

North East Scotland Pension Fund DRAFT

2017/18 Annual Audit Report



 AUDIT SCOTLAND

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

14 September 2018

Who we are

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

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



About us

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

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

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

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Key messages

2017/18 annual report and accounts

- 1 In our opinion the 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 are 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 The fund's investment return performance in comparison to other Scottish LGPS funds has improved in 2017/18 compared to 2016/17, with a move from second lowest to second highest performer.

Financial sustainability

- 5 The 2017 triennial funding valuation assessed the Main Fund as 107% funded, an increase of 13% from the 2014 valuation. Council employers' contribution rates are maintained for 2018-2021 at 2017/18 levels. Other employers' contribution rates range from 11% to 33.8%.
- 6 The 2017 triennial funding valuation assessed the Transport Fund as 94% funded, an increase of 1% from the 2014 valuation. Employer contributions will remain at the current level for 2018-2021, but with an additional £1.5 million payment per annum, to reduce the deficit.
- 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 Pensions Committee.
- 9 Decisions are transparent with committee papers and detailed minutes of meetings of the Pensions Committee available on the fund's website and 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.

Introduction

1. This report is a summary of our findings arising from the 2017/18 audit of the North East Scotland Pension Fund (NESPF). The Fund consists of two funds, the North East Scotland Pension Fund (the main fund) and the Aberdeen City Council Transport Fund (the transport fund). Both funds are part of the Local Government Pension Scheme (LGPS). Hereafter we will refer to “the Fund” in the singular.

2. The scope of our audit was set out in our Annual Audit Plan presented to the March 2018 meeting of the Aberdeen City Council 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](#).

Exhibit 1

Audit dimensions



Source: Code of Audit Practice 2016

3. The main elements of our audit work in 2017/18 have been:

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

4. Aberdeen City Council is the administering authority for the pension fund. The council delegates this responsibility to the Pensions Committee. The Committee is responsible for establishing effective governance arrangements and ensuring that

financial management is effective. Additionally, the Committee is required to review the effectiveness of internal control arrangements and approve the annual accounts.

5. Our responsibilities as independent auditors are established by the Local Government (Scotland) Act 1973, the [Code of Audit Practice 2016](#), and supporting guidance, and are guided by the auditing profession's ethical guidance.

6. As public sector auditors we give independent opinions on the annual accounts. We also review and provide conclusions on the effectiveness of the Fund's performance management arrangements, suitability and effectiveness of corporate governance arrangements, and financial position and arrangements for securing financial sustainability.

7. Further details of the respective responsibilities of management and the auditor can be found in the [Code of Audit Practice 2016](#).

8. This report raises matters from the audit of the annual accounts, risks and control weaknesses. Communicating these does not absolve management from its responsibility to address the issues we raise, and to maintain adequate systems of control.

9. Our annual audit report contains an agreed action plan at [Appendix 1](#) setting out specific recommendations, responsible officers and dates for implementation. It also includes outstanding actions from last year and progress against these.

10. We can confirm that we comply with the Financial Reporting Council's Ethical Standard. We can also confirm that we have not undertaken any non-audit related services and the 2017/18 audit fee of £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.

Adding value through the audit

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

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

13. We would like to thank all management and staff who have been involved in our work for their co-operational and assistance during the audit.

Part 1

Audit of 2017/18 annual accounts



Main judgements

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

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

Unqualified audit opinions

14. The annual accounts for the year ended 31 March 2018 were approved by Aberdeen City Council Pensions Committee on 14 September 2018. We reported, within our independent auditor's report:

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

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

Submission of annual accounts for audit

15. We received the unaudited annual accounts on 25 June 2018, in line with the audit timetable set out in our 2017/18 Annual Audit Plan.

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

Risks of material misstatement

17. [Appendix 2](#) provides a description of those assessed risks of material misstatement that were identified during the planning process which had the greatest effect on the overall audit strategy, the allocation of staff resources to the audit and directing the efforts of the audit team. We also include the wider dimension risks, how we addressed these and our conclusions in the appendix.

Materiality

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

19. Our initial assessment of materiality for the annual accounts was carried out during the planning phase of the audit. We assess the materiality of uncorrected misstatements, both individually and collectively. The assessment of materiality

was recalculated on receipt of the unaudited financial statements 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
<p>Overall materiality – This is the calculated figure we use in assessing the overall impact of audit adjustments on the financial statements. It was set at 10% of contributions receivable for the year ended 31 March 2018 based on the unaudited accounts.</p>	<p>Main Fund £13.8 million</p> <p>Transport Fund £0.245 million</p>
<p>Performance materiality – This acts as a trigger point. If the aggregate of errors identified during the financial statements audit exceeds performance materiality this would indicate that further audit procedures should be considered. Using our professional judgement, we have calculated performance materiality at 75% of overall materiality.</p>	<p>Main Fund £10.3 million</p> <p>Transport Fund £0.184 million</p>
<p>Reporting threshold (i.e. clearly trivial) – We are required to report to those charged with governance on all unadjusted misstatements in excess of the 'reporting threshold' amount. This has been calculated at 2.5% of overall materiality. (With a maximum level of £100,000).</p>	<p>Main Fund £100,000</p> <p>Transport Fund £6,000</p>

How we evaluate misstatements

20. There were no material adjustments to the unaudited financial statements arising from our audit. In common with previous years, the Private Equity (type 3) investments have been updated in the audited accounts for more recent valuations received from the fund managers. The unaudited accounts were prepared with the most up to date figures available for Private Equity (type 3) investments, as at 31 December. The Private Equity valuations as at 31 March were received by the Pension Fund in August and the accounts were updated for these figures. The result was an increase of £8 million in Private Equity investments.

