

# Orkney Islands Council Pension Fund

2018/19 Annual Audit Report



 AUDIT SCOTLAND

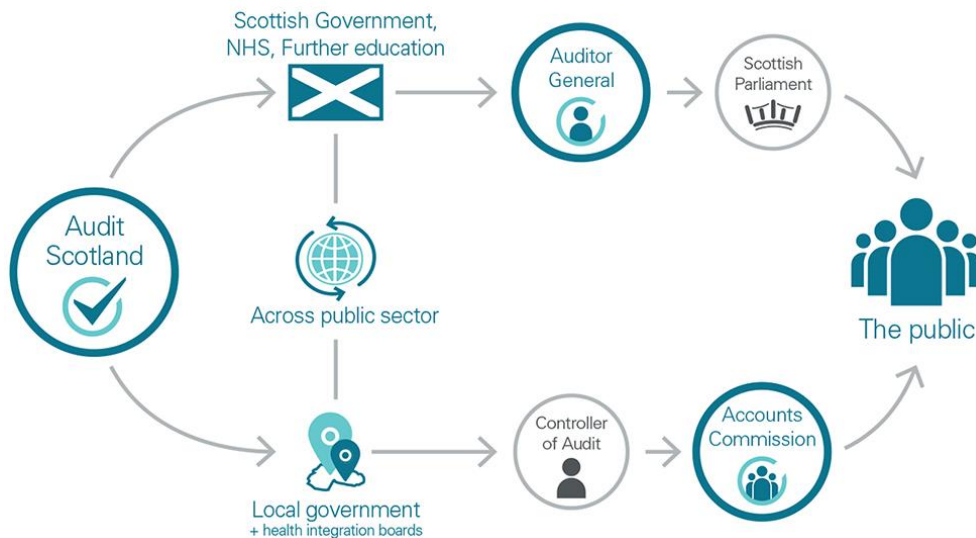
To Members of the Orkney Islands Council Pension Fund sub-committee and the Controller of Audit

17 September 2019

## 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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## 2018/19 annual report and accounts

- 1 Orkney Islands Council Pension Fund's (the Fund) 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 From our review of unaudited accounts, Orkney has the highest funding level relative to other Scottish pension funds in 2018/19.
- 4 Orkney Islands Council achieved a 6.2% return against a benchmark of 8.2%. Returns from the Fund have performed ahead of its benchmark over each of the previous 3, 5 and 10-year periods. The target is for the fund manager to outperform the aggregate benchmark over a rolling 5-year period.
- 5 The Fund has effective arrangements in place for financial management. This includes comprehensive reporting of investment performance.

## Financial sustainability

- 6 During 2018/19 the net assets of the Fund increased by 6% to £390.7 million at 31 March 2019. The Fund's Actuary, Hymans Robertson, estimated that pension liabilities had increased by 14% over the same period to £391 million at 31 March 2019.
- 7 The number of active members continues to be more than the number of pensioners.

## Governance and transparency

- 8 The Fund has effective governance arrangements in place that support scrutiny of decisions made by the pension fund sub-committee.
- 9 Decisions are transparent with committee papers and detailed minutes of meetings of the pension fund sub-committee available on Orkney Islands Council's website.

## Value for money

- 10 The Fund's investment performance is subject to regular review and scrutiny by the pension fund sub-committee.
- 11 The Fund has good arrangements in place for monitoring investment performance and scrutinising investment management expenses.

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# Introduction

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1. This report is a summary of our findings arising from the 2018/19 audit of Orkney Islands Council Pension Fund (the Fund).
2. The scope of our audit was set out in our Annual Audit Plan presented to the February 2019 meeting of the pension fund sub-committee. This report comprises the findings from:
  - 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](#).

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## Exhibit 1 Audit dimensions



Source: Code of Audit Practice 2016

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3. The main elements of our audit work in 2018/19 have been:
  - an audit of the Fund's 2018/19 annual accounts including the issue of an independent auditor's report setting out our opinions
  - a review of the Fund's main financial systems
  - consideration of the four audit dimensions of public audit.

## Added Value

4. We add value to the Fund through the audit by:

- identifying and providing insight on significant risks, and making clear and relevant recommendations for improvements that have been accepted by management
  - reporting our findings and conclusions in public
  - sharing intelligence and good practice through our national reports ([Appendix 3](#)) and good practice guides
  - providing clear and focused conclusions on the appropriateness, effectiveness and impact of corporate governance, performance management arrangements and financial sustainability.
5. 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.

