North East Scotland Pension Funds

2015/16 Audit

Annual Audit Report to Members and the Controller of Audit

September 2016

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

Stephen Boyle is the engagement lead for the audit of North East Scotland Pension Funds for the period 2012/13 to 2015/16.

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

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.

Contents

Key messages

Audit of financial statements	• The independent auditor's report on the 2015/16 financial statements of the North East Scotland Pension Fund (the main fund) and the Aberdeen City Council Transport Fund (the transport fund) is unqualified. • Management costs in the audited accounts have been reduced by approx. £4m to reflect the funds' early adoption of revised CIPFA guidance, otherwise there were no significant amendments made to the accounts as a result of the audit.
Financial management and sustainability	• During 2015/16, the main fund's net assets increased by £10.4m to £3,182m, an increase of 0.33% in the year. This was significantly less than the previous year due to widely fluctuating market conditions. • Estimated pension liabilities have reduced by 1.9% to £3,803m due to an increase in the discount rate used to estimate their current value. Funding levels for the main and transport funds ended the year on 84% and 85% respectively. The fund has requested an interim actuarial valuation as at 31 March 2016 to maintain oversight of the position. • Overall, the funds' financial management arrangements are sound but there is scope to further improve performance reporting to the Pensions Committee.
Governance and transparency	• The Pensions Board was established in March 2015 and meets concurrently with the Pensions Committee. There has been a good level of engagement between committee and board members. • There are open and transparent arrangements in place, and there are areas where practices continue to be improved to meet requirements e.g. formalising arrangements for reporting to the Pension Regulator. • Systems of internal control operated effectively and there are sound arrangements for the prevention and detection of fraud and corruption.

Best Value	• The main fund performed below benchmark for the year. Investment performance over 3 and 5 years periods were closer to the benchmark but remained below target. • The Transport Fund's performance has been volatile and its funding level is below that of the 2014 actuarial valuation. New fund management arrangements are being negotiated following the decision to terminate the previous mandate. • Administration performance is positive and the average cost per member is among the lowest in Scotland.
Outlook	• The outlook for local government and pension funds remains challenging as funding cuts continue to impact staff numbers in local government and across the public sector. • The aftermath of the vote to leave the EU has led to volatility in the markets which is likely to have an adverse impact on investment performance in the short term. A period of ongoing uncertainty may increase the challenges around future investment strategy and achievement of performance targets. • Scrutiny of investment performance and scheme management costs are likely to come under increasing scrutiny and Scottish Ministers have already expressed an interest in the views of the national Scheme Advisory Board on fund structure and asset pooling.

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 (LGPS).

Our Annual Audit Report

2. This report is a summary of our findings arising from the 2015/16 audit of NESPF. The report is divided into sections which reflect our public sector audit model:
   - financial statements
   - financial management and sustainability
   - governance and transparency; and
   - best value/value for money.
3. Our responsibility, as the external auditor for NESPF 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. A revised Code was issued in May 2016 and while it is effective from 2016/17, the principles have, where possible, been adopted early as part of the 2015/16 audit.
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. The management of NESPF is also responsible for:
   - implementing appropriate internal control systems
   - putting in place proper arrangements for the conduct of its affairs
   - ensuring that the financial position is soundly based.
6. **Appendix II** 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".
7. We recognise that not all risks can be eliminated or even minimised. What is important is that NESPF understands its risks and has 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.

8. 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.

9. The cooperation and assistance afforded to the audit team during the course of the audit is gratefully acknowledged.

Our audit appointment

10. Audit Scotland is responsible for public sector audit in Scotland with audit appointments generally covering a five year cycle. The financial year 2015/16 is the final year of the current cycle. From 2016/17, the auditor of NESPF will continue to be Audit Scotland but conducted under a different engagement lead (Gillian Woolman, Assistant Director). In accordance with agreed protocols and international standards on auditing we will be liaising with the incoming auditors as part of this transition.

11. From 2016/17, as well as the annual audit report, other significant outputs, such as the annual audit plan, will be published on Audit Scotland's website.

Audit of the 2015/16 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 events or conditions that may cast significant doubt on the pension fund's ability to continue as a going concern.
Annual report & other information	• We review the annual report and information published with the financial statements, including the management commentary, annual governance statement and the governance compliance statement. We have nothing to report in respect of these statements.

Submission of financial statements for audit

12. We received the unaudited financial statements on 15 June 2016, 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.

Overview of the scope of the audit of the financial statements

13. 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 11 March 2016.

14. 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 2015/16 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.

15. 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.

16. 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

17. 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).

18. 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.

19. 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, £1.355m for the fund account (FA) and £31.713m for the net assets statement (NAS) and
- for the transport fund, £34,000 for the fund account and £896,000 for the net assets statement.

20. We report all misstatements greater than £34,000 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 2015/16, these were calculated as:

- for the main fund, £678,000 for the fund account and £15.857m for the net assets statement
- for the transport fund, £17,000 for the fund account and £448,000 for the net assets statement.

21. 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

22. All misstatements identified during the audit, which exceeded our misstatement threshold, have been amended in the financial statements. The main adjustment is a decrease of £3.956m in management expenses due to the funds' early adoption of revised CIPFA guidance on pension scheme management costs. The matter is explained further at page 22.

Exhibit 1: Materiality levels

	Materiality £'000	Performance Materiality £'000	Clearly Trivial £'000
Main Fund	1,355 (FA) 31,713 (NAS)	678 (FA) 15,857 (NAS)	34 (FA) 100 (NAS)
Transport Fund	34 (FA) 896 (NAS)	17 (FA) 448 (NAS)	1(FA) 22 (NAS)

Significant findings from the audit

23. 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.

24. Table 1 on page 10 details those issues or audit judgements that, in our view, require to be communicated to those charged with governance in accordance with ISA 260.

Future accounting and auditing developments

Code of Practice on Local Authority Accounting

25. The financial statements of pension funds are prepared in accordance with the Code of Practice on Local Authority Accounting in the UK (the Accounting Code) which interprets and adapts International Financial Reporting Standards (IFRS) to the local authority context. There are amendments to the Accounting Code in respect of:
    - amendments to the format of the accounts to be consistent with the new Financial Reports of Pension Schemes – A Statement of Recommended Practice 2015
    - new disclosure requirements for investments measured at fair value
    - recommendations for new disclosure on investment management transaction costs.