Significant findings from the audit in accordance with ISA 260

21. International Standard on Auditing 260 (UK & Ireland) requires us to communicate significant findings from the audit to those charged with governance. These are summarised below 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.

22. The findings include our views about significant qualitative aspects of the Fund's accounting practices including:

- Accounting policies
- Accounting estimates and judgements
- Significant financial statements disclosures
- Timing of transactions and the period in which they are recorded
- The impact on the financial statements of any uncertainties
- The effect of any unusual transactions on the financial statements
- Misstatements in the annual accounts
- Disagreement over any accounting treatment or financial statements disclosure

Exhibit 3

Significant findings from the audit of financial statements

Issue	Resolution
<p>1. Events after the reporting period</p> <p>The risk of employers being unable to meet their pension obligations is managed through the NESPF Termination Policy and the NESPF Employer Covenant Assessment Policy. At 31 March 2018 the Fund recognised that there were three employers who had exited from the Fund where payment of the termination fee may not be recovered in full.</p> <p>For one of these, a termination fee of £0.212 million had been registered with the company liquidator but the final payment, received after the year end, was only £0.086 million. The fund therefore incurred a loss of £0.126 million. The current assets in the NESPF Net Assets Statement are overstated by £0.126 million and the impairment of this debt is understated by the same amount in the NESPF Fund Account.</p>	<p>Management decided that this amount was not material and therefore did not adjust the 2017/18 accounts. This is recorded as an unadjusted misstatement of £0.126 million.</p>

Source: North East Scotland Pension Fund 2017/18 matters arising

Good practice in financial reporting

23. The annual report and accounts include all the required disclosures for pension fund accounts. We noted Section 12 “Corporate, Environmental and Social Governance” as a good practice example. It reports the activities and engagement of the fund in relation to good corporate governance and good social and environmental practice. This includes:

- Voting at the AGMs of companies the fund invests in, to influence the management of those companies. The main reasons for voting ‘against’ the companies are disclosed (e.g. vote on dividend or dividend policy not put to shareholders, not rotating audit firms on a regular basis, high level of audit fees potentially leading to undue influence over the auditor, executive pay deemed to be excessive etc.) A link to the fund’s voting record is included.
- Engagement through the Local Authority Pension Fund Forum (LAPFF) to support shareholder resolutions on climate change; to engage with companies on: employment standards, use of cluster munitions, sexual harassment, worker access to corporate boards; and seeking assurances from companies on how they are addressing cyber security risks.
- Principles for Responsible Investment (PRI): the fund signed up in 2010 to PRI’s aspirational and voluntary guidelines for investment entities wishing to address environmental, social and corporate governance issues. The disclosure includes 2017/18 issues (working practices: fire and building safety, labour issues: labour standards, and climate change) and a link to where further information can be found.

Other findings

24. Our audit identified several presentational and disclosure issues which were discussed with management. These were adjusted and reflected in the audited annual accounts. This includes disclosing the full Governance Compliance

Statement rather than including a link to the statement on the fund's website, which is a requirement of the guidance for local government pension fund annual report and accounts. The presentation of some performance measures was also amended to make it clearer.

Pre-audit inspection and objections to the accounts

25. 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 on the North East Scotland Pension Fund accounts.

Part 2

Financial management



Main judgements

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

The Fund's investment return performance in comparison to other Scottish LGPS funds has improved in 2017/18 compared to 2016/17, with a move from second lowest to second highest performer.

Financial performance in 2017/18

26. 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 (see paragraphs 40-44).

27. The Fund's performance in 2017/18 is summarised in [Exhibit 4](#). This shows that the net assets of the Fund increased to £4.1 billion at 31 March 2018 from £3.8 billion at 31 March 2017. The Transport Fund's net assets increased by £0.1 million to £100 million. This represents an increase of 7.95% for the Main Fund and 0.11% for the Transport Fund.

Exhibit 4

Assets, liabilities, funding level and investment performance

Increase in net assets



Main Fund
+£303 million
 (+7.95%)

Transport Fund
+£0.1 million
 (0.11%)

Increase in estimated liabilities



Main Fund
+£174 million
 (+24.1%)

Transport Fund
-£7.6 million
 (13.7%)

Funding level



107% Main Fund
94% Transport Fund

2017 Funding Valuation

Investment performance



7.95% Main Fund
0.11% Transport Fund

Return on investments 2017/18

Closing net assets:	Closing liabilities:	94% Main Fund	Return on investments over 5 years:
Main Fund	Main Fund	93% Transport Fund	
£4,118 million	£4,892 million	2014 Funding Valuation	Main Fund 10.7%
Transport Fund	Transport Fund		Transport Fund not reported
£100.0 million	£78 million		

Source: NESPF 2017/18 audited financial statements and NESPF reports

28. In addition to the Triennial Funding Valuation, the fund's actuary also undertakes a valuation of pension fund liabilities (actuarial present value of promised retirement benefits) at the accounting date as required by International Accounting Standard (IAS) 26 and calculated in line with IAS 19 assumptions. This uses the same base data as the Triennial Funding Valuation rolled forward to the current financial year, taking account of changes in membership numbers and updating assumptions to the current year. This valuation is not carried out on the same basis as that used for setting employer contribution rates and the Fund does not take account of liabilities to pay pensions and other benefits in the future.