## Responsibilities and reporting

6. Orkney Islands Council is the administering authority for the Fund. The council delegates this responsibility to the pension fund sub-committee. The committee is responsible for establishing effective governance arrangements and ensuring that financial management is effective. The committee is also required to review the effectiveness of internal control arrangements and approve the annual accounts.
7. Our responsibilities as independent auditors are established by the Local Government (Scotland) Act 1973, the [Code of Audit Practice 2016](#), and supplementary guidance, and International Standards on Auditing in the UK.
8. As public sector auditors we give independent opinions on the annual accounts. Additionally, we also conclude on:
- the effectiveness of the Fund's performance management arrangements,
  - the suitability and effectiveness of corporate governance arrangements, and financial position and,
  - the arrangements for securing financial sustainability.
9. In doing this we aim to support improvement and accountability. Further details of the respective responsibilities of management and the auditor can be found in the [Code of Audit Practice 2016](#).
10. This report raises matters from the audit of the annual accounts and consideration of the audit dimensions. Weaknesses or risks identified are only those which have come to our attention during our normal audit work and may not be all that exist. Communicating these does not absolve management from its responsibility to address the issues we raise and to maintain adequate systems of control. In doing this we aim to support improvement and accountability. Further details of the respective responsibilities of management and the auditor can be found in the [Code of Audit Practice 2016](#) and supplementary guidance.
11. Our annual audit report contains an agreed action plan at [Appendix 1](#). It sets out specific recommendations, responsible officers and dates for implementation. It also includes outstanding actions from last year and the steps being taken to implement them.
12. 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 therefore the 2018/19 audit fee of £20,560 as

set out in our Annual Audit Plan remains unchanged. We are not aware of any relationships that could compromise our objectivity and independence.

- 13.** This report is addressed to both the members of the Pension Fund sub-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) in due course.
- 14.** We would like to thank all management and staff for their cooperation and assistance during the audit.

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# Part 1

## Audit of 2018/19 annual accounts

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### Main judgements

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

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

### Audit opinions on the annual accounts

15. The annual accounts for the year ended 31 March 2019 were approved by the Orkney Islands Council pension fund sub-committee on 17 September 2019. We reported, within our independent auditor's report that:
  - the 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 in accordance with the guidance.
16. We have nothing to report in respect of misstatements in information other than the financial statements, the adequacy of accounting records and the information and explanations we received.

### Submission of annual accounts for audit

17. We received the unaudited annual accounts on 14 June 2019, in line with the audit timetable set out in our 2018/19 Annual Audit Plan.
18. 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

19. [Appendix 2](#) provides a description of those assessed risks of material misstatement in the annual report and accounts and any wider audit dimension risks that were identified during the audit planning process. It also summarises the work we have done to address the risks and our conclusions.
20. We have no issues to report from our work on the risks of material misstatement highlighted in our 2018/19 Annual Audit Plan.



## Materiality

- 21.** 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. It is affected by our perception of the financial information needs of users of the financial statements.
- 22.** Our initial assessment of materiality for the annual accounts was carried out during the planning phase of the audit. We assess the materiality of uncorrected misstatements both individually and collectively. On receipt of the unaudited annual accounts we reviewed our planning materiality calculations and concluded that they required to be slightly revised. The revised materiality figures are shown in [Exhibit 2](#).

## Exhibit 2 Materiality values

| Materiality level                | Amount         |
|----------------------------------|----------------|
| Overall materiality              | £3.900 million |
| Performance materiality          | £1.950 million |
| Reporting threshold              | £100 thousand  |
| Specific materiality             | £0.800 million |
| Specific performance materiality | £0.400 million |

Source: Orkney Islands Council Pension Fund Annual Audit Plan 2018/19

## Significant findings from the audit in accordance with ISA 260

- 23.** International Standard on Auditing (UK) 260 requires us to communicate significant findings from the audit to those charged with governance, including our view about the qualitative aspects of the body's accounting practices covering accounting policies, accounting estimates and financial statements disclosures.

## Qualitative aspects of the audit

- 24.** We identified one significant finding in relation to the qualitative aspects of accounting practices which is highlighted in [Exhibit 3](#).

## Significant findings from the audit of financial statements

| Issue                                                                                                                                                                                                                                                                                                                                                                                                        | Resolution                                                                                                                                                                                                                                                                                                                                                                                                         |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <p><b>1. Actuarial present value of promised retirement benefits</b></p> <p>Two distinct legal rulings, affecting Local Government Pension Schemes, have impacted upon the actuarial present value of promised retirement benefits at 31 March 2019 disclosed at Note 4 in the Fund's accounts.</p> <p>The first of these was the Guaranteed Minimum Pension case which related to sex discrimination on</p> | <p>Management obtained a revised IAS26 actuarial report reflecting the impact of the McCloud ruling and made the required adjustment in the audited accounts. The revised assessment did not impact on the primary financial statements of the Fund but it increased the actuarial value of the promised retirement benefits as at 31 March 2019, disclosed at Note 4 in the audited accounts by £1.1 million.</p> |

| Issue                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         | Resolution |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------|
| <p>guaranteed minimum pension rights. As the actuary's assessment of the impact of this ruling was not reflected in the unaudited accounts a post-audit adjustment was required in respect of this.</p> <p>The other ruling was the McCloud case challenging age discrimination on pension scheme transitional protection. As the actuary's assessment of the impact of this ruling was not reflected in the unaudited accounts a post-audit adjustment was also required in respect of this.</p> <p>The ruling on McCloud was issued after the accounts were submitted for audit, so the pension fund would not have been in a position to obtain the reports prior to submission of the draft accounts.</p> |            |

Source: Audit Scotland

## How we evaluate misstatements

25. It is our responsibility to request that all errors above the reporting threshold are corrected. The final decision on this lies with those charged with governance considering advice from senior officers and materiality.
26. There were no material adjustments to the unaudited financial statements arising from our audit.

