

# North East Scotland Pension Fund

2016/17 Annual Audit Report



 AUDIT SCOTLAND

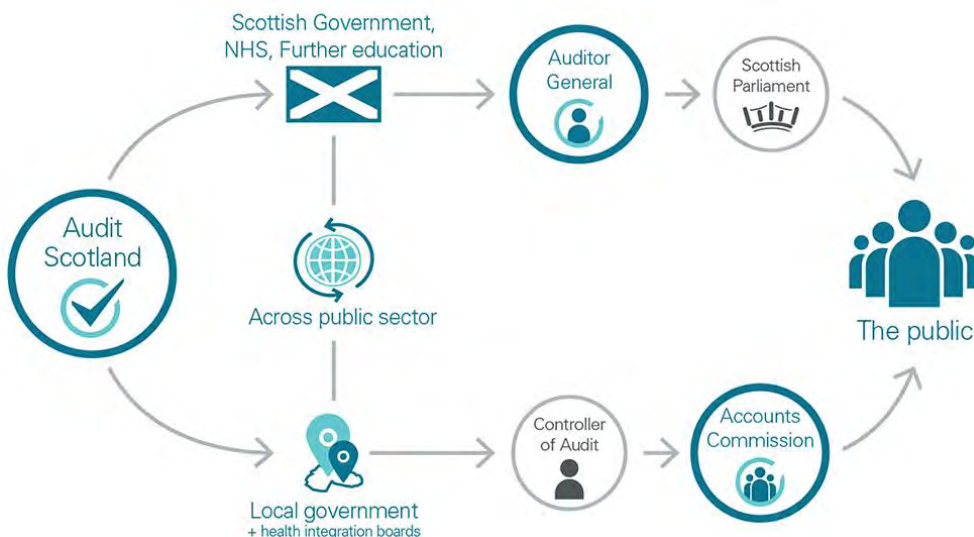
To Members of the Aberdeen City Council Pensions Committee and the Controller of Audit

21 September 2017

## Who we are

The Auditor General, the Accounts Commission and Audit Scotland work together to deliver public audit in Scotland:

- The Auditor General is an independent crown appointment, made on the recommendation of the Scottish Parliament, to audit the Scottish Government, NHS and other bodies and report to Parliament on their financial health and performance.
- The Accounts Commission is an independent public body appointed by Scottish ministers to hold local government to account. The Controller of Audit is an independent post established by statute, with powers to report directly to the Commission on the audit of local government.
- Audit Scotland is governed by a board, consisting of the Auditor General, the chair of the Accounts Commission, a non-executive board chair, and two non-executive members appointed by the Scottish Commission for Public Audit, a commission of the Scottish Parliament.



## About us

Our vision is to be a world-class audit organisation that improves the use of public money.

Through our work for the Auditor General and the Accounts Commission, we provide independent assurance to the people of Scotland that public money is spent properly and provides value. We aim to achieve this by:

- carrying out relevant and timely audits of the way the public sector manages and spends money
- reporting our findings and conclusions in public
- identifying risks, making clear and relevant recommendations.

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# Key messages

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## 2016/17 annual report and accounts

- 1 Our audit opinions are all unqualified. These cover the financial statements, the management commentary, the annual governance statement and governance compliance statement.

## Financial management

- 2 The Fund has effective arrangements in place for financial management. This includes comprehensive reporting of investment performance.

## Financial sustainability

- 3 Pension contributions for the Main Fund continue to exceed benefits payable.
- 4 The increase in pensioners in the Transport Fund's membership will make funding pension payments increasingly challenging with a greater reliance on selling investments. However funding levels do not give any concerns in the short to medium term.

## Governance and transparency

- 5 The Fund has effective governance arrangements in place that support scrutiny of decisions made by the Pensions Committee.
- 6 Decisions are transparent with committee papers and detailed minutes of meetings of the Pensions Committee available on Aberdeen City Council's website.

## Value for money

- 7 The Fund's performance is subject to regular review and scrutiny by the Pensions Committee.
- 8 The Fund reviews the value for money that it receives from its investments on an on-going basis. Adequate arrangements are in place through monitoring of investment performance and participation in fee and performance benchmarking surveys.

# Introduction

**1.** This report is a summary of our findings arising from the 2016/17 audit of North East Scotland Pension Fund (NESPF). The Fund 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). Hereafter we will refer to “the Fund” in the singular.

**2.** The scope of our audit was set out in our Annual Audit Plan presented to the March 2017 meeting of the Pensions Committee. This report comprises our findings arising from:

- an audit of the annual accounts
- consideration of the wider dimensions set out in the Code of Audit Practice (2016) as illustrated in [Exhibit 1](#).

## Exhibit 1

### Audit dimensions



Source: Code of Audit Practice 2016

**3.** The main elements of our audit work in 2016/17 have been:

- an interim audit of the Fund's main financial systems and governance arrangements
- an audit of the Fund's 2016/17 annual accounts including the issue of an independent auditor's report setting out our opinions.

**4.** Aberdeen City Council is the administering authority for the pension fund. The council delegates this responsibility to the Pensions Committee. The Committee is responsible for establishing effective governance arrangements and ensuring that financial management is effective. Additionally, the Committee is required to review the effectiveness of internal control arrangements and approve the annual accounts.

- 5.** Our responsibilities as independent auditor are established by the Local Government (Scotland) Act 1973, the [Code of Audit Practice \(2016\)](#), and supporting guidance, and are guided by the auditing profession's ethical guidance.
- 6.** As public sector auditors we provide independent opinions on the annual accounts. We also review and report on the arrangements within the Fund to manage its performance and use of resources such as money and assets. In doing this, we aim to support improvement and accountability.
- 7.** Further details of the respective responsibilities of management and the auditor can be found in the [Code of Audit Practice \(2016\)](#),
- 8.** This report raises matters from the audit of the annual accounts, risks or control weaknesses. Communicating these does not absolve management from its responsibility to address the issues we raise, and to maintain adequate systems of control.
- 9.** Our annual audit report contains an action plan at [Appendix 1 \(page 25\)](#). It sets out specific recommendations, responsible officers and dates for implementation.
- 10.** As part of the requirement to provide fair and full disclosure of matters relating to our independence, we can confirm that we have not undertaken non-audit related services. The 2016/17 audit fee is as set out in our Annual Audit Plan as we did not carry out any work additional to our planned audit activity. The fee remains unchanged.
- 11.** This report is addressed to both the members of the Pensions Committee and the Controller of Audit and will be published on Audit Scotland's website [www.audit-scotland.gov.uk](http://www.audit-scotland.gov.uk).
- 12.** We would like to thank all management and staff who have been involved in our work for their co-operation and assistance during the audit.

