Strathclyde Pension Fund

Annual audit report to Members and the Controller of Audit

September 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 Gillian Woolman as the external auditor of Strathclyde Pension Fund for the period 2011/12 to 2015/16.

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

This report will be published on our website after it has been considered by the Pension Fund 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.

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Key messages

Audit of financial statements	• Unqualified audit report on the 2014/15 financial statements.
Financial management and sustainability	• Net assets in Fund 1 increased by 13% to £15.8 billion. Fund 3 increased 20% to £186.9 million. • March 2014 triennial valuation reports that the funds assets were sufficient to meet 94.3% for Fund 1 and 96% for Fund 3. • A shortfall of £20.8 million reported in contributions received compared with benefits paid. • Satisfactory financial management arrangements are in place.
Governance and transparency	• Effective governance arrangements in place. • Pensions Board established from April 2015. • System of internal control operated effectively.

Performance	• Sixth year of continuous investment growth with a return of 13.4% recorded for Fund 1. • Investment management expenses of £130.4 million (0.8% of net assets) are reported (2013/14: £108 million). • Based on 2014 triennial valuation, employers' contributions largely held at 19.3%. • Improving administration performance.
Outlook	• From the start of 2015/16, Strathclyde Pension Fund will provide benefits on the basis of career average revalued earnings (CARE). This is likely to increase the complexity and workload of fund administration. • The global investment outlook is less certain due to political and economic challenges. • The funding position within the public sector remains challenging. The possibility of further staff reduction schemes is likely to impact Strathclyde Pension Fund by way of reductions to active members and increased workload for fund administration.

Introduction

1. This report is a summary of our findings arising from the 2014/15 audit of Strathclyde Pension Fund (the 'Fund'). The report is divided into sections which reflect our public sector audit model.
2. The management of the Fund 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.
3. Our responsibility, as the external auditor of Strathclyde Pension Fund, 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.
4. 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; this does not relieve management of their responsibility for the preparation of financial statements which give a true and fair view.
5. A number of reports have been issued by Audit Scotland during the year. These are summarised in **Appendix II** and include recommendations for improvements, where appropriate.
6. **Appendix III** is an action plan setting out our recommendations to address the high level risks we have 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 Strathclyde Pension Fund understands its risks and has arrangements in place to manage these risks. The Pension Fund Committee 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. The cooperation and assistance afforded to the audit team during the course of the audit is gratefully acknowledged.

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 3 years by the actuary, the financial statements of the Pension Fund have been prepared on a going concern basis. We are unaware of any 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 and annual governance 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 25 June 2015, in accordance with the agreed timetable. The working papers were of a good standard and council staff provided good support to the audit team which assisted the delivery of the audit to deadline.

10. The financial statements were considered by Strathclyde Pension Fund Committee at their meeting on 17 June 2015. A number of changes were made to several lines within the financial statements before the financial statements were submitted to audit. Although the changes made did not impact upon the overall financial position, making changes to statements which have been previously considered by committee does not represent good practice.

Overview of the scope of the audit of the financial statements

11. 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 Pension Fund Committee on 2 March 2015.

12. 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. The 2014/15 agreed fee for the audit was set out in the Annual Audit Plan and, as we did not carry out any work additional to our planned audit activity, the fee remains unchanged.

13. 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.

14. 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

15. Materiality can be defined as the maximum amount by which auditors believe the financial statements could be misstated and still not be expected to affect the decisions of users of financial statements. A misstatement or omission, which would not normally be regarded as material by amount, may be important for other reasons (for example, an item contrary to law).

16. We consider materiality and its relationship with audit risk when planning the nature, timing and extent of our audit and conducting our audit programme. Specifically with regard to the financial

statements, we assess the materiality of uncorrected misstatements, both individually and collectively.

17. We summarised our approach to materiality in our Annual Audit Plan. Based on our knowledge and understanding of Strathclyde Pension Fund and following receipt of the unaudited financial statements, we have set our materiality for 2014/15 at £4.8 million or 1% of benefits paid for the Fund Account (Fund 1) and £0.6 million (Fund 3) Fund Account. For the Net Assets Statement for Fund 1, materiality was set at £78.8 million or 0.5% of net assets and £0.9 million for Fund 3.

18. We report all misstatements greater than £100,000. Performance materiality was re-calculated at £3.9 million and £0.4 million for Fund 1 and Fund 3 respectively and £51.2 million and £0.6 million for the respective Net Asset Statements. Performance materiality is used to reduce to an acceptable level the probability of uncorrected and undetected audit differences exceeding our planning materiality level.

19. On receipt of the financial statements and following completion of audit testing we reviewed our materiality levels and concluded that our original calculation remained appropriate.

Evaluation of misstatements

20. A number of presentational adjustments were identified within the financial statements during the course of our audit. These were discussed with relevant officers who agreed to amend the unaudited financial statements.

21. One misstatement identified during the audit has not been adjusted in the financial statements. If adjusted this would increase current liabilities by £1.4 million. We requested that all errors be corrected, although the final decision on this matter rests with those charged with governance taking into account advice from officers.

Significant findings from the audit

22. 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 representation requested by the auditor.
- Other matters which in the auditor’s professional judgement, are significant to the oversight of the financial reporting process.

23. During the course of the audit we identified the following significant issues that, in our view, require to be communicated to you. These are detailed below:

Significant findings from the audit

Issue	Resolution
Prior Year Adjustment The 2013/14 audited financial statements reflected management expenses of £18.4 million. The restated 2013/14 statements disclosed management expenses of £108.3 million The separate disclosure of management expenses on the face of the Fund Account represents a change in accounting policy. IAS 8 requires that where there has been a change in accounting policy a prior year restatement note should be provided and this should be fully disclosed. A prior year restatement note has not been provided within the unaudited financial statements.	A prior year adjustment note has been added to the financial statements identifying the changes made to the audited 2013/14 figures.

