

External Audit Progress Update – 2015/16 Audit

Prepared for Aberdeen City Council Pension Committee
June 2016

Purpose of this report

1. This report aims to provide an update of progress with the 2015/16 audit of North East Scotland Pension Funds. Our Annual Audit Plan was considered by the Pension Committee in March 2016. A significant element of our work relates to gathering the assurances required to support our opinion on the pension funds' annual accounts.

Summary of planned audit work for 2015/16

2. Our planned work in 2015/16 includes:
 - an audit of the financial statements and provision of an opinion on whether:
 - they give a true and fair view of the state of affairs of North East Scotland Pension Funds as at 31 March 2016 and their income and expenditure for the year then ended
 - the accounts have been properly prepared in accordance with the Local Government (Scotland) Act 1973 and the 2015/16 Code of Practice on Local Authority Accounting in the United Kingdom
 - a review and assessment of North East Scotland Pension Funds' governance and performance arrangements in a number of key areas including a review of adequacy of internal audit and arrangements to support the annual governance and governance compliance statements.

Progress of 2015/16 audit work

3. As set out in our Annual Audit Plan, key elements of our audit include:
 - assessing the key systems of internal control, and considering how risks in these systems could impact on the financial statements
 - identifying major transaction streams, balances and areas of estimation and understanding how North East Scotland Pension Funds will include these in the financial statements
 - assessing and addressing the risk of material misstatement in the financial statements
4. While we undertake a review of a number of high level key controls, traditionally, a significant element of our audit has focused on the financial statements with assurances largely drawn from substantive procedures at the year end i.e. verification of transactions through reviewing samples for appropriateness and confirmation of balances with the financial ledger and other supporting systems via reconciliations.
5. Two main areas of the accounts where we devote significant time include contributions received (income) and fund management activities (investments held and investment income).

Contributions

- We have seen improvements in this area during the year with the largest scheduled bodies now providing information via I-Connect, a cloud based portal for employers to provide monthly payroll data which identifies changes for automated processing onto the pension administration system. The implementation of I-Connect enables officers to carry out regular checks. Smaller employers have the option to use a similar service to I-Connect or to continue to submit contribution listings on an annual basis. In most cases, smaller employers still submit their data on an annual basis.
- The new checks, involving completion of a checklist, are carried out by the recently formed Employer Relationship Team to confirm if employer contribution details reconcile with the pensions administration system. These checks are part of the reporting requirements to support the funds' Administration Strategy. While checks have been carried out throughout 2015/16, formalisation of the checklist has only been in place since November 2015.
- We have recommended that the Employer Relationship Team and the Accounting Team liaise on the different reconciliations carried out by their respective teams with regard to the different employers in order to streamline activities and strengthen the overall audit trail.

Improved in-year controls should provide greater audit assurance allowing the option for less year end testing. We therefore anticipate that these new checks will provide audit with greater assurance from 2016/17.

Fund management activities

- The majority of the funds' investment activities are outsourced to a range of fund managers. While the senior pensions officer with responsibility for accounting and investments reviews investment transactions including fund manager and custodian reports, reliance is largely placed on the investment accounting provided by the custodian. ISA 620 allows auditors to place reliance on expert opinions.
6. **Orders of Reference** - Internal audit has commented on the need for the Orders of Reference for the Pensions Committee, the investment policy and other strategy documents to be brought up to date to reflect the removal of the Joint Investment Advisory Committee and the implementation of the Pensions Board. We would also suggest that the council's delegated powers in respect of the head of finance are updated to reflect recent changes in responsibility such as the establishment of a Pensions Board, reporting to the Pensions Regulator and auto-enrolment responsibilities.

Next Steps

7. Other than the issues set out above, we have no significant matters to bring to members' attention, from our review of the operation of key controls in 2015/16, which are likely to materially affect our opinion on the accounts. In addition to our consideration of these high level controls, we set out a number of risks in our Annual Audit Plan. In most cases, we will collate our assurances as part of our audit of the accounts (during June to August 2016) and include our final results and conclusions on each risk in our Annual Audit Report in September 2016. Any matters arising which might impact on the funds' annual governance statement will be brought to officers' attention in sufficient time for consideration before the audited accounts are submitted to the Pensions Committee.
8. The appendix provides a reminder of these risks and our planned audit approach in each case.