# Part 1

## Audit of 2016/17 annual accounts



### Main judgements

**Our audit opinions are all unqualified. These cover the financial statements, the management commentary, the annual governance statement and governance compliance statement.**

#### Unqualified audit opinions

**13.** The annual accounts for the year ended 31 March 2017 were approved by the Aberdeen City Council Pensions Committee on 15 September 2017. We reported, within our independent auditor's report:

- an unqualified opinion on the financial statements;
- unqualified audit opinions on the management commentary, annual governance statement and governance compliance statement.

**14.** Additionally, we have nothing to report in respect of those matters which we are required by the Accounts Commission to report by exception.

#### Submission of annual accounts for audit

**15.** We received the unaudited annual accounts on 23 June 2017, in line with our agreed audit timetable.

**16.** The working papers provided with the unaudited accounts were of a good standard and finance staff provided good support to the audit team which helped ensure the final accounts audit process ran smoothly.

**17.** Significantly more time was taken than planned in agreeing the financial statements to custodian reports. As the Fund does not now receive cumulative reports from the custodian, pension fund finance staff had to compile cumulative records from the individual monthly custodian reports. This required additional finance staff time to prepare more complex working papers than needed previously and more auditor time to audit these working papers.

#### Risks of material misstatement

**18.** [Appendix 2 \(page 26\)](#) provides a description of those assessed risks of material misstatement that were identified during the planning process which had the greatest effect on the overall audit strategy, the allocation of staff resources to the audit and directing the efforts of the audit team. Also, included within the appendix are wider dimension risks, how we addressed these and conclusions.

The annual report and accounts are the principal means of accounting for the stewardship of resources and performance in the use of those resources.

## Materiality

**19.** Materiality defines the maximum error that we are prepared to accept and still conclude that that our audit objective has been achieved. The assessment of what is material is a matter of professional judgement. It involves considering both the amount and nature of the misstatement.

**20.** Our initial assessment of materiality for the annual accounts was undertaken during the planning phase of the audit and is summarised in [Exhibit 2](#). Specifically with regard to the financial statements, we assess the materiality of uncorrected misstatements, both individually and collectively.

**21.** On receipt of the annual report and accounts we reviewed our materiality calculations and these are shown in Exhibit 2.

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## Exhibit 2

### Materiality values

Materiality level	Amount
<p><b>Overall materiality</b> – This is the calculated figure we use in assessing the overall impact of audit adjustments on the financial statements. It was set at 0.5% of net assets for the year ended 31 March 2017 based on the unaudited accounts.</p>	<p>Main Fund £12.9 million</p> <p>Transport Fund £0.3 million</p>
<p><b>Performance materiality</b> – This acts as a trigger point. If the aggregate of errors identified during the financial statements audit exceeds performance materiality this would indicate that further audit procedures should be considered. Using our professional judgement we have calculated performance materiality at 80% of overall materiality.</p>	<p>Main Fund £6.8 million</p> <p>Transport Fund £0.1 million</p>
<p><b>Reporting threshold (i.e. clearly trivial)</b> – We are required to report to those charged with governance on all unadjusted misstatements in excess of the 'reporting threshold' amount. This has been calculated at 1% of overall materiality. (With a maximum level of £100,000).</p>	<p>Main Fund £100,000</p> <p>Transport Fund £10,000</p>

## Evaluation of misstatements

**22.** There were no material adjustments to the unaudited financial statements arising from our audit. In common with previous years, the Private Equity (type 3) investments have been updated in the audited accounts for more recent valuations received from the fund managers. The unaudited accounts were prepared with the most up to date figures available for Private Equity (type 3) investments, as at 31 December. The Private Equity valuations as at 31 March were received by the Pension Fund in August and the accounts were updated for these figures. The result was an increase of £9.1 million in Private Equity investments.

## Significant findings

**23.** International Standard on Auditing 260 requires us to communicate to you significant findings from the audit. There are no significant findings from the audit of the financial statements.



## Other Findings

**24.** Our audit identified a number of presentational and disclosure issues and minor monetary errors which were discussed with management. These were adjusted and reflected in the audited financial statements.

# Part 2

## Financial management



### Main judgements

The Fund has effective arrangements in place for financial management. This includes comprehensive reporting of investment performance.

### Financial performance in 2016/17

25. Pension fund finances are independently assessed every three years by an actuary. This assessment determines the employer contribution rates and deficit funding payments for the upcoming three year period and takes account of the strength of employer covenants and the fund's investment strategy. The most recent triennial valuation of the Fund was as at 31 March 2014. The next valuation as at 31 March 2017 is in progress and is expected to be finalised in March 2018.

26. The Fund's performance in 2016/17 is summarised in [Exhibit 3](#):

### Exhibit 3

Assets, liabilities, funding level and investment performance

Increase in net assets	Increase in estimated actuarial liabilities (IAS19)	Funding level	Investment performance
<b>Main Fund</b> <b>+£632.9 million</b> (+19.8%)	<b>Main Fund</b> <b>+£915 million</b> (+24.1%)	<b>94% Main Fund</b> <b>93% Transport Fund</b> 2014 Funding Valuation	<b>19.6% Main Fund</b> <b>17.9% Transport Fund</b> Return on investments 2016/17
<b>Transport Fund</b> <b>+£13.7 million</b> (15.9%)	<b>Transport Fund</b> <b>+£10.3million</b> (13.7%)		

<b>Increase in net assets</b>	<b>Increase in estimated actuarial liabilities (IAS19)</b>	<b>Funding level</b>	<b>Investment performance</b>
Closing net assets:	Closing liabilities:	Interim valuation as at 31 March 2016:	Return on investments over 5 years:
<b>Main Fund</b>	<b>Main Fund</b>	<b>97% Main Fund</b>	<b>Main Fund 11%</b>
<b>£3,814.7 million</b>	<b>£4,718 million</b>	<b>93% Transport Fund</b>	<b>Transport Fund not reported</b>
<b>Transport Fund</b>	<b>Transport Fund</b>		
<b>£100.0 million</b>	<b>£85.6 million</b>		

Source: NESPF 2016/17 audited financial statements and NESPF reports

**27.** The net assets of the Main Fund increased to £3.815 billion at 31 March 2017 from £3.182 billion at 31 March 2016. The Transport Fund's net assets increased from £86 million to £100 million over the same period. This represents an increase of 19.8% for the Main Fund and 15.9% for the Transport Fund.

**28.** During 2016/17 contributions to the Main Fund amounted to £129.739 million. This was in excess of the benefits paid out which totalled £126.709 million. The Transport Fund, which is closed to new members, had contributions of £2.544 million with benefits paid out totalling £4.030 million.

**29.** The Fund's actuary, Mercer Limited, estimated that pension liabilities for the Main Fund had risen from £3.803 billion at 31 March 2016 to £4.718 billion at 31 March 2017 (£915 million increase) based on IAS19 calculations. The bulk of the increase in liabilities (£767 million) is due to actuarial losses, mostly as a result of discount rate changes and future CPI assumption changes because corporate bond yields decreased during the year. Interest over the year also increased the liabilities by £137 million.

