Strathclyde Pension Fund

2017/18 Annual Audit Report

AUDIT SCOTLAND

To Members of the Strathclyde Pension Fund Committee and the Controller of Audit

27 September 2018

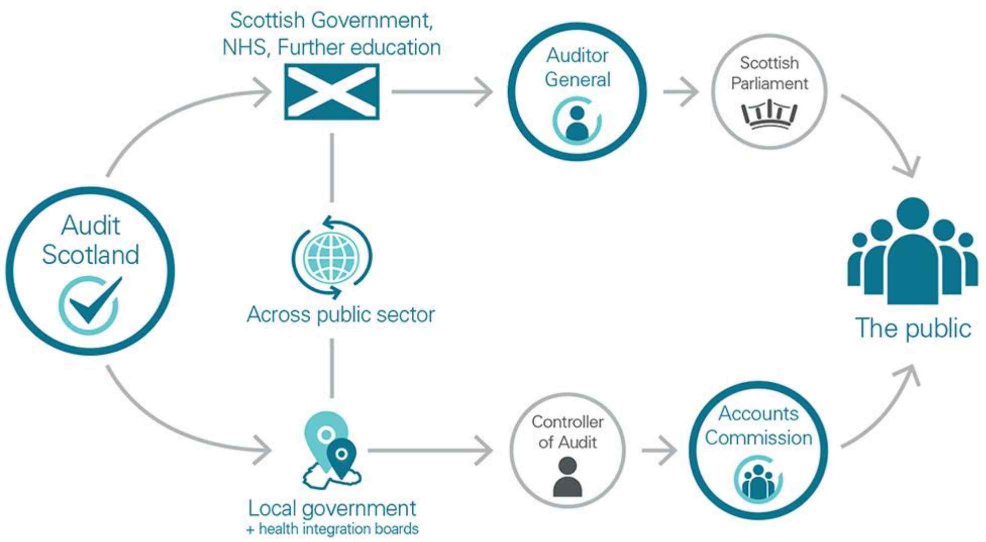
Who we are

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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2017/18 annual report and accounts

1 In our opinion Strathclyde Pension Fund's financial statements give a true and fair view and were properly prepared.

2 The management commentary, annual governance statement and governance compliance statement were all consistent with the financial statements and properly prepared.

Financial management

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

4 Local Government Pension Schemes reported a range of investment performance in 2017/18. Strathclyde Pension Fund achieved a return of 6.0%.

5 The fund's internal controls systems were found to be operating satisfactorily in year.

Financial sustainability

6 The 2017 triennial valuation for Fund No. 1 reported that fund assets were sufficient to meet 105% of its liabilities. The main employer group contributions will remain at 19.3%.

7 The continued increase in pensioners membership will make funding pension payments increasingly challenging. Cash flow projections show that the fund will continue to use investment income to pay pensions over the next ten years.

Governance and transparency

8 The fund has effective governance arrangements in place that support scrutiny of decisions made by the Pension Fund Committee.

9 Decisions are transparent with Pension Fund Committees held in public, and committee papers and detailed minutes available on the fund's website via a link to Glasgow City Council's website.

Value for money

10 The fund's investment performance is subject to regular review and scrutiny by the Pension Fund Committee.

11 The fund has adequate arrangements in place for monitoring investment performance and scrutinising investment management.

Introduction

1. This report is a summary of our findings arising from the 2017/18 audit of Strathclyde Pension Fund (the fund).

2. The scope of our audit was set out in our Annual Audit Plan presented to the February 2018 meeting of the Strathclyde Pension Fund Committee. This report comprises:

- an audit of the fund's annual accounts
- consideration of the wider dimensions that frame the wider scope of public audit 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 2017/18 have been:

- a review of the fund's main financial systems and governance arrangements
- an audit of the fund's 2017/18 annual accounts including the issue of an independent auditor's report setting out our opinions
- consideration of the four audit dimensions.

4. Glasgow City Council is the administering authority for the Strathclyde Pension Fund. The council delegates this responsibility to the Strathclyde Pension Fund Committee. It is responsible for establishing effective governance arrangements and ensuring that financial management is effective. The Pension Fund Committee is required to review the effectiveness of internal control arrangements and approve the annual accounts.

5. Our responsibilities as independent auditors 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 give independent opinions on the annual accounts. We also review and provide conclusions on the effectiveness of the fund's performance management arrangements, suitability and effectiveness of corporate governance arrangements, and financial position and arrangements for securing financial sustainability.

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 agreed action plan at Appendix 1 setting out specific recommendations, responsible officers and dates for implementation. It also includes actions from last year and progress against these.

10. We can confirm that we comply with the Financial Reporting Council's Ethical Standard. We can also confirm that we have not undertaken any non-audit related services and the 2017/18 audit fee of £54,250 as set out in our annual audit plan, remains unchanged. We are not aware of any relationships that could comprise our objectivity and independence.

Adding value through the audit

11. Our aim is to add value to Strathclyde Pension Fund by providing insight and foresight, by identifying areas of improvement and by recommending and encouraging good practice. In so doing, we aim to help the fund promote improved standards of governance, better management and decision making and more effective use of resources.

12. This report is addressed to both the members of the Strathclyde Pension Fund Committee and the Controller of Audit and will be published on Audit Scotland's website www.audit-scotland.gov.uk.

13. 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 2017/18 annual accounts

Main judgements

In our opinion Strathclyde Pension Fund's financial statements give a true and fair view and were properly prepared.

The management commentary, annual governance statement and governance compliance statement were all consistent with the financial statements and properly prepared.

Unqualified audit opinions

14. The annual accounts for the year ended 31 March 2018 were approved by the Strathclyde Pension Fund Committee on 27 September 2018. We reported, within our independent auditor's report:

- an unqualified opinion on the financial statements
- the management commentary, annual governance statement and governance compliance statement were all consistent with the financial statements and properly prepared in accordance with the guidance
- we have nothing to report in respect of those matters which we are required by the Accounts Commission to report by exception.

The fund's annual accounts are the principal means by which the pension fund demonstrates effective stewardship and use of resources to its external stakeholders.

Submission of annual accounts for audit

15. We received the unaudited annual accounts by 30 June 2018, in line with the audit timetable set out in our 2017/18 Annual Audit Plan.

