

# North East Scotland Pension Fund

2021/22 Annual Audit Report



 AUDIT SCOTLAND

Prepared for the Aberdeen City Council Pensions Committee and the Controller of Audit

16 December 2022

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# Key messages

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## 2021/22 annual report and accounts

- 1 Our audit opinions on the annual report and accounts are unmodified.
- 2 The financial statements of North East Scotland Pension Fund give a true and fair view of the state of affairs of the Fund as at 31 March 2022 and have been properly prepared in accordance with the financial reporting framework.

## Financial management

- 3 Fund performance levels in 2021/22 were below the annual target. The annual performance of the Fund was significantly impacted by Covid-19 and other world events.
- 4 The Fund has appropriate and effective financial management arrangements in place which includes comprehensive reporting of investment performance.

## Financial sustainability

- 5 The most recent triennial valuation, as at 31 March 2020, assessed both funds as fully funded and the funding strategy was updated accordingly.
- 6 Medium-term financial planning arrangements are appropriate and effective.

## Governance and transparency

- 7 Governance arrangements were appropriate and operated effectively during 2021/22. More recently, political disagreement has entered into Pensions Committee discussions and detracted from engagement in the Committee's scrutiny role.
- 8 There have been several membership changes in the Pensions Committee during 2022 which reinforce the need for member engagement with robust training and development.

## Best Value

- 9 The pension administration function performed well against targets.
- 10 The Fund has effective arrangements for monitoring investment performance and scrutinising investment management.
- 11 Fund investment performance levels in 2021/22 were below target but the longer-term increase in the value of net assets is the third largest across Scottish local government pension funds.

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# Introduction

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**1.** This report is a summary of our findings arising from the 2021/22 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 2022 meeting of the Aberdeen City Council Pensions Committee. This report comprises:

- an audit of the Fund’s annual report and accounts
- consideration of the wider dimensions of financial management, financial sustainability, governance and transparency, and value for money, that frame the wider scope of public audit set out in the Code of Audit Practice 2016.

**3.** The main elements of our audit work in 2021/22 have been:

- an audit of the Fund’s 2021/22 annual report and accounts including the issue of an independent auditor’s report setting out our opinions
- a review of the Fund’s main financial systems
- consideration of the four audit dimensions of financial management, financial sustainability, governance and transparency and value for money.

## 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 2](#)) and good practice guides
- providing clear and focused conclusions on the appropriateness, effectiveness and impact of corporate governance, performance management arrangements and financial sustainability.

## Responsibilities and reporting

**5.** 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.

**6.** 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.

**7.** 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
- arrangements for securing financial sustainability.

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

**9.** 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.

**10.** 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

**11.** 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.

**12.** We can confirm that we comply with the Financial Reporting Council's Ethical Standard. We can also confirm that we have not undertaken any non-audit related services and therefore the 2021/22 audit fee of £44,100 as set out in our Annual Audit Plan remains unchanged.

**13.** This report is addressed to both the members of the Pensions Committee and the Controller of Audit and will be published on Audit Scotland's website [www.audit-scotland.gov.uk](http://www.audit-scotland.gov.uk) in due course.

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

### **Audit appointment from 2022/23**

**15.** The Accounts Commission is responsible for the appointment of external auditors to local government bodies. External auditors are usually appointed for a five-year term either from Audit Scotland's Audit Services Group or a private firm of accountants. The current appointment round was due to end in 2020/21 but this was extended for a year so that 2021/22 is the last year of the current appointment round.

**16.** The procurement process for the new round of audit appointments was completed in May 2022. Audit Scotland will continue as the appointed auditor for North East Scotland Pension Fund for the new round of appointments starting in 2022/23. To maintain the independence and objectivity of the audit team, the engagement lead and other staff working on the audit will be changed for the 2022/23 audit. We will work closely with the new audit team to ensure a well-managed transition.

**17.** A new [Code of Audit Practice](#) applies to public sector audits for financial years starting on or after 1 April 2022. It replaces the Code issued in May 2016.

**18.** We would like to thank pension fund staff, Pensions Committee members and Pension Board members for their co-operation and assistance over the last six years.

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# 1. Audit of 2021/22 annual report and accounts

The principal means of accounting for the stewardship of resources and performance

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## Main judgements

Our audit opinions on the annual report and accounts are unmodified.

The financial statements of North East Scotland Pension Fund give a true and fair view of the state of affairs of the Fund as at 31 March 2022 and have been properly prepared in accordance with the financial reporting framework.

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## Our audit opinions on the annual report and accounts are unmodified

**19.** The annual report and accounts for the year ended 31 March 2022 were approved by the Aberdeen City Council Pensions Committee on 16 December 2022. 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.

## The unaudited annual report and accounts were provided within the agreed timescale and were of a good standard

**20.** The unaudited annual report and accounts were received in line with our agreed audit timetable on 30 June 2022. The working papers provided with the unaudited accounts were of a good standard and finance staff provided good support to the audit team during the audit. This helped ensure that the audit of the annual accounts process ran smoothly. As in the previous two years the audit was conducted remotely, observing social distancing measures.

**21.** Audit Scotland's audit timetable has been affected by the impact of Covid-19 pandemic. The target timescale in our 2021/22 Annual Audit plan was completion of the audit in October. The next scheduled Pensions Committee meeting was in December. The 2021/22 annual report and accounts were

signed off on 16 December which was after the Scottish Government's revised deadline for the submission of audited annual accounts.

## There were no objections raised to the annual report and accounts

**22.** 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 complied with the regulations. No objections were received to the North East Scotland Pension Fund accounts.

