

# North East Scotland Pension Fund

2018/19 Annual Audit Report – DRAFT



 AUDIT SCOTLAND

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

13 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 North East Scotland 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 Net assets increased in 2018/19: by £343 million to £4.5 billion for the Main Fund and by £5 million to £105 million for the Transport Fund. Performance of investments remained above the benchmark.
- 5 Systems of internal control operated appropriately and effectively in 2018/19.

## Financial sustainability

- 6 The Fund has appropriate and effective financial planning arrangements in place.
- 7 Although Main Fund contributions from members currently exceed benefits paid out, this is likely to change in the coming years.

## Governance and transparency

- 8 The Fund has effective governance arrangements in place that support scrutiny of decisions made by the Pension Fund Committee. However, not all members of the Committee or the Pension Board attended the expected number of training sessions; it is important that members maintain an appropriate level of knowledge to fulfil their role effectively.
- 9 Decisions are transparent with committee papers and detailed minutes of meetings of the Pension Fund Committee available on Aberdeen City Council's website.

## Value for money

- 10 The Fund has adequate arrangements in place for monitoring investment performance and scrutinising investment management expenses. Investment performance is subject to regular review and scrutiny by the Pensions Committee.

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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 the North East Scotland Pension Fund (NESPF or the Fund). The Fund consists of two funds, the North East Scotland Pension Fund (the main fund) and the Aberdeen City Council Transport Fund (the transport fund). Both funds are part of the Local Government Pension Scheme (LGPS). Hereafter we will refer to “the Fund” in the singular.

**2.** The scope of our audit was set out in our Annual Audit Plan presented to the March 2019 meeting of Aberdeen City Council’s Pensions 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](#).

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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. Aberdeen City Council is the administering authority for the North East Scotland Pension Fund. The council delegates this responsibility to the Pensions Committee. The committee is responsible for establishing effective governance arrangements and ensuring that financial management is effective. The Pensions Committee is 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
- suitability and effectiveness of corporate governance arrangements, and financial position, and
- 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 £40,000 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 Pensions Committee and the Controller of Audit and will be published on Audit Scotland's website [www.audit-scotland.gov.uk](http://www.audit-scotland.gov.uk) 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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**North East Scotland Pension Fund's financial statements give a true and fair view and were properly prepared.**

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

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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 Aberdeen City Council Pensions Committee on 13 September 2019. We reported within the 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 gain assurance over the outcome of these risks.

**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 and included in our Annual Audit Plan. With regards to the annual accounts, we assess the materiality of uncorrected misstatements both individually and collectively. The assessment of materiality was recalculated on receipt of the unaudited annual accounts and is summarised in [Exhibit 2](#). The revised materiality levels were not sufficient to require a change in our audit approach.

## Exhibit 2 Materiality values

Materiality level	Amount Main Fund	Amount Transport Fund
Overall materiality (1% of net assets)	£44.5 million	£1.1 million
Performance materiality (75% of overall materiality)	£33.4 million	£0.8 million
Reporting threshold	£100,000	£10,000
Specific materiality (Benefits Payable)	£14.0 million	£0.4 million
Specific performance materiality (Benefits Payable)	£10.5 million	£0.3 million

## 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.

**24.** The significant findings are summarised in [Exhibit 3](#). Where a finding has resulted in a recommendation to management, a cross reference to the Action Plan in [Appendix 1](#) has been included.

### Qualitative aspects of the audit

**25.** We have no significant findings to report around the qualitative aspects of the 2018/19 accounting practices.

## Exhibit 3 Significant findings from the audit of financial statements

Issue	Resolution
<p><b>1. Updated Investment Valuation</b></p> <p>There was an investment revaluation for one asset which reduced its value at 31 March 2019 by £2.46 million. This arose due to an audit judgement by the auditor of the investment manager, in light of ongoing litigation regarding the asset, between the investment manager and a contractor. If this revaluation was adjusted for in the financial statements, it would reduce the Net Return on</p>	<p>Management proposed not to adjust the annual accounts for this as it was below the materiality threshold. This is reported as an unadjusted misstatement in paragraph 27 below.</p>

Issue	Resolution
Investments in the Fund Account by £2.46 million and reduce Net Assets in the Net Assets Statement by the same amount.	
<p><b>2. Classification error</b></p> <p>£5.9 million was identified as incorrectly included in Sundry Creditors rather than in Benefits Payable, within Main Fund Note 18 Current Liabilities.</p>	<p>An adjustment to the classification of creditors was made, to move £5.9 million from Sundry Creditors to Benefits Payable. This did not affect the overall Current Liabilities figure in the Net Assets Statement.</p>

Source: Audit Scotland 2018/19 matters arising from the NESPF financial statements audit.