29. The actuarial present value of promised retirement benefits estimates the Main Fund's liabilities increasing from £4.7 billion at 31 March 2017 to £4.9 billion at 31 March 2018 (£174 million increase). Transport Fund pension liabilities decreased from £85.6 million at 31 March 2017 to £78 million at 31 March 2018. It should be recognised that not all funds have liabilities assessed on the same prudential scales. The use of differing actuarial firms and assumptions creates difficulties in direct comparisons. It should be noted that this valuation is an accounting estimate.

Financial management arrangements

30. From 3 September 2018, 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.

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

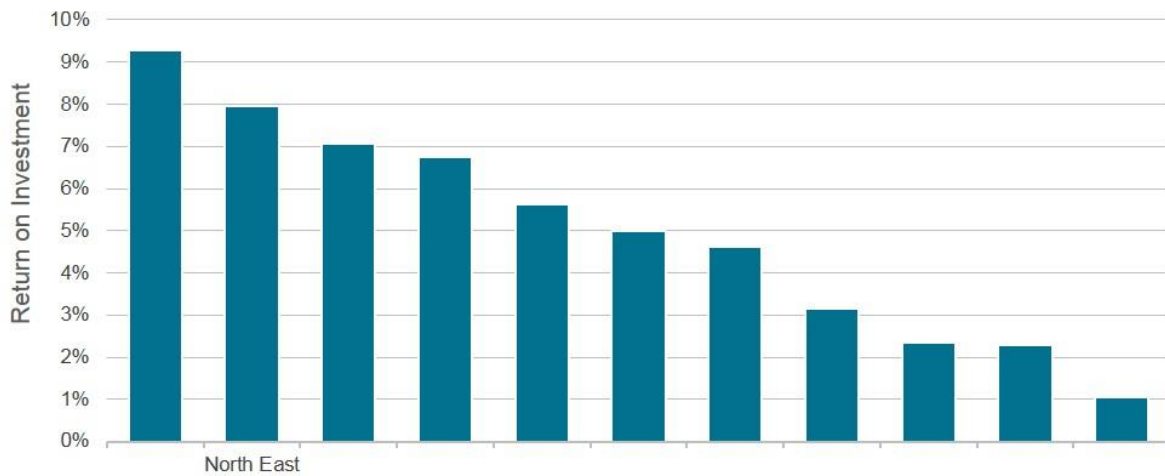
32. Based on evidence reviewed, we conclude that the Fund has effective financial management arrangements in place, including comprehensive reporting and review of investment performance.

Financial outcomes

33. 2017/18 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 2017/18 (unaudited figures)



Source: 2017/18 LGPS pension fund unaudited financial statements

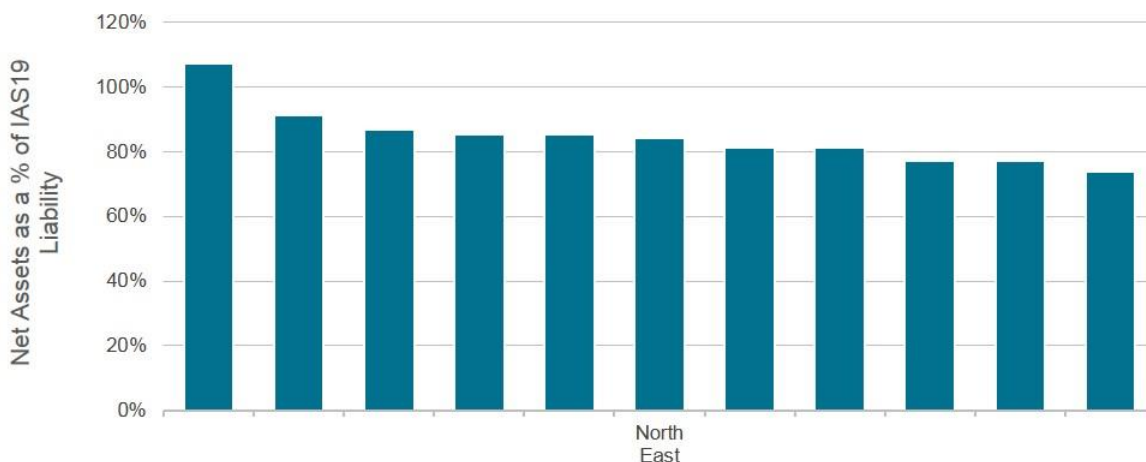
34. Exhibit 5 shows that the North East Scotland Pension Fund's in year investment return is 7.95% which, compared to other Scottish LGPS funds, sits in the top 2 performers in terms of net return on investments (based on unaudited figures for 2017/18). This is an improvement in its position compared to 2016/17 when its investment return placed the Fund second lowest across all local government pension funds in Scotland and below the Fund's own target. We note that the relative performance should not be considered without acknowledging that there are different investment strategies for different funds.