## Overall materiality is £59.25 million

**23.** We apply the concept of materiality in both planning and performing the audit and in evaluating the effect of identified misstatement on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the independent auditor's report. We identify a benchmark on which to base overall materiality, such as gross expenditure or gross assets, and apply what we judge to be the most appropriate percentage level for calculating materiality values.

**24.** The determination of materiality is based on professional judgement and is informed by our understanding of the entity and what users are likely to be most concerned about in the financial statements. In assessing performance materiality, we have considered factors such as our findings from previous audits, any changes in business processes and the entity's control environment including fraud risks.

**25.** Our initial assessment of materiality for the annual report and accounts was carried out during the planning phase of the audit. This was reviewed on receipt of the unaudited annual report and accounts and is summarised in [Exhibit 1](#).

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### Exhibit 1 Materiality values

Materiality level	Main Fund	Transport Fund
Overall materiality	£59.25 million	£3 million
Performance materiality	£44.5 million	£2.25 million
Reporting threshold	£250 thousand	£75 thousand
Specific materiality (applied to benefits expenditure and contributions income in the fund account)	£16 million	£1.1 million

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Materiality level	Main Fund	Transport Fund
Specific performance materiality	£12 million	£0.8 million

Source: Audit Scotland

## We have one significant finding to report from the audit of the financial statements

**26.** 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.

**27.** We have one significant finding to report from the audit of the annual report and accounts as summarised in [Exhibit 2](#). We also identified a small number of disclosure and presentational matters which have been corrected in the audited accounts.

### Exhibit 2

#### Significant findings from the audit of the annual report and accounts

Finding	Resolution
<p><b>1. Private equity level 3 investments valuations as at 31 March 2022</b></p> <p>The draft accounts were prepared using the latest available valuations of private equity level 3 investments (as at 31 December 2021). The valuations of private equity level 3 investments as at 31 March 2022 were subsequently received by the pension fund in August 2022. These valuations showed a £24 million increase in the value of these assets and management proposed to adjust the accounts so the most recent available information would be reflected in the audited accounts.</p>	<p>Management adjusted the accounts for the 31 March 2022 valuations, increasing Net Assets as at 31 March 2022 by £24 million. We have reviewed this adjustment and are satisfied that it reflects the most recent available 2021/22 valuations.</p>

Source: Audit Scotland

## We have obtained audit assurances over the significant financial statements risk identified in our 2021/22 Annual Audit Plan

**28.** We have obtained audit assurances over the identified significant risk of material misstatement to the financial statements. [Exhibit 3](#) sets out the significant risk of material misstatement to the financial statements we identified in our 2021/22 Annual Audit Plan. It summarises the further audit procedures we performed during the year to obtain assurances over this risk and the conclusions from the work completed.

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### Exhibit 3 Significant risks of material misstatement in the financial statements

Audit risk	Assurance procedure	Results and conclusions
<p><b>1. Risk of material misstatement due to fraud caused by the management override of controls</b></p> <p>As stated in International Standard on Auditing (UK) 240, management is in a unique position to perpetrate fraud because of management's ability to override controls that otherwise appear to be operating effectively.</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><b>Results:</b> Our detailed journals testing, review of accounting estimates and testing of year end entries identified no errors. Our review of the Transport Fund employer surplus refund (as a significant unusual transaction) concluded that this was appropriately accounted for.</p> <p><b>Conclusion:</b> We concluded from our audit procedures that there was no evidence of management override of controls.</p>

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### Other areas of audit focus

**29.** In our 2021/22 Annual Audit Plan we identified areas where we considered there to be other risks of material misstatement to the financial statements. Based on our assessment of the likelihood and magnitude of the risk, we did not consider these to represent significant risks.

**30.** We kept these areas under review throughout our audit. As set out in [Exhibit 4](#) we have obtained audit assurances over these risks.

## Exhibit 4

### Other areas of audit focus

Audit risk	Results and conclusions
<p><b>Actuarial valuation of future retirement benefits</b></p> <p>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. As a result we will carry out a 'review of the work of an expert' in accordance with ISA 500 for the work of the actuary and review actuarial assumptions and consider the report by Audit Scotland's consulting actuary on the actuarial valuations.</p>	<p><b>Results:</b> We carried out 'reliance on a management expert' work on the actuary. This included review of Audit Scotland's consulting actuary's report on actuarial assumptions. We concluded that we could place reliance on the valuations provided by the actuary.</p> <p>We reviewed the actuarial valuation reports for the Main Fund and the Transport Fund and confirmed these to the actuarial valuation disclosures in the accounts, with no issues identified.</p> <p><b>Conclusion:</b> We did not identify any significant issues with the actuarial valuation of future retirement benefits disclosed in the annual report and accounts.</p>
<p><b>Valuation of unquoted investments</b></p> <p>There is a significant degree of subjectivity in the measurement and classification of certain investments. As a result we will carry out a 'review of the work of an expert' in accordance with ISA 500 and confirm valuations to valuation reports and/ or other supporting documentation for significant unquoted investments.</p>	<p><b>Results:</b> We carried out 'reliance on a management expert' work on the custodian and on the valuer who provides the valuation of property (level 2) assets. We concluded that we could place reliance on the custodian and the valuer.</p> <p>We reviewed the Fund's arrangements for ensuring that the fund managers' valuations of unquoted investments were sufficiently robust.</p> <p>We reviewed the valuation reports and confirmed these to the asset valuations in the accounts with no issues identified.</p> <p>The draft accounts were amended to reflect the Private Equity level 3 investment valuations for 31 March 2022 which became available in August 2022. We confirmed all valuations to fund manager reports.</p> <p><b>Conclusion:</b> We did not identify any significant issues with the valuation of unquoted investments (level 2 and level 3) in the annual report and accounts.</p>
<p><b>Actuarial valuation of Transport Fund Insurance buy-in contract</b></p> <p>The valuation depends on a number of assumptions about the future. These</p>	<p><b>Results:</b> We reviewed the accounting disclosures and management commentary for appropriateness. We confirmed the valuation to supporting documentation.</p>

Audit risk	Results and conclusions
include investment returns, contribution rates, commutation assumptions, pensioner mortality, discount rates and earning assumptions. We will carry out a 'review of the work of an expert' in accordance with ISA 500, for the work of the actuary and review actuarial assumptions	<b>Conclusion:</b> We did not identify any significant issues with the accounting treatment of the insurance buy-in contract or the valuation used in the annual report and accounts.

