

North East Scotland Pension Fund

2019/20 Annual Audit Report - Draft



 AUDIT SCOTLAND

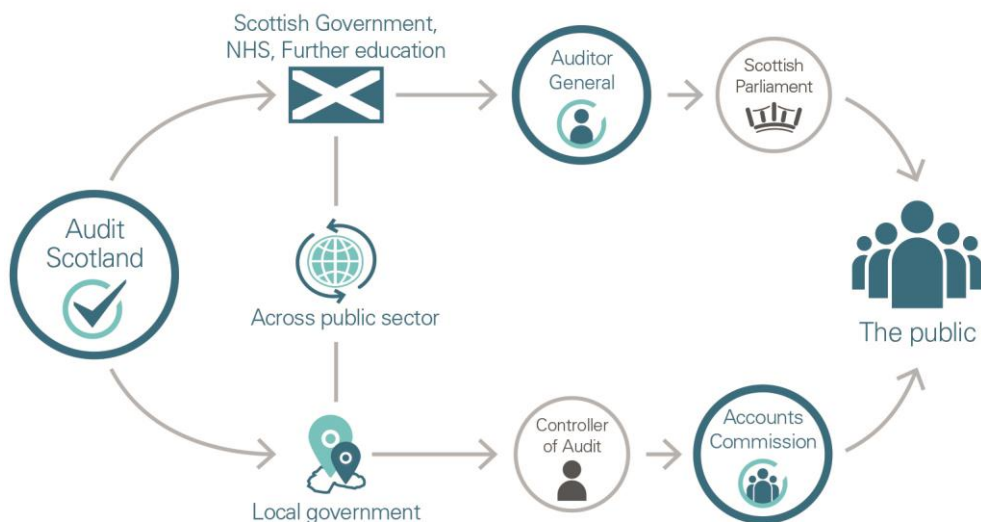
To Members of the Aberdeen City Council Pensions Committee and the Controller of Audit

29 September 2020

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

2019/20 annual 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.
- 3 North East Scotland Pension Fund has valued its Level 2 property assets on an appropriate basis and using information provided by professional valuers. We included an emphasis of matter paragraph in the independent auditor's report to draw attention to the impact of Covid-19 on the level of uncertainty over property valuations. The audit opinion is not modified in respect of this matter.

Financial management

- 4 The annual performance of the Fund was significantly impacted by Covid-19. At 31 December 2019 the value of the main fund's net assets exceeded £4.8 billion but by the end of March the value fell to £4.383 billion, as a result of Covid-19.
- 5 The Fund has appropriate and effective arrangements in place for financial management.
- 6 Systems of internal control operated appropriately and effectively in 2019/20.
- 7 Standards of conduct and arrangements for prevention and detection of fraud and error were appropriate.

Financial sustainability

- 8 There were negative cash flows from member activity in 2019/20 and the ratio of active fund members to pensioners has been falling. This trend is expected to continue.
- 9 The Fund has appropriate and effective financial planning arrangements in place.
- 10 The Fund's three year funding and investment strategy will be reviewed following the next full triennial valuation, due to be completed by 31 March 2021. This will determine the level of employer and employee contribution rates from 2021/22 onwards.

Governance and transparency

- 11 The Fund has effective governance arrangements that support scrutiny of decisions made by the Pensions Committee.
- 12 Governance arrangements changed in March 2020 as a result of the Covid-19 pandemic. Committees were suspended and replaced by an Urgent Business Committee, with meetings held virtually. We concluded

that these changes were appropriate and properly disclosed in the Annual Governance Statement.

Value for money

- 13** The impact of Covid-19 on global markets reduced annual returns significantly but investment performance continues to outperform medium and longer term benchmarks.
- 14** The Fund has adequate arrangements for monitoring investment performance and scrutinising investment management.
- 15** The Fund's 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 2019/20 audit of 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 2020 meeting of the 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 2019/20 have been:

- an audit of the Fund's 2019/20 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

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
- 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. Taking this together, 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. Further details of the respective responsibilities of management and the auditor can be found in the [Code of Audit Practice 2016](#) and supplementary guidance.

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.

11. 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 any outstanding actions from last year and progress against these.

Auditor Independence

12. Auditors appointed by the Accounts Commission or Auditor General must comply with the Code of Audit Practice and relevant supporting guidance. When auditing the financial statements auditors must comply with professional standards issued by the Financial Reporting Council and those of the professional accountancy bodies.

13. 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 2019/20 audit fee of £40,880 as set out in our Annual Audit Plan remains unchanged.

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

15. We would like to thank the management and staff who have been involved in our work for their cooperation and assistance during the audit.

Part 1

Audit of 2019/20 annual accounts



Main judgements

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 were all consistent with the financial statements and properly prepared.

North East Scotland Pension Fund has valued its Level 2 property assets on an appropriate basis and using information provided by professional valuers. We included an emphasis of matter paragraph in the independent auditor's report to draw attention to the impact of Covid-19 on the level of uncertainty over property valuations. The audit opinion is not modified in respect of this matter.

The annual accounts are the principal means of accounting for the stewardship of resources and performance

Our audit opinions on the annual accounts are unmodified

16. The annual accounts for the year ended 31 March 2020 were approved by the Aberdeen City Council Pensions Committee on 29 September 2020. We reported, within the independent auditor's report that:

- the financial statements give a true and fair view and were properly prepared in accordance with the financial reporting framework
- 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.