**30.** Transport Fund pension liabilities increased from £75.3 million at 31 March 2016 to £85.6 million at 31 March 2017. The reasons for these increases were the same as for the Main Fund.

**31.** It should be recognised that not all funds have liabilities assessed on the same prudential scales. The use of differing actuarial firms and assumptions creates difficulties in direct comparisons between funds.

**32.** The Pension Fund requested that the actuary carry out an interim valuation as at 31 March 2016, prior to the triennial valuation as at 31 March 2017. Although an interim valuation is not a requirement in the same way as the triennial valuation, the Fund has reported that this has been a very useful exercise, "helping to ensure that preparation for setting assumptions for the 2017 triennial valuation can take place, pre-emptive discussions can be held with individual employers and the NESPF covenant policy can be implemented in full". The interim valuation estimates the funding level as at 31 March 2016 to be 97% for the Main Fund and 93% for the Transport Fund. The actuary also noted the high quality of member data submitted for the interim valuation.

## Financial management arrangements

**33.** The Head of Finance for Aberdeen City Council is the proper officer responsible for the North East Scotland Pension Fund. The financial regulations of Aberdeen City Council, as administering authority, apply to the Pension Fund. We

Financial management is about financial capacity, sound budgetary processes and whether the control environment and internal controls are operating effectively.

consider these to be comprehensive, and current, and promote good financial management.

**34.** Investment and administration performance reports are submitted to the Pensions Committee on a quarterly basis. Reports are comprehensive covering reviews of the equity and bond markets, overall performance of the funds and reviews of the performance of each investment manager. Through our attendance at Pensions Committee meetings we have observed a good level of review and scrutiny by members.

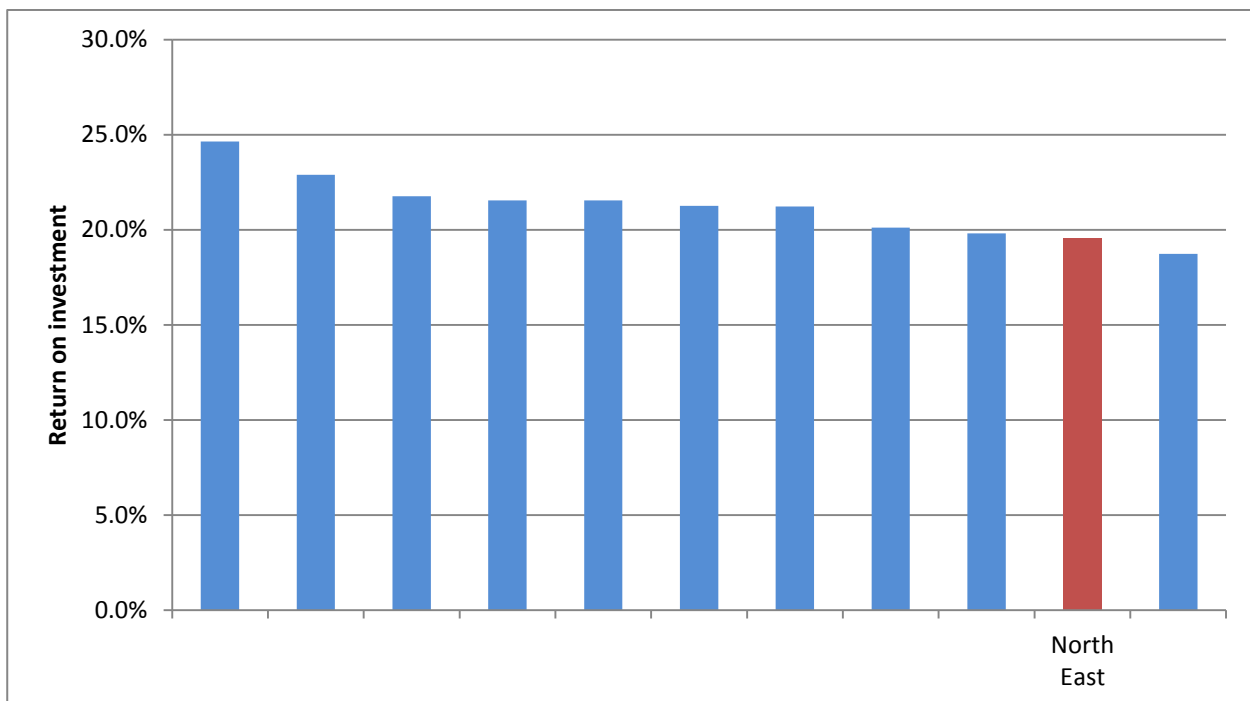
**35.** Based on evidence reviewed, we conclude that the Fund has effective financial management arrangements in place, including comprehensive reporting and review of investment performance.

## Financial outcomes

**36.** The Main Fund's performance is shown in [Exhibit 4](#) and although there was strong performance in terms of investment return in 2016/17, it was the second lowest performance of all local government pension funds in Scotland and below the Fund's own target (see [Exhibit 10](#) for performance against benchmarks). However the relative performance should not be considered without acknowledging that there are different investment strategies.