## How we evaluate misstatements

**26.** There were no material adjustments to the unaudited financial statements arising from our audit.

**27.** One individual misstatement which exceeded our reporting threshold has not been amended in the audited financial statements. As noted above, an investment manager reduced an asset valuation as at 31 March 2019 by £2.46 million, as the investment manager's auditor recommended a more prudent approach to be taken by the investment manager towards the impact of legal action regarding the asset.

**28.** 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. Management do not propose to adjust for the item above as the amount is not considered material in the context of the financial statements.

## Amendments to the accounts arising from legal and other judgements

**29.** In December 2018 the Court of Appeal upheld a claim from firefighters and judges that changes to their pension schemes were discriminatory based on age. The UK Government sought leave to appeal the decision (commonly known as the McCloud Ruling) to the Supreme Court however this was denied at the end of June 2019, after the unaudited accounts were prepared. This ruling will impact on other public sector pension schemes, including LGPS, which have seen similar changes in their pension schemes.

**30.** Following the decision, the Fund requested a revised IAS26 report from the Fund actuary in order to quantify the increase in estimated liabilities as a result of the ruling. This revised report estimated the actuarial present value of promised retirement benefits as £5.422 billion for the Main Fund, an increase of £43 million, and £80.9 million for the Transport Fund, an increase of £0.2 million. These revised assessments do not impact on the primary financial statements of the Fund, however the relevant disclosure notes in the audited accounts were updated to include the revised values of promised retirement benefits.

## Objections

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 the North East Scotland Pension Fund was published on the website of the administering authority (Aberdeen City Council) and complies with the regulations. No objections were received to the North East Scotland Pension Fund accounts.

# Part 2

## Financial management



### Main judgements

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

Net assets increased in 2018/19: by £343 million to £4.5 billion for the Main Fund and by £5 million to £105 million for the Transport Fund. Performance of investments remained above the benchmark.

Systems of internal control operated appropriately and effectively in 2018/19.

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

31. 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.

32. 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
 <p><b>Main Fund</b> <b>+£343.6 million</b> (+8.3%)</p> <p><b>Transport Fund</b> <b>+£5.2 million</b> (+5.2%)</p>	 <p><b>Main Fund</b> <b>+£530 million</b> (+10.8%)</p> <p><b>Transport Fund</b> <b>+£3 million</b> (+3.7%)</p>	 <p><b>107% Main Fund</b> <b>94% Transport Fund</b> 2017 Funding valuation</p>	 <p><b>Main Fund</b> <b>8.5%</b> Return on investments 2018/19</p> <p><b>Main Fund</b> <b>10.3%</b> Return on investments over 5 years</p>

## Exhibit 4 (continued)

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

Increase in net assets	Increase in estimated liabilities	Funding level	Investment performance
			
Closing net assets	Closing liabilities		
<b>Main Fund</b>	<b>Main Fund</b>		
<b>£4,469.2 million</b>	<b>£5,422 million</b>		
<b>Transport Fund</b>	<b>Transport Fund</b>		
<b>£105.3 million</b>	<b>£81 million</b>		

Source: NESPF 2018/19 audited financial statements and NESPF Reports

**33.** The net assets of the Main Fund increased to £4,469 million at 31 March 2019 from £4,126 million at 31 March 2018. This was an increase of £343 million (8.3%). The Transport Fund's net assets increased by £5.2 million (5.2%) over the same period to £105.3 million.

**34.** At the same time the Fund's actuary, Mercer Limited, estimated that pension liabilities had risen from £4.892 billion at 31 March 2018 to £5.422 billion at 31 March 2019 (£530 million increase) for the Main Fund. Transport Fund liabilities increased by £2.9 million, from £78 million at 31 March 2018 to £80.9 million at 31 March 2019.

**35.** During 2018/19 contributions to the Main Fund amounted to some £142 million. This was slightly higher than the benefits paid out which totalled £141 million. The Transport Fund paid out £1.6 million more in benefits than it received in contributions.