35. We have concluded that the pension fund's overall performance is good. However, the pension fund requires to continually monitor performance as it is unlikely that high performance returns will continue.

36. The IAS19 calculations give a guide to the relative funding positions of each fund as shown in Exhibit 6. When this is considered the North East Scotland Pension Fund is mid-range for 2017/18.

Exhibit 6

Net Assets as a proportion of IAS19 Liability as at 31 March 2018



Source: 2017/18 LGPS pension fund unaudited financial statements

Systems of internal control

37. As part of our audit we identify and inspect the key internal controls in those accounting systems which we regard as significant for the production of the financial statements.

38. 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 2017/18. Initially their planned audit approach was to be fully substantive and would not provide the requested assurance. However, the 2017/18 interim and final audit reports for Aberdeen City Council reported controls testing in the following areas, with satisfactory results: journal authorisation; payroll controls related to employee standing data, when joining, leaving and making changes; and controls around the transfer of pension data from the pension team to the actuaries. There was one recommendation from the testing of general IT controls including user access: that the review of ledger user access includes consideration of whether access is appropriate to the user's role. (Internal audit also made recommendations about strengthening controls especially super user access.) KPMG have given an unmodified opinion on Aberdeen City Council's 's 2017/18 accounts.

39. 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 2018."

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

41. 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.

Part 3

Financial sustainability



Main judgement

The 2017 triennial valuation assessed the Main Fund as 107% funded, an increase of 13% from the 2014 valuation. Council employers' contribution rates are maintained for 2018-2021 at 2017/18 levels. Other employers' contribution rates range from 11% to 33.8%.

The 2017 triennial valuation assessed the Transport Fund as 94% funded, an increase of 1% from the 2014 valuation. Employer contributions will remain at the current level for 2018-2021, but with an additional £1.5 million payment per annum, to reduce the deficit.

Although Main Fund contributions from members currently exceed benefits paid out, this is likely to change in the coming years.

Funding position and financial planning

42. 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%.

43. 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.

44. 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.

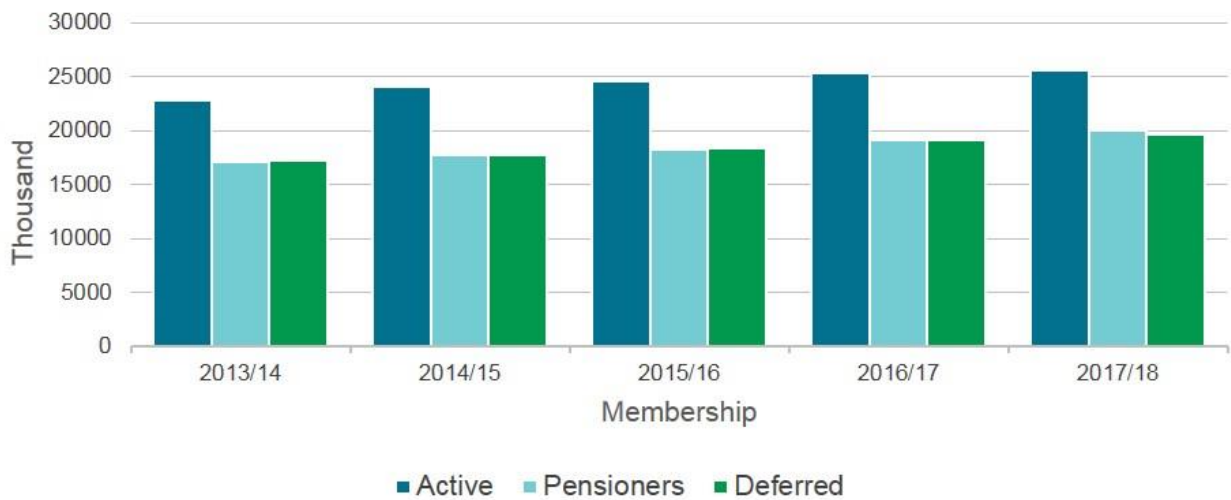
Financial sustainability looks forward to the medium and longer term to consider whether the Fund maintains the capacity to meet the current and future needs of its members.

Membership levels

45. 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 2017/18 audited financial statements