### Exhibit 4

#### LGPS pension funds – Net return on investment 2016/17 (unaudited figures)

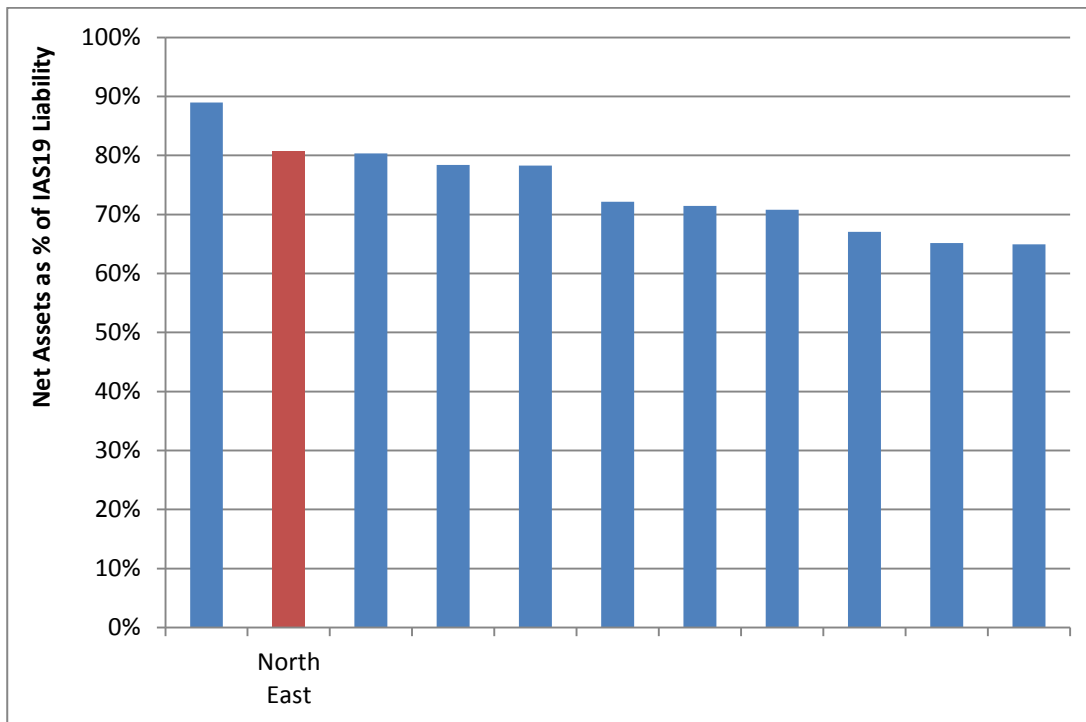


Source: 2016/17 LGPS pension fund unaudited financial statements

**37.** The IAS19 deficit calculations give a guide to the relative funding positions of each fund, as shown in [Exhibit 5](#). When this is considered the North East Scotland Pension Fund is amongst the best funded and the lower returns may reflect differing investment strategies across the different funds, in terms of their attitudes to risk and return.

## Exhibit 5

### Net Assets as a proportion of IAS19 Liability as at 31 March 2017



Source: 2016/17 LGPS pension fund unaudited financial statements

## Internal controls

**38.** As part of our audit we identify and inspect the key internal controls in those accounting systems which we regard as significant for the production of the financial statements. Our objective is to gain assurance that the North East Scotland Pension Fund has systems of recording and processing transactions which provide a sound basis for the preparation of the financial statements.

**39.** The Pension Fund uses some of the administering authority's key financial systems, in particular the general ledger, payroll and accounts payable systems. We obtained assurances from KPMG, the external auditor of Aberdeen City Council, that their audit testing of financial systems did not identify any significant internal control weaknesses which could affect the Fund's ability to record, process, summarise and report financial and other relevant data so as to result in a material misstatement in the financial statements. Their audit findings were included in an interim management report presented to Aberdeen City Council's Audit, Risk and Scrutiny Committee on 22 June 2017. They concluded that the controls were operating effectively.

**40.** Our audit testing of the Pension Fund's own pension administration system did not identify any significant internal control weaknesses which could affect the Fund's ability to record, process, summarise and report financial and other relevant data so as to result in a material misstatement in the financial statements.

## Fraud prevention and detection

**41.** We assessed the Fund's arrangements for the prevention and detection of fraud. The Fund relies on the administering authority's (Aberdeen City Council) arrangements for the prevention and detection of fraud and corruption. These

include codes of conduct for elected members and officers, a whistleblowing policy and a counter-fraud strategy.

**42.** We concluded that appropriate arrangements were in place for preventing and detecting fraud and corruption in 2016/17.

# Part 3

## Financial sustainability



### Main judgement

**Pension contributions for the Main Fund continue to exceed benefits payable.**

**The increase in pensioners in the Transport Fund's membership will make funding pension payments increasingly challenging with a greater reliance on selling investments. However funding levels do not give any concerns in the short to medium term.**

### Funding position

**43.** The March 2014 triennial valuation reports that the Main Fund's assets were sufficient to meet 94% of its liabilities and the Transport Fund had assets to meet 93% of its liabilities. The 2016 interim valuation by the Fund's actuary, estimated that the funding level for the Main Fund had increased to 97% and the Transport Fund's level remained at 93%.

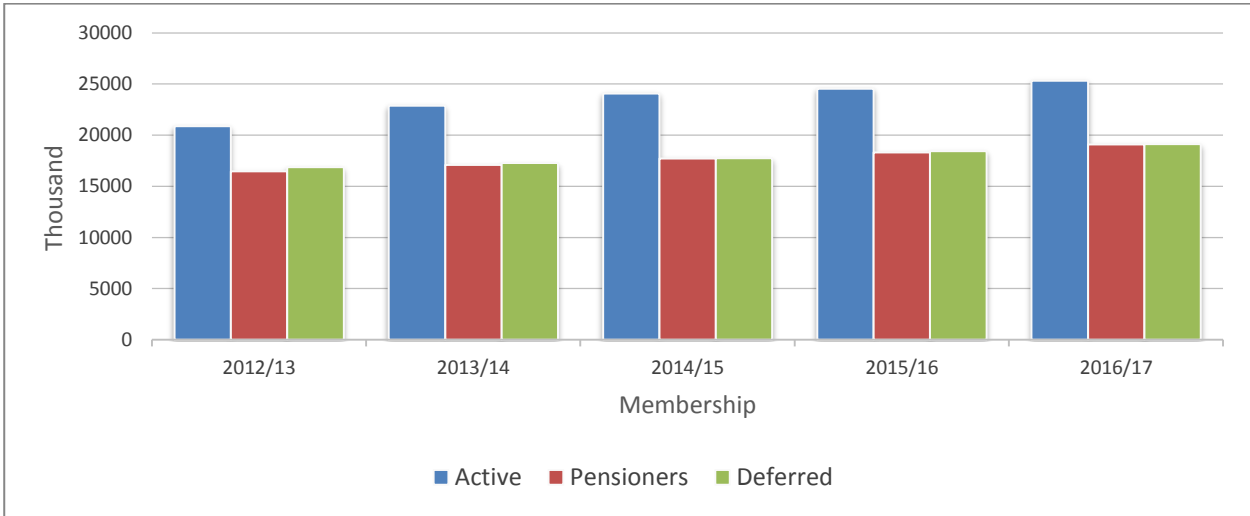
**44.** Contribution rates and deficit payments will be considered by the actuary at the next triennial funding valuation as at 31 March 2017.

### Membership levels

**45.** The Pension Fund is a multi-employer fund with 3 local authorities and 53 other employers. The membership profile across the past 5 years is shown at [Exhibit 6](#). The number of active members continues to outweigh the number of pensioners for the Main Fund.

Financial sustainability looks forward to the medium and longer term to consider whether the Fund maintains the capacity to meet the current and future needs of its members.