**36.** Although the Fund continues to perform well, management are aware that a number of challenges face the Fund and the wider environment in which it operates. A number of issues may increase pressures on the future funding position, including economic growth and the impact of EU withdrawal. Pension specific issues such as the scheme cost cap mechanism, guaranteed minimum pension (GMP) equalisation and the McCloud ruling on age discrimination within pension schemes are also likely to impact on the funding position in the coming years.

**37.** The Fund has considered these challenges and continues to monitor risks through the corporate risk register. The funding strategy statement and investment strategy are reviewed and revised following actuarial valuations to ensure that the Fund is well placed to continue to pay its liabilities.

### Financial management arrangements

**38.** The Chief Officer - Finance for Aberdeen City Council is the proper officer responsible for the North East Scotland Pension Fund. The financial regulations of Aberdeen City Council, as administering authority, apply to the pension fund. We consider these to be comprehensive, and current, and promote good financial management.

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

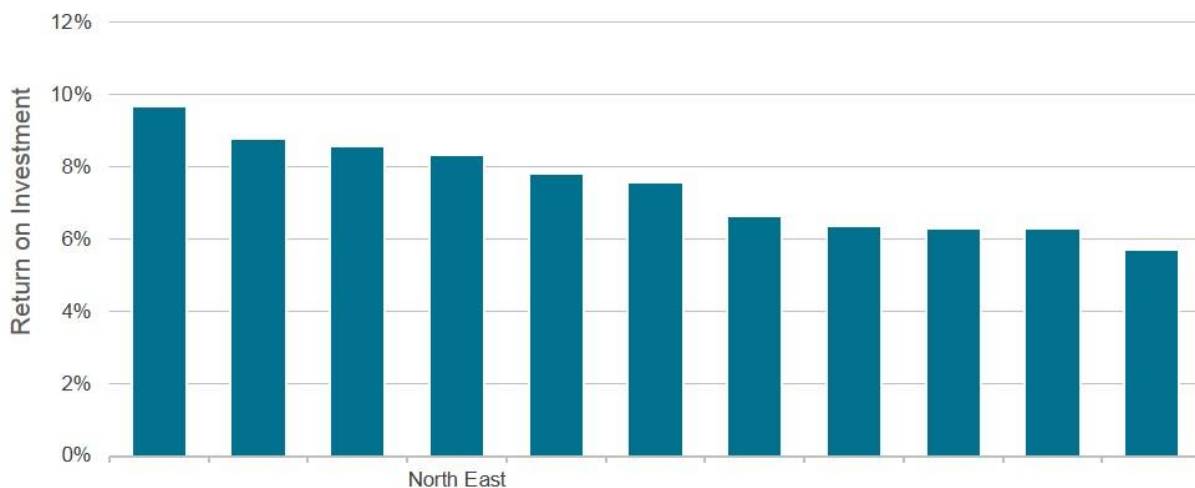
**40.** Based on evidence reviewed, we conclude that the Fund has effective management arrangements in place, including comprehensive reporting and review of investment performance.

### Investment performance in 2018/19

**41.** 2018/19 has been a relatively good year for investment performance compared to the other LGPS pension funds across Scotland as illustrated in [Exhibit 5](#).

## Exhibit 5

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



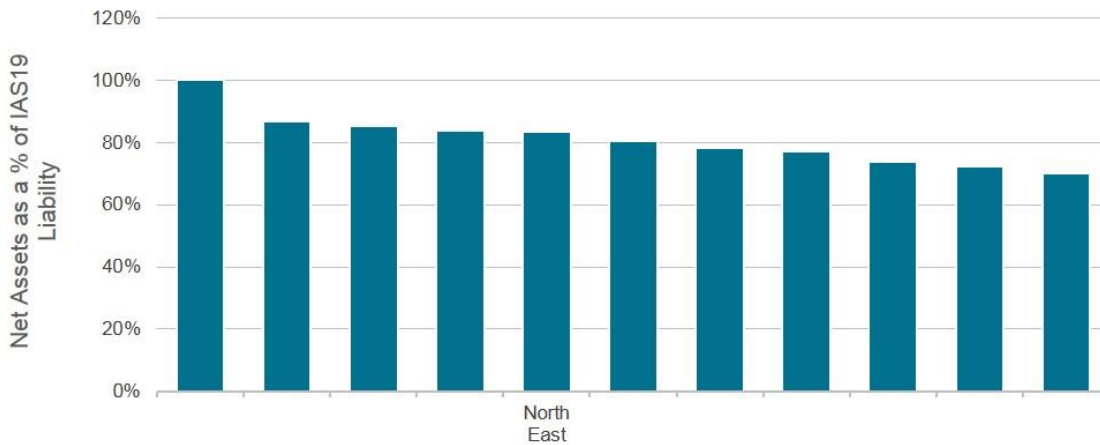
Source: 2018/19 LGPS pension fund unaudited financial statements

**42.** Investment performance across the Local Government Pension Scheme funds was at a broadly similar level with 2017/18. North East Scotland Pension Fund achieved a return of 8.5% on its investments, above the Fund benchmark of 7.4% for 2018/19. The Fund highlights the use of active investments as the reason for this good performance.