Source: Audit Scotland

## We have no unadjusted misstatements above our reporting threshold to report

**31.** It is our responsibility to request that all misstatements above the reporting threshold are corrected. We have no unadjusted misstatements above our reporting threshold to report from the 2021/22 audit.

## Additional voluntary contributions disclosure was based on estimates as the information was not available to the Fund

**32.** The Code of Practice on Local Authority Accounting in the United Kingdom 2021/22 requires pension funds to disclose the amount of additional voluntary contributions (AVCs) paid by members during the year and the value at the Balance Sheet date of separately invested AVCs within a note to the annual report and accounts.

**33.** Note 22 Additional Voluntary Contributions in the annual report and accounts presented for audit included the required information for those members paying AVCs through Standard Life but included an estimate of this information for those members paying AVCs through Prudential for 2021/22.

**34.** Management explained that this information was not yet available for 2021/22 and Prudential had advised that it was unlikely to be available prior to the certification date. The late provision of this information from Prudential was also an issue for the 2020/21 annual report and accounts.

## Good progress was made on prior year recommendations

**35.** North East Scotland Pension Fund has made good progress in implementing our prior year audit recommendations, as set out in [Appendix 1](#).

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## 2. Financial management

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

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### Main judgements

Fund performance levels in 2021/22 were below the annual target. The annual performance of the Fund was significantly impacted by Covid-19 and other world events.

The Fund has appropriate and effective financial management arrangements, including comprehensive reporting of investment performance.

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### The annual performance of the Fund was significantly impacted by Covid-19 and other world events

**36.** When considering the investment performance of the Fund during 2021/22, it is important to recognise the impact of Covid-19 and other world events on financial markets and investments. The global impact of the pandemic and the conflict in Ukraine has significantly increased market volatility. The Fund's performance in 2021/22 is summarised in [Exhibit 5](#) and [Exhibit 6](#).

**37.** The Fund has faced a challenging year in 2021/22. The net assets of the Fund increased from £5,777 million at 31 March 2021 to £5,926 million at 31 March 2022, after reaching a peak of £6.3 billion in December 2021, the invasion of Ukraine cited as of significant impact. Consequently the Fund had a return of 2.4%, against a benchmark of 8.9%. We report on performance against other benchmarks at [paragraph 91](#).

**38.** The Fund's actuary, Mercer Limited, estimated that pension liabilities had increased by 1.7% from £6,003 million as at 31 March 2021 to £6,117 million at 31 March 2022 (£104 million increase) for the Main Fund.

**39.** During 2021/22 the £158 million benefits payable by the Main Fund exceeded the £152 million contributions receivable by the Fund. Pensioner numbers rose by 1,162, a 5.1% increase. Other factors also affected the rise in benefits payable, including individual members' entitlement. This is the fourth year that the Main Fund has reported negative cash flows and this position is expected to continue as the scheme matures.

**Exhibit 5****Main fund assets and liabilities**

	Opening (as at 1 April 2021)	Closing (as at 31 March 2022)	Change in Year
Net Assets	<b>£5,777 million</b>	<b>£5,926 million</b>	+£149 million (+2.6%)
Estimated Liabilities	<b>£6,003 million</b>	<b>£6,107 million</b>	+£104 million (+1.7%)

Source: 2021/22 North East Scotland Pension Fund audited annual report and accounts

**Exhibit 6****Main fund investment performance**

	1 Year	3 Year	5 Year
Return on Investments	<b>2.4%</b>	<b>10.3%</b>	<b>10.1%</b>

Source: 2021/22 North East Scotland Pension Fund audited annual report and accounts

**40.** As shown in [Exhibit 7](#), the Transport Fund's net assets have decreased from £304.6 million as at 31 March 2021 to £290 million as at 31 March 2022 (£14.6 million decrease). The estimated Transport Fund liabilities reduced by £12 million (5%), from £238 million as at 31 March 2021 to £226 million as at 31 March 2022. During the year £12.5 million was returned to First Glasgow Ltd. as a result of First Glasgow Ltd exiting the Transport Fund, leaving First Aberdeen Ltd as the only employer body in the Transport Fund.

**Exhibit 7****Transport Fund assets and liabilities**

	Opening (as at 1 April 2021)	Closing (as at 31 March 2022)	Change in Year
Net Assets	<b>£304.6 million</b>	<b>£290 million</b>	-£14.6 million (4.8%)
Estimated Liabilities	<b>£238 million</b>	<b>£226 million</b>	-£12 million (-5%)

Source: 2021/22 North East Scotland Pension Fund audited annual report and accounts

## **The Fund has appropriate and effective financial management arrangements in place which includes comprehensive reporting of investment performance**

**41.** 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 current, comprehensive and support good financial management.

**42.** The Aberdeen City Council Pensions Committee receives administration and performance reports at its quarterly meetings. These reports are comprehensive and include fund performance trends, investment manager performance against benchmarks and movements in asset allocations. From attendance at committee meetings we observed and concluded that administration and performance reports presented to members are subject to appropriate review and scrutiny.