## Exhibit 6 Main Fund Membership

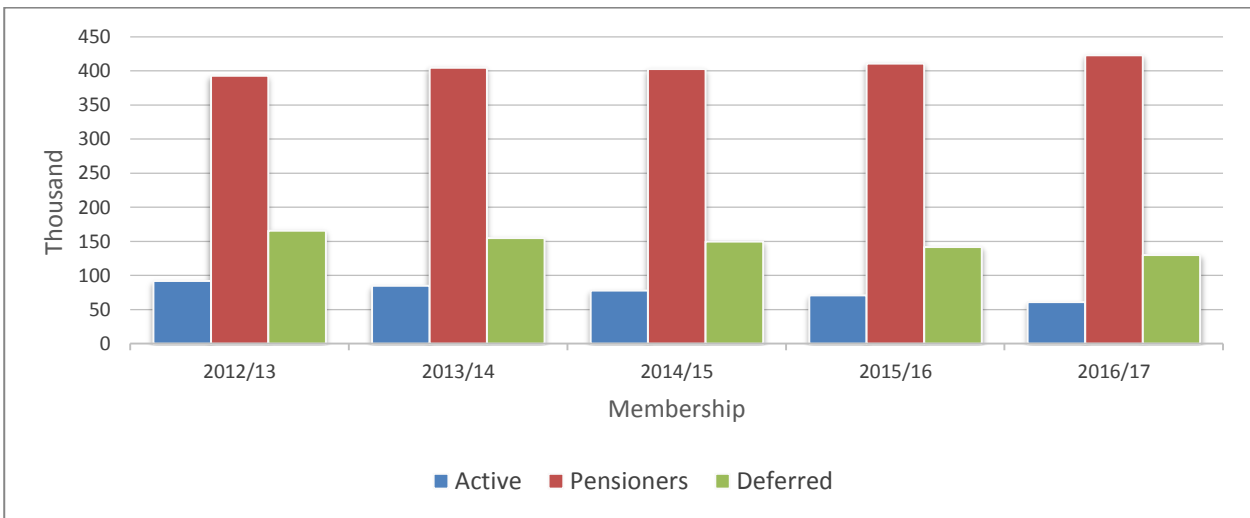


Source: Pension Committee Reports

**46.** Membership of the Main Fund increased by 2,231 to 63,560 members at 31 March 2017; an increase in active members of 3.6%. Since 2012/13 membership has increased by 9,343 (17.2%). The impact of auto-enrolment contributed to the increase in members.

**47.** The Transport Fund, which is closed to new entrants, continues to fall in overall membership numbers and more members move to pensioner status. This is shown in [Exhibit 7](#) below.

## Exhibit 7 Transport Fund Membership



Source: Pensions Committee Reports

**48.** The Fund gives its members a guarantee that in exchange for contributions during their employment, the Fund will pay a pension until the end of each



member's life. It is important that the Fund maintains the capacity to meet the current and future needs of its members.

## Contributions

49. Following the last triennial valuation in 2014, the actuary agreed employer contribution rates with individual employers for the period 2015 to 2018. An element of these employer costs includes deficit recovery contributions to support employers' financial planning. The approximate split of all contributions received in year is set out at [Exhibit 8](#).

### Exhibit 8

#### Main Fund Contributions in 2016/17

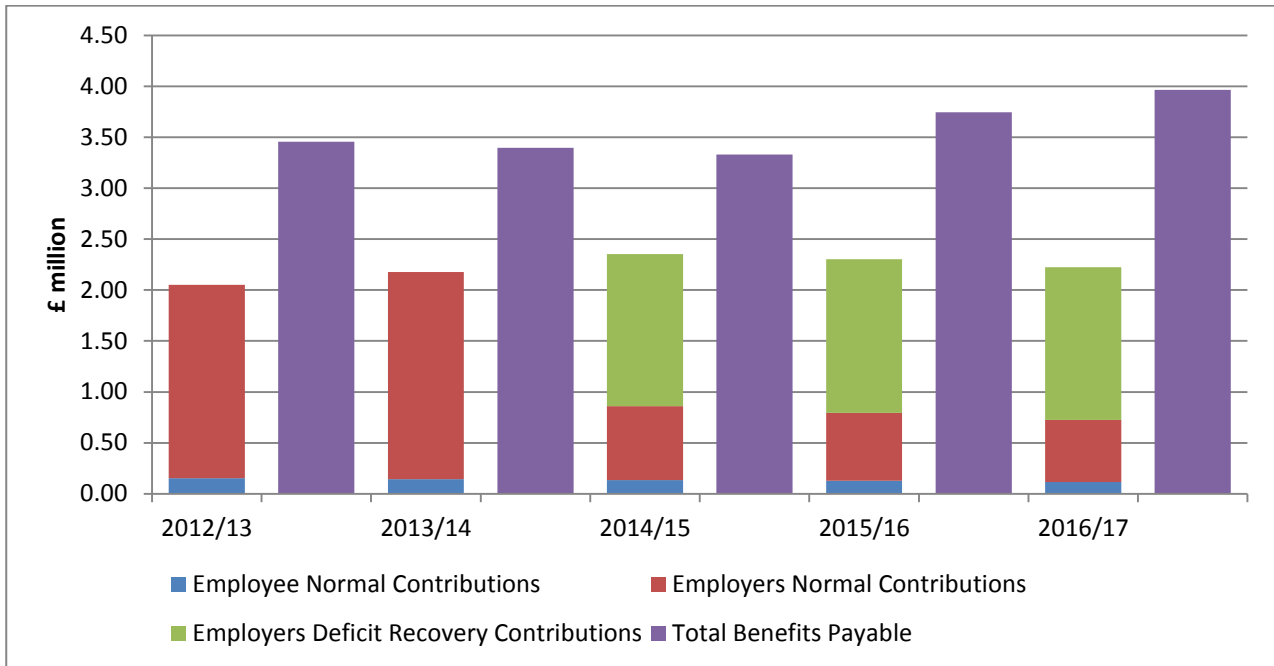
	Administering authority £m	Other scheduled bodies £m	Admitted bodies £m	Transferee Admission Bodies £m	Total £m
Employer contributions	27.5	55.8	3.0	8.5	94.8
Employee contributions	8.3	17.4	1.1	2.1	28.9
Deficit Recovery Contributions	1.1	2.2	0.1	0.3	3.7

Source: NESPF 2016/17 audited financial statements

50. The Main Fund reported a surplus from dealings with members of £5.988m in 2016/17. This means that member contributions exceeded pension payments. In contrast, in the Transport Fund which is now closed to new members, pension contributions are exceeded significantly by benefits payable (see [Exhibit 9](#) for contributions and benefits payable over the past 5 years). In 2016/17 total contributions were £2.224m and benefits payable were £3.955m. Therefore investment income is relied on in funding pension payments.

## Exhibit 9

### Transport Fund Contributions in 2016/17



Source: NESPF Fund 2012/13 to 2016/17 audited financial statements (NB: the split of normal and deficit contributions was not in accounts for 2012/13 and 2013/14)

# Part 4

## Governance and transparency



### Main judgements

**The Fund has effective governance arrangements in place that support scrutiny of decisions made by the Pensions Committee.**

**Decisions are transparent with committee papers and detailed minutes of meetings of the Pensions Committee available on Aberdeen City Council's website.**

### Governance arrangements

**51.** Aberdeen City Council is the administering body for the North East Scotland Pension Fund. The council has delegated responsibility for governance to the Pensions Committee. This committee, supported by the Pension Board, is responsible for establishing arrangements that ensure the proper conduct of the affairs of North East Scotland Pension Fund. It is also responsible for ensuring that decisions are made within the terms of the Local Government Pension Scheme.