Table 1: Significant findings from the audit (in accordance with ISA260)

Issue	Resolution
1. Investment Management Expenses – From 2014/15, the Code of Practice on Local Authority Accounting has required 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. This sets out a framework for consistent disclosure of administrative expenses analysed across Administration Expenses, Oversight and Governance Expenses and Investment Management Expenses. One of the most common areas of uncertainty is the identification of private equity fees. The fund took the same approach as the previous year and contacted private equity managers to obtain the necessary information for both the current and previous years. The private equity fee returns from the fund manager included 2 elements - fees directly attributable to the pension fund and indirect fees, those attributable to the overall fund of funds. In June 2016, CIPFA issued revised guidance on accounting for pension fund management costs. One of the main changes was to amend the 2014 guidance which previously stated that investments management expenses should be ‘ reported up to the authority where the investments are actually made’ (all fees) to only ‘reported up to the level where the pension fund has contractual liability to pay; and control’ i.e. direct fees only. While the revised guidance is applicable from 2016/17, there was an option for early adoption which NESPF opted to do by amending the accounts provided for audit. The consequence of this decision has been to remove £3.956 million of indirect management fees from the accounts.	We concurred with this treatment. The revised accounts were amended to reflect the revised guidance.

Issue	Resolution
2. Private Equity Investments - Included in the Net Assets Statement for the main fund is £180m representing private equity investments held at 31 March 2016. 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 2016 were received by the pension fund in July 2016 and showed that the amount in the accounts was overstated by £22,745. Whilst this amount is not material, the funds opted to make the adjustment to ensure accurate opening balances both in terms of the accounts and the balance to be transferred to the new global custodian.	The revised accounts were amended to reflect the year end valuation.

Issue	Resolution
3. Impairment Losses – Included within sundry debtors is an amount of £0.173m representing outstanding strain on the fund contributions due to the pension fund from Oakbank School Trust, an admitted body of the fund. 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 approximately £2m due to the pension fund from the admitted body which represents the final amount due following a termination valuation, initially carried out by the actuary in 2011. The pension fund has been negotiating collection of this amount for several years but payment has been dependent on the trust putting an alternative arrangement in place to ensure that its pensioners continue to receive all their retirement related benefits once the Trust has been legally wound up. Due to the time which had elapsed, a potential impairment loss was recognised in a note to the accounts. This was initially disclosed in the funds' 2011/12 accounts and as the negotiations continued, the amount was carried forward in the accounts each year thereafter. With regard to the 2015/16 financial statements, the relevant disclosure is contained in Note 24. The agreement of all relevant parties was formally obtained, enabling final transfer documentation to be concluded and the cash was released in full to the pension fund on 16 September 2016. .	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. The outstanding termination value was identified within a provision for impairment losses contained in a note to the accounts (note 24). This note has been updated to acknowledge that an event subsequent to the date of the net assets statement has taken place by confirming receipt of the final amount due to the fund from this employer. On the basis that the amount involved is not material, no adjustment has been made to the Fund Account/Net Assets Statement to reflect the final sum collected from Oakbank Trust. We concur with the accounting treatment of this matter.

Financial management and sustainability

Combined dealings with employers and members - net income - £1.9m	Combined returns on investments - £21.9m	Combined asset value increased 0.22%	Funding Level at 31/03/16
Contribution income £124.6m	Net income from investments £52.9m	Main Fund investments up 0.33%	Main Fund 84%
Pension Costs £122.7m	Capital growth (£31.0m)	Transport Fund investments down 3.8%	Transport Fund 85%

Financial management

Financial performance and sustainability

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

27. 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.

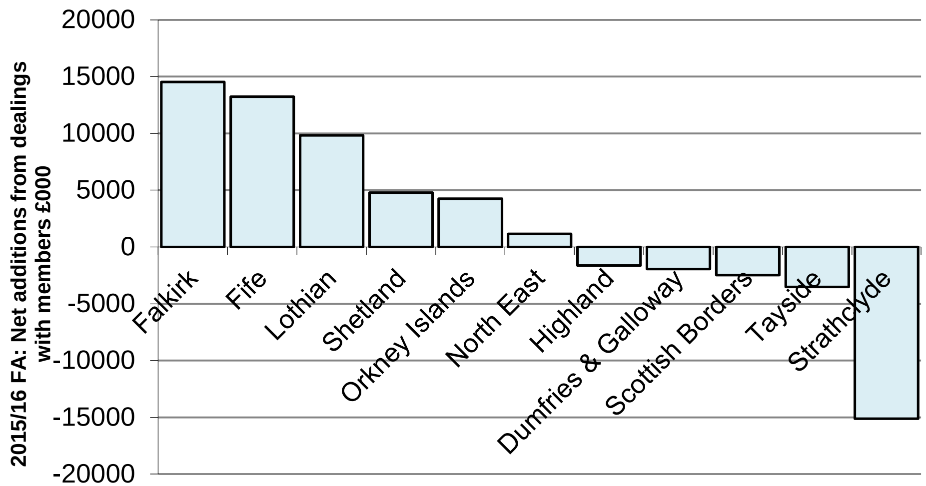
28. Pension fund finances are independently assessed every three years by the funds' actuary, most recently as at 31 March 2014. Employer contribution rates are determined by the actuary and used by the council as administering authority to set estimates for the pension funds' expenditure and income.

29. Setting the funds' investment strategy and monitoring performance against it are key aspects of financial management. Investment strategy is a complex area and has to take account of factors such as the overall fund deficit, cash flows from dealing with members and the maturity of fund membership. Balancing the risks and rewards from various asset types and approaches is something that the fund takes advice on from professional advisors.

Financial outcomes

30. During 2015/16, net assets of the main fund grew by £10.4m to £3,182m, an increase of 0.33% in the year, this was significantly lower than the prior year which experienced an increase of 11.3%. Only £3.0m of the 2015/16 increase came from dealings with members. This is broadly consistent with the previous year's level. Contributions increased by £3.7m which included implementation of an increased contribution rate for one of the main scheduled employers following the 2014 actuarial valuation. The rise in income however was largely matched by an increase in retirement and other benefits of £3.4m. This position is reflective of the last few years. Exhibit 2 shows the position for all local government pension schemes in Scotland.