## Objections

27. 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 Orkney Islands Council Pension Fund was published on the website of the administering authority (Orkney Islands Council) and complies with the regulations. No objections were received to the Fund accounts.

# Part 2

## Financial management



### Main judgements

From our review of unaudited accounts Orkney has the highest funding level relative to other Scottish pension funds in 2018/19.

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

Our testing of the design and operation of the financial controls over significant risk areas confirmed that controls relating to financial systems and procedures are designed appropriately and operating effectively. We did not identify any significant internal control weaknesses.

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





### Financial performance in 2018/19

28. 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.

29. The Fund's performance in 2018/19 is summarised in [Exhibit 4](#).

### Exhibit 4

#### Assets, liabilities, funding level and investment performance

| Increase in net assets                                                                                                  | Increase in estimated liabilities                                                                                      | Funding level                                                                                                                   | Investment performance                                                                                                                |
|-------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------|
| <br><b>£24.3 million</b><br>(+6.64%) | <br><b>£50 million</b><br>(+14.66%) | <br><b>112.7%</b><br>2017 Funding valuation | <br><b>6.2%</b><br>Return on investments 2018/19 |
| <b>£390.7 million</b><br>Closing net assets                                                                             | <b>£391 million</b><br>Closing liabilities                                                                             | <b>115.3%</b><br>31 March 2019 Interim valuation                                                                                | <b>10.4%</b><br>Return on investments over 5 years                                                                                    |

30. The net assets of the Fund increased to £390.7 million at 31 March 2019 from £366.4 million at 31 March 2018. This increase of £24.3 million has been achieved mainly through a surplus of contributions receivable (£10.1m) less benefits payable (£7.4m) and management expenses (£1.7m), investment net income (£8.1m) along with an increase in the market value of investments (£15.2m). This represents a year on year increase of 6.6%
31. At the same time the Fund's Actuary, Hymans Robertson, estimated that pension liabilities had risen from £341 million at 31 March 2018 to £391 million at 31 March 2019 (£45 million increase). The 2019 figure reflects the McCloud judgement, with £1.1 million of the increase attributable to it.
32. Based on the interim valuation by the actuary, Orkney Islands Council Pension Fund's funding level is estimated to be 115.3% as at 31 March 2019. On an IAS19 basis, which is more prudent basis, the fund is around 100% funded. From our review of unaudited accounts, Orkney has the highest funding level relative to other Scottish pension funds in 2018/19, as shown in [Exhibit 6](#).
33. During 2018/19 contributions to the Fund amounted to some £10.9 million. This was greater than the benefits paid out which totalled £8 million. [Exhibit 9](#) shows that Orkney Islands Council has the lowest proportion of benefits payable

## Financial management arrangements

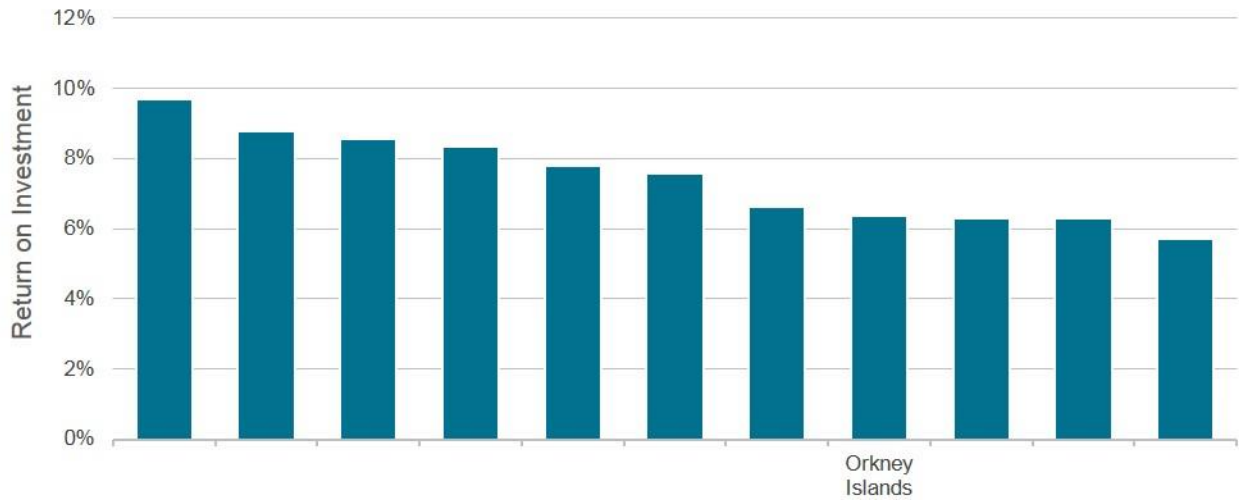
34. The Head of Finance for Orkney Islands Council is the proper officer responsible for Orkney Islands Council Pension Fund. The financial regulations of Orkney Islands Council, as administering authority, apply to the pension fund. We consider these to be comprehensive, and current, and promote good financial management.
35. Investment and administration performance reports are submitted to the pension fund sub-committee on a quarterly basis. Reports are comprehensive, and we observed a good level of review and scrutiny by members at the meetings we attended.
36. We have concluded that the financial management arrangements are sufficient to ensure the ongoing success of the pension fund.