Issue	Resolution
Critical Judgements and Use of Estimates CIPFA issued guidance on the disclosure of management expenses within pension funds in July 2014, to be applied in the 2014/15 financial statements. Management expenses of £130.4 million for Fund 1 and £0.3 million for Fund 3 have been included in the financial statements. Due to the nature of its asset holding, there is likely to be a high degree of estimation and judgements made in the calculation of management expenses. This is particularly so with private equity costs. Overall, we are satisfied that SPF has complied with the CIPFA guidance and has provided where possible third party evidence to support the figures. However, no disclosure has been made in the financial statements to provide details of the critical judgements made in preparing the financial statements. Given the value of the management expenses, we have requested additional representations from management on the accuracy of the figures disclosed in the financial statements.	A note will be added to the financial statements detailing the critical judgements applied in quantifying the value of management expenses. Given the degree of estimation involved, we have requested additional representation for management on the completeness and accuracy of management expenses in the accounts.
Funding Position The financial statements show a net deficit of £20.8 million from dealings with members over both Funds. This negative cashflow is predicted to be a long-term trend. SPF has the objective of achieving a funding target of 100% within 12 years. Careful management of investments and investment income will be required to ensure that this target is met.	SPF closely monitors the cash flow position at every meeting of the Pension Fund Committee. In addition, a 10 year cashflow projection is reviewed annually by the Pension Fund Committee. The net cash flow predictions have informed the Fund's recent revised Investment Strategy.

Future accounting and auditing developments

Public Service Pensions Act 2013

24. In terms of the 2013 Act, there are a number of significant changes to the Local Government Pension Scheme (LGPS) (Scotland) that will apply from 1 April 2015. Some of the main changes are illustrated below:

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

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

Revised Governance Arrangements

25. The 2013 Act is supported by a number of new sets of regulations including the Local Government Pension Scheme (Governance) (Scotland) Regulations 2015. These set out new governance arrangements from 1 April 2015.

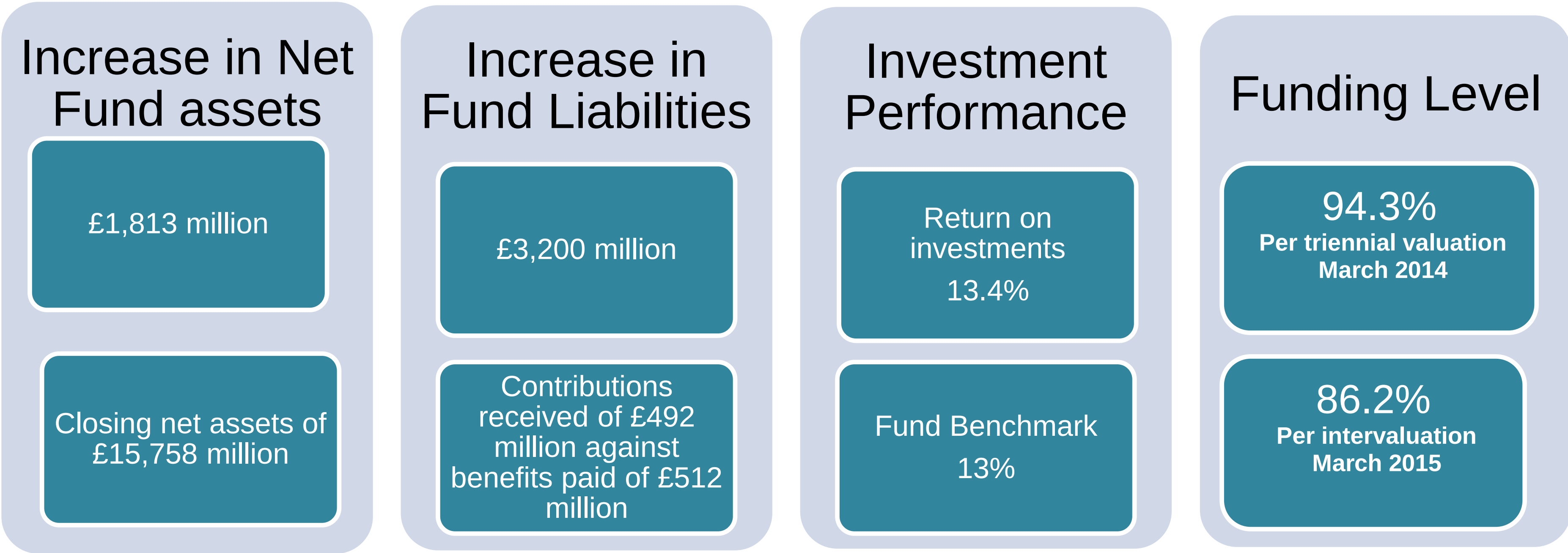
26. At a national level the new arrangements include the establishment of a Scheme Advisory Board. Its role is to:

- provide advice to Scottish Ministers on proposed changes to the LGPS (Scotland)
- provide advice to Scheme Managers or the Scheme's Pension Boards on the effective and efficient administration of the Scheme and any funds within the Scheme.

27. In addition, the powers of the Pensions Regulator have been extended to cover standards of governance and administration in the LGPS (Scotland).

28. Another key feature of the new governance arrangements is the requirement for a local Pension Board to be established from 1 April 2015 to assist the Scheme Manager (i.e. Strathclyde Pension Fund Committee) in securing compliance with the scheme rules and with the Pension Regulator's Codes of Practice. The Pension Board of Strathclyde Pension Fund came into operation on 1 April 2015.

Financial management and sustainability



Source: Strathclyde Pensions Fund Financial Statements – Fund 1

Financial management

29. Pension fund finances are independently assessed every three years by the fund's actuary. This assessment determines the employer contribution rates for the upcoming 3 year period and provides details of the funding position of the fund. Following the triennial valuation, the Investment Strategy of the fund is updated to ensure the objective of 100% funding is achieved.