### Other aspects of governance

**52.** We reviewed various other aspects of governance that apply to the Fund including standing orders, orders of reference, financial regulations and arrangements for reporting breaches of regulation to the Pensions Regulator.

**53.** Overall, we concluded that there are effective and transparent governance arrangements in place. However the Orders of Reference for the Pensions Committee have not been updated and still refer to the Joint Investment Advisory Committee which was disbanded in March 2015. Out of date committee information on the website may reduce public confidence in the quality of published information and imply that regular review of governance information does not occur. The Pension Fund should request that the administering authority updates the Pension Committee Orders of Reference within the council's Standing Orders.

Governance and transparency is concerned with the effectiveness of scrutiny and governance arrangements, leadership and decision-making and transparent reporting of financial and performance information.

### Appendix 1 action plan no. 1

### Pensions Regulator Public Service Code

**54.** The Public Sector Pensions Act 2013 provided for extended regulatory oversight by the Pensions Regulator. The Pensions Regulator issued a code on the governance and administration of public service pension schemes in January 2015 which funds are expected to comply with. The last report assessing the Fund's compliance with the Pensions Regulator's code was submitted to the Pensions Committee and Pension Board in March 2017. This provided assurance that the Fund is largely in compliance with the regulations. There were no breaches of the Code that required to be reported to the Pensions Regulator in 2016/17.

## Internal audit

**55.** Internal audit provides the Fund with independent assurance on the Fund's overall risk management, internal control and corporate governance processes.

**56.** The internal audit function is carried out by Aberdeenshire Council. We carried out a review of the adequacy of the internal audit function and concluded that it operates in accordance with the Public Sector Internal Audit Standards (PSIAS) and has sound documentation standards and reporting procedures in place.

**57.** The 2014 Accounts Regulations require a regular review of the effectiveness of internal audit to be undertaken. It was reported to the Pensions Committee and Pension Board last year that plans should be put in place to have an independent review carried out. An external peer review of Internal Audit has been carried out this year, but the results of the review are not yet available.

## Transparency

**58.** Transparency means that the public, in particular members, have access to understandable, relevant and timely information about how the Fund is taking decisions and how it is using resources.

**59.** There is evidence from a number of sources which demonstrate the Fund's commitment to transparency. For example, the Fund's annual accounts are available on the administering authority's website.

**60.** The Pensions Committee and Pension Board meetings, which are held concurrently, are held in public, with commercially sensitive information dealt with in private session. The minutes of these meetings are publicly available on the Fund's website.

**61.** Overall, we concluded that the Fund conducts its business in an open and transparent manner.

# Part 5

## Value for money



### Main judgements

The Fund's performance is subject to regular review and scrutiny by the Pensions Committee.

The Fund reviews the value for money that it receives from its investments on an on-going basis. Adequate arrangements are in place through monitoring of investment performance and participation in fee and performance benchmarking surveys.

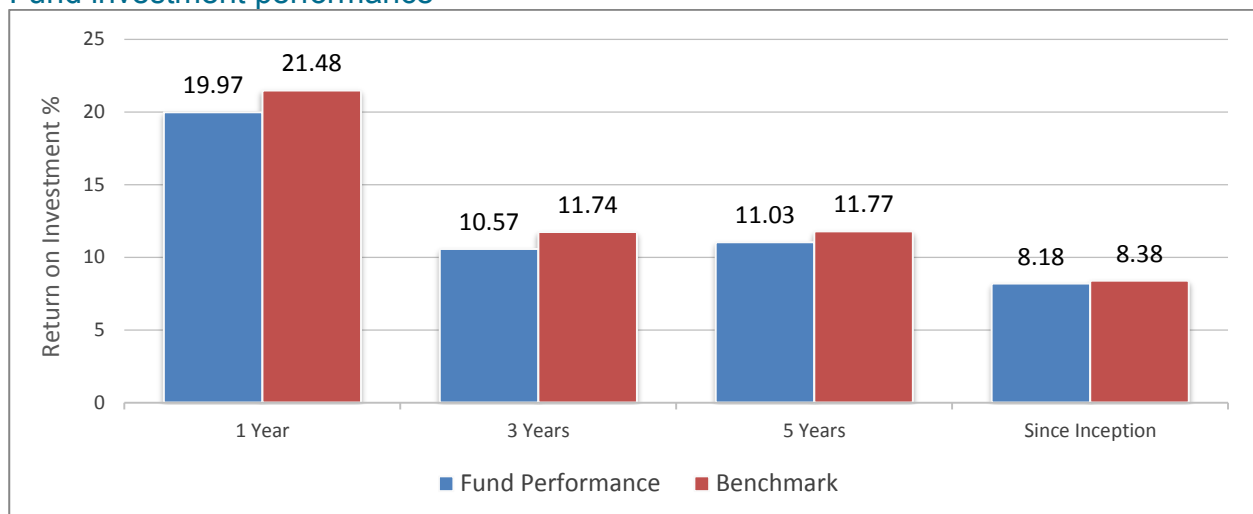
### Investment performance

62. The Pensions Committee meets on a quarterly basis. A review of fund managers' performance is a standing item on the committee's agenda. At each meeting, committee members receive a report outlining overall fund performance including an analysis of risks and returns. The committee also considers the performance of individual investment managers.

63. In 2005 a long term investment strategy for the Main Fund was agreed with a customised benchmark that aimed to deliver a return of 1% above the benchmark over a rolling three year period. [Exhibit 10](#) shows that the Fund's investment fell just short of its benchmark in 2016/17 and for the 3 and 5 year periods to 31 March 2017.

### Exhibit 10

#### Fund investment performance



Source: NESPF Performance Reports

**64.** Investment return and risk are inextricably linked and it is not possible for us to give an opinion on the relative performance of the Fund's investments given the risk exposure of the asset allocation and investments made. However, we are aware that the Pensions Committee is regularly updated with details of how closely aligned the Fund's investments are with its investment strategy. The Fund is currently taking steps to realign the portfolio asset allocations with the investment strategy, which have become out of line due to the increase in equity valuations.

**65.** We concluded that the Fund has adequate arrangements in place for monitoring investment performance.

## **Management expenses**

**66.** 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.

**67.** CIPFA published revised guidance on local government pension scheme management expenses (LGPS). This guidance sets out a framework for the reporting of investment management costs and was applied from 2016/17. The new guidance recommends that only expenses that can be directly controlled by the fund should be included.

**68.** Now that the additional information on the cost of LGPS investment management services is available, the Fund should continue to review the level of management expenses. This includes the development of bench-marking information and in the context of returns achieved, to ensure that value for money is being secured.