17. We have included an 'Emphasis of Matter' paragraph in our independent auditor's report which refers to the impact of Covid-19 on the valuation of property assets. Emphasis of Matter paragraphs are added to auditors' reports where the auditor considers it necessary to draw users' attention to matters which are fundamental to the understanding of the accounts. The Statement of Accounting Policies in the financial statements describes the uncertainty caused. The audit opinion is not modified in respect of this matter. Further information is contained in [Exhibit 3, no.1](#) below.

Objections

18. 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 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.

The annual accounts were signed off in line with the timescales permitted to reflect Covid-19

19. The provisions in Schedule 6 of the Coronavirus (Scotland) Act 2020 allowed each local authority to determine its own revised timetable for the annual accounts. The pension fund invested considerable effort into delivering the unaudited annual accounts and working papers in accordance with the original audit timetable.

20. The working papers provided with the unaudited accounts continued to be of a high standard and were delivered on time despite the challenges to staff of preparing accounts under lockdown restrictions. During our audit we identified the potential to enhance some detail in the working papers to support year end cut-off testing; we will discuss this as a development for next year's working papers.

21. NESPF staff provided excellent support to the audit team during the audit and worked with us to ensure we could access all the information we needed while working remotely. We noted the significant challenges experienced by the accounting team in preparing accounts with the team members dispersed and working from home due to Covid-19 lockdown restrictions. This required new ways of working, including a move to fully electronic working (the accounting team is now paper-free) and in some cases, new working patterns to accommodate caring responsibilities.

22. The impact of Covid-19 was a factor for the audit team which led to staff shortages and some loss of audit staff productivity due to remote working in this period. The audit timetable was extended by 2 weeks in response to this. The annual accounts were signed off by 30 September which was in line with the Scottish Government's original deadline for the submission of audited annual accounts.

Overall materiality is £44 million

23. The assessment of what is material is a matter of professional judgement. It involves considering both the amount and nature of the misstatement.

24. Our initial assessment of materiality for the annual accounts was carried out during the planning phase of the audit and is summarised in [Exhibit 2](#). With regards to the annual accounts, we assess the materiality of uncorrected misstatements both individually and collectively.

25. On receipt of the unaudited annual accounts we reviewed our materiality and concluded that no significant changes were required to our planned levels and no change was required to our audit approach.

Exhibit 2 Materiality values

Materiality level	Main Fund	Transport Fund
Overall materiality (1% of gross assets)	£45 million	£3.2 million
Performance materiality (75% of overall materiality)	£33.75 million	£2.4 million
Reporting threshold	£250 thousand	£80 thousand
Specific materiality (Benefits payable)	£14million	£0.8 million
Specific performance materiality (Benefits Payable)	£10.5 million	£0.6 million

Source: North East Scotland Pension Fund Annual Audit Plan 2019/20

Appendix 2 identifies the main risks of material misstatement and our audit work to address these

26. [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 in relation to these risks.

27. We have no issues to report from our work on the risks of material misstatement highlighted in our 2019/20 Annual Audit Plan.

28. We identified a risk of material misstatement in relation to the merger of Strathclyde Pension Fund No.3 Fund with the Aberdeen City Council Transport Fund during 2019/20. Strathclyde Pension Fund No.3 Fund's assets, liabilities and members' data have all transferred to the Aberdeen City Council Transport Fund. The Transport Fund financial statements reflect the combined position at 31 March 2020. We are satisfied that the accounting treatment of the merger is appropriate.

We have no significant findings to report on the accounts, except for material valuation uncertainty

29. 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. We have no significant findings to report around the qualitative aspects covering accounting policies, accounting estimates and financial statements disclosures.

30. The Fund included some additional disclosures in the audited accounts as a result of the audit. The accounts were also updated for the 31 March 2020 valuations of Level 3 investments, which were received from Fund Managers after the unaudited accounts were prepared. This amendment reduced the value of Level 3 investments by £16.1 million.

31. The significant findings are summarised in [Exhibit 3](#).

Exhibit 3 Significant findings from the audit of financial statements

Issue	Resolution
<p>1. Material uncertainty in the valuation of property investments</p> <p>The valuer included a "material valuation uncertainty" clause in the valuation report as at 31 March 2020, regarding its valuation of the Fund's property assets. These property assets are valued at £348.8 million, which is 7.9% of total investment assets value at 31 March 2020. Covid-19 meant the property sector was faced with an unprecedented set of circumstances on which to base a judgement. As at the valuation date, the valuer considered that less weight could be given to previous market evidence for comparison purposes to inform opinions of value. Consequently, less certainty and a higher degree of caution should be attached to the valuations than would normally be the case.</p>	<p>North East Scotland Pension Fund updated the "Critical judgements in applying accounting policies" section of the Accounting Policies in the Annual Report and Accounts to disclose this material valuation uncertainty.</p> <p>We have included an 'Emphasis of Matter' paragraph in our independent auditor's report to highlight this matter. Emphasis of Matter paragraphs are added to auditors' reports where the auditor considers it necessary to draw users' attention to matters which are fundamental to the understanding of the accounts.</p> <p>The audit opinion is not modified in respect of this matter.</p>

We have no misstatements above our reporting threshold to report

32. It is our responsibility to request that all misstatements above the reporting threshold are corrected. We have no misstatements above our reporting threshold to report from the 2019/20 audit.