Financial outcomes

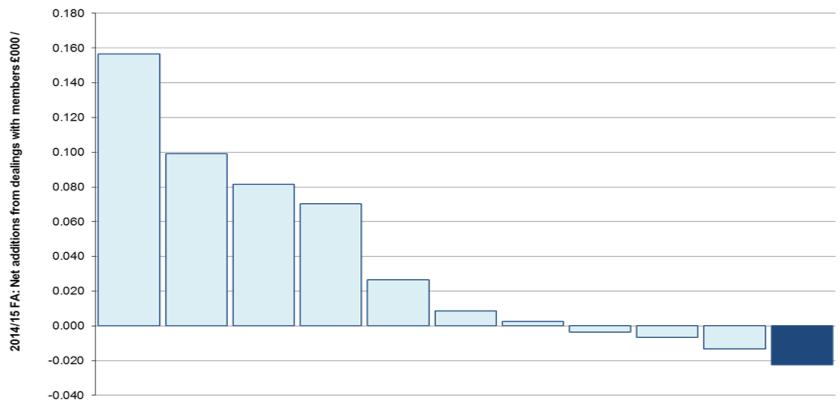
30. Fund 1 reported an increase in net assets of £1.8 billion (13%). This increase in assets largely relates to increase in investment values at 31 March 2015.

31. In 2014/15, Fund 1 recorded a deficit from dealings with members of £19.3 million. Membership of the fund increased by 6,033 to 210,877 members at 31 March 2015; an increase in active members of 3.2%. This increase is expected to continue as auto-enrolment continues. SPF actively monitors its cashflow position and reports the position to every meeting of the Pension Fund Committee. A 10 year cash-flow forecast is prepared annually. This is submitted to the Pension Fund Committee in March. The March 2015 report forecasts that the negative cash flows will be an ongoing trend and that SPF will require investment income going forward for at least the next 10 years.

Refer action plan point 1

32. Exhibit 1 shows the net cash flow position for SPF (shaded) compared to the other Scottish Local Government Pension Funds.

Exhibit 1: Net Additions from dealings with members



Source: Unaudited 2014/15 financial statements

33. One of the main aims of SPF's revised Funding Strategy Statement is to ensure that there are sufficient funds to meet pension obligations. The revised Investment Strategy will see diversification of the asset portfolio and a move away from growth generating assets such as equities to income generating assets in order to manage the changing liabilities of the fund.

34. Fund 1 reported an increase in liabilities of £3.2 billion reflecting a fall in gilt yields over the period.

35. Fund 3 reported growth in net assets of £31.4 million. However it also reported a continuation of deficits from member dealings of £1.5m. Liabilities in Fund 3 also increased in 2014/15 by £18 million.

Financial management arrangements

36. As auditors we are required to consider the financial management arrangements put in place by SPF to ensure these are adequate. We do this by considering the following:

- financial regulations are comprehensive, adhered to and maintained by officers
- reports monitoring performance are accurate, timely and contain both financial and non-financial data
- members provide a good level of challenge of financial variances and performance weaknesses.

37. Investment and administration performance reports are submitted to every meeting of the Pension Fund Committee. From our attendance at these meetings, we are content with the level of review and scrutiny by members.

Funding position & sustainability

38. One of the key objectives of SPF, as set out in its Funding Strategy Statement, is to hold sufficient assets in the Fund to meet the assessed cost of members' past service benefits.

39. The most recent triennial valuation at 31 March 2014 valued Fund 1 at £13,949 million and reported a funding level of 94%. The funding shortfall was £839 million.

40. Fund 3 is a closed fund with only one contributing employer. The triennial valuation at 31 March 2015 recorded a funding position of 95.9%. It is noted that the total employers' contribution rate based on the funding position at 31 March 2014 is 46.4% with possible additional monetary payments being required in 2016/17 and 2017/18. This reflects repaying the funding deficit of Fund 3 over 5.9 years, the average remaining period of contributory membership of the current active workforce.

Table 1: Triennial Funding valuations 2011 to 2014

Fund Details	Fund 1		Fund 3	
	March 2011 £m	March 2014 £m	March 2011 £m	March 2014 £m
Assets	11,322	13,949	127	156
Liabilities	(11,642)	(14,788)	(143)	162
Net Liability	(320)	(839)	(16)	(6)
Funding Level	97.3%	94.3%	89%	96%

Source: Actuary Valuation 2011 and 2014

41. The current funding position represents a slightly weaker position than that reported in the March 2011 triennial valuation.

42. The triennial valuation determines employer contribution rates required over the next three year period. Based on the March 2014 funding level, the actuary calculated that the common employer contribution rate for the period 2015 to 2018 could remain at 19.3%. The continuation of this rate provides financial stability for employers over the short to medium term. It is noted however that there have been increases to the contribution rates for a number of smaller employers and the impact of this on their financial sustainability should be kept under review.

43. The results of the triennial valuation have informed the Pension Fund's revised Investment and Funding Strategies, approved by members of the Pension Fund Committee on 2 March 2015.

44. The key objective of the Investment Strategy is 100% funding by 2027. The Actuary report provides assurance the SPF is 66% likely to make up the £839 million shortfall within 12 years. To this end, a more risk-based diversified investment framework is being developed which should result in a continued move away from equity holdings.