**43.** Overall, we have concluded that the Fund has appropriate and effective financial management arrangements in place, including comprehensive reporting of investment performance.

## **Financial systems of internal control operated effectively**

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

**45.** The Pension Fund uses some of the administering authority's key financial systems, in particular the general ledger, payroll and accounts payable systems. We 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 2021/22. The 2021/22 annual audit report for Aberdeen City Council reported controls testing in the following areas, with satisfactory results: journal entries; budget monitoring; bank reconciliations; procurement (contract awards); and review of pension assumption rate of return. KPMG have given an unmodified opinion on Aberdeen City Council's 2021/22 accounts.

**46.** Internal audit's annual opinion for Aberdeen City Council confirmed that "the council had adequate and effective framework for Governance, Risk Management and Control, covering the period 1 April 2021 to 31 March 2022".

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

**48.** We also gain assurance from internal audit's work on the North East Scotland Pension Fund, and from our own audit testing of pension fund key controls. Internal audit's annual report on their work in relation to North East Scotland Pension Fund was reported to the Pensions Committee in June 2022.



The internal auditor's 2021/22 opinion for North East Scotland Pension Fund confirmed that "NESPF had an adequate and effective framework for Governance, Risk Management and Control, covering the period 1 April 2021 to 31 March 2022".

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

**49.** 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.

**50.** 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, Whistle Blowing Policy and the Fraud, Bribery and Corruption Policy.

**51.** The risk profile of public bodies during 2021/22 has been significantly affected by the Covid-19 pandemic. This is likely to have increased the risk of fraud and error as control environments and internal controls have had to change to allow for services to operate effectively and respond to issues in a timely manner. We have reviewed the arrangements put in place by North East Scotland Pension Fund to address any heightened risks and concluded that there are appropriate arrangements for the prevention and detection of fraud, error, and irregularities.



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## 3. Financial sustainability

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

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### Main judgements

The most recent triennial valuation, as at 31 March 2020, assessed both funds as fully funded and the funding strategy was updated accordingly.

Medium term financial planning arrangements are appropriate and effective.

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### The most recent triennial valuation, as at March 2020, assessed both funds as fully funded

**52.** The most recent full triennial valuation of the North East Scotland Pension Fund was carried out at 31 March 2020 and reported to the Pensions Committee in March 2021. One of the main purposes of the triennial valuation is to inform the setting of pension contribution rates for the following 3 years and to inform a review of funding and investment strategies to ensure the continued payment of members' pension benefits as they fall due.

**53.** The March 2020 triennial funding valuation reported that the Main Fund assets were sufficient to meet 103% of its liabilities. This was a slight drop from 107% in the 2017 valuation, but it still meant that, overall, the investment assets were higher than the projected liabilities. This, alongside some deficit recovery contributions being made, enabled the fund to reduce the employer's contribution rate for one council and maintain the employer's contribution rate at 19.3% for the other two councils for the period 2021-2024. The rates for the other employer bodies range from 11.9% to 65.8%.

**54.** The Transport Fund was assessed as 114% funded, meaning that the Fund's assets were higher than its projected liabilities. This is an improved funding position from the 2017 funding valuation when the Transport Fund was assessed as 94% funded. The triennial funding valuation takes account of the completed merger with the former Strathclyde No.3 Fund. The former Strathclyde No.3 Fund was assessed as 114% funded in its 2017 funding valuation. The administering authority and the Transport Fund employers, First Aberdeen Limited and First Glasgow Limited, agreed to set the new employer contribution rate at nil for the period 2021-2024. In 2021/22 £12.5 million was returned to First Glasgow Limited and that employer left the pension fund.

## Medium term financial planning arrangements are appropriate and effective

**55.** The funding strategy is a summary of the Fund's approach to funding liabilities. The investment strategy outlines the types of investment to be held and the balances between the different types of investment. The Investment Strategy Review 2021 was reported to the Pensions Committee in June 2022. The strategy is largely unchanged from the March 2021 review: the significant changes relate to employer flexibility, which is outlined at [paragraphs 61-62](#).

**56.** The Fund is 103% funded and has the long-term objective of maintaining its funding level at 100%. To achieve this, it is seeking to lock in recent gains and rebalance its investments closer to the benchmarks set for different asset types: growth assets 55%; income/protection assets 45%. The Fund therefore needs to reduce its growth asset allocation and increase its income/protection allocation. This can be done by reducing global equities and increasing bonds/credit and infrastructure assets. This move will take time and progress will be reported to the Pensions Committee.

**57.** The Transport Fund has a different risk profile and investment strategy as a maturing closed fund. De-risking is a key objective to ensure the Fund can cover its liabilities. In 2020 the Fund completed a buy-in arrangement with an insurance company, Rothesay Life PLC, to cover the combined future liabilities of Transport Fund members. A buy-in is an insurance policy purchased by a pension fund, which is matched against some or all of the liabilities held. The Transport Fund insurance buy-in contract reduces longevity risk for the pension fund (transferring it to the insurer) and provides greater certainty over funding of the estimated liabilities (because pension payments are funded by the insurer). It is the first arrangement of its kind in the Local Government Pension Scheme in Scotland.

**58.** This policy covers the liabilities of 1,371 members who were pensioners at the agreement date of 19 November 2020. The Fund continues to administer the pensions of these members, but Rothesay Life PLC reimburses the Fund for the pension payments. The value of the buy-in contract is assessed annually by the Fund's actuary and is included as a long-term asset in the Net Assets Statement (£202 million as at 31 March 2022). The actuarial revaluation is reflected in the Fund Account.

**59.** Other Transport Fund members are not covered by the insurance buy-in contract and these pension liabilities will be funded by income from the remaining investment assets as set out in the Funding Strategy Statement and Investment Strategy.