## Investment performance in 2018/19

37. 2018/19 has been a relatively good year for investment performance for most LGPS pension funds across Scotland as illustrated in [Exhibit 5](#).

## Exhibit 5

### LGPS pension funds – Net return on investment 2018/19 (unaudited figures)

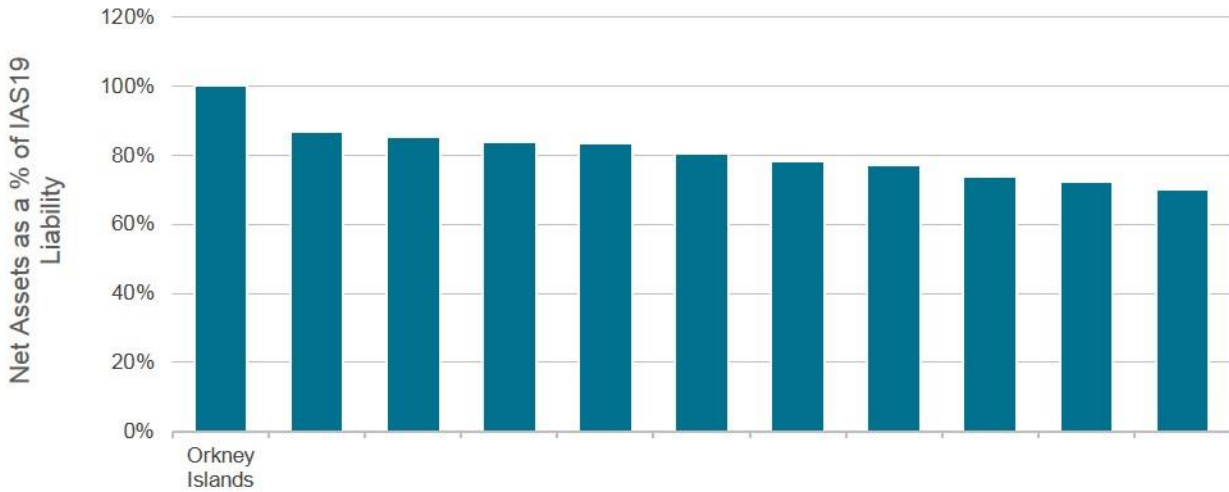


Source: 2018/19 LGPS pension fund unaudited financial statements

38. Orkney Islands Council has achieved a 6.2% return on assets in 2018/19 against a benchmark of 8.2%. The Fund Manager attributed the majority of the failure to achieve the benchmark to under performance of stock selection. Although 2018/19 has been challenging, the fund has achieved the highest return of all funds in Scotland in the past few years.
39. We have concluded that the pension fund's overall performance is good. However, the pension fund sub-committee requires to continually monitor performance to ensure the fund can pay future pension benefits.
40. The IAS19 calculations give a guide to the relative positions of each fund in terms of funding level as shown in [Exhibit 6](#). When this is considered the Orkney Islands Council Pension Fund has the highest funding level for 2018/19.

## Exhibit 6

### LGPS pension funds – Net Assets as a percentage of IAS19 Liability 2018/19 (unaudited figures)



Source: 2018/19 LGPS pension fund unaudited financial statements

## Systems of internal control

41. Our objective is to gain assurance that the pension fund has systems of recording and processing transactions which provide a sound basis for the preparation of the financial statements.
42. The pension fund uses some of the administering authority's key financial systems in particular the financial ledger and payroll. We obtained confirmation from the external auditors of the Council that there were no significant weaknesses in the internal controls for those systems for 2018/19.
43. Each year, the pension fund receives internal control reports on their investment managers, Baillie Gifford, and on Bank of New York Mellon, for asset services. These are high-level reviews developed under International Standard on Assurance Engagements (ISAE3402), to provide assurance to user organisations and their auditors on the controls at a service organisation that are likely to impact or be a part of the user organisation's system of internal control over financial reporting. We noted that management complete a review of the internal control reports and the reports with the details of the reviews performed by management are reported to the pension fund sub-committee.
44. During 2018/19 management recorded that systems of internal controls were assessed as operating effectively and no action was required by the pension fund.

## Internal audit

45. Internal audit provides the pension fund with independent assurance on the pension fund's overall risk management, internal control and corporate governance processes.
46. The internal audit function is carried out by the internal audit section of Orkney Islands Council. We conducted a review of the adequacy of the internal audit function and concluded that it operates in accordance with

Public Sector Internal Audit Standards (PSIAS) and has sound documentation standards and reporting procedures in place.