**43.** The IAS19 calculations give a guide to the relative positions of each fund in terms of funding level as shown in [Exhibit 6 \(page 14\)](#). When this is considered the North East Scotland Pension Fund is mid-range for 2018/19.

## Exhibit 6

### Net Assets as a proportion of IAS19 Liability as at 31 March 2019



Source: 2018/19 LGPS pension fund unaudited financial statements

## Systems of internal control

**44.** 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.

**45.** The Pension Fund uses some of the administering authority's key financial systems, in particular the general ledger, payroll and accounts payable systems. We requested assurances from KPMG, the external auditor of Aberdeen City Council, that the internal controls over these financial systems were operating effectively during 2018/19. The 2018/19 annual audit report for Aberdeen City Council reported controls testing in the following areas, with satisfactory results: journal entries; budget monitoring; bank reconciliations and controls over the provision of pension fund membership information to the actuary. 4 of the 8 prior year recommendations by KPMG to improve general IT controls are still in progress. KPMG have given an unmodified opinion on Aberdeen City Council's 2018/19 accounts.

**46.** Internal audit's annual opinion for Aberdeen City Council confirmed that "reasonable assurance can be placed upon the adequacy and effectiveness of the Council's framework of governance, risk management and control in the year to 31 March 2019."

**47.** We have taken assurance over the administering authority's financial systems from these sources.

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

## Internal audit

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

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

**51.** 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**

**52.** 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.

**53.** We assessed the Fund's arrangements for the prevention and detection of fraud. The Fund relies on the administering body's (Aberdeen City Council) arrangements for the prevention and detection of fraud and corruption. These include Codes of Conduct for members and officers, Whistleblowing Policy and the Fraud, Bribery and Corruption Policy.

**54.** 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 Fund has appropriate and effective financial planning arrangements in place.**

**Although Main Fund contributions from members currently exceed benefits paid out, this is likely to change in the coming 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 and financial planning

**55.** The March 2017 triennial funding valuation reports that the Main Fund assets were sufficient to meet 107% of its liabilities, which compares to 94% at the 2014 triennial review. The funding level means that, overall, the investment assets were higher than the projected liabilities. This enabled the fund to maintain the employer's contribution rate at 19.3% for the three councils for the period 2018-2021. The rates for the other bodies range from 11% to 33.8%.

**56.** The Transport Fund was assessed as 94% funded, meaning that the Fund's assets were sufficient to cover 94% of its liabilities. The administering authority and the employer, First Aberdeen Limited, have agreed to maintain the current level of contributions which are 33% of pensionable pay (plus £1.5 million per annum which is being used to finance the costs in relation to future service). On this basis the deficit would be expected to be removed in around 5 years. These contributions will continue over the period 2018-2021 unless the funding level reaches 105% as assessed by the fund actuary.

