee until March 2015. ***Risk: the committee does not have the opportunity to monitor budgets for which it is has delegated responsibility.*** ***Recommendation:*** *The required cycle should be reviewed and agreed and reports submitted accordingly.*	This has now been rectified. Quarterly reports have been submitted to committee since March 2015 and this is scheduled to continue.	Pensions Manager	Completed

No/ para	Issue/risk/Recommendation	Management action/response	Responsible officer	Target date
3/46-48	Following the recent implementation of a pensions committee with wider membership and plans to have regular oversight of all the funds' activities, there is an opportunity to strengthen scrutiny and accountability roles and become more effective. In addition, officers have plans in place to review the frequency and content of reports submitted to members as part of the process of streamlining the business of the committee and the Pensions Board. ***Risk: there is insufficient accountability and scrutiny on the administration and performance of the funds****.* ***Recommendation:*** While a balance needs to be struck between providing the committee with assurances and obtaining its approval, there is scope for improved agenda planning and more structure around timescales for consideration of different reports. It would be useful to involve the committee in this process, for example, through the use of a self-assessment exercise on the role of the committee and a training needs analysis.	Steps are being taken to review the format, frequency and timetable for reports to committee. This will also ensure that there is coverage of service performance across all the activities within the funds. Training needs will be reviewed both in terms of specialist pensions knowledge but also in respect of more generic challenge and scrutiny skills to support the Pensions Committee in carrying out its responsibilities.	Head of Finance Pensions Manager	Commenced and will continue throughout 2015/16 31 December 2015