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

Risks of material misstatement

17. Appendix 2 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. We also include the wider dimension risks, how we addressed these and our conclusions in the appendix.

Materiality

18. Misstatements are material if they could reasonably be expected to influence the economic decisions of users taken based on the financial statements. The assessment of what is material is a matter of professional judgement and involves considering both the amount and nature of the misstatement.

19. Our initial assessment of materiality for the annual report and accounts was carried out during the planning phase of the audit and was reported in our annual audit plan. Upon receipt of the unaudited financial statements, materiality levels were revised, and these are summarised in Exhibit 2. With regards to the financial statements, we assess the materiality of uncorrected misstatements both individually and collectively.

20. Following completion of our audit testing, we reviewed our materiality calculations and concluded that they remained appropriate.

21. In accordance with International Standard on Auditing (UK and Ireland) 315, when establishing the audit approach, materiality for the financial statements is determined as a whole. However, in certain circumstances it is appropriate to apply a lower level of materiality to one or more particular classes of transactions, account balances or disclosures, where misstatements of lesser amounts could influence the economic decisions of users taken on the basis of the financial statements. In the case of the pension fund we use a lower materiality level when assessing particular income and expenditure streams.

Exhibit 2

Materiality values

Materiality level	Amount
Overall materiality 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 2018 based on the latest set of unaudited accounts.	Fund No. 1 £104.031 million Fund No. 3 £1.035 million
Performance materiality 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 75% of overall materiality.	Fund No. 1 £78.023 million Fund No. 3 £0.776 million
Reporting threshold 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 £0.250 million).	Fund No. 1 £0.250 million Fund No. 3 £0.010 million

How we evaluate misstatements

22. There was one adjustment to the financial statements arising from our audit which was above our reporting threshold. Fund No. 1 Note 28 sets out an analysis of the total current assets included in the net assets statement. Cash balances were overstated by £4.585 million and contributions due from employers understated by £4.585 million. The disclosures in the note have been amended in the audited financial statements. The adjustment did not impact on the total current asset value included in the net assets statement.

Significant findings from the audit in accordance with ISA 260

23. International Standard on Auditing 260 (UK & Ireland) requires us to communicate significant findings from the audit to those charged with governance. This includes our views about significant qualitative aspects of the fund's accounting practices including:

- Accounting policies
- Significant financial statements disclosures
- Accounting estimates and judgements
- Timing of transactions and the period in which they are recorded

- The impact on the financial statements of any uncertainties
- Misstatements in the annual accounts
- The effect of any unusual transactions on the financial statements
- Disagreement over any accounting treatment or financial statements disclosure

24. We have no significant findings to report.

Other findings

25. During our audit we identified presentational and disclosure matters which were discussed with management. A number of changes have been made to the annual report and accounts as a result of these discussions, in addition to changes in response to prior year recommendations. However, there is still scope to enhance existing disclosures, including more consistent presentation of information across funds. Officers noted that a review of the annual report template was planned for 2018/19, and this would provide scope to further review and enhance the annual report and accounts document.

Recommendation 1

The fund should review the structure and presentation of the annual report and accounts, to further enhance the flow of the document and incorporate good practice into the existing reporting template.

Follow up of prior year recommendations

26. As part of our audit work in 2017/18, we have followed up actions previously reported and assessed progress with implementation. These are reported in Appendix 1 and identified by the prefix b/f (brought forward).

27. In total, 3 agreed actions were raised in 2016/17. Although we have raised two further action plan points in 2017/18 on similar themes, we are satisfied that the fund has addressed the three actions raised in 2016/17 (see Appendix 1).

Pre-audit inspection and objections to the accounts

28. The Local Authority Accounts (Scotland) Regulations 2014 require local government bodies to publish a public notice on their website that includes details of the period for inspecting and objecting to the accounts. This must remain on the website throughout the inspection period. The notice for Strathclyde Pension Fund was published on the website of the administering authority (Glasgow City Council) and complies with the regulations. No objections were received to the Strathclyde Pension Fund accounts.

Part 2

Financial management

Main judgements

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

Local Government Pension Schemes reported a range of investment performance in 2017/18. Strathclyde Pension Fund achieved a return of 6.0%.

The fund’s internal controls systems were found to be operating satisfactorily in year.

Financial performance in 2017/18

29. 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 performance of Fund No. 1 in 2017/18 is summarised in Exhibit 3.

Exhibit 3

Assets, liabilities, funding level and investment performance

Increase in net assets (Fund No. 1)	Decrease in estimated actuarial liabilities (Fund No. 1)	Funding level (Fund No. 1)	Investment performance (Fund No. 1)
£20.806 billion Closing net assets as at 31 March 2018 (+5.62%)	**£22.787 billion** Liability at 31 March 2018 based on roll forward and rebased approximation from 2017 valuation (-9.35%)	**105.6%** 31 March 2018 Interim valuation	**10.1%** Average annual return on investments over 5 years
£19.699 billion Opening net assets as at 1 April 2017	**£25.136 billion** Liability as at 31 March 2017	**105.0%** 2017 Funding valuation	**6.0%** Return on investments 2017/18

Source: 2017/18 Strathclyde Pension Fund unaudited annual report and financial statements

30. The combined net assets of Fund No. 1 and Fund No. 3 increased to £21.013 billion at 31 March 2018 from £19.910 billion at 31 March 2017. This increase of £1.103 billion (5.54%) reflected the relatively strong growth in global stock prior to the variable market conditions faced by investors towards the end of the financial year. Fund No. 1 was helped by the sale of £2 billion of equity portfolios in quarter 3 of 2017/18 prior to those more variable market conditions. The fund also began the implementation of a revised strategic target model for the Fund No. 1 portfolio of investment assets to hold less equity and move to more short term and long term enhanced yield assets.

31. During 2017/18, benefits paid out by Fund No. 1 amounted to £581 million which was in excess of the £549 million contributions received by the fund.

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

32. The fund's actuary, Hymans Robertson, estimated that pension liabilities had fallen from £25.136 billion at 31 March 2017 to £22.787 billion at 31 March 2018 (£2.349 billion decrease). The liabilities have been estimated by rolling forward cash flows and investment returns from the 2017 triennial valuation.