Good progress was made on prior year recommendations

33. The Fund has made good progress in implementing our prior year audit recommendations. More information on these recommendations is included in [Appendix 1](#).

Part 2

Financial management



Main judgements

The annual performance of the Fund was significantly impacted by Covid-19. At 31 December 2019 the value of the main fund's net assets exceeded £4.8 billion but by the end of March the value fell to £4.383 billion, as a result of Covid-19.

The Fund has appropriate and effective arrangements in place for financial management.

Systems of internal control operated appropriately and effectively in 2019/20.

Standards of conduct and arrangements for prevention and detection of fraud and error were appropriate.

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





The annual performance of the Fund was significantly impacted by Covid-19

34. 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.

35. The Fund's performance in 2019/20 is summarised in [Exhibit 4](#).

Exhibit 4

Assets, funding level and investment performance

Increase/ (decrease) in net assets	Increase/(decrease) in estimated liabilities	Funding level	Investment performance
 Main Fund (-£86.5 million) (-1.9%) Transport Fund (-£5.1 million) ¹ (-1.6%) ¹	 Main Fund (-£170 million) (-3.1%) Transport Fund (-£24.6 million) ² (-10.2%) ²	 107% Main Fund 94% Transport Fund 2017 Funding valuation	 Main Fund (-1.8%) Return on investments 2019/20

Increase/ (decrease) in net assets	Increase/(decrease) in estimated liabilities	Funding level	Investment performance
Main Fund £4,383 million	Main Fund £5,252 million		Main Fund 7.4%
Transport Fund £308.8 million	Transport Fund £217.3 million		Return on investments over 5 years
Closing net assets	Closing liabilities		

¹This reflects the combined opening net assets of ACCTF £105.3 million and Strathclyde Pension Fund No.3 Fund £208.6 million

²This reflects the combined opening estimated liabilities of ACCTF £80.9 million and Strathclyde Pension Fund No.3 Fund £161 million

Source: 2019/20 North East Scotland Pension Fund audited annual report and accounts and Strathclyde Pension Fund 2018/19 audited accounts

36. The net assets of the Main Fund decreased to £4,383 million at 31 March 2020 from £4,469 million at 31 March 2019. This was a decrease of £86.5 million (1.9%) reflecting the year end impact of Covid-19 on global markets. Prior to the pandemic outbreak, reported performance in the year had been positive. The reported value of the main fund at 31 December 2019 was £4,832 million.

37. At the same time the Fund's actuary, Mercer Limited, estimated that pension liabilities had fallen slightly from £5,422 million at 31 March 2019 to £5,252 million at 31 March 2020 (£170 million decrease) for the Main Fund.

38. The closing net assets in the Transport Fund Net Assets Statement increased by £203.5 million (193%) in 2019/20, to £308.8 million, due to the assets of Strathclyde Pension Fund No.3 Fund merging with those of the Aberdeen City Council Transport Fund during 2019/20. The underlying performance of investment assets was affected by Covid-19: the additional assets transferred from Strathclyde masked this fall in asset values. The combined net assets of ACCTF and SPF No.3 Fund dropped from £313.9 million at 31 March 2019 to £308.8 million at 31 March 2020.

39. The combined estimated Transport Fund liabilities fell slightly by £24.6 million, from £241.9 million at 31 March 2019 (based on 2018/19 accounts for ACCTF and SPF No. 3 Fund) to £217.3 million at 31 March 2020.

40. During 2019/20 contributions to the Main Fund amounted to some £144 million. This was slightly lower than the benefits paid out which totalled £154 million. Benefits payable in 2019/20 were 10% higher than in 2018/19. Pensioner numbers continue to rise, and a record number of retirements were processed by the Fund in 2019/20, although there are factors other than pensioner numbers (including individual members' entitlement) affecting the rise in benefits payable.

41. The Transport Fund paid out £6.7 million more in benefits in 2019/20 than it received in contributions. The increase in benefits payable reflects the increase in pensioner numbers as a result of the merger with Strathclyde Pension Fund No.3 Fund. There was not a corresponding increase in contributions receivable because the previous triennial funding valuation for Strathclyde Pension Fund No.3 Fund set the employer's contribution rate at nil, as the Fund was over 100% funded.

42. In addition to the year-end impact of Covid-19, a number of other 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.

43. 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.

44. The Fund is also committed to ensuring it has appropriate resources in place to support ongoing pension administration activities, along with strategies and plans that take account of future challenges.

Financial management arrangements were appropriate and effective

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

46. 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 and the virtual Urgent Business Committee meeting in June 2020, we have observed a good level of review and scrutiny by members. Overall, the Fund has appropriate and effective financial management arrangements in place.