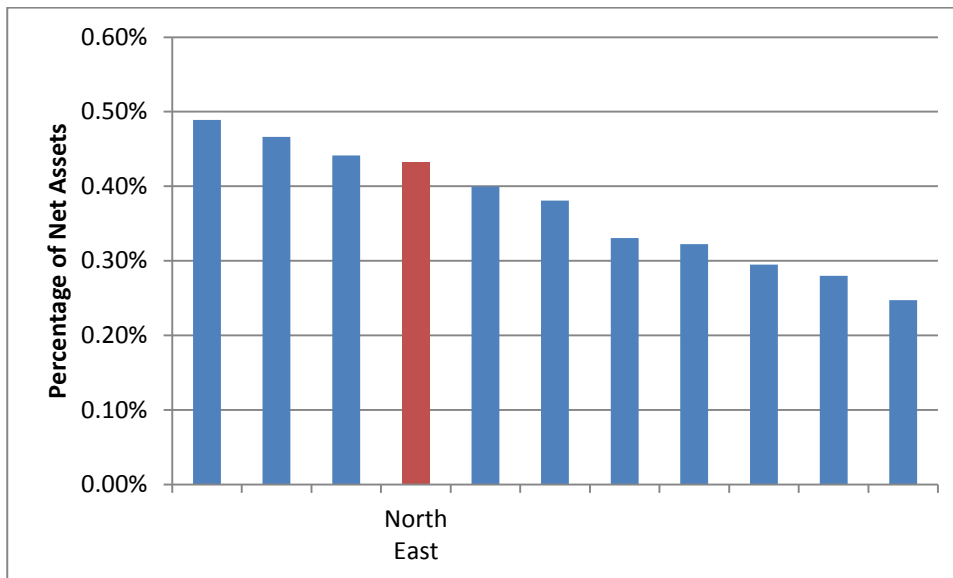
**69.** External investment manager fees are agreed in the respective mandates governing their appointments. Generally these are based on the market value of the investments under their management and therefore increase or reduce as the value of these investments changes.

**70.** Total management expenses have increased from £16.5m in 2015/16 to £18.5m in 2016/17. This is primarily due to increased investment management fees aligned to the increased value of the Fund and an increase in performance fees as a result of the increased annual return on investments in 2016/17.

**71.** [Exhibit 11 \(page 23\)](#) shows figures for total management expenses relative to net assets across the Scottish Local Government Pension Funds, with investment management expenses for the North East Scotland Pension Fund highlighted. The Fund had the fourth highest percentage in Scotland; however, variances in investment strategies and administrative structures (e.g. in-house staff vs. outsourced services) will impact on the amount of external investment management expertise purchased.

## Exhibit 11

### Investment management expenses



Source: 2016/17 unaudited local government pension fund financial statements

**72.** We concluded that the Fund has adequate arrangements in place for scrutinising investment management expenses.

### Administrative expenses

**73.** The workload of the pension administration section continues to grow primarily due to the introduction of the career average pension scheme (CARE) from 1 April 2015. Other factors impacting on the administration workload include auto enrolment. Membership has increased by 17.2% in the past 5 years.

**74.** The Fund has recently completed a restructure to better serve members and pensioners, with further staff being recruited in the Employee Relationship Team in 2017/18.

**75.** Employers are required to submit contributions returns to the Pension Fund; this is an important control over the accuracy of pension contributions received and recorded in the pensions system and is of increased importance following the introduction of CARE as the member benefit statement requires actual salary data from all employers. 10 of the larger employers submitted this monthly through I-Connect, a cloud based data exchange portal for employers to securely provide monthly data that generates events for automated processing on the pension administration system.

**76.** Electronic submissions are also supplied by a further 14 employers through a web portal, providing electronic data via online forms that generate interface files for automated processing of starters, amendments and leavers on the pension administration system. In total, over half a million updates were received in 2016/17 through I-Connect or electronic submissions. By March 2018 it is expected all employers will submit information through I-Connect.

### National performance audit reports

**77.** Audit Scotland carries out a national performance audit programme on behalf of the Accounts Commission and the Auditor General for Scotland. During 2016/17,

we published a number of reports which are of direct interest to the Fund. These are outlined in [Appendix 3 \(page 30\)](#) accompanying this report.

**78.** The Local Government Overview report 2015/16 contains a supplement on the LGPS which provides a view of the national picture.



# Appendix 1

## Action plan 2016/17

### 2016/17 recommendations for improvement



Page  
no.

Issue/risk

Recommendation

Agreed management  
action/timing

20

#### 1. Pensions Committee Orders of Reference

The Pensions Committee Orders of Reference within Aberdeen City Council's Standing Orders have not been updated to reflect changes in pension fund governance. The Orders of Reference still refer to the Joint Investment Advisory Committee, which was disbanded in March 2015.

#### Risk

Out of date committee information on the website may reduce public confidence in the quality of published information and imply that regular review of governance information does not occur.

The Pension Fund should request that the administering authority updates the Pension Committee Orders of Reference within the council's Standing Orders.

The Pension Fund has provided the administering authority with a revised version of the Orders of Reference and the Fund awaits Council approval.

**Responsible Officer:**  
Pensions Manager

**Target Date:** March 2018

# Appendix 2

## Significant audit risks identified during planning

The table below sets out the audit risks we identified during our planning of the audit and how we addressed each risk in arriving at our conclusion. The risks are categorised between those where there is a risk of material misstatement in the annual report and accounts and those relating to our wider responsibility under the [Code of Audit Practice 2016](#).

Audit risk	Assurance procedure	Results and conclusions
<b>Risks of material misstatement in the financial statements</b>		
<p><b>1 Assurances on administering authority key financial systems used by NESPF</b></p> <p>Aberdeen City Council (ACC) is the administering authority for the North East Scotland Pension Fund. Several ACC key financial systems (general ledger; accounts payable; accounts receivable) underpin the NESPF accounting records. We are dependent on the council's external auditor, KPMG, for audit assurances on these systems.</p>	<p>Assurances will be agreed with and obtained from KPMG on key Aberdeen City Council financial systems which underpin NESPF accounting records.</p>	<p>Assurances were obtained from KPMG confirming that their audit testing of financial systems did not identify any significant internal control weaknesses which could affect the Fund's ability to record, process, summarise and report financial and other relevant data so as to result in a material misstatement in the financial statements.</p>
<p><b>2 Risk of management override of controls</b></p> <p>ISA 240 requires that audit work is planned to consider the risk of fraud, which is presumed to be a significant risk in any audit. This includes consideration of the risk of management override of controls in order to change the position disclosed in the financial statements.</p>	<p>Detailed testing of journal entries.</p> <p>Review of accounting estimates.</p> <p>Evaluation of significant transactions that are outside the normal course of business.</p>	<p>Journals – a sample of 29 journal entries were tested as part of debtors (14) and creditors (15) testing. Further journals were tested within other audit areas.</p> <p>Estimates – based on testing of debtors, creditors and provisions/contingencies, we found no evidence of bias in accounting estimates.</p> <p>Significant transactions – based on our work on the annual accounts, we did not find any evidence of transactions out with the scope of the council.</p> <p>Overall, we found no evidence to suggest that management were overriding controls.</p>
<p><b>3 Risk of fraud over income and expenditure</b></p> <p>ISA 240 presumes a risk of</p>	<p>Evaluating the effectiveness of systems for income recognition and recording.</p>	<p>Interim controls testing results were satisfactory.</p> <p>We carried out 'reliance on a</p>