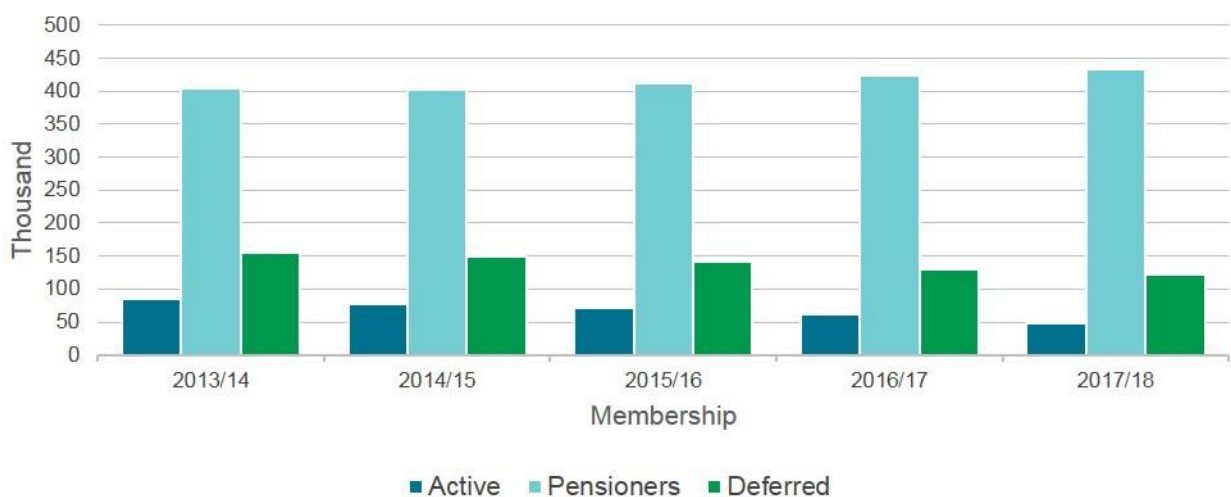
46. Membership of the main fund increased slightly by 239 in 2017/18 to 25,568 members at 31 March 2018; over the past 5 years membership has grown by 2,688 active members, which represents an increase of 11.7%. The impact of auto-enrolment contributed to the increase in members.

47. The Transport Fund, which is closed to new entrants, continues to fall in overall membership numbers and more members move to pensioner status. This is shown in Exhibit 8 below.

48. The Fund gives its members a guarantee that in exchange for contributions during their employment, the Fund will pay a pension until the end of each member's life. It is important that the fund maintains the capacity to meet the current and future needs of its members.

Exhibit 8

Transport Fund Membership



Source: NESPF 2017/18 audited financial statements

Contributions

49. 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](#). Other scheduled bodies include Aberdeenshire Council, Moray Council and 8 other bodies.

Exhibit 9

Contributions in 2017/18

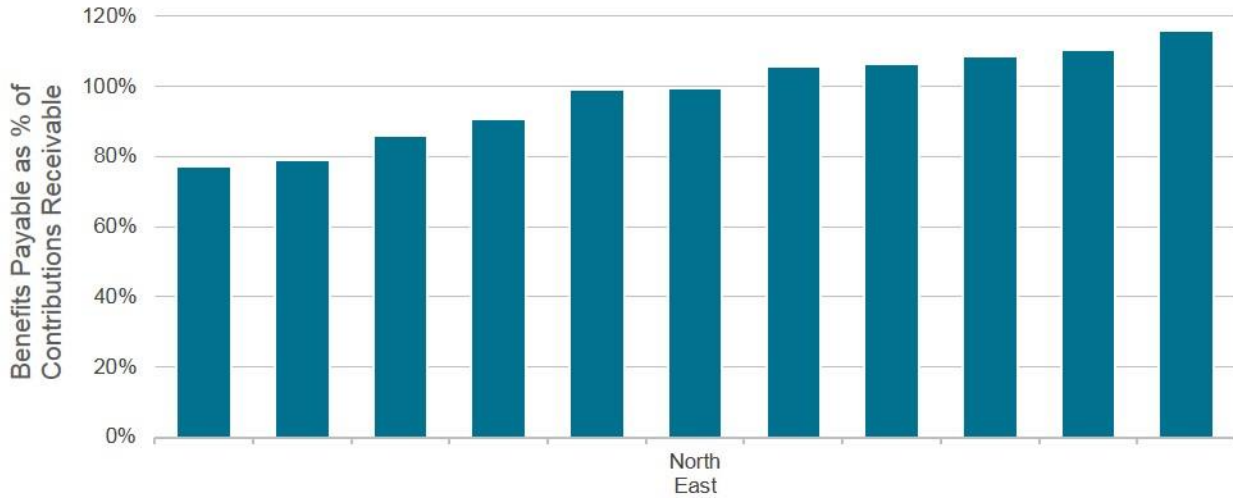
	Administering authority £m	Other scheduled bodies £m	Admitted bodies £m	Transferee Admission Bodies £m	Total £m
Employer contributions	26.751	56.009	6.427	3.251	92.438
Employee contributions	8.504	17.797	2.104	1.127	29.532
Strain Contributions	5.050	1.160	0.552	0	6.762
Deficit Recovery Contributions	2.312	3.513	0.095	0	5.920

Source: NESPF 2017/18 audited financial statements

50. The main fund reported a surplus from dealings with members of £2.9 million in 2017/18. This means that member contributions and investment income exceeded pension payments. [Exhibit 10](#) below shows how North East Scotland Pension Fund compares with the other ten local government pension funds in Scotland in terms of contributions receivable and benefits payable. Five of the eleven pay out more than they receive. 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.