Financial systems of internal control operated effectively

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

48. The Pension Fund uses some of the administering authority's key financial systems, in particular the general ledger, payroll and accounts payable systems. We take assurance from audit reporting by KPMG, the external auditor of Aberdeen City Council, that the internal controls over these financial systems were operating effectively during 2019/20. The 2019/20 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. Progress is reported against the 4 outstanding prior year recommendations to improve general IT controls: but in 2 cases, KPMG note that it's still unclear how access will be reviewed. KPMG will follow up implementation of these recommendations in their 2020/21 audit. KPMG have given an unmodified opinion on Aberdeen City Council's 2019/20 accounts.

49. 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 2020."

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

51. 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.

Standards of conduct and arrangements for prevention and detection of fraud and error were appropriate

52. North East Scotland Pension Fund is 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 Code of Conduct for members and officers, Whistleblowing Policy and the Fraud, Bribery and Corruption Policy.

54. We have concluded that appropriate arrangements are in place within the Fund for the prevention and detection of fraud, error and irregularities, bribery and corruption. We are not aware of any specific issues that we need to bring to your attention.

Part 3

Financial sustainability



Main judgement

There were negative cash flows from member activity in 2019/20 and the ratio of active fund members to pensioners has been falling. This trend is expected to continue.

The Fund has appropriate and effective financial planning arrangements in place.

The Fund's three year funding and investment strategy will be reviewed following the next full triennial valuation, due to be completed by 31 March 2021. This will determine the level of employer and employee contribution rates from 2021/22 onwards.

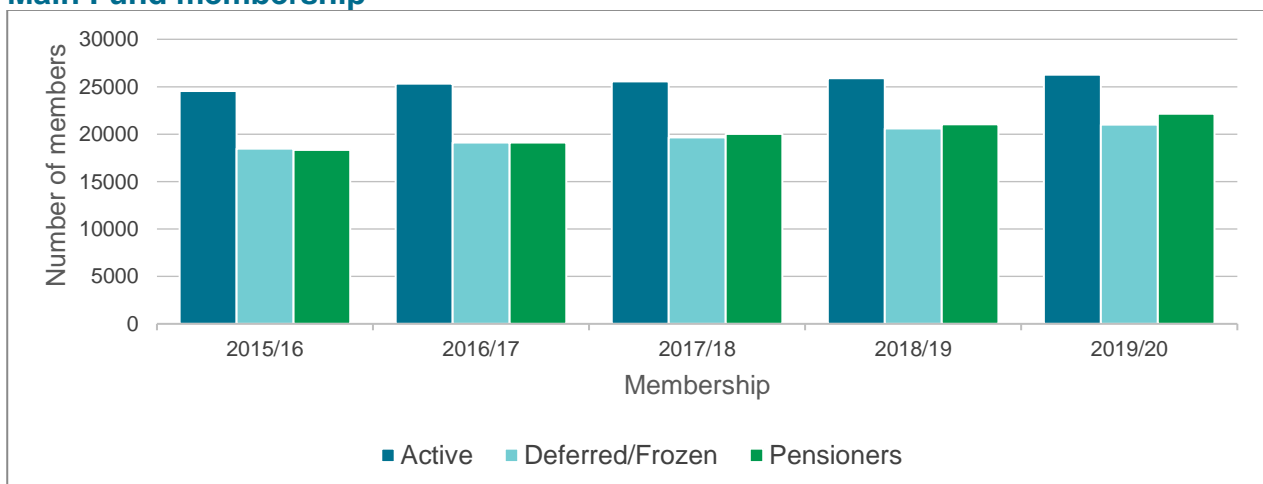
Financial sustainability looks forward to the medium and longer term to consider whether the Fund maintains the capacity to meet the current and future needs of its members.

Main fund membership levels have increased over the last five years but the ratio of active members to pensioners has reduced over the same period

55. The main fund is a multi-employer fund with three local authorities, and around 50 other employers. The current membership profile of the main fund is shown at [Exhibit 5](#).

56. The Fund gives its members a guarantee that in exchange for contributions during their employment, it 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 pension entitlements of its members.

Exhibit 5 Main Fund membership



Source: North East Scotland Pension Fund 2019/20 audited annual report and accounts