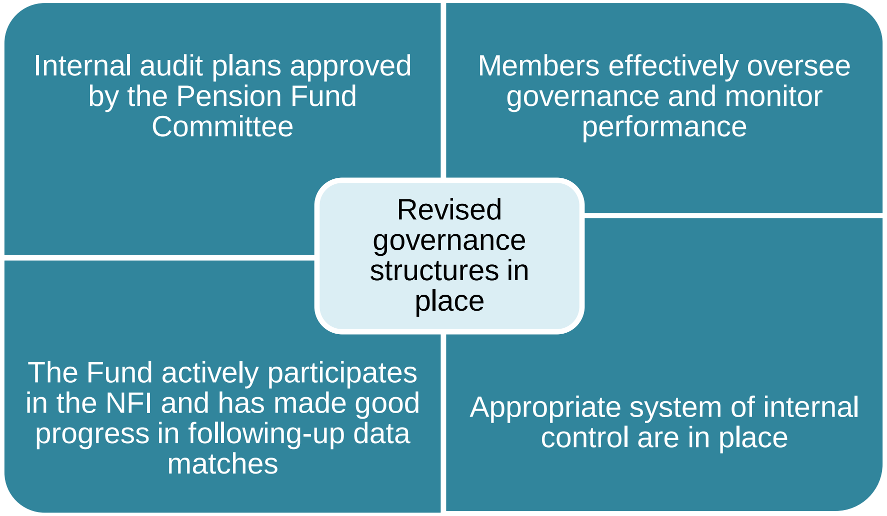
Outlook

45. It is clear that the outlook for public spending remains very challenging and the need for spending and budget constraints will continue. There is uncertainty around local government funding in the medium term and the need for further budget savings. Further staff reduction schemes will place additional demands on pension funds both in terms of additional administration and the impact on funding.

46. The Pension Fund Committee has approved revised Investment and Funding Strategies which are aimed at alleviating the pressure on the pension fund and reducing the funding deficit over time.

47. SPF estimates that the fund will become dependent on investment income to pay pensions going forward. It is important that the fund continues to closely monitor and review its Investment Strategy in the light of future cash flow predictions.

Governance and transparency



48. Members of Glasgow City Council as administering authority, and the Executive Director of Financial Services as the Proper Officer are responsible for establishing arrangements for ensuring the proper conduct of the affairs of Strathclyde Pension Fund and for monitoring the adequacy and effectiveness of these arrangements.

49. As part of our planning work on the council audit we reviewed various aspects of governance that also apply to the Fund including standing orders, financial regulations, Codes of Conduct for officers and members, anti-fraud and corruption arrangements.

50. Overall we concluded that these arrangements are adequate and support governance arrangements.

Governance structures

51. The main governance structures in place during 2014/15 are summarised below:

- **Pension Fund Committee**. The committee meets quarterly to consider a range of reports covering areas such as investment performance, responsible investment, budget and cash flow monitoring, and administration performance. The quality of reporting to committee is good and is supported by comprehensive reports and committee papers. Members of the committee provide a good level of scrutiny.
- **Representative Forum**. The Representative Forum is the main mechanism for engagement with the fund’s stakeholders and enables their involvement in the decision making process. The forum meets quarterly on the same cycle as the Pension Fund Committee. Forum membership is drawn from a broadly representative cross section of the fund’s stakeholders including local authorities, scheduled bodies, admitted bodies, trade unions and pensioners.
- **Investment Advisory Panel.** The Investment Advisory Panel provides advice to the Pension Fund Committee and assists members in carrying out their responsibilities. Membership of the panel includes senior officers, actuarial consultants and investment advisers.

52. As previously mentioned new governance arrangements came into force on 1 April 2015. These were discussed and agreed by the Pension Fund Committee in December 2014 and later approved by Strathclyde Pension Fund in March 2015.

53. The main change in the governance framework since 1 April 2015 has been the dissolution of the Representative Forum and the introduction of a local Pension Board in compliance with the Public Service Pensions Act 2013. The Board's role is to assist the Scheme Manager (i.e. Strathclyde Pension Fund Committee) in ensuring compliance with the rules relating to scheme governance and administration.

54. The Pension Board met for the first time on 21 May 2015. The Pension Fund Committee and Board plan to meet concurrently to avoid duplication and ensure that business is focused and streamlined.

Transparency

55. Transparency means that scheme members have access to understandable, relevant and timely information about how the Fund is taking decisions and how it is using its resources. Members should also be able to hold the Fund to account for the decisions it makes.

56. The meetings of the Pension Fund Committee are open to the public. Committee agenda, papers and reports are published on Strathclyde Pension Fund's website and also on Glasgow City Council's website. The Committee papers and reports provide comprehensive information on all aspects of the Fund's activities including investment performance and the performance of individual companies used by the Fund to manage its portfolio investments.

57. Overall we concluded that the Fund is open and transparent in the way it conducts its business.

Internal control

58. As auditors we concentrate on significant systems and the key controls within them to provide us with assurance on the accuracy and reliability of figures generated by those systems. SPF uses the main accounting systems of the administering authority, Glasgow City Council. Based on our review of these systems as part of our 2014/15 audit of the council, along with our testing of pension administration and investment processes, we concluded that there were no material weaknesses in the accounting and internal control systems.

Internal audit

59. Internal audit provides members and management of the council with independent assurance on risk management, internal control and corporate governance processes. The SPF's internal audit service is provided by Glasgow City Council's internal audit section.

60. We are required by international auditing standards to make an assessment of the internal audit function and the extent to which we can formally rely on their work. We concluded that the internal

audit function operated in accordance with the main requirements of the Public Service Internal Audit Standards and had sound documentation standards and procedures in place.

Annual Governance Statement

61. The Local Authority Accounts (Scotland) Regulations 2014 introduced a new requirement from 2014/15 for local authorities (including pension funds) to undertake an annual review of their system of control and report this in an annual governance statement. This statement requires to be published as part of the annual accounts.

62. The regulations require that the Pension Fund Committee approve the Governance Statement by the 31 August. This was approved by Committee on 17 June 2015. We reviewed the annual Governance Statement in the unaudited accounts. With the exception of a few minor presentational issues, we are satisfied that the content and presentation of the Governance Statement is in accordance with the guidance.