Exhibit 10

Main Fund Benefits Payable as a proportion of contributions receivable

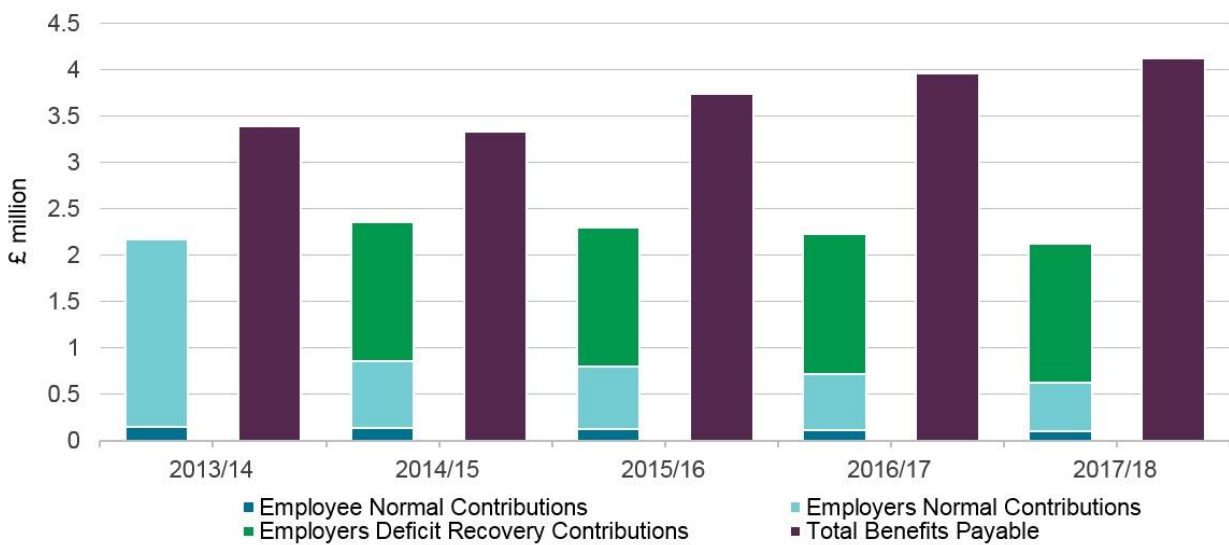


Source: 2017/18 LGPS pension fund unaudited financial statements

51. The Transport Fund is a closed fund and has not been open to new members for a number of years. Pension contributions, including £1.5 million annual deficit recovery payments, are exceeded significantly by benefits payable (see [Exhibit 11](#) for contributions and benefits payable over the past 5 years). In 2017/18 total contributions were £2.448 million and benefits payable were £4.126 million. Therefore, investment income is relied on in funding pension payments.

Exhibit 11

Transport Fund Contributions in 2017/18



Source: NESPF 2017/18 audited financial statements

EU withdrawal

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

- Workforce - the extent to which changes to migration and trade policies are likely to affect the availability of skilled and unskilled labour.
- Funding – the extent to which potential changes to funding flows are likely to affect the finances of the organisation and the activity that such funding supports.
- Regulation – the extent to which potential changes to regulation across a broad range of areas overseen at an EU level are likely to affect the activities of the organisation.

53. The fund recognises the difficulty of planning for Brexit amid considerable uncertainty. In terms of the market implications for investment performance, the fund is taking a diversified, balance approach to mitigate against the risk. For example, reducing equity investment and increasing investment in infrastructure, which is not as tied to global events.

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.

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

Governance arrangements

54. 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.

55. 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.

56. There have been significant changes in the membership of the Pensions Committee and Pension Board during 2017/18, largely due to the local government elections in May 2017. The fund must ensure that members are provided with training so that they are clear about their roles and responsibilities and are kept up to date on current issues so that they can scrutinise papers effectively.

57. 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.

Transparency

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

59. There is evidence from 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.

60. The Pensions Committee and Pension Board meetings are held in public, with commercially sensitive information dealt with in private session. The committee

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.

papers and minutes of these meetings are publicly available on the pension fund's website and on the administering authority's website.

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

Other aspects of governance

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

63. Last year we reported that the Orders of Reference for the Pensions Committee had not been updated. The Pension Fund provided updated Orders of Reference to the administering authority and these were approved by the council in March 2018.

64. Overall, we concluded that there are open and transparent arrangements in place.

Pensions Regulator Public Service Code

65. 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 2018. 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 2017/18.

Internal audit

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

67. 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.

68. Every local authority internal audit function must be externally assessed against the Public Sector Internal Audit Standards (PSIAS) once every 5 years. In 2017 Aberdeen City Council engaged KPMG to undertake a review of the internal audit function covering the PSIAS requirements and making comparisons to best practice for an entity listed on the London Stock Exchange. The report assessed internal audit as fully or generally compliant with the majority of the standards and partially compliant with the rest. Where the service was partially compliant, recommendations were made. These related to: closer linking of the audit plan to the council's risk register; a multi-year strategic plan; key performance indicators; management agreement of detailed scopes; communication with and feedback from key stakeholders. KPMG's report recommendations and Internal Audit's response to these were presented to and noted by Aberdeen City Council's Audit, Risk and Scrutiny Committee in November 2017. Actions accepted by Internal Audit were approved by Committee, the majority of which have since been implemented.