Anne MacDonald, Senior Audit Manager

June 2016

Progress update - Significant audit risks

| Audit Risk | Audit assurance procedure | Progress update |
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| <p>1. Income</p> <p>North East Scotland Pension Funds receive a significant amount of income from employer and employee contributions and investment income. The extent and complexity of income means there is an inherent risk of fraud in accordance with ISA 240.</p> <p>There is a risk that fund income per the annual accounts is materially misstated.</p> | <p>Contributions</p> <ul style="list-style-type: none"> • Focused year end testing of contribution reconciliations • Verification that contributions have been properly deducted on employer payrolls and transferred to the funds. <p>Investment Income</p> <ul style="list-style-type: none"> • Review of controls in place • Focused year end substantive testing of investment income. | <p>Contributions (year end audit activity)</p> <ul style="list-style-type: none"> • Contributions are received from 11 scheduled bodies and around 40 admitted bodies. Historically, our review of the figure in the accounts has depended on the completion of year end reconciliations by the pension fund. While monthly checks have been carried out by officers to ensure that monthly contributions were received and that these appeared reasonable, it was only at the year end, once listings of employee and employer contributions were received that complete reconciliations could be undertaken. • We have seen improvements in this area during the year with the largest scheduled bodies now providing information via I-Connect, a cloud based portal for employers to provide monthly payroll data which identifies changes for automated processing onto the pension administration system. The implementation of I-Connect enables officers to carry out regular checks. Smaller employers have the option to use a similar service to I-Connect or to continue to submit contribution listings on an annual basis. In most cases, smaller employers still submit their data on an annual basis. • The new checks, involving completion of a checklist, are carried out by the recently formed Employer Relationship |

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| | | <p>Team to confirm if employer contribution details reconcile with the pensions administration system. These checks are part of the reporting requirements to support the funds' Administration Strategy. While checks have been carried out throughout 2015/16, formalisation of the checklist has only been in place since November 2015.</p> <ul style="list-style-type: none"> • We have recommended that the Employer Relationship Team and the Accounting Team liaise on the different reconciliations carried out by their respective teams with regard to the different employers in order to streamline activities and strengthen the overall audit trail. Improved in-year controls should provide greater audit assurance allowing the option for less year end testing. We therefore anticipate that these new checks will provide audit with greater assurance from 2016/17. • On a sample basis, we also verify that that contributions deducted from employees through employer payrolls are correct. At present we gather assurance by direct confirmation with a sample of fund employers. <p>Investment Income (year end audit activity)</p> <ul style="list-style-type: none"> • On a sample basis, we confirm monthly cash reconciliations for each fund manager with the financial ledger. We also review samples of investment income and confirm that transactions have been posted to the correct financial year. |

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| <p>2. Management override of controls</p> <p>As stated in ISA 240, management is in a unique position to perpetrate fraud because of management's ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively.</p> | <ul style="list-style-type: none"> • Detailed testing of journal entries • Review of accounting estimates for bias • Evaluating significant transactions that are outside the normal course of business. | <p>Year end audit activity – Our work in this area traditionally involves a review of samples of Journals, accounting estimates and significant/unusual transactions to ensure that there are valid reasons and authority for the transactions posted.</p> |
| <p>3. Private Equity</p> <p>Private equity investments are included in the net assets statement on the basis of the best estimate (i.e. valuations at 31 December).</p> <p>There is a risk that investments per the accounts are materially misstated.</p> | <ul style="list-style-type: none"> • Review of client working papers • Reliance on an expert in accordance with ISA 620 – review of investment approach. | <p>Year end audit activity - Unlike equities, private equity investments are not listed and therefore we rely on the expertise of the fund managers who prepare the valuations.</p> <p>ISA 620 enables auditors to place reliance on experts.</p> |
| <p>4. Fund management costs</p> <p>CIPFA have issued best practice guidance on <i>Accounting for local government pension scheme management costs</i>. Guidance has been given for further analysis of costs and it also covers areas where historically, difficulty has been experienced in identifying all the management costs.</p> <p>There is a risk the fund does not comply with best practice.</p> | <ul style="list-style-type: none"> • Review of management action to identify costs • Focused year end substantive testing of management costs • Comparison of disclosures with other local government pension funds. | <p>Year end audit activity -Significant work was undertaken in 2014/15 to ensure that fund management costs were disclosed in in accordance with the new CIPFA guidance. While we will undertake some comparative work against other pension funds in 2015/16, we would anticipate that a similar approach to last year's audited position should be sufficient for us to confirm that the figures in the accounts are not materially misstated.</p> <p>Updated guidance from CIPFA has just been issued but is not effective until 2016/17.</p> |

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| <p>5. Provision for non-collection</p> <p>A significant debt in respect of a termination agreement due from an admitted body has been the centre of dispute for some time.</p> <p>There is a risk that debt collection is not being effectively managed.</p> | <ul style="list-style-type: none"> • Review of management action. | <p>Work-in-progress - We have maintained a 'watching brief' on action to collect this outstanding debt. The delay has been due to the time required to secure members' agreement to purchase annuities to fund pension enhancements. This agreement has now been obtained and arrangements are being made to conclude the necessary documentation. Once this is completed, the trustees of the former admitted body will be able to make final payment to the pension fund.</p> |
| <p>6. Local Government Pension Scheme (Scotland) (2015)</p> <p>A new local government pension scheme was implemented from 1 April 2015. This has resulted in a number of changes for members including pensions being based on care average revalued earnings, as opposed to final salary and the rate at which pension accrues reducing from 1/60 to 1/49.</p> <p>There is a risk pensions or contributions may be calculated incorrectly.</p> | <ul style="list-style-type: none"> • Project Plan for implementing the new scheme and progress reports to committee • Website updates • Separate training and briefings provided for employers and staff • Testing of pension administration system prior to implementation of the new scheme • Management controls in place. | <p>Work-in-progress - Based on our general awareness of the funds' preparations, we considered the arrangements to be well planned and resourced. This exercise is intended to verify that initial view having considered the project outcomes against the project plan.</p> |