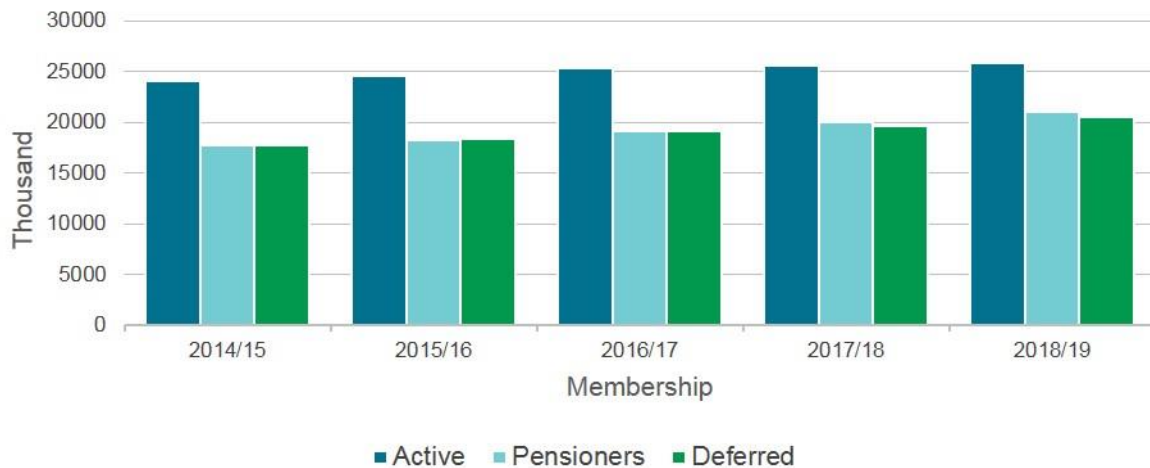
**57.** As identified at [Exhibit 10](#) the Main Fund still has a positive cash flow in that contributions received exceed benefits payable. However as shown at [Exhibit 7](#) the increase in member numbers is decreasing, while the number of pensioners is increasing. The Fund will move to a situation in the coming years where the benefits payable by the Main Fund will exceed contributions received and current pensioners will need to be paid from investment income or the sale of investments.

### Membership levels

**58.** The pension fund is a multi-employer fund with 3 local authorities and around 50 other employers. The current membership profile is shown at [Exhibit 7](#). The number of active members continues to outweigh the number of pensioners.



## Exhibit 7 Main Fund Membership



Source: NESPF 2018/19 audited financial statements

**59.** Membership of the Main Fund increased slightly by 324 active members in 2018/19 to 25,892 members at 31 March 2019; over the past 5 years membership has grown by 1,803 active members, which represents an increase of 7.5%. The impact of auto-enrolment contributed to the increase in members. Overall membership, including pensioners and deferred members, has increased by 2,282 over the past year, and 7,952 over the past 5 years.

**60.** The Transport Fund, which is closed to new entrants, continues to fall in overall membership numbers as more members move to pensioner status. This is shown in [Exhibit 8](#) below.

**61.** 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.

## Exhibit 8 Transport Fund Membership



Source: NESPF 2018/19 audited financial statements

## Contributions

62. Following the latest triennial valuation in 2017, the actuary agreed employer contribution rates with individual employers for 2018/19 onwards. An element of these employer costs includes deficit recovery contributions to support employers' financial planning. The approximate split of all contributions received in year is set out at [Exhibit 9](#).

### Exhibit 9 Contributions in 2018/19

	Administering authority £m	Other scheduled bodies £m	Admitted bodies £m	Transferee Admission Bodies	Total £m
Employer contributions	26.331	59.290	6.536	3.653	95.810
Employee contributions	8.297	18.641	2.123	1.163	30.224
Strain Contributions	5.497	0.972	0.331	0	6.800
Deficit Recovery Contributions	2.360	3.566	0.095	0	6.021

Source: North East Scotland Pension Fund 2018/19 audited financial statements

63. The main fund reported a surplus from dealings with members of £1.1 million in 2018/19. This means that member contributions and investment income exceeded pension payments. However, this has decreased significantly in recent years and the North East Scotland Pension Fund is close to becoming one of the funds that pays out more in pensions than it receives in contributions. This is likely to be the case in future years. The Transport Fund has been in that position for a number of years.

### Transport Fund merger with Strathclyde Pension Fund No.3 Fund

64. The Fund has agreed that members of the Strathclyde Pension Fund Transport Fund (known as No.3 Fund) will transfer to the Aberdeen City Council Transport Fund. The Strathclyde No.3 Fund is a similar LGPS arrangement managed for First Glasgow by Strathclyde Pension Fund. It has been a closed fund to new employers since it was established in 1993 and at the 2017 triennial valuation it had an estimated funding level of 114%. The Fund is now very mature and the sole employer, First Glasgow, is expected to exit the Fund when active membership ceases. The planned merger is expected to take place during 2019/20. The Pensions Committee has identified delivery of the merger as a 2019/20 priority.



#### Recommendation 1

**The Fund should ensure that adequate arrangements are in place for the transfer of membership data, assets and liabilities from Strathclyde Pension Fund Transport Fund.**

## EU Withdrawal

**65.** The Fund continues to prepare for the UK's withdrawal from the European Union. The Fund's external fund managers, who are responsible for managing investments, have arrangements in place to ensure regulatory requirements will continue to be met following EU withdrawal. The Fund should continue to monitor the wider impact of EU withdrawal on the Fund and its wider environment.