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

## The Fund is considering different investment strategies for managing liabilities at an employer level

**61.** In May 2022 the Local Government Pension Scheme (Scotland) Miscellaneous Amendments) Regulations 2022 were published. These

regulations, which came into effect on 1 June 2022, included changes which provide administering authorities with greater flexibilities for dealing with employers exiting the fund. The Fund is looking to adopt different investment strategies known as ‘investment buckets’ as a risk management tool for managing employer liabilities and potential exits. The Funding Strategy Statement 2022 allows the Fund to adopt these changes where required.

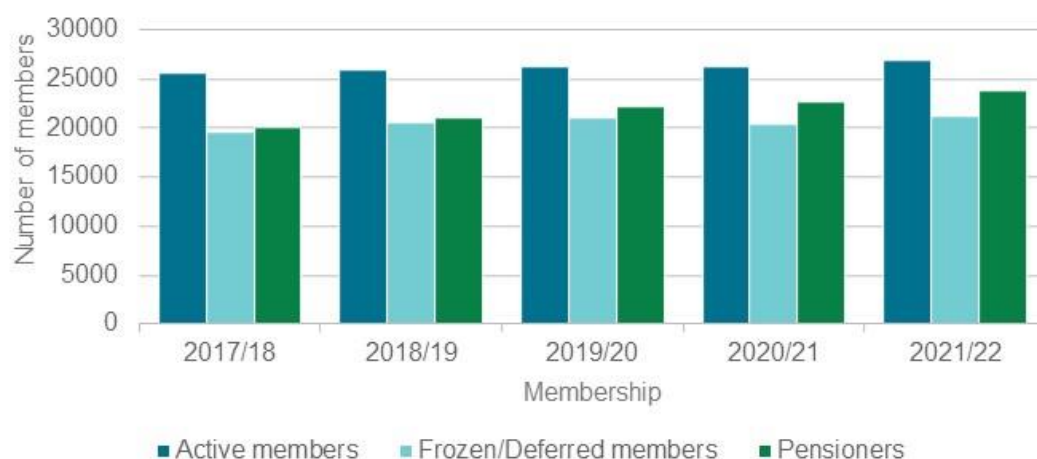
**62.** The investment strategy buckets would have different risk/return profiles: the current strategy would be the highest risk, and two strategies with lower risks would be introduced. Employers with weaker covenants or those expected to exit the fund in the near future could be moved to the lower risk strategies to help protect against a deterioration in the funding position and protect the Fund as a whole.

### Fund membership levels continue to increase but the ratio of active members to pensioners is reducing

**63.** The Main Fund is a multi-employer fund with 3 local authorities, and 43 other employers. The current Main Fund membership profile is shown at [Exhibit 8](#).

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 8 Main Fund membership



Source: North East Scotland Pension Fund 2021/22 audited financial statements

**64.** Membership of the Main Fund increased by 2,701 members to 72,076 members in total at 31 March 2022. The number of pensioner members continues to increase, with an additional 1,162 at the year end. 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 6 years.

**65.** Cash flows from dealing with members were negative for the fourth year running, with more paid out in benefits than was received from contributions. Over the long term, the cash flow position will impact on the investment strategy as income from investments rather than contributions will be needed to pay pensions.

**66.** The Transport Fund membership profile is shown at [Exhibit 9](#).

## Exhibit 9 Transport Fund membership



Source: North East Scotland Pension Fund 2021/22 audited financial statements

**67.** The Transport Fund is a closed 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. In the past year membership reduced by 38, with 1,566 members at 31 March 2022.

### **Future rates of employer contributions have remained stable or fallen for the largest employers but there is greater variation in rates across the smaller employers.**

**68.** Following the triennial valuation in 2020, the actuary agreed employer contribution rates with individual employers from 1 April 2021 to 31 March 2024. As noted above, the employer rate has reduced from 19.3% to 17.9% for one local authority and remained at 19.3% for the other two local authorities. The rates for the other bodies range from 11.9% to 65.8%. These rates previously

ranged from 11% to 33.8%. For the majority of employers, the current funding surplus is being used to subsidise and stabilise contribution rates. For a small number of employers, these rates include an element of deficit recovery contributions to support employers' financial planning. The approximate split of all contributions received in year is set out at [Exhibit 10](#).

## Exhibit 10

### Main fund contributions in 2021/22

	Administering authority £m	Scheduled bodies £m	Other bodies £m	Total £m
Employer contributions	28.061	69.292	11.576	108.929
Employee contributions	9.045	20.954	3.565	33.563
Strain Contributions	1.044	3.365	0.026	4.434
Deficit Recovery Contributions	0.822	1.633	0.111	2.566
<b>Total</b>	<b>38.971</b>	<b>95.243</b>	<b>15.278</b>	<b>149.492</b>

Source: North East Scotland Pension Fund 2021/22 audited financial statements and supporting working papers

**69.** The continued growth in pensioner numbers within the Fund's membership makes funding pension payments increasingly challenging. The Fund has considered this as part of its investment strategy and is further diversifying its investment structure to increase investment in income generating assets.

# 4. Governance and transparency

The effectiveness of scrutiny and oversight and the transparent reporting of information

## Main judgements

Governance arrangements were appropriate and operated effectively during 2021/22. More recently, political disagreement has entered into Pensions Committee discussions and detracted from engagement in the Committee's scrutiny role.

There have been several membership changes in the Pensions Committee during 2022 which reinforce the need for member engagement with robust training and development.

## We have obtained audit assurances over the wider audit dimension risk identified in our 2021/22 Annual Audit Plan

70. [Exhibit 11](#) sets out the wider audit dimension risk we identified in our 2021/22 annual audit plan. It summarises the further audit procedures we performed during the year to obtain assurances over these risks and the conclusions from the work completed.