47. To avoid duplication of effort we place reliance on the work of internal audit wherever possible. In 2018/19 we did not place any formal reliance on internal audit reviews for obtaining direct assurance for our financial statements work, as the coverage was not directly relevant to our audit of the financial statements. We considered internal audit's report findings on the pensions system as part of our wider dimension work.

### **Standards of conduct for prevention and detection of fraud and error**

48. Audited bodies are responsible for establishing arrangements for the prevention and detection of fraud, error and irregularities, bribery and corruption and to ensure that their affairs are managed in accordance with proper standards of conduct by putting proper arrangements in place.
49. We assessed the Fund's arrangements for the prevention and detection of fraud. The Fund relies on the administering body's (Orkney Islands Council) arrangements for the prevention and detection of fraud and corruption. These include Code of Conduct for members and officers, whistleblowing policy and an anti-fraud strategy.
50. We concluded that appropriate arrangements were in place for preventing and detecting fraud and corruption in 2018/19. We are not aware of any specific issues we require to bring to your attention.

# Part 3

## Financial sustainability



### Main judgement

**The interim valuation at 31 March 2019 is 115.3% which represents a slight decline from 31 March 2018 when it was 117%**

**The fund has appropriate and effective financial planning arrangements in place.**

**There continues to be more active members than pensioners.**

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 and financial planning

51. The funding level of the Pension Fund has been maintained broadly in-line with the previous valuation produced at the 31 March 2017. The last triennial valuation, produced at 31 March 2017, showed that the Fund's assets were valued at £335m, and were sufficient to meet 112.7% of the liabilities accrued up to that date.
52. Following the Fund's actuary (Hymans Robertson) recommendation, as a result of the valuation process, the contribution rate for 2017-2018 of 19.2% was reduced to 18.2% during 2018-2019, with further reductions to 17.6% and 17.0% to be applied in 2019-20 and 2020-21 respectively.
53. The most recent funding update produced at 31 March 2019 showed that the funding surplus has increased since the last full valuation. However there has been a fall in asset returns, partially offset against contributions less benefits accruing and the impact of change in yields and inflation. This has resulted in a minor reduction from last year's funding level of 117.0%, to 115.3% at 31 March 2019.

### Membership levels

54. The pension fund is a multi-employer fund with members from five admitted bodies in addition to members employed by Orkney Islands Council. The current membership profile is shown at Exhibit 7. The number of active members continues to outweigh the number of pensioners.



## Exhibit 7 Orkney Island Council Pension Fund Membership



Source: Orkney Island Council Fund 2018/19 unaudited financial statements

- 55.** Active membership of the pension fund increased slightly by 3 in 2018/19 to 1,969 members at 31 March 2019. Over the past 5 years membership has grown by 284 active members, which represents an increase of 16.8%. The impact of auto-enrolment contributed to the increase in members.
- 56.** 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

- 57.** Following the latest triennial valuation in 2017, the Actuary agreed employer contribution rates with individual employers for 2018/19 onwards. The approximate split of all contributions received in year is set out at [Exhibit 8](#).

## Exhibit 8 Contributions in 2018/19

|                        | Administering authority<br>£m | Admitted bodies<br>£m | Total<br>£m |
|------------------------|-------------------------------|-----------------------|-------------|
| Employer contributions | 6.703                         | 0.775                 | 7.478       |
| Employee contributions | 2.252                         | 0.278                 | 2.530       |
| Strain Contributions   | 0.109                         | 0.09                  | 0.118       |

Source: Orkney Island Council Fund 2018/19 unaudited financial statements

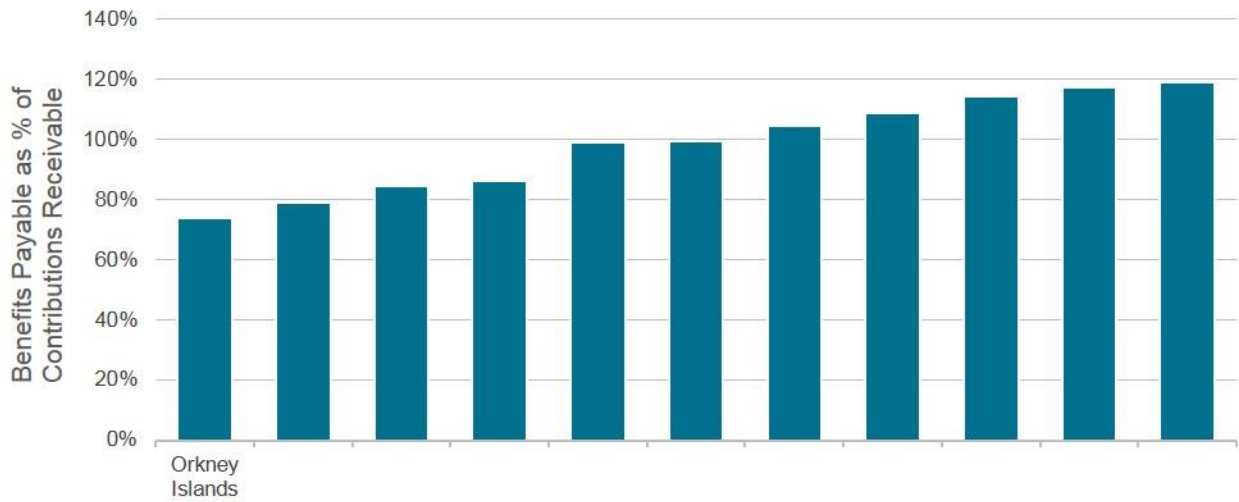
- 58.** The Fund reported a surplus from dealings with members of £2.826m in 2018/19. This means that member contributions exceeded pension payments. Exhibit 9 below shows how Orkney Islands Council Pension Fund compares with the other 10 Local Government Pension Funds (LGPF's) in Scotland in terms of contributions receivable and benefits payable. Five of