# Part 4

## Governance and transparency



### Main judgements

The fund has effective governance arrangements in place that support scrutiny of decisions made by the Aberdeen City Council Pensions Committee. However, not all members of the Committee or the Pension Board attended the expected number of training sessions; it is important that members maintain an appropriate level of knowledge to fulfil their role effectively.

Decisions are transparent with committee papers and detailed minutes of meetings of the Pensions Committee available on Aberdeen City 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

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

**67.** The Pension Board was established by the Public Service Pensions Act 2013. Its role is to assist the Scheme Manager in securing compliance with scheme regulations and expectations set by the Pensions Regulator. The Pension Board meets concurrently with the Pensions Committee. Its annual report is available on the Fund's website and on the administering authority's website.

**68.** From our attendance at committee meetings we concluded that committee papers were well prepared and issued a week before meetings to allow time for review, sufficient time was given to discuss the issues on the agenda, and committee members asked appropriate questions. We concluded that arrangements were appropriate and supported good governance and accountability.

**69.** However, training attendance records indicated that two Pension Board and two Pensions Committee members did not meet the training requirement in 2018/19. The Training Policy states that each Committee/Board member is expected to receive at least 2 days of training each year. It is important that members have the appropriate level of pensions knowledge to monitor Pension Fund performance effectively.



## Recommendation 2

**Pensions Committee and Pension Board members should ensure that they keep their pensions knowledge up to date and take advantage of the training and development opportunities offered.**

### Openness and transparency

**70.** 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.

**71.** 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.

**72.** There is evidence from several sources which demonstrate the Fund's commitment to transparency. For example, the Fund's annual accounts and information on governance arrangements are available on the Fund's website. The annual accounts are also available on the administering authority's website.

**73.** The Pensions Committee and Pension Board meetings are held in public, with commercially sensitive information dealt with in private session. The committee papers and minutes of these meetings are publicly available on the pension fund's website and on the administering authority's website.

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

### Pensions Regulator Public Service Code

**75.** The Public Sector Pensions Act 2013 provided for extended regulatory oversight by the Pensions Regulator. The Pensions Regulator issued a code on the governance and administration of public service pension schemes in January 2015 which funds are expected to comply with. The last report assessing the Fund's compliance with the Pensions Regulator's code was submitted to the Pensions Committee and Pension Board in March 2019. This provided assurance that the Fund is largely in compliance with the regulations. There were no breaches of the Code that required to be reported to the Pensions Regulator in 2018/19.

### General Data Protection Regulation (GDPR)

**76.** The General Data Protection Regulation (GDPR) came into force on 25 May 2018, replacing the UK Data Protection Act 1998. GDPR sets out further requirements than the DPA and has introduced new and significantly changed data protection concepts.

**77.** GDPR introduced 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 GDPR data handling arrangements could result in the Fund incurring significant fines.

**78.** The Fund carried out work to ensure full compliance with GDPR and protect the quality of data held on the pension administration system. A review of e-mail processing was carried out, with changes made to working practices that complimented the Aberdeen City Council policy. A new System Access policy and a Local Contingency Plan were implemented.

### **Review of the future structure of Local Government Pension Scheme in Scotland**

**79.** The Scottish Scheme Advisory Board is undertaking a review of the future structure of the Local Government Pension Scheme in Scotland. Four options have been 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 funds
- Merge the funds into one or more funds.

**80.** Stakeholder views were sought through a consultation process and the North East Scotland Pension Fund submitted a response in December 2018. Following the consultation process, a draft report incorporating stakeholder views was considered at the Scheme Advisory Board meeting on 24 April 2019. The outcome of consideration by the Scheme Advisory Board, and any ministerial consideration, is awaited.

# Part 5

## Value for money



### Main judgements

The Fund's investment performance is subject to regular review and scrutiny by the Aberdeen City Council Pensions 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

**81.** 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.

**82.** [Exhibit 10](#) shows that over the year, the Fund generated a return of 8.5% against a benchmark of 7.4%. Equity portfolios were the most significant contributor to this increase. Over the medium to longer term the Fund has outperformed its three-year, five-year and since inception benchmarks.

### Exhibit 10 Fund investment performance



Source: North East Scotland Pension Fund 2018/19 audited financial statements

**83.** The Fund appoints several external investment managers. Individual investment manager performance is reported on a quarterly basis to the Pensions Committee. The Fund's investments team also carries out annual diligence reviews for each appointed fund manager.