### Exhibit 11

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

Audit risk	Assurance procedure	Results and conclusions
<p><b>1. Local Government Elections</b></p> <p>There may be changes to the composition of the Pension Committee and the Pension Board as a result of the local government elections in May 2022. There is a risk that following the elections, a</p>	<p>We will monitor the council's arrangements for developing members and preparations for inducting newly elected members.</p>	<p>Following initial induction training there is ongoing training and development available to Pensions Committee and Pension Board members.</p> <p>Our review of arrangements for induction and ongoing training concluded that those</p>

Audit risk	Assurance procedure	Results and conclusions
number of new members do not have the necessary experience and understanding of their role and responsibilities in such areas as governance, scrutiny and decision making in respect of the Pension Fund.		arrangements were appropriate.

## Governance arrangements were appropriate and operated effectively during 2021/22

**71.** The governance and transparency arrangements we consider in reaching our conclusions include:

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

**72.** We concluded that governance arrangements were appropriate and operated effectively during 2021/22. Pensions Committee and Pension Board members received appropriate and timely information to support decision making and scrutiny.

## Scrutiny of the accounts and audit reports is more limited than scrutiny of investment performance

**73.** Pensions Committee meetings are the vehicle for member scrutiny of pension fund decision making and use of resources. We have observed effective scrutiny of investment performance at Pensions Committee meetings but limited public scrutiny in other areas, particularly in relation to the accounts and audit reports. We acknowledge this may be because Fund performance has been positive, and reports to the Pensions Committee contain sufficient detail and explanation.

**74.** The Pension Fund should support members through training and development to feel confident in their monitoring and scrutiny role. Training opportunities are offered throughout the year; 2021/22 training included seminars on investment strategies, and two virtual training sessions for all Scottish local government pension funds.

**75.** There has been considerable change in committee membership during 2022; this emphasises the need for ongoing training tailored to individuals' needs and we encourage members to work with officers to assess training



needs and develop a training plan. There may also be scope to re-run training on the annual report and accounts for newer committee members.

### **More recently, political disagreement has entered into Pensions Committee discussions and detracted from member engagement in their scrutiny role.**

**76.** The Pensions Committee, which carries out the functions of an audit committee for the Pension Fund, should be non-political in its discussions, as set out in best practice for audit committees. Recently, political disagreement entered into Pensions Committee discussions and detracted from member engagement in their scrutiny role; committee membership changes also followed this political disagreement. We recognise that local government is a political environment but members should be mindful of the role and remit of the committee.

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## **Recommendation 1**

**Pensions Committee members should remain as politically neutral as possible when exercising their scrutiny role.**

The Pension Fund should work with Pension Board and Pensions Committee members to ensure that individuals' training needs are being met and members are supported in their monitoring and scrutiny role. Members should review their training needs to ensure they keep their pensions knowledge up to date. Specific training should be requested if required.

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## **There are effective arrangements for complying with the Pensions Regulator Public Service Code**

**77.** 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.

**78.** The Fund conducts a compliance review against the code on a six-monthly basis and reports annually to the Pensions Committee and Pension Board. 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 2022. 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 2021/22.

**79.** The Pensions Regulator places a legal requirement on Pension Board members to maintain an appropriate level of knowledge and understanding of scheme rules, documents recording scheme administration policies and pensions law. Pensions Committee and Pension Board members are expected to attend at least two training sessions per year. Two Pension Board members



and two Pensions Committee members did not attend at least two training sessions during 2021/22; they are no longer Pension Board or Pensions Committee members.

**80.** Members have varying levels of experience in their roles and their training needs will vary accordingly. Individual training needs are assessed in conjunction with pension fund officers and members can request targeted training. As noted above, it is important that members engage with the development opportunities on an ongoing basis to build and maintain an appropriate level of knowledge.

### **Performance reporting was of a good standard**

**81.** The Management Commentary included in the annual report and accounts should provide information on a body, its main objectives and the principal risks faced. It should provide a fair, balanced and understandable analysis of a body's performance as well as helping stakeholders understand the financial statements.

**82.** The Fund's 2021/22 management commentary is of good quality and is written with the stakeholder in mind. It presents some complex areas in an understandable style. We noted that some of the language used in the prior year's management commentary was more straightforward than in the 2021/22 commentary on the economic and market background. Using plain language increases transparency in reporting the financial performance and financial position.

### **Good practice point: The Fund actively considers Environmental, Social and Corporate Governance matters**

**83.** The Fund actively engages with the companies it invests in regarding Environmental, Social and Governance (ESG) matters. The Statement of Investment Principles sets out the Fund's approach to responsible investment. The Fund's membership of the Local Authority Pension Fund Forum (LAPFF) offers 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 and reducing the use of plastics. The Fund is also a signatory to Principles for Responsible Investment, a signatory to Climate Action 100+ and a member of the Carbon Disclosure Project.

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# 5. Best Value

Using resources effectively and continually improving services

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## Main judgements

The pension administration function performed well against targets with most areas recovering to pre-pandemic performance levels.

The Fund has effective arrangements for monitoring investment performance and scrutinising investment management.

Fund investment performance levels in 2021/22 were below target. The longer-term increase in the value of net assets is the third largest across Scottish local government pension funds.

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## The pension administration function has performed well against targets

**84.** The Pensions Committee meets on a quarterly basis and receives regular reports on both fund administration and investment performance. The focus of measuring the performance of pensions administration includes both member experience and statutory compliance. Performance of the fund's administration function is summarised in [Exhibit 8](#) below.