33. Based on the triennial valuation by the actuary, the Fund No. 1 funding level was calculated at 105% as at 31 March 2017 (reported in December 2017). An inter-valuation monitoring report from the actuary has recorded a projected funding position of 105.6% as at 31 March 2018. Similarly, Fund No. 3's funding level was calculated at 114% as at 31 March 2017 (reported in December 2017). An inter-valuation monitoring report from the actuary has recorded a projected funding position of 114.1% as at 31 March 2018.

34. Both funds are reporting a surplus position, and this is the first time that Fund No. 1 has shown a surplus since 2002. This has allowed the employer contribution rates for the main employers to remain fixed for the next 3 years, until the next valuation. However, the actuarial reports indicate that future years may still be challenging. Future investment returns are expected to be reduced and there may be future demographic challenges.

Financial management arrangements

35. The Executive Director of Finance for Glasgow City Council is the proper officer responsible for Strathclyde Pension Fund. The financial regulations of Glasgow City Council, as administering authority, apply to the pension fund. We consider these to be comprehensive, current, and promote good financial management.

36. Investment and administration performance reports are submitted to the Pension Fund Committee on a quarterly basis. Reports are comprehensive and include fund performance trends, investment manager performance against benchmarks and movements in asset allocations. The committee also consider for approval proposed investments recommended by the Investment Advisory Panel on a regular basis. Through our attendance at the committee we have observed a good level of review and scrutiny by members.

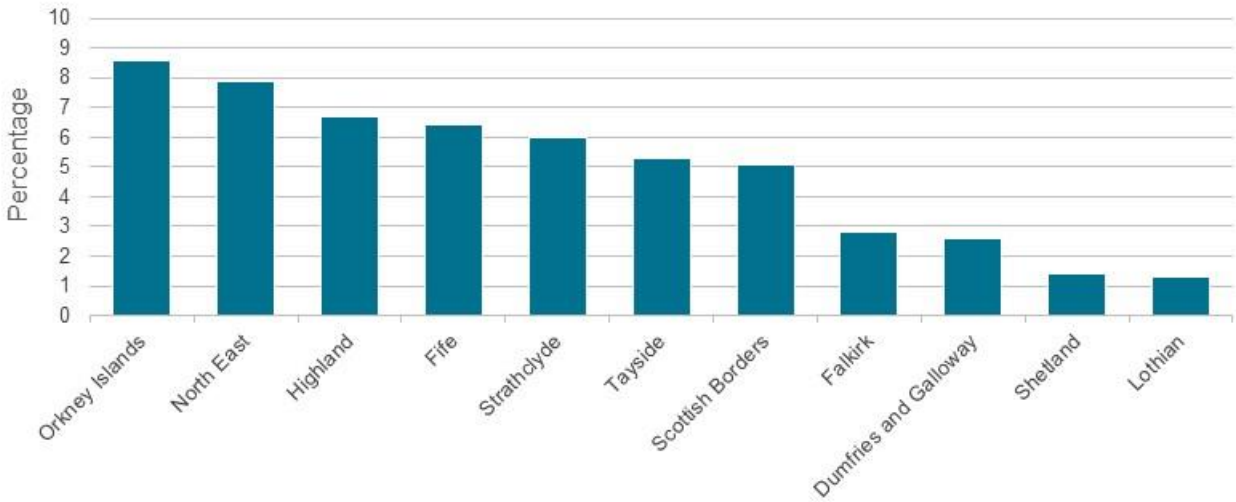
37. Based on evidence reviewed, we conclude that the fund has effective financial management arrangements in place. This includes comprehensive reporting of investment performance.

Financial outcomes

38. 2017/18 has been a relatively positive year for investment performance for most Local Government Pension Schemes (LGPS) across Scotland as illustrated in Exhibit 4.

Exhibit 4

LGPS pension funds – Net return on investment 2017/18 (unaudited figures)



Source: 2017/18 LGPS pension funds unaudited financial statements

39. Performance across the Local Government Pension Scheme funds in Scotland was lower than in 2016/17, when the average return on investment was approximately 20%. In a more challenging 2017/18, Strathclyde Pension Fund achieved a return of 6.0% on its investments. This is above the fund benchmark of 3.9% for 2017/18. The fund's average annual return is 10.1% per annum over the last 5 years, which is ahead of the strategic benchmark of 9.0%.

Systems of internal control

40. As part of our audit, we identify and inspect the key internal controls in those accounting systems which we regard as significant to produce the financial statements. Our objective is to gain assurance that the fund has systems of recording and processing transactions which provide a sound basis for the preparation of the financial statements.

41. The fund uses a number of the financial systems of Glasgow City Council, such as the financial ledger system, but uses its own systems for pensions and investments administration.

42. Our findings were included in a management letter presented to the Pension Fund Committee on 13 June 2018. We concluded that the controls were operating effectively. No significant control weaknesses were identified which could affect the fund's ability to record, process, summarise and report financial and other relevant data to result in a material misstatement in the financial statements.

Part 3

Financial sustainability

Main judgement

The 2017 triennial valuation for Fund No. 1 reported that fund assets were sufficient to meet 105% of its liabilities. The main employer group contributions will remain at 19.3%.

The continued increase in pensioners membership will make funding pension payments increasingly challenging. Cash flow projections show that the fund will continue to use investment income to pay pensions over the next ten years.

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.

Funding position

43. The March 2017 triennial valuation for Fund No. 1 (issued in December 2017) reported that fund assets were sufficient to meet 105% of its liabilities. The interim valuation by the fund's actuary estimated that the funding level had increased to 105.6% as at 31 March 2018. This interim valuation uses the same base data as the triennial funding valuation, rolled forward to take account of changes in membership and updated assumptions. However, this is not directly comparable to the triennial funding valuation, as it is not carried out on the same basis as that used for setting employer contribution rates.