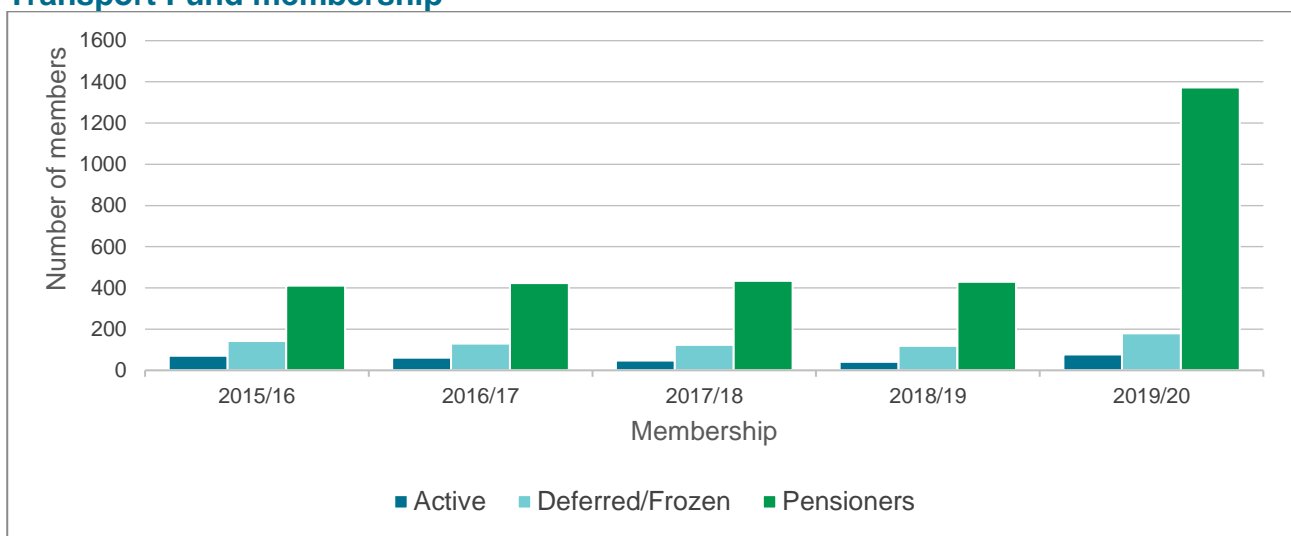
57. Membership of the main fund increased by 1,891 to 69,417 members at 31 March 2020; an increase in membership of 2.8%. The impact of auto-enrolment continues to contribute to the increase in employee members. 2019/20 was a re-enrolment year for the larger authority employers, meaning that employees who had previously opted out were automatically re-enrolled.

58. In 2019/20, the number of pensioners receiving a pension from the main fund increased by over 1,100. The number of pensioner members continues to increase steadily each year. The number of active members continues to outweigh the number of pensioners but the ratio of active members to pensioners has reduced in the past 5 years. 2019/20 cash flows from dealing with members were negative for the first time in 2019/20, with more paid out in benefits that was received from contributions.

59. Future membership numbers are difficult to predict with any certainty as they are dependent on a number of factors including employer budgets, recruitment decisions, and promotion of the pension scheme.

60. With most employers still open to new membership and with continuing support from auto enrolment, the recent trend of growth in membership seems likely to continue for the foreseeable future.

Exhibit 6 Transport Fund membership



Source: North East Scotland Pension Fund 2019/20 audited annual report and accounts

61. Transport Fund membership increased significantly in 2019/20 due to the merger of Strathclyde Pension Fund No.3 Fund with the Aberdeen City Council Transport Fund.

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 7](#).

Exhibit 7

Contributions in 2019/20

	Administering authority £m	Other scheduled bodies £m	Admitted bodies £m	Transferee admission bodies £m	Total £m
Employer contributions	26.352	61.690	6.511	3.731	98.284
Employee contributions	8.291	19.290	2.099	1.190	30.870
Strain Contributions	2.381	3.601	95	0	6.077
Deficit Recovery Contributions	3.902	2.037	22	0	5.961
Total	40.926	86.618	8.727	4.921	141.192

Source: North East Scotland Pension Fund 2019/20 audited financial statements and supporting working papers

63. For the first time, the Main Fund reported a deficit from dealings with members of £10.780 million in 2019/20. This means that pension payments exceeded member contributions and investment income was used to ensure pensions were paid.

64. Strategic cashflow forecasting forms part of the triennial valuation outcome and provides the Fund future cashflow requirements that will assist in the development of the investment strategy.

65. The Main Fund currently holds a number of income-generating assets that will assist with future cashflow requirements and, following the investment strategy review in line with the triennial valuation outcome, these types of assets may increase.

The Fund will require to review its funding strategy and investment strategy following the completion of the next triennial valuation

66. The March 2017 triennial funding valuation reported that the Main Fund assets were sufficient to meet 107% of its liabilities. The funding level means that, overall, the investment assets were higher than the projected liabilities. This, alongside some deficit recovery contributions being made, 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%.

67. 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, 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.

68. The Strathclyde Pension Fund No.3 Fund, which merged with Aberdeen City Council Transport Fund in 2019/20, had a higher funding level at its previous

funding valuation (114% funded at 31 March 2017). The merger of the two funds improves the combined funding position of the Transport Fund.

69. At the request of First Group (the employer for members of the Strathclyde Pension Fund No.3 Fund and Aberdeen City Council Transport Fund) NESPF is working towards a buy-in arrangement with an insurance company to cover the combined future liabilities of these members. A buy-in is an insurance policy purchased by a pension fund, which is matched against some or all of the liabilities held. This will allow the pension fund to transfer the longevity risk to the insurer and create certainty around the valuation of the liabilities insured. This process is expected to complete during 2020/21.

70. The funding strategy statement is a summary of the Fund's approach to funding liabilities and sets out the level of employer and employee contribution rates required to ensure sufficient resources are available to provide for members' pensions and lump sum benefits. Following the completion of each triennial funding valuation, the Fund reviews and revises the funding strategy statement. The next full review is due to be completed by 31 March 2021. Initial funding valuation results are expected from the actuary in October to allow NESPF to begin its discussions with individual employers and carry out the required consultation on the funding strategy statement.

71. The investment strategy is set for the long-term but is monitored continually and reviewed every three years to ensure that it remains appropriate to the profile of the Fund's liabilities.

72. The current funding strategy statement and investment strategy are included within the Fund's 2019/20 annual report and accounts and both will be reviewed following the completion of the triennial funding valuation, which will determine the level of employer and employee contribution rates from 2021/22 onwards.