**85.** Performance has increased against six of the seven administration targets with one (the time taken to issue letters notifying transfer in quotes) remaining stable. [Exhibit 8](#) also shows the performance for 2019/20 which was largely unaffected by the Covid-19 pandemic. The only two areas that are not broadly in line with pre-Covid performance are issuing letters detailing transfers in and issuing letters detailing transfers out. We note that these areas are likely to involve communication with other pension funds, so performance is not wholly under the control of the Fund.

## Exhibit 8

### Administration Performance

	Target	Percentage processed within standard 2019/20	Percentage processed within standard 2020/21	Percentage processed within standard 2021/22	Relative performance compared to prior year
Letter notifying death in service to dependent	5 days	88%	72%	90%	↑
Letter notifying retirement estimate	10 days	98%	94%	97%	↑
Letter notifying actual retirement benefit	10 days	96%	76%	86%	↑
Letter notifying deferred benefit	10 days	91%	69%	92%	↑
Letter notifying amount of refund	10 days	95%	93%	96%	↑
Letter detailing transfer in quotes	10 days	84%	61%	60%	↔
Letter detailing transfer out quotes	10 days	76%	33%	58%	↑

Source: North East Scotland Pension Fund 2021/22 unaudited financial statements

**86.** Administrative expenses for the Main Fund increased in 2021/22 to £3 million from £2.9 million in 2020/21, including governance and oversight costs. The unit cost per member has increased by 29% in the past 5 years. Fund membership has increased by 10.4% over the same period. Staffing levels increased from 34.1 Full Time Equivalent (FTE) in 2020/21 to 36.3 FTE in 2021/22.

**87.** The Fund is expecting its workload to increase further as a result of the McCloud judgement and the proposed remedy, with 16,000 members needing to be recalculated. Work is ongoing with the software supplier which should result in the ability to bulk recalculate benefits based on the draft regulations.

**88.** The fund has expanded the use of the My Pension self-service portal in the year, with several new features applied including an enhanced upload function allowing members to upload multiple documents. The Fund issues Annual Benefit Statements digitally through My Pension; this reduces the environmental impact, paper usage costs and time savings.

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

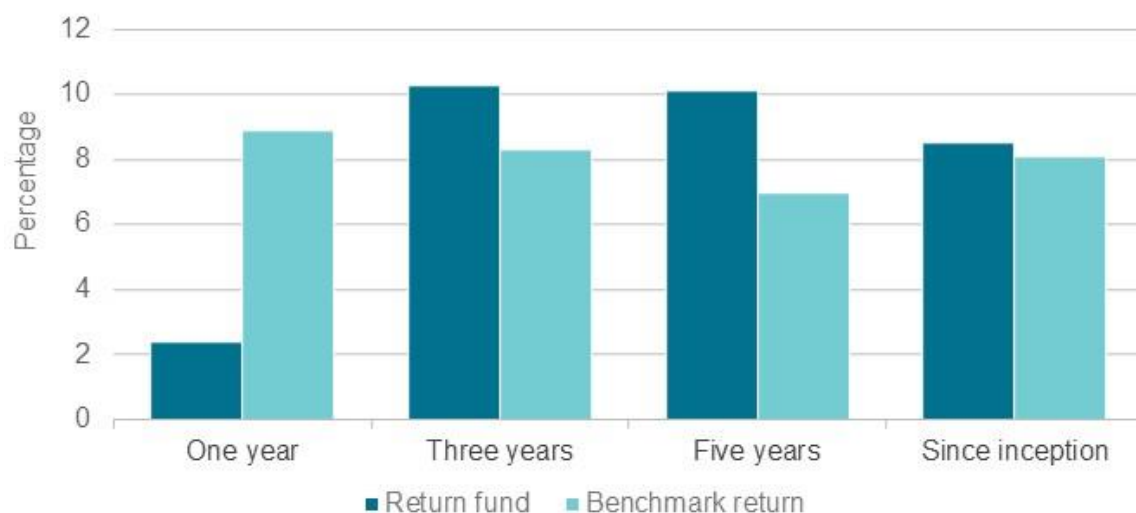
**89.** The Fund appoints several external investment managers. Individual investment manager performance is reviewed regularly by the Pensions Committee and the Fund's investments team also carries out annual diligence reviews for each appointed fund manager.

**90.** Financial markets have been exceptionally volatile in recent years due to the ongoing Covid-19 pandemic and more recently as result of the conflict in Ukraine. Returns against most asset classes, especially equities reduced significantly.

**91.** [Exhibit 9](#) shows that over the year, the Fund generated a return of 2.4% against a benchmark of 8.9%. In the first three quarters of 2021/22, the Fund had generated a return of around 9%. However, in the final quarter of 2021/22 these gains were largely reversed. Over the medium to longer term, the Fund has outperformed its three-year, five-year and since-inception benchmarks.

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### Exhibit 9 Fund investment performance