the 11 pay out more than receive. Orkney is in a relatively healthy position in that it does not need to move from capital generating assets to income generating assets.

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## Exhibit 9

### Benefits Payable as a proportion of contributions receivable



Source: 2018/19 LGPS pension fund unaudited financial statements

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# 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 sub-committee.**

**Decisions are transparent with sub-committee papers and detailed minutes of meetings of the pension fund sub-committee available on Orkney Islands Council's website.**

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.

### Governance arrangements

59. Orkney Islands Council is the administering body for the pension fund. The council has delegated responsibility for governance to the pension fund sub-committee.
60. Members of the pension fund sub-committee are supported by the pension board. The pension board is responsible for establishing arrangements to ensuring the proper conduct of the affairs of the pension fund in accordance with the law and the requirements of the Pensions Regulator which includes the administration of the pension fund and investments, as well as responsibility for preparing, publishing and maintaining the funding strategy statement and the Statement of Investment Policies. The pension fund sub-committee monitors the adequacy and effectiveness of these arrangements.
61. From attendance at meetings we found effective scrutiny and challenge of policy and investment decisions, and evidence that pension board and sub-committee members receive appropriate and sufficient training in order to carry out their roles.

### Openness and transparency

62. Openness and transparency are individually important and working well together they help demonstrate that public organisations are acting in the public interest. There is an increasing focus on how public money is used and what is achieved. In that regard, openness and transparency supports understanding and scrutiny. There are increasing public expectations for more openness and transparency as citizens want to understand how public money is used and, to support their participation in local service design and delivery.
63. Public sector governance guidance indicates that an organisation that is transparent shows the basis for its decisions and shares information about performance and outcomes, including when targets have and have not been achieved as well as how it is using its resources such as money, people and assets.
64. There is evidence from several sources which demonstrate the Fund's commitment to transparency. For example, the Fund's annual accounts are

available on Orkney Islands Council website, and pension fund sub-committee papers are available on the website in advance of the meetings.

65. We conclude that Orkney Islands Council Pension Fund demonstrates a commitment to openness and transparency.

### **Pensions Regulator Public Service Code**

66. 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 pension fund participates in an annual “Pensions Regulator: Public Service Governance Survey” and the Pension Fund Annual Report and Accounts 2018/19 contains a Governance Compliance Statement which sets out the extent to which the Orkney Islands Council Pension Fund governance arrangements comply with best practice. This provided assurance that the pension 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 2018/19.

# Part 5

## Value for money



### Main judgements

The Fund's investment performance is subject to regular review and scrutiny by the Pension Fund sub-committee.

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

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

### Investment performance

67. The Pension Fund sub-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.
68. [Exhibit 9](#) shows that over the year, the Fund generated a return of 6.2% against a benchmark of 8.2%. Equity portfolios were the most significant contributor to this increase.

### Exhibit 9 Fund investment performance



Source: Orkney Islands Council Pension Fund 2018/19 audited financial statements

69. Over the medium to longer term the Fund has outperformed its benchmark over three, five and since inception years.

- 70.** As shown earlier in [Exhibit 5](#) net investment performance was in the lower range of returns compared with other LGPS Funds in Scotland. This comes after a period of years where Orkney had the highest returns in Scotland.
- 71.** Investment return and risk are inextricably linked, and it is not possible for us to give an opinion on the relative performance of the pension fund's investments given the risk exposure of the asset allocation and investments made. However, we are aware that the pension sub-committee is regularly updated with details of how closely aligned the pension fund's investments are with its investment strategy. The pension 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.
- 72.** We concluded that the pension fund has adequate arrangements in place for monitoring investment performance.

## Management expenses

- 73.** 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.
- 74.** 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.
- 75.** 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 benchmarking information and in the context of returns achieved, to ensure that value for money is being secured.
- 76.** 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.
- 77.** Investment management expenses have increased from £1.055 million in 2017/18 to £1.189 million in 2018/19. This is because they are based on the value of the fund which has increased year on year.
- 78.** We have concluded that the Fund has adequate arrangements in place for monitoring investment performance and scrutinising investment management expenses. 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

- 79.** 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 and freedom of choice.
- 80.** [Exhibit 10](#) illustrates that 3 out of 5 of the standards reported decreased performance compared to 2017/18.