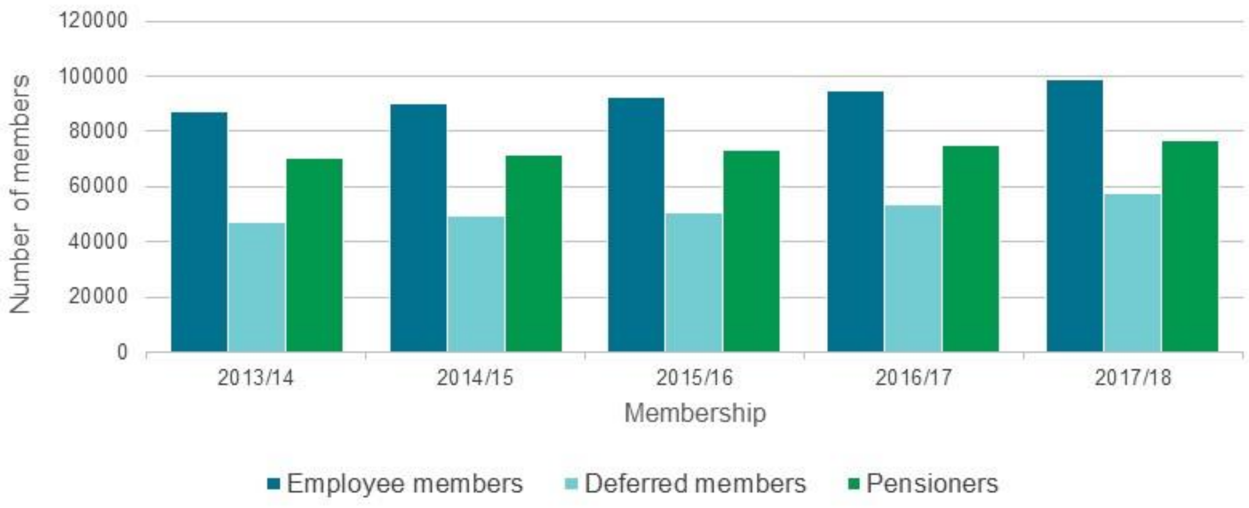
44. At the 2017 valuation, the actuary noted that the future service cost of the workforce implied that the employers' contribution would continue at 19.3% for Fund No. 1's main employer group. The Funding Strategy Statement was updated as part of the triennial valuation and approved by the Committee on 28 February 2018. Across Scotland, the picture is mixed with some other funds increasing or lowering employer contributions depending on their funding position.

45. The March 2017 triennial valuation for Fund No. 3 (issued in December 2017) reports that the fund assets were sufficient to meet 114% of its liabilities. The interim valuation by the fund's actuary, estimated that the funding level had increased to 114.1% as at 31 March 2018. The actuary noted that the future service cost of the workforce implied a contribution of 53.3%, but due to the funding surplus the actual rate payable is 0%.

Membership levels

46. The pension fund is a multi-employer fund with 12 Local Authorities, and around 170 other employers. The current membership profile is shown at Exhibit 5. The number of active members continues to outweigh the number of pensioners.

Exhibit 5
Strathclyde Pension Fund (Fund No. 1) membership



Source: Strathclyde Pension Fund 2017/18 unaudited financial statements

47. Membership of the fund increased by 10,452 to 233,312 members at 31 March 2018; an increase in members of 4.7%. The impact of auto-enrolment contributed to the increase in members.

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 these current and future pension costs.

49. Membership is likely to continue to increase following the introduction of auto-enrolment. New legislation means that by October 2018, all employers must offer workplace pension schemes to eligible workers.

50. Transitional delay guidance, issued in June 2017, indicated that employers cannot automatically enrol employees who opted out more than 12 months before the original transitional delay assessment date of 1 October 2017. Although this will have lessened the anticipated administrative pressure in 2017/18, automatic enrolment will continue to present the fund with increased administration challenges going forward.

Contributions

51. Following the latest triennial valuation in 2017, the actuary agreed employer contribution rates with individual employers for 2018/19 onwards. For a small number of employers, these rates include an element of deficit recovery contributions to support employers financial planning. The approximate split of all contributions received in year is set out at Exhibit 6.

Exhibit 6
Contributions and benefits paid in 2017/18 (Fund No. 1)

	Administering authority £m	Other scheduled bodies £m	Admitted bodies £m	Total £m
Employer contributions including strain costs	54.159	259.463	103.139	416.761
Employee contributions	17.567	77.931	29.994	125.492
Transfer in/other				5.836
Total income				**549.167**
Benefits paid	80.715	383.907	83.448	548.070
Transfers out				32.577
Total expenditure				**580.647**

Source: Strathclyde Pension Fund 2017/18 unaudited financial statements

52. As in previous years, the fund has reported a deficit in its dealings with members. Pension benefits paid to pensioners have exceeded the contributions received from employers and employees. When including employee transfers to/from the fund there was a deficit from dealing with members of £31.5 million for Fund No. 1 and a deficit from dealing with members of £6.1 million for Fund No. 3. The fund has relied on investment income to meet this deficit.

53. The fund actively monitors its cash flow position and reports the position to each meeting of the Pension Fund Committee. A ten-year cash flow forecast is prepared annually and is submitted to the Pension Fund Committee at the February meeting (as an appendix to the Annual Business Plan).

54. The February 2018 forecasts show that over the next ten years, negative cash flows will be an ongoing trend. Looking forward, it is anticipated that the fund will use investment income to pay pensions each year over the next decade. There is currently sufficient projected investment income to cover this deficit. Cash flow predictions indicate that this will continue to be the case over the next decade. However, changes in market conditions could make this increasingly more challenging over the medium to longer term.

Recommendation 2

The fund should continue to closely monitor the implementation of the funding and investment strategies and the impact of the fund's cash flow position, given the negative cash flows forecast for the next ten years.

EU withdrawal

55. There remains significant uncertainty about the detailed implications of EU withdrawal (i.e. Brexit). It is critical that public sector bodies are working to understand, assess and prepare for the impact on their business in three broad areas:

- Workforce - the extent to which changes to migration and trade policies are likely to affect the availability of skilled and unskilled labour.

- Funding – the extent to which potential changes to funding flows are likely to affect the finances of the organisation and the activity that such funding supports.

- Regulation – the extent to which potential changes to regulation across a broad range of areas overseen at an EU level are likely to affect the activities of the organisation.

56. The nature of the pension fund means that workforce and funding issues are comparatively less significant than regulation. There is also an additional issue relating to the impact of investments and market volatility.

57. Fund No. 1 invests significantly in global markets and uncertainties over Brexit throughout 2017/18 has not had a significant impact on market performance, with all the major market indices rising through 2017. However, in 2018, the position on Brexit has introduced further challenges and complexities. The fund will want to continue to monitor progress in this area.