73. We concluded that the Fund has an appropriate framework in place through which it demonstrates effective financial planning.

Part 4

Governance and transparency



Main judgements

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

Governance arrangements changed in March 2020 as a result of the Covid-19 pandemic. Committees were suspended and replaced by an Urgent Business Committee, with meetings held virtually. We concluded that these changes were appropriate and properly disclosed in the Annual Governance Statement.

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.

The governance and transparency arrangements support good governance and accountability

74. Our previous year's conclusion is still relevant, that overall, the Fund had appropriate governance arrangements, as there has been no significant change during 2019/20, with the exception of specific comments below on the response to the Covid-19 outbreak in March 2020. The governance and transparency arrangements we consider include:

- Pension Board and Pensions Committee structure, conduct and openness.
- overall arrangements and standards of conduct including those for the prevention and detection of fraud, error, bribery and corruption.
- the reporting of performance and whether this is fair, balanced and understandable.

The Covid-19 pandemic had a significant impact on governance arrangements from March 2020

75. The impact of Covid-19 from March 2020 has been set out in the Annual Governance Statement in the Fund's annual accounts. We note that the following changes were made in response to the outbreak:

76. Aberdeen City Council suspended all its committees from March to August 2020, including the Pensions Committee. An Urgent Business Committee was established to ensure that necessary decision making by elected members could continue. Meetings were held remotely using Microsoft Teams software. Webcast recordings of the meetings were made publicly available on the council's website, as the public was unable to attend meetings in person. The Urgent Business Committee considered the NESPF unaudited accounts in June 2020. Members of the Pensions Committee substituted for Urgent Business Committee members for this agenda item, to ensure that the accounts were considered by members with the necessary pensions knowledge and training. Pension Board members did not participate in this meeting under the revised arrangements, but they considered the audited NESPF annual accounts at the September Pensions Committee meeting, as the council recommenced its committee cycle from 24 August 2020.

77. We concluded that these amended governance arrangements were appropriate and supported good governance and accountability.

Appropriate arrangements are in place to comply with the Pensions Regulator Public Service Code

78. 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 Fund conducts an annual review against the code: the latest report assessing the Fund's compliance with the Pensions Regulator's code was submitted to the Pensions Committee and Pension Board in March 2020. 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 2019/20.

The SSAB consultation on the future structure of the Local Government Pension Scheme in Scotland found the majority of respondents were in favour of retaining the existing structure

79. In June 2018 the Scottish Scheme Advisory Board (SSAB) commenced a consultation on the future structure of the Local Government Pension Scheme in Scotland and identified four potential options:

- Option 1: retain the current structure of eleven funds
- Option 2: promote cooperation in investment and administration between the eleven funds
- Option 3: pool investments between the eleven funds, or
- Option 4: merge the eleven funds into one or more funds.

80. The SSAB commissioned the Pensions Institute to consult with a range of stakeholders, including employers and employee representative groups but not investment managers, between June and December 2019. The consultation asked stakeholders to consider the advantages and disadvantages of the current scheme structure against the other three options presented. North East Scotland Pension Fund's response to the consultation stated that the Fund's preference was to retain the current structure, but with greater collaboration and co-operation with other Funds.

81. In November 2019 the outcome of the consultation was published. This showed that the majority of respondents (36 out of 53) were in favour of either option 1 or option 2, with 9 of the 11 administering authorities preferring to retain the existing structure and promote cooperation in investment and administration between the funds.

82. Following the publication of the report, the Scheme Advisory Board wrote to the Cabinet Secretary stating that it intended to commission further work on the merger model. The Cabinet Secretary has encouraged the continuing work to look at the structure of the Local Government Pension Scheme in Scotland and monitor the impact of pooling in England and Wales. The SSAB is in the process of undertaking scoping work to expedite this.

83. We will continue to monitor developments in this area and report on any potential implication for the future organisation or operation of the Fund.

Good practice points

84. The Fund actively engages with the companies it invests in regarding Environmental, Social and Governance (ESG) matters. Its membership of the

Local Authority Pension Fund Forum (LAPFF) and being a signatory to Principles for Responsible Investment offer an opportunity to engage on a wider scale on key issues: examples include working with companies to secure commitment to achieving a carbon neutral position, reducing the use of plastics and withdrawing from fossil fuel mining.

Part 5

Value for money



Main judgements

The impact of Covid-19 on global markets reduced annual returns significantly but investment performance continues to outperform medium and longer term benchmarks.