## Exhibit 9

### Administration Performance

|                   | Performance Standard (days) | Percentage processed within standard 2017/18 | Percentage processed within standard 2018/19 | Relative performance compared to prior year |
|-------------------|-----------------------------|----------------------------------------------|----------------------------------------------|---------------------------------------------|
| Pension estimates | 10                          | 65.0%                                        | 65.9%                                        | ↑                                           |
| Retirements       | 5                           | 100.0%                                       | 100.0%                                       | →                                           |
| Transfers in      | 10                          | 95.6%                                        | 76.0%                                        | ↓                                           |
| Transfers out     | 10                          | 94.7%                                        | 85.7%                                        | ↓                                           |
| Refunds           | 5                           | 93.6%                                        | 90.3%                                        | ↓                                           |

Source: OICPF Reports

- 81.** The standards set above were set a number of years ago. We would recommend that given the changes to the pension fund in recent years and the increase in staffing in the pension fund that the performance measures and targets should be reviewed.



Recommendation 1 (Appendix 1 - Action Plan)

### National performance audit reports

- 82.** Audit Scotland carries out a national performance audit programme on behalf of the Accounts Commission and the Auditor General for Scotland. During 2018/19, we published reports which might be of direct interest to the Fund. These are outlined in [Appendix 3](#) accompanying this report.
- 83.** Each year Audit Scotland produces a Local Government Overview Report, the report is usually reviewed by Orkney Islands Council. Included within the report is a supplement specifically relating to pension funds. The pension fund sub-committee should review this report annually.



Recommendation 2 (Appendix 1 - Action Plan)

# Appendix 1

## Action plan 2018/19



| No. | Issue/risk                                                                                                                                                                                                                                                                                                                                           | Recommendation                                                                                                                                                              | Agreed management action/timing                                                                                                                                                                |
|-----|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 1   | <p><b>Performance Measures</b></p> <p>The performance measures used to monitor the performance of the administration of the fund were set many years ago. There have been many developments in pension funds including freedom of choice.</p> <p><b>Risk</b></p> <p>The measures and targets may no longer be the most appropriate for the fund.</p> | <p>A review of the performance measures should be carried out to meet the needs of monitoring the funds administrative performance.</p> <p>Paragraph <a href="#">81</a></p> | <p>A review of the Administrative Performance Measures will be carried out as recommended.</p> <p>Payroll and Pensions Manager</p> <p>April 2020</p>                                           |
| 2   | <p><b>Review of Local Government Overview Report – Pension Fund Supplement</b></p> <p>Each year Audit Scotland produces an overview report supplement relating to Pension Funds, this is not currently reviewed by the pension fund sub-committee.</p>                                                                                               | <p>The pension fund sub-committee should review the Pension Fund Supplement of the Local Government Overview.</p> <p>Paragraph 83</p>                                       | <p>The annual Audit Scotland overview report supplement will be reported to the Pension Fund Sub-committee in future.</p> <p>Head of Finance</p> <p>At the earliest available opportunity.</p> |

### Follow up of prior year recommendations

|   |                                                                                                                                                                                                                                                                                                                                                                                                                                                 |                                                                                                                                                                                                                                  |                                                      |
|---|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------|
| 3 | <p><b>Performance management reporting</b></p> <p>Each year, the pension fund receives internal control reports on their investment managers, Baillie Gifford, and on Bank of New York Mellon for asset services. These are high-level reviews developed under International Standard on Assurance Engagements (ISAE3402), to provide assurance to user organisations and their auditors on the controls at a service organisation that are</p> | <p>To enhance performance management reporting, details of the investment manager internal control reports should be provided to members of the pension fund sub-committee along with and observations raised by management.</p> | <p>Recommendation implemented in September 2018.</p> |
|---|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------|





**No.**    **Issue/risk**



**Recommendation**



**Agreed  
management  
action/timing**

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likely to impact or be a part of the user organisation's system of internal control over financial reporting. We noted that management complete a review of the internal control reports and record their observations but that neither the reports nor the details of reviews performed by management are reported to the pension fund sub-committee