Part 4

Governance and transparency

Main judgements

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

Decisions are transparent with Pension Fund Committees held in public, and committee papers and detailed minutes available on the fund's website via a link to Glasgow City Council's website.

Governance arrangements

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.

58. Glasgow City Council is the administering authority for Strathclyde Pension Fund. The council has delegated responsibility for governance to the Executive Director of Finance. The Pension Fund Committee is the main decision-making body of the fund. It is supported by the Pension Board and is responsible for establishing arrangements that ensure the proper conduct of the affairs of the fund. It is also responsible for ensuring that decisions are made within the terms of the Local Government Pension Scheme.

59. The responsibilities of the Executive Director of Finance, the Pension Fund Committee and the Pension Board are set out in the Statement of Investment Principles.

60. The main functions of the fund are management of investments and administration of scheme benefits. These functions are carried out in accordance with the Local Government Pension Scheme (Scotland) regulations which are statutory instruments made under the Superannuation Act 1972 and Public Service Pensions Act 2013.

61. From our work we concluded that effective arrangements were in place for governance, decision making and scrutiny during the financial year. A training policy and practice statement for the fund together with a training plan for 2017/18 has been reported to the Committee. This has been completed in year and a new plan has been put in place for 2018/19. We concluded that effective arrangements are in place for member training and development.

62. In addition to the Pension Fund Committee and Pension Board, an Investment Advisory Panel (IAP) is also in place which comprises of investment officers from the fund and representatives from Hymans Robertson as the fund's actuary and investment consultant. The panel also includes three independent expert advisors. The IAP supports the Pension Fund Committee and is responsible for developing investment strategy and monitoring investment performance.

63. Overall, we concluded that the fund has adequate governance arrangements in place which support good governance and accountability.

Management commentary, annual governance statement and governance compliance statement

64. The applicable legislation and regulations require pension funds to prepare and publish, along with their financial statements, a management commentary, an annual governance statement, and a governance compliance statement that are consistent with the disclosures made in the financial statements. The management commentary should be fair, balanced and understandable and clearly address the longer-term financial sustainability of the body.

65. Based on our knowledge and work performed, we concluded that the management commentary, the annual governance statement and the governance compliance statement are consistent with the financial statements.

Transparency

66. Transparency means that the public, in particular, members of the pension fund have access to understandable, relevant and timely information about how the fund is taking decisions and how it is using resources.

67. There is evidence from several sources which demonstrate the fund's commitment to transparency:

- The Pension Fund Committee meetings are held in public
- Papers and meetings for the Pension Fund Committee are publicly available on the fund’s website via a link to Glasgow City Council website
- Funding strategy statements and actuarial valuations for both Fund No. 1 and Fund No. 3 are available on the pension fund’s website.

68. The pension fund held an annual general meeting on 15 June 2018 and over 100 stakeholders attended. Senior officers presented an overview of the fund’s business for 2017/18 and the actuary provided information about the results of the recent triennial valuation.

69. We concluded that that the fund conducts its business in an open and transparent manner.

Pensions Regulator Public Service Code

70. The Public Sector Pensions Act 2013 requires all public sector pensions schemes to produce an annual benefit statement for all active members by the 31 August following the end of the financial year. For 2016/17 (completion by 31 August 2017), the fund produced and issued annual benefit statements to all of its employee members. 98% were issued within the 31 August statutory deadline. The remaining 2% related to new members and were issued later, once data had been obtained from employers.

Consultation on the future of the Local Government Pension Scheme

71. The Scottish Scheme Advisory Board is undertaking a review of the future structure of the Local Government Pension Scheme in Scotland. Four options were identified by the Board:

- Retain the current structure of eleven funds
- Promote cooperation in investment and administration between the eleven funds
- Pool investments between the eleven funds
- Merge the eleven funds into one or more funds.

72. The Board is currently consulting on these options, and has set a range of criteria to be considered by stakeholders:

- Cost of investing
- Governance
- Operating risks

- Infrastructure investment.

73. The consultation will take place through to December 2018 with the Scottish Scheme Advisory Board to report back to the Scottish Government in 2019. The Pension Fund Committee intends to respond by December 2018, in line with the timescale for consultation.

Local Government Pension Scheme Regulations (Scotland) 2018

74. Revised Local Government Pension Scheme regulations came into effect on 1 June 2018 and were noted by the Pension Fund Committee at the June 2018 meeting.

75. The changes to the regulations aim to consolidate amendments since April 2015 and include:

- LGPS members can elect to take early payment of their pension from age 55, with an actuarial reduction. They will not require consent from their employing body.
- There is increased flexibility for administering authorities when employers exit the pension scheme. Exit credit can be provided to exiting employers if appropriate.
- There are changes to additional voluntary contributions following the introduction of Freedom and choice in pensions by the UK Government, which permits payment from age 55 as a lump sum.

Internal audit

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

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

78. To avoid duplication of effort we place reliance on the work of internal audit wherever possible. In 2017/18 we did not place any formal reliance on internal audit reviews for obtaining direct assurance for our financial statements work. We considered internal audit report findings on the following areas as part of our wider dimension work:

- Preparedness for auto-enrolment
- Transfers
- Guarantors/covenants
- I-Connect
- Investments (DIP)
- European Directives

79. We also considered internal audit findings in relation to Glasgow City Council which were relevant to the pension fund including the payroll verification and creditors audits.

Quality of financial and performance reporting

80. During the year, we reviewed and assessed the quality of reporting to the Pension Fund Committee. We consider the reports on fund performance, investment and administration to be comprehensive with sufficient detail and comparative information to allow stakeholders to make informed judgments on the fund's performance over time.

81. One of the key mechanisms for public performance reporting is the fund's annual report and financial statements. As noted in part one of this report, the fund has enhanced the presentation and structure of the document in recent years and plans to introduce a new template for 2018/19.

Standards of conduct for prevention and detection of fraud and error

82. We assessed the fund's arrangements for the prevention and detection of fraud. The fund relies on the administering authority, Glasgow City Council's arrangements for the prevention and detection of fraud and corruption. These include codes of conduct for members and officers, whistleblowing policy, an anti-fraud strategy and response plan.

83. We concluded that appropriate arrangements were in place for preventing and detecting fraud and corruption in 2017/18.