63. In undertaking a review of the system of control the Pension Fund Committee should obtain assurances on the adequacy of the governance arrangements. A key source of assurance for this was the Annual Assurance report produced by the Head of Audit and Inspection. This was submitted to the Pension Fund Committee on 17 June 2015 with no specific issues being disclosed for members attention.

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

64. SPF has adopted the policies used by Glasgow City Council for preventing and detecting fraud and maintaining standards of conduct. Following a review of the council's arrangements there are no matters we need to draw to members' attention.

National Fraud Initiative

65. SPF participates in the National Fraud Initiative. This is a counter fraud exercise led by Audit Scotland. It uses computerised techniques to compare information about individuals held by different public bodies, and on different systems, to identify (matches) that might suggest the existence of fraud or error.

66. SPF has made good progress to date in investigating data matches. No frauds or potential frauds have been identified.

67. Overall we concluded that pension fund staff are proactive in reviewing and investigating NFI matches.

Outlook

68. The change to CARE is likely to increase administrative workloads initially and generate more enquiries from Fund members seeking clarification of their benefits on an ongoing basis.

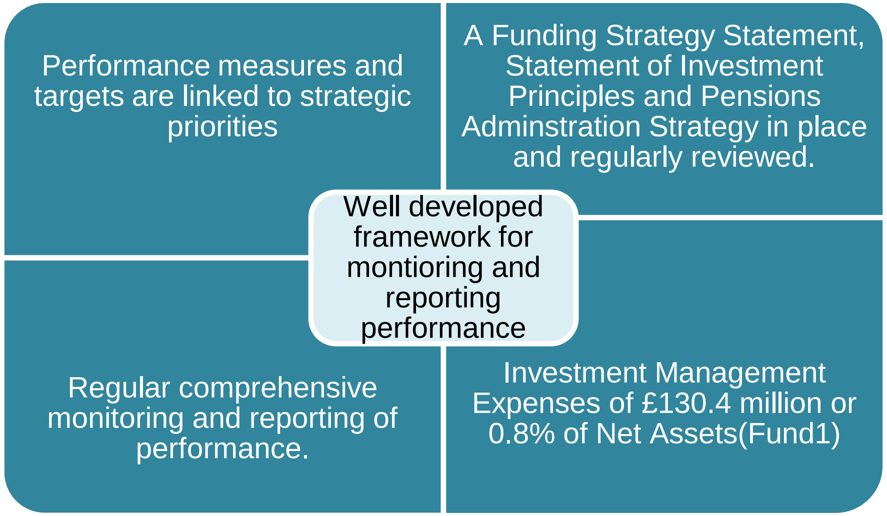
69. The UK Government's pension initiatives, including auto enrolment, freedom and choice, and abolition of contracting out, means that the pace of pension reform remains challenging.

70. The Scottish LGPS Advisory Board has been established with effect from 1 April 2015. This Board operates at a national level and has members drawn from employers and trade unions, together with professional advisors and bodies such as the Pensions Regulator and the National Association of Pension Funds.

71. Membership annual statements under the new regulations will require to be sent out early in future. These statements will become increasingly complicated as members' benefits will apply across a variety of scheme regulations.

Refer action plan point 3

Best Value



72. Administering authorities have a duty to ensure Best Value in the provision of services and to report performance publicly so that pension fund members, employers and other stakeholders know the quality of service being delivered and what they can expect in the future.

73. The main elements of any Best Value framework are clear strategic goals and priorities. The key strategic documents for SPF are the Funding and Investment Strategies. The SPF's current Funding Strategy Statement was agreed in March 2015 following the triennial actuarial valuation.

74. The Investment Strategy broadly defines the types of investment to be held by the Fund and the balance between the different types of investment.

Performance management

75. The Fund has a well structured framework in place for monitoring the performance of its investments and administration activities. Comprehensive reports are prepared for every Pension Fund Committee meeting and for the Investment Advisory Panel on a quarterly basis. Actual levels of performance are clearly measured against agreed targets.

76. Throughout the year, fund managers are required to present to the Investment Advisory Panel on their performance and an annual report on overall performance is produced and reported to Committee.

77. The Fund's Administration Strategy contains the standards which are required from participating employers to ensure that the Fund meets its statutory obligations and is able to deliver services efficiently. The Strategy contains a variety of performance measures against which the Fund and the participating employers are assessed. Progress against the Strategy is reported to the Pension Fund Committee on a quarterly basis.

78. Overall, we concluded that SPF has effective performance management arrangements in place.

Investment performance

79. SPF's performance against benchmark targets is regularly reported to the Pension Fund Committee. Performance against the Fund's benchmark has remained positive over the short, medium and longer term as illustrated in the table below.

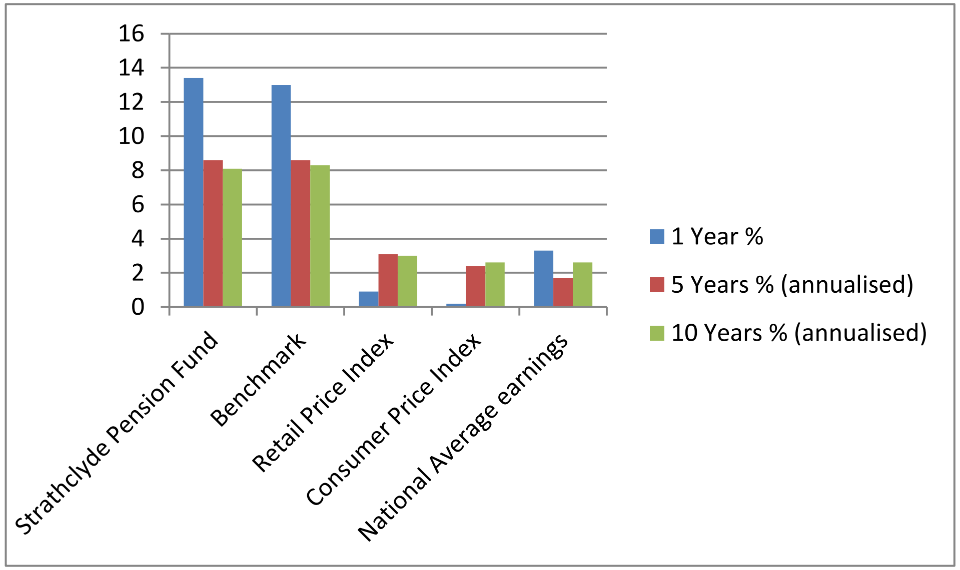
Table 2: Investment performance Fund 1

	2014/15 % per annum	3 years % per annum	5 years % per annum
Fund return	13.4	11.6	8.6
Benchmark return	13.0	11.1	8.6
Excess	0.4	0.5	0.0