Exhibit 2 – Net Additions from Dealing with Members



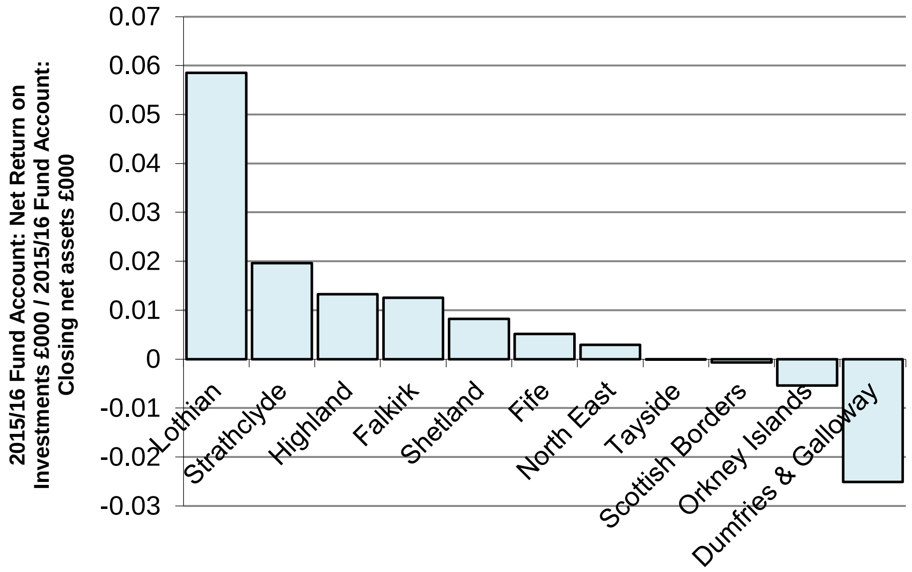
Source: Audit Scotland – Unaudited Pension Fund Annual Accounts Database

31. Assuming rates remain constant and public sector pay increases remain low, there is an ongoing risk that employer contributions may increase at a slower rate than benefit payments and therefore not be sufficient to meet such payments. This potential situation could be alleviated in NESPF next year when two of the fund's larger scheduled bodies are due to implement auto-enrolment. The fund retained a higher number of new members than anticipated when the administering authority introduced auto-enrolment and consequently, a similar outcome is anticipated next year.

32. However, the fund recognises the potential pressures of falling contributions relative to benefit payments and aims to address this challenge through the investment strategy agreed with fund managers. In addition, the fund has instructed an interim actuarial valuation to be carried out as at 31 March 2016. This should be available in autumn 2016.

33. The performance of the fund's investment assets in 2015/16 relative to other funds is reflected in the net return on investments set out in Exhibit 3. In this case, the main fund had a lower return than most other funds.

Exhibit 3: Net Return on Investments



Source: Audit Scotland – Unaudited Pension Fund Annual Accounts Database

Sustainability

34. The fund gives its members a guarantee that in exchange for contributions during their employment, it will pay pension benefits in the future to members, or their spouses and dependents subject to personal circumstances. There is a timing difference of many years between the receipt of contributions and the payment of pensions. Financial sustainability means that the fund maintains the capacity to meet the current and future needs of its members, despite changes in investment performance and life expectancy.

35. In assessing financial sustainability we are concerned with whether:

- the fund's liabilities are greater or smaller than the fund's assets (the actuarial position)
- contribution rates strike an appropriate balance between the needs of the scheme and the needs of employers
- where there is a deficit, long term recovery measures are in place
- the fund's investments have a profile of risk that is consistent with expected cash flows.

36. Effective investment strategy, investment management and regular actuarial review are crucial to sustainability.

37. The main fund is a multi-employer fund with 11 scheduled bodies, 11 transferee and 33 admitted bodies. Given the nature of these employers the funding risk associated with default is seen as relatively low and the fund currently plans to recoup deficits over a 19 year period for most employers.

38. The new LGPS includes a cost sharing arrangement which will cap employer costs in relation to current service and help ensure that the schemes remains affordable for employers. Additionally, the retirement age for most LGPS members going forward is linked to the state retirement age and this may also act to limit scheme liabilities for active members.

39. Exhibit 4 shows that fund assets do not cover the fund's estimated liabilities. Liabilities have reduced by 1.9% due to an increase in the discount rate used to estimate their current value (which reflects an increase in high quality corporate bond rates during 2015/16).

Exhibit 4: Snap-shot of assets and liabilities – Main Fund

	2014 Valuation £m	2015 Roll-forward estimate £m	2016 Roll-forward estimate £m
Assets	2,834	3,162	3,182
Liabilities	3,025	3,874	3,803
Net surplus/(liability)	(191)	(712)	(621)
Funding Level	94%	82%	84%

Source: NESPF Annual Accounts

40. In the unlikely event that the fund was wound up immediately, employers would be left with an estimated funding gap of around £621m based on estimates at 31 March 2016.

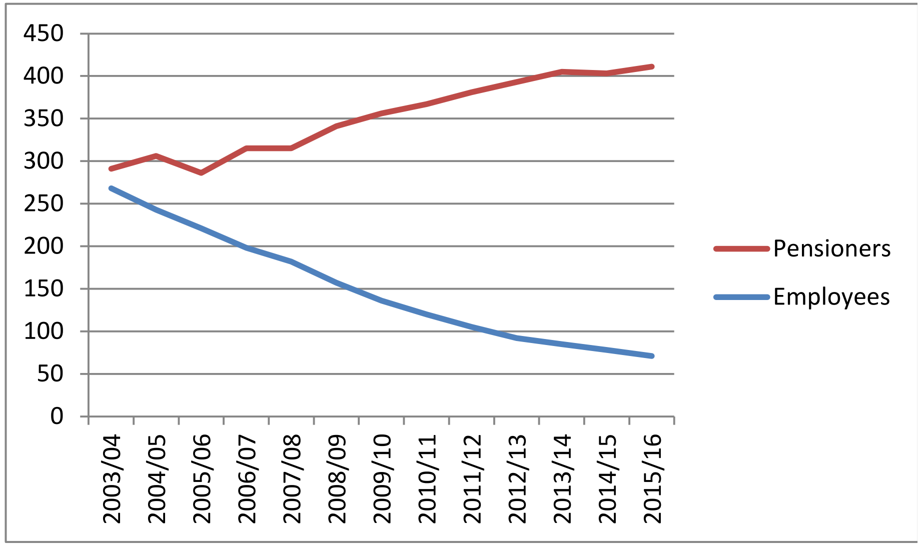
41. The triennial valuation carried out as at 31 March 2014 showed that the fund could cover 94% of its liabilities as set out in Exhibit 4. The roll forward position at 31 March 2016 shows a slightly improved position on that at 31 March 2015 although it is still below the valuation. The fund however, continues to be considered as a going concern as the funding position is calculated every three years by an actuary. Nonetheless, the fund has been proactive in recognising and taking action in respect of the diminished position and has requested that the actuary carry out an interim actuarial valuation at 31 March 2016. The results of this are expected to be available to the fund at the end of October 2016.