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

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

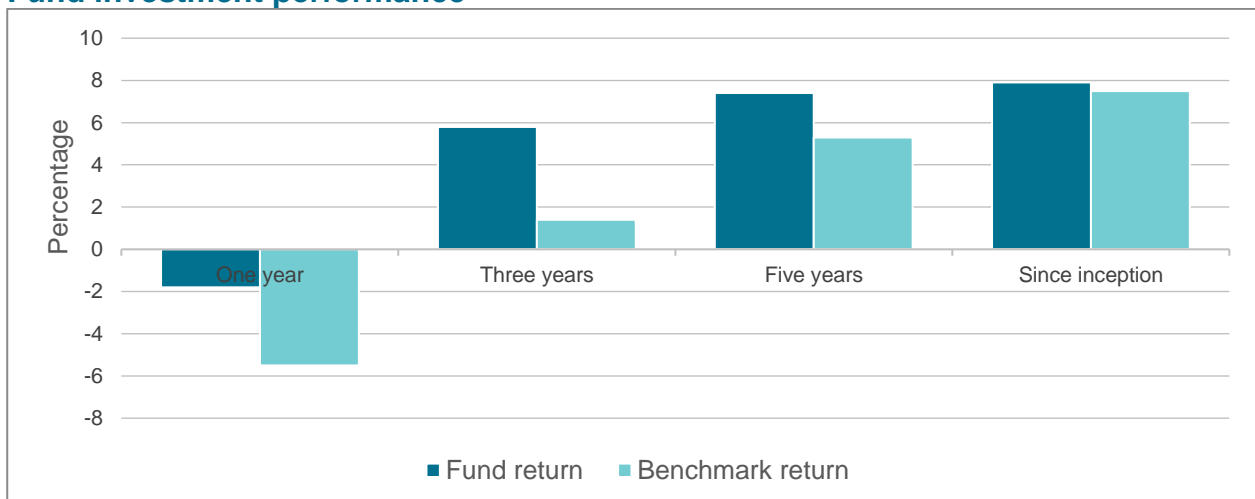
Value for money is concerned with using resources effectively and continually improving services.

The impact of Covid-19 on global markets reduced annual returns significantly but investment performance continues to outperform medium and longer term benchmarks

85. 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.

86. [Exhibit 8](#) shows that over the year, the Fund returned a loss of 1.8% against a benchmark loss of 5.5%. (The benchmark is to beat the market by a set percentage, hence the apparently negative benchmark.) This reflects the impact of Covid-19 on global markets in March 2020, where returns against most asset classes, especially equities, reduced significantly. Over the medium to longer term the Fund has outperformed its three-year, five-year and since inception benchmarks.

Exhibit 8 Fund investment performance



87. 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.

88. 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.

89. The Fund's Investment Strategy sets out how the Fund would like to structure its investments in terms of the different types of investments. Since the 2017 actuarial valuation, the Fund has progressively reduced its equity exposure and diversified its asset base in line with its Statement of Investment Principles. Equities made up 65.5% of the fund investments at 31 March 2020, 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.

90. A further review of the investment strategy is planned to be carried out alongside the 2020 actuarial valuation.

91. Internal audit carried out a 2019/20 audit of Investment Strategy and Investment Performance Management and made recommendations for improvement: progress in implementing these recommendations will be followed up by internal audit in due course.

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

The Fund adequately scrutinises investment management expenses

93. 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 oversight and governance costs.

94. 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.

95. Investment management expenses have decreased slightly from £18.9 million in 2018/19 to £18.1 million in 2019/20 (excluding administration, governance and oversight expenses: see paragraph 91 below). The main reason for this decrease in expenses relates to the 1.8% decrease in asset value.

96. The Fund has adequate arrangements in place for monitoring investment performance and scrutinising investment management expenses. As noted in the Fund's response to Internal Audit's recent report on Investment Strategy and Investment Performance Management, the Fund continues to work with Fund Managers to increase transparency in reporting of investment management expenses.

Administrative expenses

97. Administrative expenses have increased in 2019/20 to £2.4 million, from £2.2 million in 2018/19, including governance and oversight costs. The unit cost per member has decreased due to the increase in membership. Fund membership has increased by 14.7% in the past 5 years. The workload of the pension administration

section continues to grow, including the administration of the merger with Strathclyde Pension Fund No.3 (for First Glasgow employees) which transferred to the Aberdeen City Council Transport Fund during 2019/20. Other factors, such as the introduction of the career average pension scheme (CARE) from 1 April 2015 and auto enrolment, also increase the administration workload.

98. 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.

99. 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. At 31 March 2020, all participating employers were providing information online (increased from 96% in 2018/19).

Good practice points

100. In its Management Commentary the Fund has reported several good practice examples relating to its pension administration. These include:

- Data quality - all LGPS pension funds are required to score the quality of their data as part of their annual scheme return to the Pensions Regulator. NESPF have contracted with Aquila Heywood to provide accurate data quality scores that are comparable to other pension funds. In November 2019 Aquila Heywood carried out the first of three annual evaluations against the data held by NESPF. The reported scores of 98.3% for common data and 97.1% for scheme specific data were well above the national average for the other LGPS funds that have used this analysis tool for the same purpose.
- Employer returns – from March 2020, all participating employers now submit monthly returns online through the i-Connect online portal. Moving from annual employer returns to receiving monthly data through i-Connect has improved information accuracy for the Fund and improved its ability to record, check and reconcile contributions paid to the Fund.
- Data processing times – the move to employers using i-Connect to notify the Fund of new records, member movements and leaver information for all active members has allowed the Fund to reduce its processing times for pensions administration. We noted the reduction in time taken by NESPF to process the year-end from 328 working days (2013/14) to 21 working days (2018/19).
- Testing working parties – in 2019/20 the Fund participated in two Testing Working Parties with the software supplier and other pension funds, to test software releases and new developments designed to improve functionality for members.