**84.** Investment return and risk are inextricably linked, and it is not possible for us to give an opinion on the relative performance of the Fund's investments given the risk exposure of the asset allocation and investments made. However, we are aware that the Pensions Committee is regularly updated with details of how closely aligned the Fund's investments are with its investment strategy.

**85.** The Fund's Investment Strategy sets out how the Fund would like to structure its investments in terms of the different types of investments. The Fund holds less investments than its benchmark in all categories except Equities. Equities made up 76% of the fund investments at 31 March 2019, against a benchmark of 57.5%. We are aware that the level of investment in equities is partly due to their significant returns in recent years compared to other categories of investment. We appreciate that moving investments between categories can take time, as investment managers look for appropriate opportunities, but the Fund should ensure it is happy with the pace of alignment with the benchmark.

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

## Management expenses

**87.** 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.

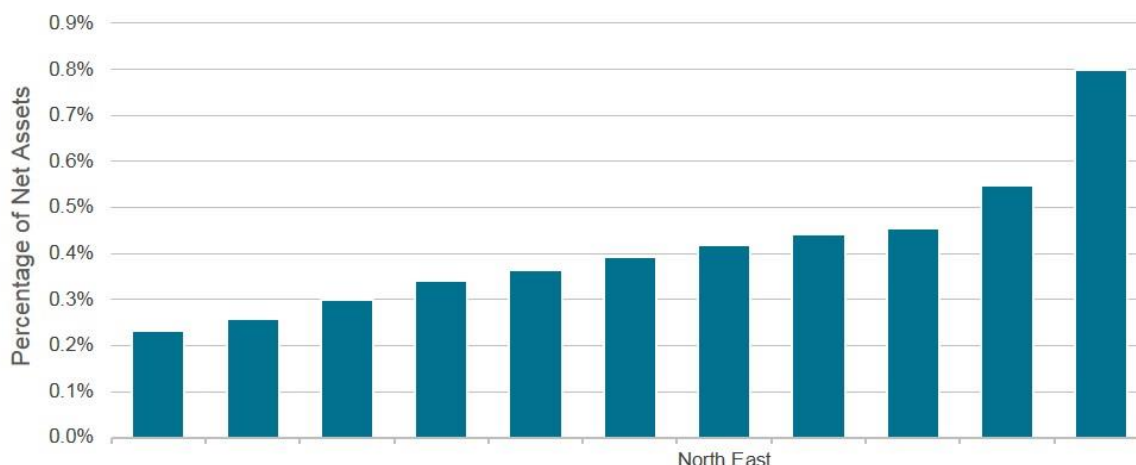
**88.** External investment manager fees are agreed in the respective mandates governing their appointments. The fees are relative to the risk and complexity involved in managing a particular asset and strategy.

**89.** Investment management expenses have decreased slightly from £19.9m in 2017/18 to £18.9m in 2018/19.

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

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## Exhibit 11 Investment Management Expenses





**91.** 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 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

**92.** Administrative expenses have remained broadly similar year on year, at £2.2 million in both 2017/18 and 2018/19. 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, such as auto enrolment, also increase the administration workload. Fund membership has increased by 7.5% in the past 5 years.

**93.** 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.

**94.** Employers are required to submit contributions returns to the Pension Fund; this is an important control over the accuracy of pension contributions received and recorded in the pensions system and is of increased importance following the introduction of CARE as the member benefit statement requires actual salary data from all employers. The fund made monthly online submissions of data a mandatory requirement for employers from 1 April 2017. This facility was an extension of a system used by larger employers, which was amended to cater towards the needs and capabilities of smaller employers, with 96% of employers providing information online.

**95.** Governance and oversight expenses have also remained similar year on year, at £0.5 million for both 2017/18 and 2018/19.

### National performance audit reports

**96.** 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.

**97.** The Pensions Committee considered the LGPS supplement to the Local Government in Scotland: Financial Overview 2017/18 at its March 2019 meeting. We have drawn other relevant publications to the attention of the committee during the year.