Transport Fund

42. 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 5 shows the membership profile of the transport fund. Currently, the proportion of active employees represents only 11% of the membership (2014/15 12%).

43. In recognition of the above, in March 2015, the Pensions Committee implemented a de-risking strategy for the fund with the aim to provide more certainty over investment values and easier access to funds to meet liabilities as the fund matures and reduce the risk associated with existing equity investments by replacing them with lower risk bonds and pooled investments. The strategy also saw a move to monitoring against a funding target of 100% as opposed to a performance benchmark.

Exhibit 5: Transport fund – Trends in Membership



Source: NESPF Annual Accounts

44. The net assets of the transport fund decreased by £3.4m during the year which is a significant change compared with the increase of £9.8m in the previous financial year. The annual cost of pensions and benefits is approximately £1.1m more (2014/15 £0.7m more) than contributions received from members. This outcome will continue due to the closed nature of the fund and hence the change in strategy so that the fund is better placed to meet the liabilities of a maturing fund with a reducing number of contributing members. Exhibit 6 shows the falling funding position at 31 March 2016 compared to the previous year and the last actuarial valuation in 2014.

Exhibit 6: Snap-shot of assets and liabilities – Transport Fund

	2014 Valuation £m	2015 Roll-forward estimate £m	2016 Roll-forward estimate £m
Assets	79.8	89.6	86.2
Liabilities	86.2	103.8	101.1
Net surplus/(liability)	(6.4)	(14.2)	(14.9)
Funding Level	93%	86%	85%

Source: NESPF Annual Accounts

Financial management arrangements

45. 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.

46. 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.

47. Aberdeen City Council's financial regulations, as those of the administering authority, 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.

48. The fund submits three types of financial information to the Pensions Committee covering fund performance, funding position and budget monitoring. We confirmed that asset and investment performance reports and reviews against investment strategy are submitted to the Pensions Committee on a quarterly basis. While reports are comprehensive, providing performance information at both a fund and individual manager level, we made the following observations:

    - we previously commented that there was scope for more clarity around performance against benchmarks due to the number of targets used. With the introduction of the Pensions Board, there is scope to revisit the range of information produced to ensure it provides the right detail to meet committee and board members' requirements
    - we also noted that the funding position for both funds is no longer reported to committee as regularly as it was in the past. In light of the current position and the request for an interim valuation, this information should be regularly provided to committee for members' scrutiny

      Refer Action Plan, Recommendation 1

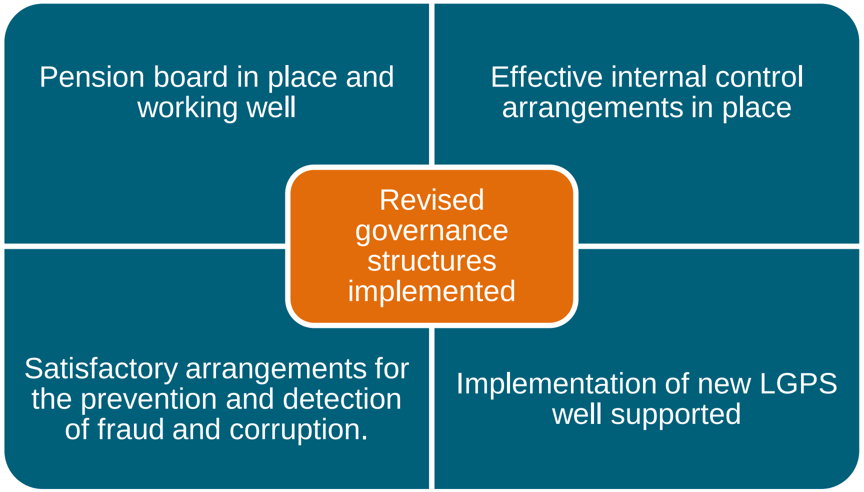
    - the council agrees a budget for the funds' administration costs and management fees and in accordance with the committee's remit, budget monitoring should be reported to the Pensions Committee twice a year. Reporting in this area has improved during the year with the consideration of quarterly reports now taking place since September 2015.

Outlook

49. The financial outlook across the public sector and in local government in particular remains challenging. Recent revisions to the LGPS should help ensure that the scheme is affordable to employers going forward whilst the scheme remains attractive to employees.

50. It is perhaps inevitable that management costs and investment performance will come under increasing scrutiny given the financial pressures faced by employers and employees alike. Pension funds may need to be more radical in their approaches to administration and investment going forward.

Governance and transparency



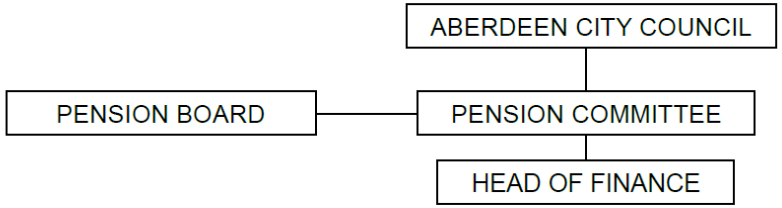
51. Members of Aberdeen City Council's Pensions Committee and the Head of Finance as the Proper Officer are responsible for establishing arrangements for ensuring the proper conduct of the affairs of the NESPF and for monitoring the adequacy and effectiveness of these arrangements.

52. As part of our work we reviewed various aspects of governance that apply to the fund including standing orders, financial regulations, Codes of Conduct for officers and members, anti-fraud and corruption arrangements, and arrangements for reporting to the Pension Regulator on breaches of regulation.

Governance structure

53. The Local Government Pension Scheme (Governance) (Scotland) Regulations 2015 (2015 Regulations) set out new governance arrangements for LGPS pension funds from 1 April 2015 one of which was the requirement for funds to set up local pension boards. The Pension Board (shown in Exhibit7) is responsible for assisting the administering authority in complying with scheme regulations and with requirements the Pension Regulator.

Exhibit 7: Governance structure



Source: NESPF Governance Policy Statement

54. The Pension Board consists of 4 employer representatives and 4 union representatives and each side appoints a joint secretary. The Board currently has one member vacancy in respect of one of the trade unions although efforts are being made to appoint one. The Board chair is alternated each year and we noted that the second chair took up post in May 2016.