National Fraud Initiative

84. The National Fraud Initiative (NFI) in Scotland is a counter-fraud exercise co-ordinated by Audit Scotland. It uses computerised techniques to compare information about individuals held by different public bodies, and on different financial systems, to identify 'matches' that might suggest the existence of fraud or error. NFI activity is summarised in Exhibit 7.

Exhibit 7

Total number of matches	Number recommended for investigation	Completed/closed investigations
		
2,925	1,048	2,835

Source: NFI website 2017/18

85. A range of reports are produced comparing pension data to payroll information and the register of deaths from a variety of sources. Matches identified through this work are priorities and investigated by officers. Work has continued throughout 2017/18 to review the recommended and other matches. This also improves the integrity of the data on the Altair pension administration system.   As at August 2018, no frauds had been identified and a small number of errors has identified overpayments of £0.124 million.

86. The matching exercise remains an important control which provides assurance that the fund's records are consistent with those of other public bodies. The fund is proactive in participating in the NFI exercise and investigates matches in a timely manner.

Cyber security

87. The Scottish Government issued a Public Sector Action Plan on Cyber Resilience in November 2017 which requires all public sector bodies to carry out a review to ensure their cyber security arrangements are appropriate.

88. The pension fund uses Glasgow City Council's system as the administering authority. In addition, although the fund uses Altair which is a pension specific system, this operates within the council's system network.

89. The council is presently going through the Cyber Essentials accreditation pre-assessment and, once this is complete, will make a decision on whether to pursue Cyber Essentials or Cyber Essentials (Plus) accreditation. The council is aiming to obtain accreditation by October 2018, but this will be dependent on the results of the pre-assessment. We have concluded that the council is actively working towards strengthening its cyber resilience arrangements.

General Data Protection Regulation

90. The new General Data Protection Regulation (GDPR) came into force on 25 May 2018. This replaced the UK Data Protection Act 1998 (DPA). As a Regulation, all EU member states must implement it in the same way. GDPR sets out further requirements than the DPA and has introduced new and significantly changed data protection concepts.

91. GDPR introduces a wide range of new rights for individuals in respect of their personal data. These include the right to be forgotten, the right to object to certain processing activities and to decisions taken by automated processes. Failure to comply with new GDPR data handling arrangements could result in the council incurring significant fines.

92. Since April 2016 the council, as administering authority for the fund, has been carrying out an implementation programme in relation to data protection reform, covering GDPR and the new Data Protection Act 2018. This work has been managed using the council's standard project management approach. All tasks due for completion by 25 May 2018 in relation to GDPR have been completed as planned. We concluded that the council had adequate arrangements in place to help ensure it was properly prepared for the introduction of GDPR.

Part 5
Value for money

Main judgements

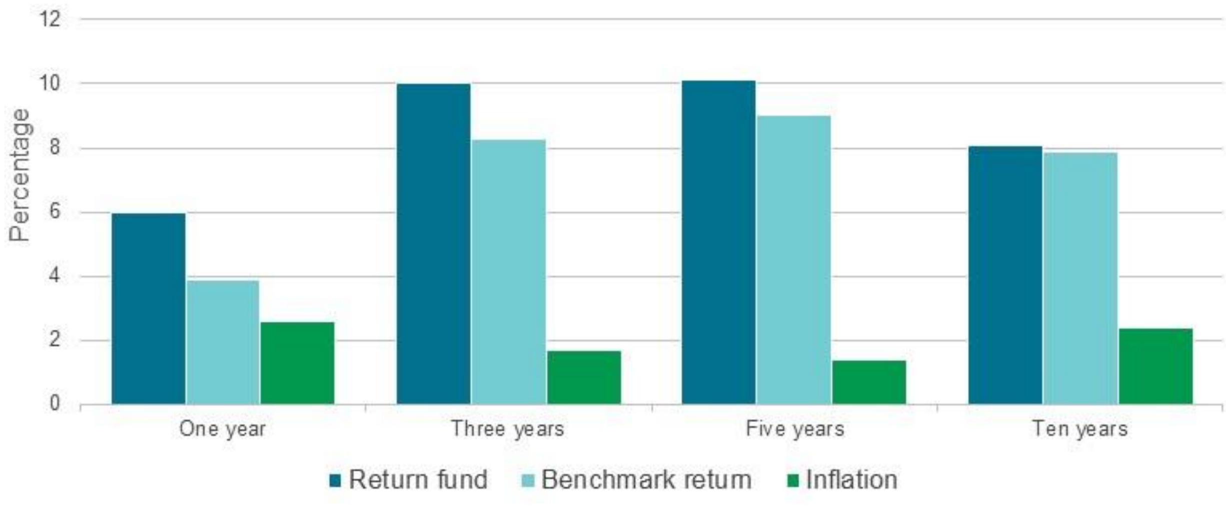
The fund's investment performance is subject to regular review and scrutiny by the Pension Fund Committee.

The fund has adequate arrangements in place for monitoring investment performance and scrutinising investment management.

Investment performance

93. The Pension Fund 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.

Exhibit 8
Fund No. 1 investment performance



Source: Strathclyde Pension Fund 2017/18 unaudited financial statements

94. Exhibit 8 shows that over the year, the Fund No. 1 generated a return of 6.0% against a benchmark of 3.9%. Although investments in global indices supported this return, the fund's performance in its specialist portfolios, e.g. global small companies and UK properties, were significant contributors to this increase.

95. Over the medium to longer term the fund has outperformed its benchmark over three, five and ten years.

96. Under the career average pension scheme (CARE), accrued benefits are indexed at Consumer Price Index (CPI). Benefits earned under the old final salary scheme will continue to increase in line with earnings. As can be seen from Exhibit 8, investment returns have outperformed inflation over the past 10 years, going some way to meeting increases in the historic liabilities.

Value for money is concerned with using resources effectively and continually improving services.

97. The fund appoints several external investment managers. Individual investment manager performance is reported on a quarterly basis to the Pension Fund Committee. In addition, all investment managers are subject to review at least annually by the Investment Advisory Panel (IAP). Investment managers are required to complete annual compliance checklists. The fund's investments team also carry out annual diligence reviews for each appointed fund manager.

98. The investment strategy of the fund is included in the Statement of Investment Principles (SIP) which was updated in April 2017. The fund has adopted a risk/return asset framework as the basis for modelling and agreeing the investment strategy. The fund is still largely equity based, but in February 2018 the Committee agreed that it would move to the next step of its investment strategy. This means reducing the level of holdings of equity assets and increasing the portfolio share of short and long term enhanced yield assets. The fund will continue to invest in other assets classes such as hedging/insurance and credit.