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# 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                                                                                                                                                                                                                                                                                                                                                                                                                                    |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Risks of material misstatement in the financial statements</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                      |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             |                                                                                                                                                                                                                                                                                                                                                                                                                                                            |
| <p><b>1 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 to change the position disclosed in the financial statements.</p>                                                                                                                                                                                                                                                            | <p>Detailed testing of journal entries.</p> <p>Review of accounting estimates.</p> <p>Focused testing of accruals and prepayments.</p> <p>Evaluation of significant transactions that are outside the normal course of business</p>                                                                                                                                                                                                                                                         | <p>Based on our testing, we found no evidence of bias in accounting estimates, no evidence of transactions out with the scope of the pension fund and no evidence to suggest that management were overriding controls.</p>                                                                                                                                                                                                                                 |
| <p><b>2 Risk of fraud over income and expenditure</b></p> <p>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).</p> <p>The Fund receives a significant amount of income from third party sources. This presents a risk due to the extent and complexity of income.</p> <p>The Fund also makes a high volume of payments, including high value payments, which can constitute a risk of misstatement of expenditure.</p> | <p>Evaluation of the effectiveness of systems for income recognition and recording.</p> <p>Review of custodian arrangements and completion of 'review of work by service auditors' in accordance with ISA 402 for the global custodian.</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>Evaluation of progress in relation to the 2018/19 National Fraud Initiative.</p> | <p>Interim controls testing results were satisfactory.</p> <p>We carried out 'reliance on a management expert' work on the custodian and the actuary and concluded that we could place reliance on third parties.</p> <p>Analytical procedures on income and expenditure, sample checking of pension contributions and confirmation of investment income did not identify any issues.</p> <p>We found no evidence of fraud over income or expenditure.</p> |
| <p><b>3 Estimation, judgements and Classification</b></p> <p>There is a significant degree of subjectivity in the measurement and classification of certain</p>                                                                                                                                                                                                                                                                                                                                                                                                                                        | <p>Completion of 'review of the work of an expert' in accordance with ISA 500, for</p>                                                                                                                                                                                                                                                                                                                                                                                                      | <p>We carried out 'reliance on a management expert' work on the fund manager and the actuary. This included review of the PwC</p>                                                                                                                                                                                                                                                                                                                          |

| Audit risk                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                           | Assurance procedure                                                                                                                                                                                                                                                                                                                                                                | Results and conclusions                                                                                             |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------|
| <p>investments and the actuarial valuation. Investments include investments such as pooled funds, where valuations involve the application of judgement in determining appropriate amounts.</p> <p>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.</p> <p>This subjectivity entails a risk of misstatement in the financial statements.</p> | <p>significant unquoted investments.</p> <p>Confirmation of valuations to valuation reports and/ or other supporting documentation.</p> <p>Completion of 'review of the work of an expert' in accordance with ISA 500, for the work of the actuary.</p> <p>Consideration of the report by the consulting actuary to Audit Scotland on actuarial assumptions in use in 2018/19.</p> | <p>report on actuarial assumptions. We concluded that we could place reliance on the custodian and the actuary.</p> |

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### Risks identified from the auditor's wider responsibility under the Code of Audit Practice

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#### 4 Internal Control Procedures

During 2017/18, the pension fund have migrated all records to the Altair ICT system which is used to record member entitlements and to perform some calculations.

With the new system and more staff now working on pensions there is an opportunity to develop new internal controls procedures for the Altair system to reduce the risks of errors and provide the opportunity for independent checks by more staff.

Review the funds authorisation and approvals hierarchy.

The pension fund has introduced an Authorisation Hierarchy to introduce greater segregation of controls.

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# Appendix 3

## Summary of national performance reports 2018/19

|                                                               |                                                                                     |  <b>2018/19 Reports</b> |                                                                                                                                                   |
|---------------------------------------------------------------|-------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------|
| Local government in Scotland: Challenges and performance 2018 |    | <b>Apr</b>                                                                                               |                                                                                                                                                   |
| Councils' use of arm's-length organisations                   |    | <b>May</b>                                                                                               |  Scottish Fire and Rescue Service: an update                     |
| Scotland's colleges 2018                                      |    | <b>Jun</b>                                                                                               |                                                                                                                                                   |
|                                                               |                                                                                     | <b>Jul</b>                                                                                               |  The National Fraud Initiative in Scotland 2016/17               |
| Forth Replacement Crossing                                    |   | <b>Aug</b>                                                                                               |  Major project and procurement lessons                          |
| Children and young people's mental health                     |  | <b>Sept</b>                                                                                              |  Superfast broadband for Scotland: further progress update     |
| NHS in Scotland 2018                                          |  | <b>Oct</b>                                                                                               |                                                                                                                                                   |
| Health and social care integration: update on progress        |  | <b>Nov</b>                                                                                               |  Local government in Scotland: Financial overview 2017/18      |
|                                                               |                                                                                     | Dec                                                                                                      |                                                                                                                                                   |
|                                                               |                                                                                     | Jan                                                                                                      |                                                                                                                                                   |
|                                                               |                                                                                     | Feb                                                                                                      |                                                                                                                                                   |
|                                                               |                                                                                     | <b>Mar</b>                                                                                               |  Local government in Scotland: Challenges and performance 2019 |

### Reports of relevant interest

[Local government in Scotland: Challenges and performance 2018](#) – April 2018

[Councils' use of arm's-length organisations](#) – May 2018

[Local government in Scotland: Financial overview 2017/18](#) – November 2018

[Local government in Scotland: Challenges and performance 2019](#) – March 2019

# Orkney Islands Council Pension Fund

## 2018/19 Annual Audit Report

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