55. We reviewed the overall operation of the Pensions Board against the requirements set out in the 2015 Regulations and noted the following:

- meetings of the Pension Committee and Pension Board were held concurrently throughout 2015/16. In addition, there have been joint training events. Working arrangements are satisfactory with a good level of interaction and engagement between committee and board members.
- if at least half the members of the Pension Board disagree with a decision of the Pension Committee, they can request a review of the decision. There have been no requests to review decisions in 2015/16.
- arrangements need to be put in place for Pension Board members to declare conflicts of interest.

Refer Action Plan, Recommendation 2

56. It will take time for these new arrangements to fully bed in and ongoing training and support will be necessary for board members to enable them to effectively fulfil their role

Implementation of the CARE scheme

57. 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. Two of the main changes were:

- 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.

58. In our 2014/15 Report, we confirmed that the funds were well prepared for implementation of the scheme. From our discussions with officers and review of evidence, we note that the implementation of the Scheme has continued to be facilitated in the following ways:

- issues arising from the scheme’s introduction have continued to be discussed at regular staff meetings post implementation. There is also an internal webpage linking to both internal and external guidance/regulations a range of guidance notes staff can access
- quarterly employer bulletins advised of scheme updates
- an administration forum was held for employers as a refresher course following the introduction of the new scheme in September 2015 covering such areas as CARE pay and contributions, assumed pensionable pay, retirement and rule of 85. This was well attended.

59. Based on our work during the year, we were satisfied that benefits and other payments made by the scheme were calculated correctly. Overall, in our opinion, the funds’ had sound arrangements in place to support the implementation and continued operation of the new scheme.

Pension Regulator public service code

60. The Public Sector Pensions Act 2013 provided for extended regulatory oversight by the Pensions Regulator. The Pension Regulator issued a code on the governance and administration of public service pension schemes in January 2015 (TPR Code) which funds are expected to comply with. A report assessing the funds' compliance with TPR code was submitted to the Pensions Committee in September 2015. Areas of weakness identified were flagged around pension board training, the lack of a formal policy for reporting breaches and the absence of a process for pension board members to declare any conflicts of interest.

61. We have reviewed the arrangements and processes in place during the year and found that steps have been taken to resolve these matters, as follows:

    - training provided to pension board members has mainly focused on investments with little coverage of TPR code requirements. This will be addressed during the 2016/17 training programme through the use of an online toolkit provided by the Pensions Regulator.
    - a policy for reporting breaches was implemented in October 2015. While this had not been in place throughout 2015/16 there are sufficient records to identify any breaches but there was no overall mechanism to centrally collate and record breaches. This has been addressed in 2016/17 with the creation of a breaches register which has been backdated to include 2015/16 and will shortly be endorsed by committee.
    - In respect of conflict of interest declarations, the Governance Team has developed a policy whereby board members will be required to complete a form to declare any interest and confirm the accuracy of records held on an annual basis.

Refer Action Plan, Recommendation 2

Internal control

62. The Accounts Regulations 2014 require the Pension Committee to consider the findings of an annual review of the system of internal control and to approve the Annual Governance Statement for the pension fund.

63. As part of our audit we reviewed the high level controls in a number of systems fundamental to the preparation of the financial statements. Our objective was to obtain evidence to support our opinion on the funds' financial statements.

64. No material weaknesses in the accounting and internal control systems were identified which could adversely affect the ability to record, process, summarise and report financial and other relevant data so as to result in a material misstatement in the financial statements. Our findings included recommendations to enhance the control system in operation.

65. For example, in respect of contributions, we have seen improvements in this area during the year with the largest scheduled bodies now providing information via I-Connect, a cloud based portal for employers to provide monthly payroll data which identifies changes for automated processing onto the pension administration

system. The implementation of I-Connect enables officers to carry out regular checks.

66. The new checks, involving completion of a checklist, are carried out by the recently formed Employer Relationship Team to confirm if employer contribution details reconcile with the pensions administration system. These checks are part of the reporting requirements to support the funds' Administration Strategy. While checks have been carried out throughout 2015/16, formalisation of the checklist has only been in place since November 2015.

67. We have recommended that the Employer Relationship Team and the Accounting Team liaise on the different reconciliations carried out by their respective teams with regard to the different employers in order to streamline activities and strengthen the overall audit trail.

Internal audit

68. Internal audit provides members and management of the council/funds with independent assurance on risk management, internal control and corporate governance processes for the pension fund. The internal auditor provider for the pension funds changed from PricewaterhouseCoopers to Aberdeenshire Council's internal audit section from 1st April 2015.

69. We are required by international auditing standards to make an assessment of internal audit to determine the extent to which we can place reliance on its work. We concluded that internal audit was provided in accordance with Public Sector Internal Audit Standards which enabled us to take assurance from their documentation and reporting procedures.

70. As the new internal audit arrangements had just been implemented, the internal audit plan had only been considered by the council's Audit, Risk and Scrutiny Committee. Separate arrangements were not made for the pensions committee. This was rectified in June, when the committee considered the 2016/17 internal audit plan.

71. The 2014 Accounts Regulations also require a regular review of the effectiveness of internal audit to be undertaken. Now that the Regulations have operated for a couple of years, plans should be put in place to have an independent review carried out.

Refer Action Plan, Recommendation 3

Investment management

72. The Pensions Committee receive regular reports enabling them to scrutinise fund management performance. In December 2015, the committee took the decision to terminate Aberdeen Asset Management as a fund manager for both funds. The relevant portfolios continued to be managed by the fund manager for the remainder of 2015/16 while decisions were taken over future plans for those investments.

- a main fund portfolio of c.£200m was transferred in April 2016 using a transition manager to diversified growth funds held by Invesco and BlackRock
- the remainder, c.£60m was held for future investments.

- Frontier portfolio was liquidated over the course of a number of months in 2016/17
- discussions are ongoing with the preferred manager identified to manage transport fund investments.

73. We reviewed the decision to replace the fund manager and the funds' approach to managing the transition process and were satisfied with the actions taken.

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

74. The pension funds complied with the relevant fraud and irregularity policies of Aberdeen City Council during 2015/16. The funds' arrangements for the prevention and detection of corruption are also satisfactory. For completeness, we recommend that an annual activity report summarising fraud/suspected fraud cases, whistleblowing cases and breaches of the Bribery Act, even if this is a nil report. Where appropriate, such a report would also include any lessons learnt and action taken. Otherwise we are not aware of any specific issues that need to be recorded in this report.