99. The fund is looking to increase its investment in long term enhanced yield assets, such as UK and overseas property. At 31 March 2018, the fund held direct property assets with a value of £1.881 billion. The objective of holding such investments is to provide a long-term income stream and a degree of inflation protection. Maintaining long term investment income is important to ensuring the fund has available funding to meet any deficit resulting from dealings with members.

100. Investment return and risk are inextricably linked, and it is not possible for us to comment on the relative performance of the fund's investments given the risk exposure of the asset allocation and investments made. Asset allocation is largely in line with the fund's interim target allocation model. In year, the fund has reduced equity holdings by £2 billion from 68.6% of assets at 31 March 2017 to 56.7% at 31 March 2018. This is against an interim target of 57.5%. The fund has relatively lower levels of both short-term enhanced yield investments and long term enhanced yields as against the interim target model.

101. A revised strategic target model was approved by the Pension Fund Committee in February 2018. The objective is to ensure that the fund implements the next stage of its investment strategy over the next three years. The Investment Advisory Panel continues to monitor asset allocation and the revised strategic target model and provides a quarterly report to the Pension Fund Committee. The investment strategy appears an appropriate strategy to de-risk the investment portfolio at a time where there is some increasing uncertainty in global markets.

102. Glasgow City Council as administering authority of the fund is currently planning the tendering process for the global custodian role to support the pension fund. This will continue into 2019.

Management expenses

103. 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.

104. CIPFA published revised guidance on local government pension scheme management expenses. This guidance sets out a framework for the reporting of investment management costs and this was applied by the fund from 2016/17. This allows funds to develop bench-marking information and in the context of returns achieved, to ensure that value for money is being secured.

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

106. Investment management expenses have increased from £96.4 million in 2016/17 to £108.8 million in 2017/18. The main reason for this increase in expenses relates to the 6.0% increase in asset value.

107. We have concluded that the fund has adequate arrangements in place for monitoring investment performance and scrutinising investment management expenses. However, CIPFA guidance on management expenses has enabled greater transparency in investment management fee information including the development of benchmarking information. Management should make use of the additional information now available on the cost of investment management services to make informed decisions on value for money, as well as the performance of managers.

Administrative expenses

108. 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, freedom of choice and further implementation of modules on the Altair (pension administration system).

109. The fund's business plan sets out a range of service standards against which administration performance is monitored. These are measured on a regular basis and are reported to the Pensions Committee quarterly.

110. The fund uses a rolling customer survey to enable it to measure members' satisfaction with the quality of service delivery. Members receive a questionnaire when each significant transaction is processed. The fund continues to report high levels of member satisfaction with a level of satisfaction amongst retirals of 89.6% in 2017/18.

111. Employers are required to submit year end contribution returns by May for the preceding 31 March year end. This is an important control over the accuracy of pension contributions received and recorded in the pensions systems and is of increased importance following the introduction of CARE as the member benefit statement requires actual salary data from all employers. All year end contribution returns relating to 2017/18 have been received.

112. As part of the fund's governance assurance framework employers are also required to submit compliance certificates verifying compliance with a range of pension fund and regulatory requirements in relation to pension administration. In 2017/18 the compliance certificates return rate was 88.8%. It has been confirmed that certificates were received from all the fund's major employers.

National performance audit reports

113. Audit Scotland carries out a national performance audit programme on behalf of the Accounts Commission and the Auditor General for Scotland. During 2017/18, we published reports which might be of interest to the fund. These are outlined in Appendix 3 accompanying this report.

Appendix 1

Action plan 2017/18

2017/18 recommendations for improvement

No.	Issue/risk	Recommendation	Agreed management action/timing
1	**Annual Report presentation** Our audit identified a number of presentational and disclosure issues which were discussed with management, including potential changes to the document structure to improve the flow of the financial statements sections within the annual report. In addition, the web links included throughout the report are only to the home page of the pension fund rather than to specific areas on funding, investment, etc. **Risk** Information in the annual report is challenging to follow and does not assist stakeholders in understanding the accounts.	The fund should review the structure and presentation of the annual report and accounts, to further enhance the flow of the document and incorporate good practice into the existing reporting template. Paragraph 25	The structure and presentation are reviewed each year and improvements, including any adjustments suggested by Audit Scotland, are introduced. In addition, a review of the template used for the 2017/18 report will be completed with a view to introducing a refreshed template for the 2018/19 report. Director of Strathclyde Pension Fund March 2019
2	**Funding Position** The fund has reported a deficit in dealings with members and although active membership has increased, the continued increase in pensioners in the fund's membership will make funding pension payments increasingly challenging. The fund's cash flow projections in the Annual Business Plan 2018/19 show that the fund will use investment income to pay pensions over the next ten years. **Risk** There is a risk that the fund will have to increasingly rely	The fund should continue to closely monitor the implementation of the funding and investment strategies and the impact of the fund's cash flow position, given the negative cash flows forecast for the next ten years. Paragraph 54	Reviews of both the funding and investment strategies were carried out during 2017/18. The review of the Funding strategy was concluded during the year alongside completion of the actuarial valuation. Revised contribution rates have been introduced for some employers as a result. The investment strategy review will result in changes to the investment structure over the next 3 years. The main theme will be a reduction in equities in favour of short-

No.	Issue/risk	Recommendation	Agreed management action/timing
	on investment income to make up the shortfall between contributions income and pension payments.		term and long-term enhanced yield investments which produce more predictable returns and cash flows. Short term cash flow will continue to be monitored and reported to the Board and Committee. In addition, a review of the cash flow model has been included in the 2018/19 business plan. This will identify options to increase reported investment income by switching to holdings which distribute rather than re-investing the income. Director of Strathclyde Pension Fund September 2018
Follow up of prior year recommendations			
b/f	**1. Annual report** Our audit identified a number of presentational and disclosure issues which were discussed with management, including potential changes to the document structure to improve the flow of the financial statements sections within the annual report. **Risk** Information in the annual report is unclear, and does not assist the user in understanding the accounts.	The fund should review the existing structure and presentation of the annual report to identify opportunities for streamlining the presentation of information.	Action completed The fund has reviewed the structure and have improvements in the presentation of information. However, there are additional improvements which can be made to continue to enhance the accounts.
b/f	**2. Automatic enrolment** The end of the transitional period will result in the automatic enrolment of employees who have been eligible to participate in the fund but have previously not chosen to join.	The fund should ensure that business plans address the resource and administrative challenges that automatic enrolment will present.	Action completed All eligible staff were auto-enrolled during 2017/18 and therefore the project plan has been completed. Automatic enrolment is primarily an employer