69. To avoid duplication of effort we place reliance on the work of internal audit wherever possible. In 2017/18 we did not place any formal reliance on internal audit reviews for obtaining direct assurance for our financial statements work, 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.

Management commentary, annual governance statement and governance compliance statement

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

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

Standards of conduct for prevention and detection of fraud and error

72. 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, a whistleblowing policy and a counter-fraud strategy.

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

Cyber security

74. The Scottish Government issued a [Public Sector Action Plan on Cyber Resilience](#) in November 2017 which requires all public sector bodies to carry out a review to ensure their cyber security arrangements are appropriate. Bodies are encouraged to seek independent assurance of critical technical controls, which in the Scottish Government's view is achieved by obtaining Cyber Essentials or Cyber Essentials Plus accreditation. We note that the administering authority has Cyber Essentials (Plus) accreditation.

General Data Protection Regulation

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

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

77. The North East Scotland Pension Fund project group, involving all teams, carried out a data gathering exercise to identify all areas that would be affected by GDPR. The fund has reviewed its documentation and contracts. It also met with other Scottish pension funds and the software supplier to identify system developments (delivered at the start of 2018) to ensure readiness for GDPR. Data protection information for members is easily accessible on its website. We concluded that the Pension Fund has made good progress in planning for and implementing GDPR requirements.

Good practice

78. The North East Scotland Pension Fund is a member of the software supplier's national Testing Working Party. The fund's receipt of early software releases (there were two in 2017/18, tested by NESPF and 5 other LGPS funds) contributes to its readiness for change, including readiness for GDPR.

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 expenses.

Investment performance

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

80. In 2005 a long term investment strategy for the Main Fund was agreed with a customised benchmark that aimed to deliver a return of 1% above the benchmark over a rolling three year period. [Exhibit 12](#) shows that over the year, the Fund generated a return of 11.1% against a benchmark of 3.0%. Equity portfolios were the most significant contributor to this increase.

Exhibit 12

Fund investment performance



Source: North East Scotland Pension Fund 2017/18 audited financial statements

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

82. As shown earlier in [Exhibit 5](#) net investment performance compared favourably with other local government pension funds in Scotland.

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. The Fund is currently taking steps to realign the portfolio asset allocations with the investment strategy, which have become out of line due to the increase in equity valuations.

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

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

Management expenses

86. 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.

87. 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.

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

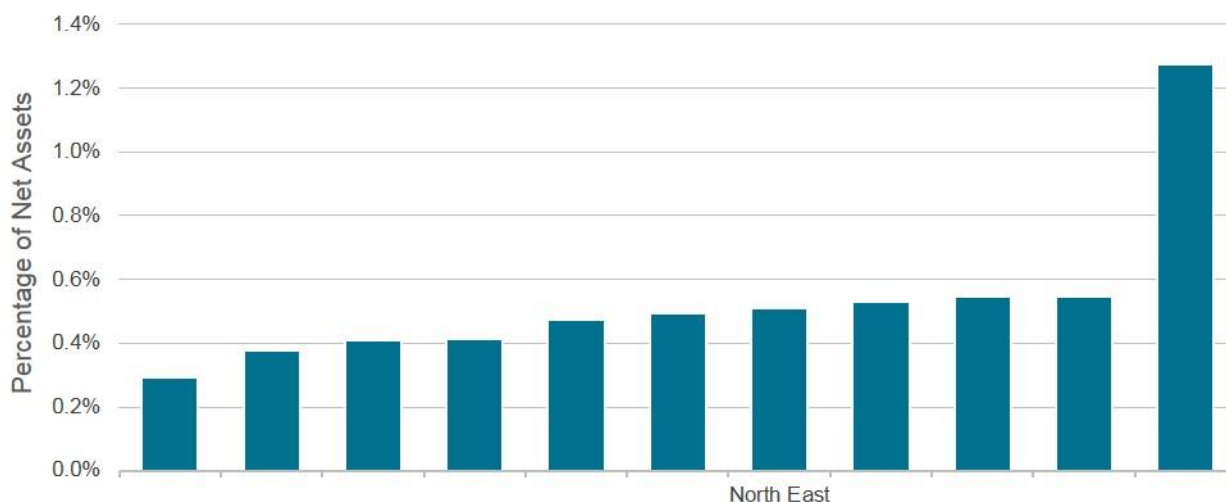
89. External investment manager fees are agreed in the respective mandates governing their appointments. Generally, these are based on the market value of the investments under their management and therefore increase or reduce as the value of these investments changes.

90. Total management expenses have increased from £18.5m in 2016/17 to £20.9m in 2017/18. This is primarily due to increased investment management fees aligned to the increased value of the Fund and an increase in performance fees as a result of the relative return on investments in 2017/18 against benchmarks.

91. [Exhibit 13 \(page 26\)](#) shows figures for total management expenses relative to net assets across the Scottish Local Government Pension Funds, with investment management expenses for the North East Scotland Pension Fund highlighted. The Fund had the fourth highest percentage in Scotland; however, variances in investment strategies and administrative structures (e.g. in-house staff vs. outsourced services) will impact on the amount of external investment management expertise purchased.

Exhibit 13

Investment Management Expenses



Source: 2017/18 LGPS pension fund unaudited financial statements

Administrative expenses

92. 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 11.7% in the past 5 years.