Refer Action Plan, Recommendation 1

Transparency

75. 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.

76. The annual report and accounts is comprehensive and helps ensure a good level of financial scrutiny and accountability.

Management costs

77. 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.

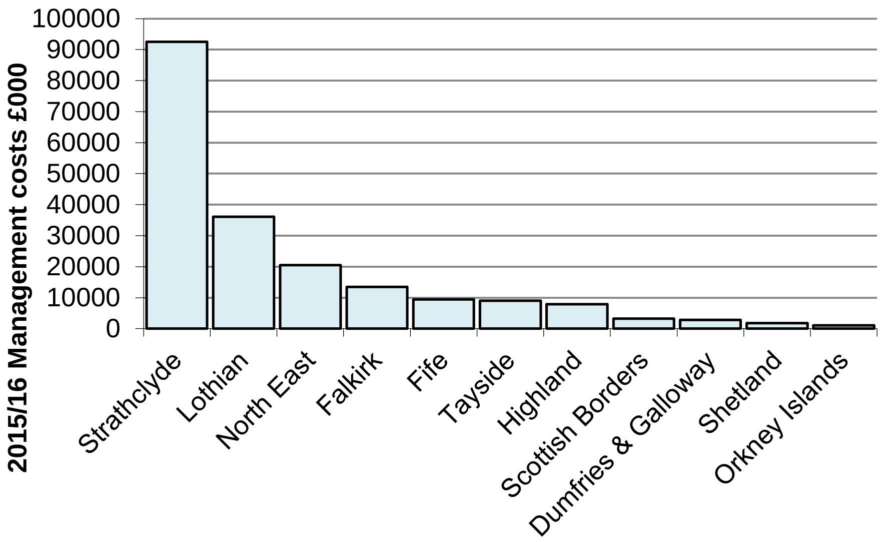
78. In 2014/15, CIPFA's issued guidance on accounting for local government pension scheme management costs which set out a common methodology for the classification and accounting of management costs and provided a framework for better data comparison.

79. Exhibit 8 sets outs a comparison of management costs across the Scottish funds as disclosed in their 2015/16 unaudited accounts. This shows NESPF's management costs to be the 3rd highest in Scotland. The position is similar when analysing the costs as a proportion of net assets as demonstrated in Exhibit 9. This is

perhaps indicative of the limited growth of the Fund’s assets during 2015/16.

80. The above comments assume a like for like comparison of costs but we recognise that different funds will have different types of investment and some may have been more rigorous than others in identifying management costs. As stated at paragraphs 22 and 24, the accounts have subsequently been amended to remove indirect investment management expenses in line with revised CIPFA guidance.

Exhibit 8: – Total Management Costs – Scottish Funds



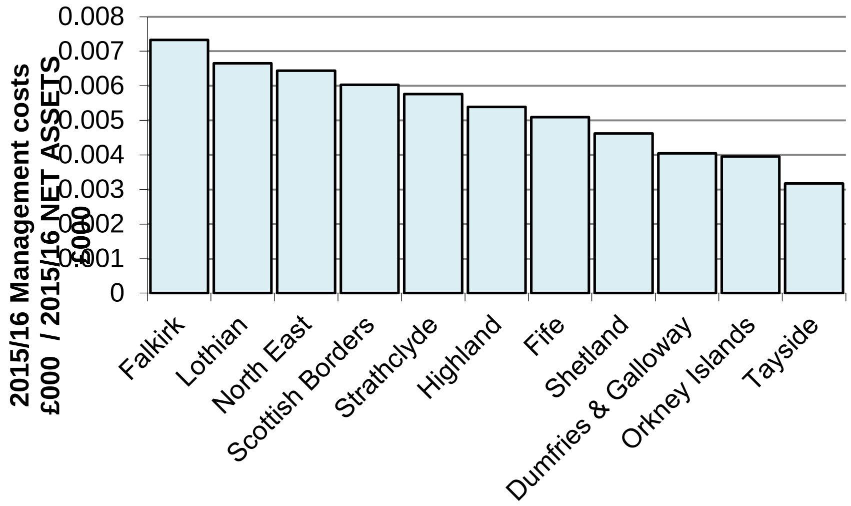
Source: Audit Scotland – Unaudited Pension Fund Annual Accounts Database

Outlook

81. The change to CARE and the introduction of new governance arrangements have been major changes for the pension fund which demand ongoing investment in terms of governance and administration.

82. Changes to the state pension arrangements and the need for Guaranteed Minimum Pension reconciliations have also added to workloads.

Exhibit 9:Total Management Costs as a Proportion of Net Assets



Source: Audit Scotland – Unaudited Pension Fund Annual Accounts Database

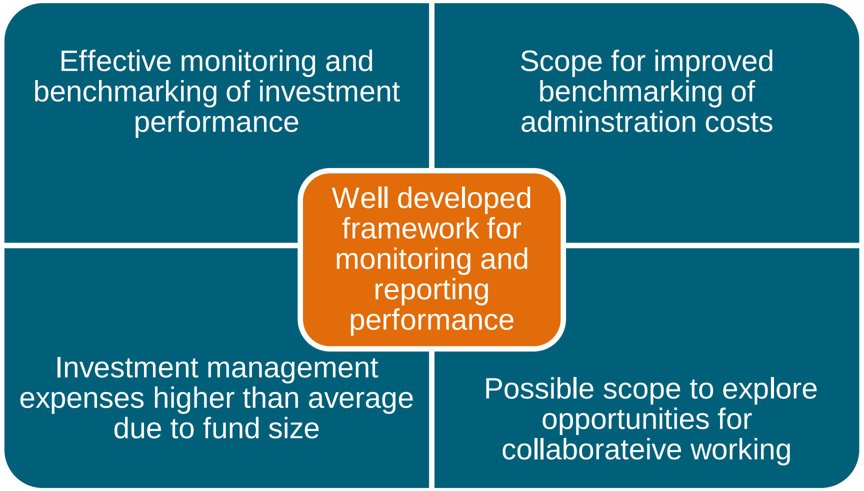
83. Going forward the operation of cost sharing mechanisms may well increase levels of interest and scrutiny in pension fund business. We understand that the Government's Actuary Department (GAD) is currently undertaking a review in relation to cost sharing on behalf of Scottish Ministers.