Source: Strathclyde Pension Fund Annual Report and Accounts 2014/15

80. Exhibit 2 shows that over a period of one, five and ten years, SPF largely outperformed measures of inflation ie consumer price index, the retail price index and national average earnings.

Exhibit 2: Fund 1 performance



Source: Strathclyde Pension Fund Annual Report and Accounts 2014/15

81. Fund 3 reported a return of 21.3% in 2014/15. This was above the benchmark return of 20.7%. In the medium to long-term performance is also above benchmark.

Fund manager performance

82. The performance of individual investment managers is reported quarterly to the Pension Fund Committee. In addition all investment managers are subject to further review at least on an annual basis by the Investment Advisory Panel.

New Opportunities Portfolio

83. Investments by SPF in the New Opportunities Portfolio has increased to £328 million, with the actual amount drawn down of £180 million to July 2015. In addition, members recently approved an increase to 5% of the total net assets which can be invested in the New Opportunities Portfolio.

Administration performance

84. The Fund has developed a range of service standards to monitor administration performance. These are measured on a regular basis and are reported to the Pension Fund Committee quarterly.

85. We had previously reported, in 2013/14, that SPF has underperformed against five of its administration targets. Performance during 2014/15 has improved, with SPF targets only not being met in relation to two: provisional and actual retirals, although performance in these areas have improved during the year.

86. Customer satisfaction rates remain high, although satisfaction rates have dropped slightly and are below target in some areas such as retirals, new starts and deferred pensioners.

87. Employers are required to submit year end contribution returns by 20 May for the preceding 31 March year end. This is an important control over the accuracy of pension contributions received and recorded in the pensions systems. All year end contribution returns relating to 2014/15 were received.

88. As part of the Fund's governance assurance framework employers are also required to submit compliance certificates verifying compliance with a range of SPFO and regulatory requirements in relation to pension administration. In 2014/15 approximately two thirds of compliance certificates were received. It has been confirmed that certificates were received from all the fund's major employers.

89. Overall, we have concluded that all aspects of Fund performance are actively monitored and reviewed with robust arrangements in place to hold investment managers to account for their performance.

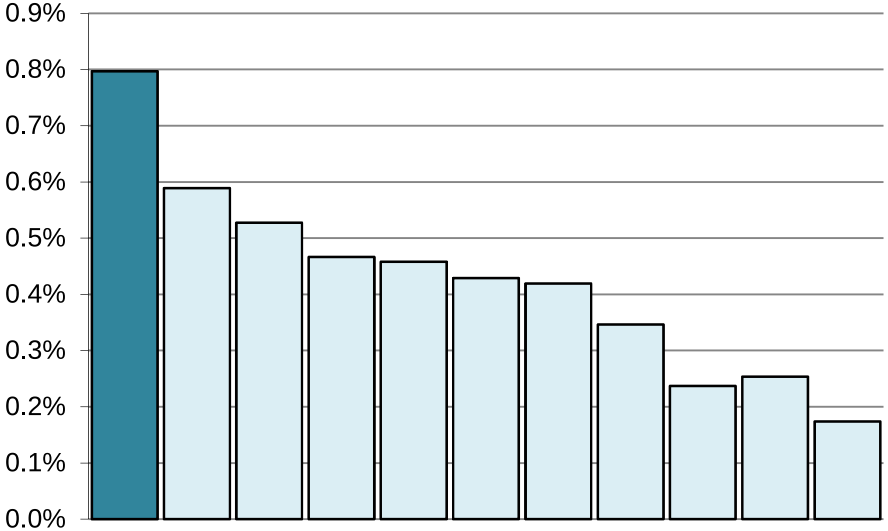
Management Expenses

90. There are three main categories of management expense, with the largest being investment management costs. Other expenses are the cost of the administration services provided by the council and the governance fees for actuarial and audit services.

91. In 2014/15 the investment management costs of Fund 1 the main fund, increased from £104 million (restated) to £125.6 million.

92. Exhibit 3 shows provisional figures for total management costs as a percentage of net assets across the Scottish Local Government Pension Funds, with investment management costs for SPF highlighted.

Exhibit 3: Investment management expenses as a % net assets



Source: Draft financial statements 2014/15

93. At just over 0.8% on net assets, SPF would appear high when compared to other pension funds. However, this graph does not highlight the impact of the differing investment strategies within the individual funds. SPF has considered each of its investment managers and begun to benchmark performance of each manager in relation to investment expenses. This additional transparency should assist with management's evaluation of whether value for money is being achieved.

Refer Action Plan no. 2

National performance audit reports

94. Audit Scotland carries out a national performance audit programme on behalf of the Accounts Commission and the Auditor General for Scotland. During 2014/15, there were no reports issued which were directly related to Pension Funds.

95. However the following local government reports were issued during the year which contained topics which would be of general interest to members':

- Scotland's public finances follow-up: Progress in meeting the challenges (June 2014).
- Update on developing financial reporting (March 2015).
- An overview of local government in Scotland (March 2015).