# Appendix 1

## Action plan 2018/19



No.	Issue/risk	Recommendation	Agreed management action/timing
1	<p><b>Merger with Strathclyde Pension Fund no.3 (Transport Fund)</b></p> <p>North East Scotland Pension Fund and Strathclyde Pensions Fund have agreed that the Strathclyde Pension Fund Transport Fund will merge with the Aberdeen City Council Transport Fund in 2019/20.</p> <p><b>Risk</b></p> <p>A lack of planning could lead to membership information, financial reporting and assets and liabilities not being transferred correctly or completely.</p>	<p>The Fund should ensure that adequate arrangements are in place for the transfer of membership data, assets and liabilities from Strathclyde Pension Fund Transport Fund.</p> <p><a href="#">Paragraph 64</a></p>	<p>A comprehensive project plan was put in place with workstreams across the project meeting regularly.</p> <p>As at 2 September the merger is almost complete with live No.3 data being held and managed by Aberdeen. Assets will be transitioned throughout September 2019 with a temporary investment strategy put in place to assist with future plans later in 2020.</p> <p>Aberdeen will make the first No.3 payroll on the 13 September 2019.</p> <p>Pension Manager</p> <p>End of October 2019</p>
2	<p><b>Training and development</b></p> <p>Pensions Committee and Pension Board members are expected to attend at least two training sessions per year. During 2018/19 two Committee members and two Board members did not attend two or more training sessions.</p> <p><b>Risk</b></p> <p>Members do not have or maintain the expertise required to monitor and scrutinise Pension Fund performance effectively.</p>	<p>Pensions Committee and Pension Board members should ensure that they keep their pensions knowledge up to date and take advantage of the training and development opportunities offered.</p> <p><a href="#">Paragraph 69</a></p>	<p>Diaries and availability is always a challenge; the Fund has moved to hold an element of its training schedule after the Pension Committee/Board quarterly meetings to assist attendance.</p> <p>If lack of attendance persists with individual Committee/ Board members, the Administering Authority will address the issue, as recently experienced with the Board.</p> <p>Annual Attendance Review of both Committee and Board are provided by the Pension Committee Effectiveness Annual Report and the Annual Pension Board Report, presented in June 2019 and annually thereafter.</p> <p>Pension Manager</p> <p>June 2020</p>

# 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 Assurances on administering authority key financial systems used by NESPF</b></p> <p>Aberdeen City Council (ACC) is the administering authority for the North East Scotland Pension Fund. Several ACC key financial systems (general ledger; accounts payable; accounts receivable) underpin the NESPF accounting records. We are dependent on the council's external auditor, KPMG, for audit assurances on these systems.</p>	<p>Assurances will be agreed with and obtained from KPMG on key Aberdeen City Council financial systems which underpin NESPF accounting records.</p>	<p>We have taken assurance from KPMG's annual audit report to Aberdeen City Council, which reported on controls testing undertaken.</p> <p>KPMG also provided satisfactory results of their testing of a control which reconciled ACC's payroll report to the data on the pension fund's I-connect system.</p>
<p><b>2 Risk of management override of controls</b></p> <p>ISA 240 requires that audit work is planned to consider the risk of fraud, which is presumed to be a significant risk in any audit. This includes consideration of the risk of management override of controls 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>3 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>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>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</p>

Audit risk	Assurance procedure	Results and conclusions
<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>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>income did not identify any issues.</p> <p>We found no evidence of fraud over income or expenditure.</p>

#### 4 Estimation and judgements

There is a significant degree of subjectivity in the measurement and valuation of investments and the actuarial valuation.

Investments include level 3 investments such as unquoted equity, where valuations involve 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 in the financial statements.

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.

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 2018/19.

We carried out 'reliance on a management expert' work on the custodian and the actuary. This included review of the PwC report on actuarial assumptions. We concluded that we could place reliance on the custodian and the actuary.

The draft accounts were amended to reflect the Private Equity level 3 investment valuations which were available in August 2019. We substantively checked all valuations to fund manager reports.

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

#### 5 Training and Development

Pension Funds are complex in nature and as such it is important that members of the Pensions Committee and Pension Board obtain sufficient training to carry out their role effectively.

The Fund's Training Policy requires each Committee and Board member to receive at least 2 days of training each year, but this is not always achieved by all members. Two Pension Board members did not meet this requirement last year.

Review training logs.

Review Pension Board minutes of 7 June for discussion/ decisions on this matter.

2 Pension Board and 2 Pensions Committee members did not meet the training requirement in 2018/19, as disclosed in the Management Commentary of the Annual Report and Accounts.

Refer Appendix 1, Action Plan no. 2 above.

# 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

# North East Scotland Pension Fund

## 2018/19 Annual Audit Report – DRAFT

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