National performance audit reports

101. Audit Scotland carries out a national performance audit programme on behalf of the Accounts Commission and the Auditor General for Scotland. During 2019/20, we published reports which may be of interest to the Fund. These are outlined in [Appendix 3](#) accompanying this report.

102. The Pensions Committee considered the LGPS supplement to the Local Government in Scotland: Financial Overview 2018/19 at its March 2020 meeting. We have drawn other relevant publications to the attention of the committee convener during the period of committee suspension: these publications related to the National Fraud Initiative and the impact of Covid-19 on public sector audit and emerging fraud risks.

Appendix 1

Action plan 2019/20



No. Issue/risk



Recommendation



Agreed management action/timing

Follow up of prior year recommendations

1	<p>Merger with Strathclyde Pension Fund no.3 (Transport Fund)</p> <p>North East Scotland Pension Fund and Strathclyde Pension Fund agreed that the Strathclyde Pension Fund Transport Fund would merge with the Aberdeen City Council Transport Fund in 2019/20.</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>Complete</p> <p>Membership data, assets and liabilities from Strathclyde Pension Fund Transport Fund have all transferred to the Aberdeen City Council Transport Fund during 2019/20.</p> <p>Now that the merger is complete, arrangements for a buy-in are progressing. The tender for the ACCTF buy-in is still ongoing. NESPF currently awaits the first bids from participating insurers with a view to moving on to the next stage of the process. It is hoped that, should pricing be favourable, NESPF will be able to complete the transaction with the selected insurer by 31 March 2021.</p>
2	<p>Training and development</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>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>Complete</p> <p>There were a number of changes to the committee membership during the year: new members have received induction training. A training needs analysis was carried out in 2019 for all Pensions Committee and Pension Board members. Pension Fund staff have confirmed that there were valid reasons for non-attendance at training and that these members are ensuring their training needs are being addressed.</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 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 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>2 Estimation, judgements and classification</p> <p>There is a significant degree of subjectivity in the measurement and classification of certain investments and in the actuarial valuation. North East Scotland Pension Fund investments include investments such as unquoted equity and pooled funds, where valuations involve the 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.</p>	<p>Completion of 'review of the work of an expert' in accordance with ISA 500, for significant unquoted investments.</p> <p>Confirmation of valuations to valuation reports and/ or other supporting documentation.</p> <p>Completion of 'review of the work of an expert' in accordance with ISA 500, for the work of the actuary.</p> <p>Consideration of the report by the consulting actuary to Audit Scotland on actuarial assumptions in use in 2019/20.</p>	<p>We carried out 'reliance on a management expert' work on the custodian, the valuer and the actuary. This included review of the PwC report on actuarial assumptions. We concluded that we could place reliance on the custodian, the valuer and the actuary.</p> <p>We concluded that could rely on the valuer as a management expert; that property assets were appropriately included in the financial statements; and that appropriate disclosure was made in the "Critical judgements in applying accounting policies" section of the Accounting Policies regarding the material uncertainty caveat in the valuer's report. We have included an Emphasis of Matter paragraph in the audit opinion on this disclosure: the opinion is not modified by this matter.</p>
		<p>The draft accounts were amended to reflect the Private Equity level 3 investment valuations for 31 March 2020 which were available in August 2020. We substantively checked</p>

Audit risk	Assurance procedure	Results and conclusions
		all valuations to fund manager reports.
<p>3 Transfer of Strathclyde Fund No.3 (Transport Fund)</p> <p>Strathclyde Fund No.3 will merge with Aberdeen City Council Transport Fund during the 2019/20 financial year. This involves the transfer of all the assets, liabilities and records of Fund No.3 to the Transport Fund. The nature of this transaction gives rise to a risk of material misstatement around the presentation and disclosure of the financial statements of the Transport Fund.</p>	<p>Ongoing dialogue with officers around transfer progress.</p> <p>Focused testing of balances transferred.</p> <p>Assessment of the presentation and disclosure of financial statements against legislative requirements and guidance.</p> <p>Confirmation with Strathclyde Pension Fund auditor that the final financial statements of Fund No.3 and the financial statements of the Transport Fund present a complete and consistent account of Fund No.3 for 2019/20.</p>	<p>Membership data, assets and liabilities from Strathclyde Pension Fund Transport Fund have all transferred to the Aberdeen City Council Transport Fund and are appropriately presented in the 2019/20 NESPF annual report and accounts.</p>

Appendix 3

Summary of national performance reports 2019/2020

		 2019/20 Reports	
		Apr	
Social security: Implementing the devolved powers		May	
Scotland's colleges 2019		Jun	 Enabling digital government
		Jul	
NHS workforce planning - part 2		Aug	
Finances of Scottish universities		Sept	
NHS in Scotland 2019		Oct	
		Nov	
Local government in Scotland: Financial overview 2018/19		Dec	
Scotland's City Region and Growth Deals		Jan	 Privately financed infrastructure investment: The Non-Profit Distributing (NPD) and hub models
		Feb	
		Mar	 Early learning and childcare: follow-up

Reports of relevant interest:

[Local Government in Scotland: Financial Overview 2018/19](#) – December 2019.

North East Scotland Pension Fund

2019/20 Annual Audit Report - Draft - Draft

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