96. These and other performance audit reports are readily accessible on Audit Scotland's website (www.audit-scotland.gov.uk).

Appendix I – Significant audit risks

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

Audit Risk	Planned Assurance procedure	Results and conclusions
Risk of material misstatement in the financial statements		
Investment Management Expenses In June 2014, CIPFA published guidance for the consistent reporting of local government pension scheme management costs. The guidance sets out a framework which recommends disclosure of specified categories of management costs in the notes to the 2014/15 financial statements. As this has never been done before, it is likely to be a challenging exercise. **Risk:** That the 2014/15 financial statements will not be prepared in line with the CIPFA guidance on investment management expenses and that there is insufficient audit evidence to provide certainty as to the amounts disclosed as investment management expenses.	• We will review the calculation of the investment management costs and confirm to supporting evidence and records. • We will review the disclosure of investment management costs against CIPFA guidance.	• We performed a full review of the management expenses reported in the financial statements. • We examined supporting evidence obtained by the pension fund from the investment managers. • We reviewed the accounting entries. We concluded that management expense are correctly accounted for and are supported by appropriate evidence.

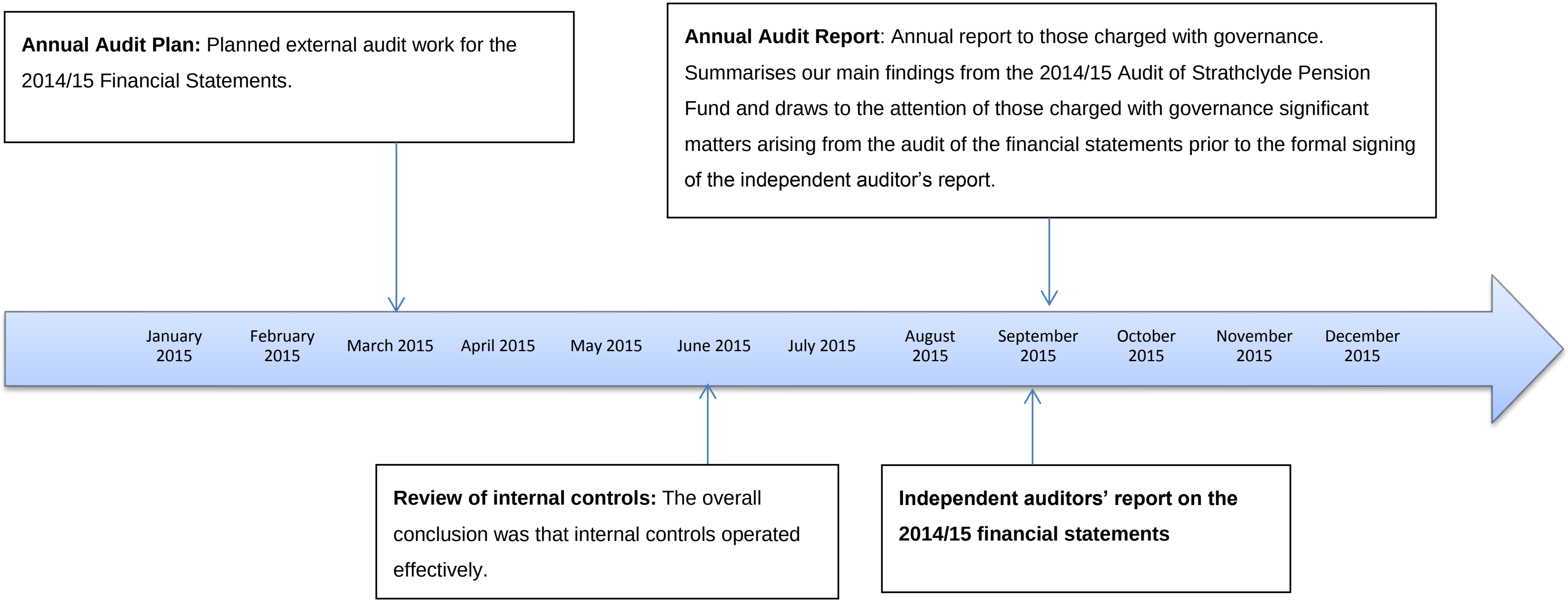
Audit Risk	Planned Assurance procedure	Results and conclusions
Income Strathclyde Pension Fund receives a significant amount of contribution income and investment income from third party sources. The extent and complexity of income means there is an inherent risk of fraud in accordance with ISA240.	• We will evaluate the effectiveness of systems of internal control for income recognition and recording including analytical review of income streams and testing controls. • We will review the content of service auditor reports.	• We reviewed service auditor reports reviewed. No issues were recorded. • We reviewed reconciliations undertaken by officers. • We agreed income to supporting documentation. We have no issues to report.
Management override of controls As stated in ISA 240, there is a risk that 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.	• We will carry out detailed testing of journal entries. • We will review accounting estimates for bias. • We will evaluate significant transactions that are outside the normal course of business.	• We carried out detailed testing of journals. We have no issues to report.
Requirements of new accounting regulations The Local Authority Accounts (Scotland) Regulations 2014 introduce some changes to the contents of the financial statements and the approval processes for the annual accounts. **Risk**: That the financial statements do not comply with the new regulations and are not approved in accordance with the new regulations.	• Our audit of the 2014/15 financial statements will review compliance with the new accounting regulations. • We will liaise with officers to ensure audit work can be completed in sufficient time to allow approval of the audited accounts by 30 September.	• Financial statements have been produced in a timetable compliant with local government regulations. • Following discussions with audit, additional disclosures were added to enhance the management commentary.