84. There is a move to the pooling of fund assets through collective investment vehicles south of the border and Scottish Ministers have already indicated that this is an area where the views of the national Scheme Advisory Board may be requested. The Scheme Advisory Board have convened a working group with a view to producing an options paper by December 2016

85. One of the potential aims of pooling is to invest more in infrastructure assets. While five Scottish Funds already have infrastructure investments, e.g. housing, some are also already working collaborately to seek opportunities. NESPF are interested in finding ways to unlock funding for investment in secure local capital projects. There is recognition amongst funds generally of potential increased risks and the need to find a balanced approach to managing that risk while meeting the fiduciary duty to make the best return for the scheme.

86. Barriers to such investment include the sheer scale required to make it attractive and consequently, increased costs and risks with perhaps limited opportunity to find the right deal. If NESPF chooses to pursue this type of investment, then it is critical that detailed due diligence is carried out , appropriate expertise is targeted and that there is transparency around the decision making process and associated audit trails maintained.

Best Value



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

88. Best value requires clear strategic goals and priorities and these are well developed and articulated for the pension fund.

Procurement

89. The funds tendered for a new custodian during 2015/16 and, in March 2016, the Pensions Committee appointed BNP Paribas. Contract negotiations are ongoing in 2016/17 prior to the changeover.

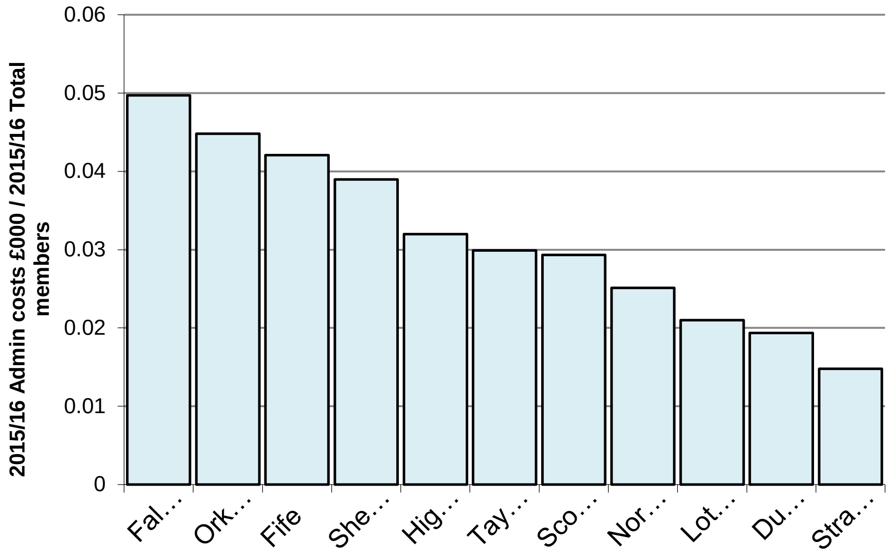
Administrative performance

90. NESPF has a Pensions Administration Strategy (PAS) which includes targets for the measurement of service performance. Workflow systems are used to report performance with a summary presented to the Pensions Committee on a quarterly basis approximately.

91. The funds' continue to use 2 online systems, i-connect and employer services, to enable employers to electronically transfer data on an ongoing basis. Take up from employers continues to be around 40% and the data submissions are considered to provide good quality. As a result, there is regular and more timely updates of pension fund systems resulting in more accurate and up to date data. For example, a new requirement of the 2015 Scheme is for employers to submit cumulative CARE pay data, At 31 March 2016, the fund was receiving this data for 97% of the membership helping to ensure that annual benefit statements could be issued by the new deadline of 31 August 2016.

92. Exhibit 10 shows that NESPF administration costs are among the lowest per member across all Scottish Funds.

Exhibit 10: Administration Costs per member – Scottish Funds



Source: Audit Scotland – Unaudited Pension Fund Annual Accounts Database

93. Whilst the overall story in terms of administration performance is generally a positive one, we noted that indicators reported to committee are based on CIPFA Local Government Pension guidance rather than those set out in the Pension Administration Scheme in June 2013. We understand there are plans to update the PAS in terms of guidance and legislation.

Refer Action Plan, Recommendation 1

Investment performance

94. 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.

95. Performance against benchmark targets is regularly reported to the Pensions Committee. Exhibit 11 shows the one, three and five year rolling average results against benchmark for the main fund. It also shows that growth in market value of the fund was 0.66% last year, well below the 1.98% benchmark. Investment performance over a 3 year and 5 year period also fell short of the benchmark but to a lesser extent.

Exhibit 11: Main fund performance – rolling average

	In-year	3-Year	5- year
Main fund	0.66	7.61	7.28
Benchmark	1.98	7.73	7.92

Source: NESPF Annual Accounts

96. The funds' performance reports as submitted to the Pensions Committee over the last year confirmed that most managers outperformed against their benchmark in the first three quarters but that performance in quarter four was more mixed. One manager,

however continued to consistently underperform over the short and long term, and as observed at paragraphs 72 and 73, the decision was taken to terminate that mandate.

97. Exhibit 12 shows the performance of the transport fund in terms of the new funding level benchmark introduced from 1 April 2015 as part of the de-risking strategy. This shows some volatility in the position over the course of the year with the funding level falling short of the target benchmark.

Exhibit 12: Transport fund performance – De-Risking Funding Level vs Benchmark

	June '15	Sept '15	Dec '15	Mar '16
De-Risking 'Flight Plan' Funding Level	85.8%	81.6%	87.0%	85.3%
Benchmark	100.0%	100.0%	100.0%	100.0%

98. Under the new CARE scheme, accrued benefits are indexed at the Consumer Price Index (CPI). Benefits earnt under the old final salary scheme will continue to increase in line with earnings. As can be seen from Exhibit 13 investment returns have outperformed earnings and CPI over the past 5 years going some way to meeting increases in the historic liabilities.

Exhibit 13: Main fund performance relative to CPI

	In-year (%)	3-Year (%)	5- year (%)
CPI	0.5	0.7	1.7
Average earnings	1.9	2.5	1.6
NESPF	0.66	7.61	7.28

Source: NESPF Annual Accounts 2015/16

Outlook

99. With financial austerity within the public sector set to continue and increased pressure from employers to keep costs and contributions down, it is imperative for funds to be able to demonstrate best value and continued improvement. Just as councils are having to look to new models of service delivery so pension funds may need to reconsider the costs and benefits of, for example, collaboration and asset pooling.