No.	Issue/risk	Recommendation	Agreed management action/timing
	The fund is required to provide basic scheme information (welcome packs) to automatically enrolled members within one month of the date employee information was received from the employer. **Risk** Implementing legislation on automatic enrolment will present the fund with additional administration pressures and challenges. Failure to comply with requirements may lead to action being taken by the Pensions Regulator.		responsibility. For SPF it is now a business-as-usual process. Requirements will be considered alongside other processes in producing the annual business plan.
b/f	**3. Funding Position** The fund has reported a deficit in dealings with members and although active membership has increased, the continued increase in pensioners in the fund's membership will make funding pension payments increasingly challenging. The fund's cash flow projections show that the fund will rely on investment income to pay pensions in 2017/18. **Risk** A mismatch between the fund's funding and investment strategies leads to insufficient cash flow to pay pensions.	The fund should continue to closely monitor the implementation of the funding and investment strategies and the impact on the fund's cash flow position.	Action completed The 2018/19 Annual Business plan includes a revised ten-year cash flow forecast which shows that cash flows over the next ten years are expected to be negative, but that there is sufficient investment income to cover this variance. The negative cash flow forecasts are a result of a number of factors including the valuation, maturity of the fund, etc.

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 accounts and those relating our wider responsibility under the *Code of Audit Practice 2016*.

Audit risk	Assurance procedure	Results and conclusions
Risks of material misstatement in the financial statements		
1 Risk of management override of controls 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 considering the risk of management override of controls in order to change the position disclosed in the financial statements.	Detailed testing of journal entries. Review of accounting estimates. Focused testing of accruals and prepayments. Evaluation of significant transactions that are outside the normal course of business.	A sample of journals was tested as part of our financial statements audit. We reviewed the accounting estimates used in preparation of the financial statements. We concluded there was no evidence of management override of controls.
2 Risk of fraud over income and expenditure ISA 240 presumes a risk of 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 Practice Note 10 (revised). The fund receives a significant amount of income from third party sources. This presents a risk due to the extent and complexity of income. The fund also makes a high volume of payments, including high value payments, which can constitute a risk of misstatement of expenditure.	Evaluation of the effectiveness of systems for income recognition and recording. Review of custodian arrangements and completion of 'review of work by service auditors' in accordance with ISA 402 for the global custodian. Analytical procedures on income and expenditure streams. Agree income to third party confirmation. Substantive testing of expenditure. Evaluation of the outcomes of the 2017 National Fraud Investigation exercise.	We reviewed the controls in place for income recognition and recording. Income and expenditure streams were satisfactorily agreed to custodian reports. Substantive testing of income and expenditure did not identify any misstatement issues.
3 Estimation and judgements There are two areas in the financial statements which involve a significant degree of subjectivity: • the measurement and valuation of investments	Completion of 'review of the work of an expert' in accordance with ISA 500, for significant unquoted investments. Confirmation of valuations to valuation reports and/ or other supporting documentation.	Completed a 'review of the work of an expert'. Verified level three investment balances to custodian reports. We did not identify any issues in relation to this risk.

	Audit risk	Assurance procedure	Results and conclusions
	• the actuarial valuation. Investments include level 3 investments such as unquoted equity, where valuations involve the significant application of judgement in determining appropriate amounts. The actuarial valuation depends on a number of assumptions about the future. These include investment returns, contribution rates, commutation assumptions, pensioner mortality, discount rates and earning assumptions. This subjectivity entails a risk of misstatement	Completion of 'review of the work of an expert' in accordance with ISA 500, for the work of the actuary. Consideration of the report by the consulting actuary to Audit Scotland on actuarial assumptions in use in 2017/18.	
Risks identified from the auditor's wider responsibility under the Code of Audit Practice			
4	**Financial sustainability** The fund reported an overall deficit in dealings with members in 2016/17. The cash flow projection for 2017/18 shows a continuing deficit position in this area, which will be funded through the use of investment income. The triennial valuation can have a significant impact on the financial position of the fund and of its member bodies. There is a risk that the position of the fund may deteriorate over time, with potential impact on its ability to meet all of its future liabilities.	Review of cash flow forecasts. Consideration of actuarial valuation reports.	We reviewed the ten-year cash flow projection issued as part of the 2017/18 Annual Business Plan and the new ten-year cash flow as part of the 2018/19 Annual Business Plan. We identified that there are now negative projected cash flows over the next ten years.
5	**Governance and transparency** Our prior year audit identified areas for improvement in the presentation of the annual report and accounts. This included potential changes to the wording of the financial statements sections within the annual report. Officers agreed to review the existing structure and presentation of the annual report to identify opportunities for streamlining the presentation of information. There is a risk that information in the annual report is unclear	Communication with officers. Review of disclosures as part of our financial statements audit.	We identified that there have been improvements in the presentation of the accounts including the reordering of some areas of the accounts. We noted that there are still further areas which can be improved to bring greater consistency across notes for Fund No.1 and Fund No. 3 to enhance the annual report and accounts.

Audit risk	Assurance procedure	Results and conclusions
and does not assist the user in understanding the accounts.		

Appendix 3

Summary of national performance reports 2017/18

2017/18 Reports

	Apr	
	May	
Common Agricultural Policy Futures programme: further update	**Jun**	Scotland's colleges 2017
	Jul	NHS workforce planning
Self-directed support: 2017 progress report	**Aug**	
Equal pay in Scottish councils	**Sept**	
Transport Scotland's ferry services	**Oct**	NHS in Scotland 2017
Local government in Scotland: Financial overview 2016/17	**Nov**	
	Dec	
	Jan	
Early learning and childcare	**Feb**	
Managing the implementation of the Scotland Acts	**Mar**	

Strathclyde Pension Fund

2017/18 Annual Audit Report

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