93. 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 1st 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.

94. 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.

National performance audit reports

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

96. The Pensions Committee considered the LGPS supplement to the Local Government in Scotland: Financial Overview 2016/17 at its March 2018 meeting. We have drawn other relevant publications to the attention of the committee during the year.

Good practice

97. The pension fund was named “Public Sector Scheme of the Year” at the Professional Pensions Pension Scheme Awards. The Fund was judged against several criteria including investment management, communications, governance, innovation and administration and the win recognises the achievements made in improving their service to members and employers.

Appendix 1

Action plan 2017/18

2017/18 recommendations for improvement



No. Issue/risk



Recommendation



Agreed management action/timing

Follow up of prior year recommendations

b/f	1. Pensions Committee Orders of Reference	The Pension Fund should request that the administering authority updates the Pension Committee Orders of Reference within the council's Standing Orders.	Updated audit response
	<p>The Pensions Committee Orders of Reference within Aberdeen City Council's Standing Orders have not been updated to reflect changes in pension fund governance. The Orders of Reference still refer to the Joint Investment Advisory Committee, which was disbanded in March 2015.</p> <p>Risk</p> <p>Out of date committee information on the website may reduce public confidence in the quality of published information and imply that regular review of governance information does not occur.</p>		<p>The Pension Fund provided the administering authority with a revised version of the Orders of Reference and these were approved by the council in March 2018.</p> <p>No further action required: closed.</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
Risks of material misstatement in the financial statements		
<p>1 Assurances on administering authority key financial systems used by NESPF</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>	<ul style="list-style-type: none"> Assurances will be agreed with and obtained from KPMG on key Aberdeen City Council financial systems which underpin NESPF accounting records. 	<p>Requested assurances were not provided due to the planned substantive nature of the Aberdeen City Council audit. We have taken assurance from KPMG's interim and annual audit reports to Aberdeen City Council, which reported on controls testing undertaken. We anticipate requiring additional assurances on internal controls next year as we can no longer take prior year assurance from earlier work by the previous auditor.</p>
<p>2 Risk of management override of controls</p> <p>ISA 240 requires that audit work is planned to consider the risk of fraud, which is presumed to be a significant risk in any audit. This includes consideration of the risk of management override of controls in order to change the position disclosed in the financial statements.</p>	<ul style="list-style-type: none"> Detailed testing of journal entries. Review of accounting estimates. Evaluation of significant transactions that are outside the normal course of business. 	<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>3 Risk of fraud over income and expenditure</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 North East Scotland Pension Fund receives a significant amount of investment income from third</p>	<ul style="list-style-type: none"> Evaluating the effectiveness of systems for income recognition and recording. Conduct a review of third party service providers, where relied upon by management, including review of service auditor reports. Analytical procedures on income and expenditure streams. 	<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>

Audit risk	Assurance procedure	Results and conclusions
<p>party sources. This presents a risk due to the extent and complexity of income.</p> <p>The Pension Fund also makes a high volume of payments, including high value payments, which can constitute a risk of misstatement of expenditure.</p>	<ul style="list-style-type: none"> • Agree income to third party confirmation. • Substantive testing of expenditure. • Assurances on contributions obtained from scheduled body external auditors. 	<p>We found no evidence of fraud over income.</p>
<p>4 Estimation and judgements</p> <p>There are two areas with a significant degree of subjectivity:</p> <ul style="list-style-type: none"> • the measurement and valuation of investments; • the actuarial valuation. <p>Investments include level 3 investments such as unquoted equity (private equity) where valuations use techniques that require significant judgement in determining appropriate assumptions.</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 represents an increased risk of misstatement in the financial statements.</p>	<ul style="list-style-type: none"> • Confirm valuations to valuation reports and/or other supporting documentation. • Completion of 'review of the work of an expert' in accordance with ISA500, for the work of the actuary and the custodian. • Consideration of the report by PwC in their capacity as consulting actuary to Audit Scotland on actuarial assumptions in use in 2017/18. • Consideration of GAD reports under Section 13 of the Local Government Pension Scheme (Scotland) of LGPS Scotland funding valuations and employer contribution rates. 	<p>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.</p> <p>The draft accounts were amended to reflect the Private Equity level 3 investment valuations which were available in August 2018. We substantively checked all valuations to fund manager reports.</p>
<p>5 Changes to financial reporting</p> <p>Pension funds will be required to disclose information on investment management transaction costs, including the amount for each asset class, their nature, and how they arise for different types of investment.</p> <p>It is essential that the pension fund is in a position to capture these costs.</p>	<ul style="list-style-type: none"> • Communication of technical changes with officers. • Agree amounts in primary financial statements to supporting documentation from third parties. 	<p>Officers were aware of the requirements when preparing the accounts.</p> <p>We agreed the disclosure on investment management transaction costs to supporting documentation. We concluded that the disclosure of this information was in line with the requirements.</p>

Appendix 3

Summary of national performance reports 2017/18



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

Reports relevant to local government pension funds

[Local Government in Scotland: financial overview 2016/17 - LGPS Supplement](#) – November 2017

North East Scotland Pension Fund DRAFT

2017/18 Annual Audit Report

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