Audit risk	Assurance procedure	Results and conclusions
<p>fraud over income; this is expanded to include the risk of fraud over expenditure in the public sector by the Code of Audit Practice and the Financial Reporting Council's <a href="#">Practice Note 10 (revised)</a>.</p> <p>The North East Scotland Pension Fund receives a significant amount of investment income from third party sources. This presents a risk due to the extent and complexity of income.</p> <p>The Pension Fund also makes a high volume of payments, including high value payments, which can constitute a risk of misstatement of expenditure.</p>	<p>Conduct a review of third party service providers, where relied upon by management, including review of service auditor reports.</p> <p>Analytical procedures on income and expenditure streams.</p> <p>Agree income to third party confirmation.</p> <p>Substantive testing of expenditure.</p>	<p>management expert' work on both custodians in place during the year and the actuary. We concluded that we could place reliance on the custodians and the actuary.</p> <p>Analytical procedures were carried out on income and expenditure. This did not identify any issues.</p> <p>Pension contributions were agreed on a sample basis to employer records, checked by the employer's external audit team.</p> <p>Investment income was confirmed to third party confirmation.</p> <p>We found no evidence of fraud over income</p>
<p><b>4 Estimation and judgements</b></p> <p>There is a significant degree of subjectivity in the measurement and valuation of investments.</p> <p>This includes level 3 investments such as unquoted equity (private equity) where valuations use techniques that require significant judgement in determining appropriate assumptions.</p> <p>This subjectivity represents an increased risk of misstatement in the financial statements.</p>	<p>Completion of 'review of the work of an expert' in accordance with ISA500.</p> <p>Test valuations to valuation reports and/or other supporting documentation.</p>	<p>The draft accounts were amended to reflect the Private Equity level 3 investment valuations which were available in August 2017. We substantively checked all valuations to custodian reports.</p>
<p><b>5 Change of a key expert on which the pension fund places reliance</b></p> <p>The custodian for the pension fund changed to BNP Paribas during 2016/17. This introduces the risk that investment assets are not properly managed and secured.</p>	<p>Conduct a review of third party service providers, where relied upon by management, including review of service auditor reports.</p> <p>Substantive testing of investment assets will provide assurance that investment assets are complete with the proper rights and obligations in place.</p>	<p>We carried out 'reliance on a management expert' work on both custodians in place during the year and concluded that we could place reliance on the custodians.</p>
<p><b>6 Changes to financial reporting</b></p> <p>There are changes to the accounting code for 2016/17 financial statements:</p> <ul style="list-style-type: none"> <li>• Presentation changes to the format of the pension fund account.</li> <li>• Application of IFRS 13 Fair</li> </ul>	<p>Communication of technical changes with officers.</p> <p>Review disclosures as part of our financial statements audit.</p> <p>Review of application of IFRS13</p>	<p>Our audit identified a number of minor presentational and disclosure issues which were adjusted in the audited financial statements.</p>

Audit risk	Assurance procedure	Results and conclusions
<p>Value measurement to pension fund investments</p> <p>New recommended disclosures in respect of management expenses. (NESPF adopted this approach early, in the 2015/16 accounts.)</p>		
<p><b>Risks identified from the auditor's wider responsibility under the Code of Audit Practice</b></p>		
<p><b>7 Governance: updates to key governance documentation</b></p> <p>The Orders of Reference within the ACC Standing Orders have not been updated to reflect changes in pension fund governance. The Orders of Reference for the Pension Committee still refer to the Joint Investment Advisory Committee, which no longer exists.</p> <p>The minutes of the ACC Pension Committee do not record attendees other than councillors; it would improve transparency if attendees such as internal audit, external audit or management experts were also listed in the minutes.</p>	<p>We will review any updates to governance documents.</p>	<p>The Orders of Reference have not been updated and therefore still refer to the Joint Investment Advisory Committee. Refer to Appendix 1 action plan no 1.</p> <p>The most recent minutes now show those in attendance.</p>
<p><b>8 Governance: declaring conflicts of interest</b></p> <p>The 2015/16 audit review of the NESPF Pension Board against the requirements of the 2015 Regulations found that there was no formal process for Pension Board members to declare conflicts of interest and maintain a register of interests. Management have not implemented the policy improvement they agreed in September 2016 (to implement a Conflicts of Interest Policy by December 2016).</p>	<p>We will review the policy and its effectiveness in practice through attendance at committees.</p>	<p>There is now a standing item on each agenda requiring Pension Board members to declare any conflicts of interests they may have.</p>
<p><b>9 Governance: local government elections</b></p> <p>There may be changes to the composition of the Pension Committee and the Pension Board as a result of the local government elections in May 2017. There is a risk that following the elections, a number of new members do not</p>	<p>We will monitor the council's arrangements for developing members and preparations for inducting newly elected members.</p>	<p>Training was provided by fund managers, investments consultant and the actuary to new members on 11 August 2017, which was well attended.</p> <p>A second session is planned for November and members are kept informed of upcoming events e.g. pensions conferences.</p>





















Audit risk	Assurance procedure	Results and conclusions
have the necessary experience and understanding of their role and responsibilities in such areas as governance, scrutiny and decision making.		There has been one committee meeting since the election and we were pleased to note the engagement shown by new members.

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# Appendix 3

## Summary of national performance reports 2016/17



Apr			
May	 Common Agricultural Policy Futures programme: an update		
Jun	 South Ayrshire Council: Best Value audit report	 The National Fraud Initiative in Scotland	
Jul	 Audit of higher education in Scottish universities	 Supporting Scotland's economic growth	
Aug	 Maintaining Scotland's roads: a follow-up report	 Superfast broadband for Scotland: a progress update	 Scotland's colleges 2016
Sept	 Social work in Scotland	 Scotland's new financial powers	
Oct	 Angus Council: Best Value audit report	 NHS in Scotland 2016	
Nov	 How councils work – Roles and working relationships in councils	 Local government in Scotland: Financial overview 2015/16	
Dec	 Falkirk Council: Best Value audit report	 East Dunbartonshire Council: Best Value audit report	
Jan			
Feb	 Scotland's NHS workforce		
Mar	 Local government in Scotland: Performance and challenges 2017	 i6: a review	 Managing new financial powers: an update

### Pension fund relevant reports

[Local Government in Scotland Financial Overview 2015/16 – LGPS Supplement](#) – November 2016.

# North East Scotland Pension Fund

## 2016/17 Annual Audit Report

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