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| <p>7. Changes in Fund Experts</p> <p>In December 2015, the agreements with the fund manager for the Main Fund Global Ex and Frontier Fund and the Transport Fund were terminated.</p> <p>There is a risk that that the funds cannot mitigate further significant losses during the period until the transfers are concluded.</p> | <ul style="list-style-type: none"> • Instructions provided to the existing fund manager in respect of 'care taking' responsibilities and arrangements for transfer • Appointment of new fund manager and arrangements for handover • Ongoing monitoring by custodian • Reports to Pensions Committee. | <p>Year end audit activity - The decisions to change the fund manager for the Main Fund Global Ex and Frontier Fund and the Transport Fund; and the custodian were made in 2015/16 but will not be in operation until 2016/17. However, the notes to the 2015/16 accounts will require to disclose the changes. The audit will therefore consider the controls in place to ensure that the value of the relevant funds is safeguarded during the transition process.</p> |
| <p>8. Funding Position</p> <p>The funding position for the Main Fund has fallen from 94% at the time of the 2014 actuarial valuation to 79% at September 2015, while there has been a similar drop for the Transport Fund from 93% to 85%.</p> <p>There is a risk the funds' assets will not meet long term liabilities.</p> | <ul style="list-style-type: none"> • Interim actuarial valuations to be undertaken by the funds as at March 2016. | <p>Year end audit activity – Interim actuarial valuations will be reviewed and we will comment on the latest position in our Annual Audit Report.</p> |
| <p>9. Local Authority Accounts (Scotland) Regulations 2014</p> <p>Schedule 7 of the Local Authority Accounts (Scotland) Regulations 2014 require that the pension committee should consider an annual internal audit plan and that arrangements should be put in place for a regular external review of the effectiveness of internal audit.</p> <p>There is a risk the funds are not fully complying with the 2014 regulations.</p> | <ul style="list-style-type: none"> • Discussions with officers including internal audit. | <p>Internal audit coverage of pension fund activities was included in the overall 2015/16 internal audit plan for Aberdeen City Council. The internal audit arrangements for 2016/17 and beyond in respect of the pension funds will need to be separately planned and reported to the Pension Committee as the body charged with governance.</p> |

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| <p>10. Scrutiny</p> <p>The Local Government Pension Scheme (Governance) Scotland Regulations 2015 required the Pension Fund to establish a Pension Board to assist it in complying with the scheme regulations and requirements of the pensions' regulator. It will take time for these new arrangements to bed in and become effective, and training and support will be necessary for board members to enable them to effectively fulfil their role</p> <p>The pensions committee has recently reviewed the frequency and content of reports it receives with a view to ensuring wider coverage of service performance across all fund activities.</p> <p>There is a risk that, as a result of the level of change, scrutiny and challenge processes are less effective.</p> | <ul style="list-style-type: none"> • Training and support provided to the Pensions Board and Pensions Committee • Reports provided to the Pension Committee/Pensions Board. | <p>In previous years we commented on the adequacy of scrutiny around pension fund performance. There was a significant change in the arrangements in 2014/15 with the termination of the Joint Investment Advisory Committee and from 1 April 2015, the introduction of the Pension Board. Our Annual Audit Report (in September 2016) will comment on:</p> <ul style="list-style-type: none"> • Operation of the Pension Board against the requirements set out in the 2015 Regulations • Adequacy of training and support provided to committee and board members • Adequacy of performance information and other governance assurances considered by the Pension Committee/Pension Board. |

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| <p>11. Pensions Regulator</p> <p>The Public Sector Pensions Act 2013 provided for extended regulatory oversight by the Pensions Regulator. Funds are therefore required to comply with the Regulator's <i>Code of Practice no. 14: Governance and Administration of Pension Schemes</i> and develop a formal policy on reporting significant failures of pension fund administration / breaches of the law.</p> <p>While the funds have undertaken work in this area, there remains a risk that adequate processes are not in place for identifying breaches and that they are not reported to the Pension Regulator.</p> | <ul style="list-style-type: none"> Assessment of compliance with the Pensions Regulator Code of Practice (reported to Pensions Committee in September 2015) Fund administration strategy and policy on reporting breaches. | <p>Our Annual Audit Report (in September 2016) will comment on:</p> <ul style="list-style-type: none"> the funds' performance reporting against the requirements of the Fund Administration Strategy progress in developing a policy for reporting of breaches. |
| <p>12. Cyber Security</p> <p>Over the past year several Scottish public organisations have been victims of cyber-attacks. All public sector bodies should be aware of a cyber-attack and take actions to reduce the risk of a successful attack.</p> | <ul style="list-style-type: none"> Overall IT environment operated by Aberdeen City Council as administering authority Discussions with officers about security around pension specific systems. | <p>Work-in-progress - A self-assessment questionnaire is currently being concluded in respect of Aberdeen City Council (including the pension fund) covering the work undertaken by the authority to minimise the risk of cyber-attacks, the resources identified to manage this risk and the adequacy of the response plan in place.</p> |