Audit Risk	Planned Assurance procedure	Results and conclusions
Financial position The early retirement/severances schemes put in place by many of the large participating employers in the last few years has put pressure on the fund's cash flows. This has also decreased the number of active members within the scheme. The fund's ten year cash flow statement projects that the fund will have to rely on investment income to pay pensions within the next ten years. **Risk**: There is a mismatch between the fund's funding and investment strategies leading to pressure on cash flow within the pension fund.	• We will review the financial position of the pension fund and the quality of financial reporting. • We will review the membership position of the fund. • We will review any changes made to the Investment Strategy and monitor impact.	• We considered the financial position along with the Fund's revised investment strategy. We note that there was a negative cash flow position at 31 March 2015.
Administration performance Although administration performance is improving, over 2014/15 performance levels are below target in a number of areas in particular with regards to retirals. **Risk:** That administration performance continues to decline with an adverse impact on the quality and timeliness of the provision of pension fund administration services.	• We will continue to monitor administration performance as reported to members. • We will consider the impact of any administration delays on audit approach.	• We reviewed administration performance at year end. We did not consider that administration delays impacted on our audit approach.

Audit Risk	Planned Assurance procedure	Results and conclusions
Local Government Pension Scheme Reform The new Local Government Pension Scheme requires, from 1 April 2015, the operation of a Local Pension Board and the introduction of career average earnings pensions. The introduction of career average pensions will require the pensions administration system to be upgraded and is likely to increase administrative workload. **Risk**: The Fund does not have an appropriate Pensions Board in place by 1 April 2015 and that pensions systems and processes cannot accommodate the new career average data requirements leading to delays or errors in calculating benefits.	• We will monitor progress to ensure adherence to required timetable. • We will review the pension administration systems to assess ability to correctly deal with career average pensions.	• Pension Board in existence by the 1 April 2015. • Elements of the scheme remain to be implemented.
Orphaned liabilities Orphaned liabilities relate to liabilities within the scheme where the employer no longer exists. Due to continued economic and funding pressures on employers, there remains the potential for employer defaults and significant orphaned liabilities for which there is no adequate matching asset. **Risk**: There is a risk that there will be increasing cessation liabilities that are not settled by employers. This will impact other pension fund member employers and require appropriate disclosure in the financial statements.	• We will consider any orphaned liabilities and any required accounting disclosures.	• We reviewed the fund's processes and procedures for dealing with employer cessations and also discussed these with officers. We have concluded that although there is a risk to the fund from employer cessations, this risk is adequately managed.

Appendix II

Summary of Strathclyde Pension Fund local audit reports 2014/15



Appendix III – Action plan

No. Para	Issue/risk/Recommendation	Management action/response	Responsible officer	Target date
1 **Para 31**	**Funding position** The fund has reported a deficit in dealings with members in 2014/15. Although active membership has increased, the continued change in the fund's membership will make funding pension payments increasingly challenging in the medium to long term as the proportion of retired members grows. This may be further exacerbated as further funding cuts are predicted within public spending in the coming years. The Fund's cash flow projections show that the fund will rely on investment income to pay pensions within the next ten years. **Risk** A mismatch between the fund's funding and investment strategies leads to insufficient cash flow or over exposure to volatile markets. **Recommendation** The Fund should continue to closely monitor the implementation of the Funding and Investment Strategies and the impact on the Fund's cash flow position.	The Fund is keenly aware of this issue. It is natural for any pension fund to see its liabilities mature over time and to adapt its investment and funding strategies and some aspects of its financial management to accommodate this. This process has been accelerated recently by significant workforce reductions by the Fund's employers. The impact of this was apparent in the 2011 actuarial valuation and looks set to continue, though the future pattern may be uneven. The 2014 actuarial valuation adopted a more probability based focus and this has been extended to the risk-based investment framework agreed in the subsequent review of investment strategy. These will both be important in managing the Fund going forward as will experience gained in managing the already very mature No.3 Fund.	Head of Pensions	Ongoing/ actuarial valuation as at 31 March 2017

No. Para	Issue/risk/Recommendation	Management action/response	Responsible officer	Target date
2 **Para 93**	**Management expenses** The main aims of the CIPFA guidance on management expenses were to improve transparency and consistency of reporting across the financial statements of Pension Funds. 2014/15 is the first year that SPF's financial statements separately disclose the cost of management expenses. The value of the expenses reported within SPF should be viewed in the context of returns that have been achieved by all the fund managers. The pension fund should continue to develop the use of bench-marking of investment manager expenses to ensure that value for money is being achieved **Risk** That investment management expenses do not represent value for money **Recommendation** Management should make use of the additional information that is now available on the costs of management expenses to inform their reviews of investment managers' performance.	The Fund has always been very conscious of costs. Fees and other costs have been a significant factor in investment manager appointments, and costs have always been closely monitored. However, the Fund has been prepared to incur higher costs where they could add net value. This has been the case in particular with the Fund's private equity programme which carries a high level of cost but has delivered a commensurately high level of performance since its inception. The Fund will continue to consider costs and value very carefully as it develops its investment strategy	Chief Pensions Officer (Investments)	Ongoing

No. Para	Issue/risk/Recommendation	Management action/response	Responsible officer	Target date
3 **Para 71**	**Local government pension scheme** The new pension regulations took effect from 1 April 2015. However, there are aspects of the new scheme which may still impact on the pension fund, such as the implementation of freedom and choice and the earlier production of members' statements. When considered in line with the on-going auto-enrolment and an end to contracted-out benefits, there may be further pressures to be experienced with pension administration at the pension fund. **Risk** That further changes within the scheme place additional pressures on administration performance **Recommendation** The impact of future developments on levels of administration performance should continue to be kept under review.	The Fund is an active participant in a number of pensions industry bodies and this helps with awareness of future developments. Over the last years the Fund has reviewed its administration processes, restructured its administration teams upgraded its systems and improved its communications – in particular its digital delivery – to address the growing complexity of the pensions environment. This trend looks set to continue and the Fund will continue to evolve to meet new challenges as they arise.	Principal Pensions Officers	Ongoing