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 Statement Issues and Risks		
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.	**Contributions** • Monthly reasonableness checks of employers' contributions and timeliness of payments • Reconciliations of contributions received with year end returns from employers and pension administration system • Annual assurance requested from key employers. **Investment Income** • Monthly cash reconciliations • Segregation of duties between fund staff for any income transactions keyed into the custodian system, Workbench • Reconciliations between custodian	**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. **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 one (main fund) investment income balance

Audit Risk	Assurance procedure	Results and conclusions
	and fund manager records.	as part of debtors testing and found all had been accounted for correctly. We tested a sample of 3 (2 main fund, 1 transport) pre- and one (main fund) post year end 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.
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.	• There are a range of policies and procedures in place to prevent and detect fraud including standing orders and financial regulations.	• Journals - a sample of journal entries covering both funds was tested as part of debtors and creditors testing, and a further sample was undertaken 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.

Audit Risk	Assurance procedure	Results and conclusions
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.	• Client working papers supporting private equity investments figures per the accounts • Due to the nature of private equity there will always be a delay in receiving valuations. With the time limits and reporting deadline for the draft accounts, the pension fund will use the most recent valuation information available to them and that will usually be the December valuations. Once March valuations have been received a review will take place to assess the movement between valuations and the draft accounts will be amended accordingly.	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 2016 when they year end statements became available in July 2016. The accounts were adjusted by £23k 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.
Fund Management Costs CIPFA introduced best practice guidance on Accounting for local government pension scheme management costs in 2014 which has been revised for 2015/16 accounts. There have been historic difficulties in identifying all the costs in prior years and some investments in new fund managers have been approved in-	• Management response to revised CIPFA guidance	The revised CIPFA guidance on pension fund management costs was issued in June 2016, after the draft accounts had been produced. The main change in respect of the funds' current practices is to remove the requirement for indirect private equity fees, i.e. those at the fund of funds level, to be accounted for under investment management expenses and only include those which are directly attributable to the fund.

Audit Risk	Assurance procedure	Results and conclusions
year. There is a risk the fund does not comply with best practice.		The guidance is effective from 2016/17, consequently there is no requirement for adoption in 2015/16, however the fund wished to do so and we are satisfied with this approach. The revised accounts were amended accordingly.
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.	• Legal correspondence reflecting action taken.	We received regular updates on this matter from the Head of Finance. The delay has been caused by the time taken to put alternative arrangements in place for the ongoing enhancement element of payments to pensioners who were employees of the former school. Arrangements were concluded to secure annuities to fund the enhancements and the agreement of all pensioners was formally obtained. This enabled final transfer documentation to be concluded and the cash was released in full to the pension fund on 16 September 2016. Note 24 to the accounts which had identified the potential impairment loss has been amended to reflect the final outcome which satisfactorily concludes this matter.

Audit Risk	Assurance procedure	Results and conclusions
Local Government Pension Scheme (Scotland) (2015) A new local government pension scheme was implemented from 1 April 2015. This has resulted in a number of changes for members including pensions being based on care average revalued earnings, as opposed to final salary and the rate at which pension accrues reducing from 1/60 to 1/49. There is a risk pensions or contributions may be calculated incorrectly.	• Project Plan for implementing the new scheme and progress reports to committee • Dedicated section for the 2015 scheme included on the pension fund website • Separate training and briefings provided for employers and staff • Testing of pension administration system prior to implementation of the new scheme • Management controls in place.	We reviewed the briefings provided to employers and training materials for staff and found these to be comprehensive. As part of our final accounts work, we substantively tested a sample of 10 new pensioners, 5 transfers in, 4 transfers out and 3 death grants and found the calculations to be correct. We also tested a sample of contributions from scheduled and admitted bodies.
Changes in Fund Experts In December 2015, the agreements with the fund manager for the Main Fund Global Ex and Frontier Fund and the Transport Fund were terminated. There is a risk that that the funds cannot mitigate further significant losses during the period until the transfers are concluded.	• Instructions provided to the existing fund manager in respect of 'care taking' responsibilities and arrangements for transfer • Appointment of new fund manager and arrangements for handover • Ongoing monitoring by custodian • Reports to Pensions Committee.	We reviewed correspondence and related documentation in respect of the Main Fund Global ex and Frontier fund and found the arrangements to be satisfactory.

Appendix II: Action plan

No.	Page /Paragraph ref.	Issue/risk/Recommendation	Management action/response	Responsible officer / Target date
1	17/48 22/74 26/93	A regular suite of reports is considered by the Pensions Committee and the format of them was determined following a review of reporting last year. Now that the Pensions Board has been in place for a year or so, it would be a timely opportunity to consider the content of the reports and whether they meet the needs of committee and board members. For example**,** • there is a need for clarity in reporting against benchmarks given the range of targets used by the fund • the funding position is not reported to members' as frequently as it used to be • the committee does not routinely receive an annual activity report summarising fraud/suspected fraud cases, whistleblowing cases and breaches of the Bribery Act, even if this is a nil report. Such a report would where relevant, also include any lessons learnt and action taken. • the pensions administration strategy needs to be updated and associated monitoring of targets revised to ensure meaningful information is collected and reported. ***Risk: there is insufficient accountability and scrutiny over funds administration and performance.*** ***Recommendation:*** *revi*ew the level and range of performance information to ensure it is balanced and transparent and covers the range of activity, a governance committee would expect to scrutinise.	Following the implementation of the new structure, a review of the reports taken to committee will take place. This will include addressing the first three points noted. The Pension Admin Strategy is currently being updated	Pensions Manager, March 2017

No.	Page /Paragraph ref.	Issue/risk/Recommendation	Management action/response	Responsible officer / Target date
2	19/55 20/61	There is no formal process for Pension Board members to declare conflicts of interest. ***Risk : reduced transparency in the operation of committee business*** **Recommendation**: We understand that plans are already in place to put a declaration process in place. These plans should be actioned and implemented as soon as possible.	A Conflicts of Interest Policy has been drafted and will be implemented as soon as possible.	Pensions Manager, December 2016
3	21/71	The 2014 Regulations require councils to assess the efficiency and effectiveness of the internal audit service from time to time. The outcome of this review should be considered as part of the system of internal controls by the committee charged with governance (in this case the Pensions Committee). The financial year 2016/17 is the third year since the regulations were implemented. It would therefore be timely for arrangements to be agreed for the time and conduct of the review. ***Risk: internal audit is not effectively supporting the Pensions Committee in carrying out is governance role.*** **Recommendation:** Plans should be agreed for the time and conduct of an independent review.	The fund acknowledges the requirement for an independent review and will coordinate with the administering authority to implement a review plan.	Pensions Manager, 2017