Source: North East Scotland Pension Fund 2021/22 unaudited financial statements

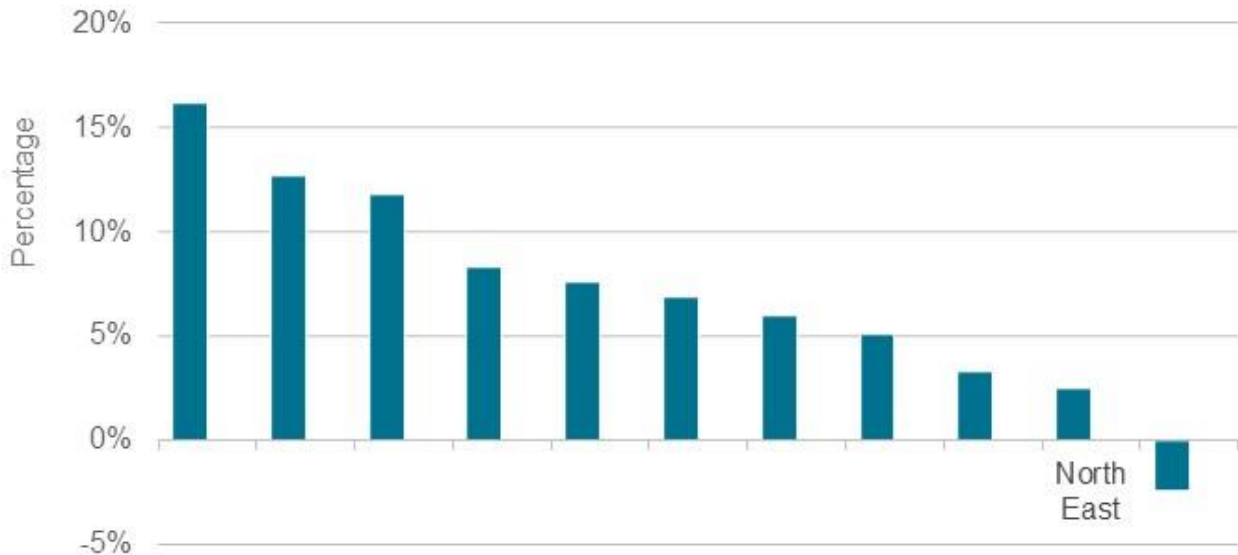
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**92.** The annual return of 2.4% is the second lowest across Scotland, as can be seen in [Exhibit 10](#) below; however, when reviewing the Fund's performance, it is important to consider the longer term.

**93.** We have considered the longer-term trends in [Exhibit 11](#) which shows the change in the value of funds since April 2016. The change in value includes the

return on investments, the impact of transfers in and out of the Fund and the net contributions from dealings with members.

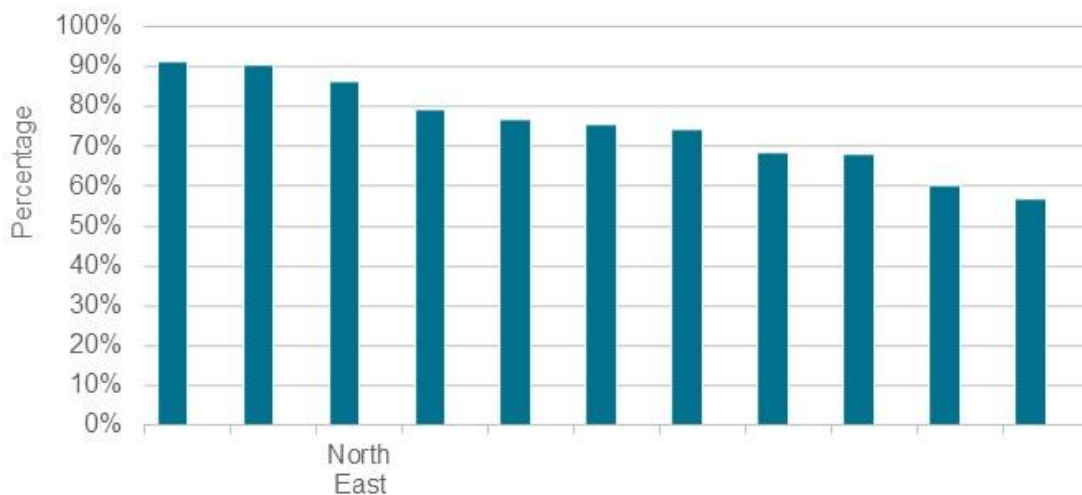
### Exhibit 10 Fund investment performance across Scotland 2021/22



Source: Unaudited annual accounts for Scottish local government pension funds 2021/22

94. Over the six year period the value of North East Scotland Pension Fund has had the third highest increase in value across Scotland.

### Exhibit 11 Change in value of funds since 1 April 2016



Source: Unaudited annual accounts for Scottish local government pension funds 2021/22

## The Fund scrutinises investment management expenses appropriately

**95.** 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 Aberdeen City Council and oversight and governance costs.

**96.** Investment management expenses for the main fund have increased slightly from £23.8 million in 2020/21 to £23.9 million in 2021/22 (excluding administration, governance and oversight expenses: see [paragraph 86](#)). The Transport Fund management expenses fell from £0.447 million in 2020/21 to £0.128 million in 2021/22.

**97.** The Fund has adequate arrangements in place for monitoring investment performance and scrutinising investment management expenses. The Fund continues to work with Fund Managers to increase transparency in reporting of investment management expenses.

## National performance audit reports

**98.** Audit Scotland carries out a national performance audit programme on behalf of the Accounts Commission and the Auditor General for Scotland. During 2021/22, we published reports which may be of interest to the Fund. These are outlined in [Appendix 2](#) of this report. The local audit team will highlight relevant national reports to the Fund for the Pensions Committee's consideration.

# Appendix 1

## Action plan 2021/22

### 2021/22 recommendations

Issue/risk	Recommendation	Agreed management action/timing
<p><b>1. Member engagement and scrutiny</b></p> <p>Pensions Committee members' engagement in some aspects of their scrutiny role has been limited at meetings.</p> <p>Political disagreement has entered what should be a politically neutral scrutiny committee; this has detracted from engagement at meetings and led to further committee membership changes after the post-election changes in elected members.</p> <p>Risk – There is a continuing risk of ineffective scrutiny, challenge and transparency on the decision making and on the financial and performance reporting.</p>	<p>Pensions Committee members should remain as politically neutral as possible when exercising their scrutiny role.</p> <p>The Pension Fund should work with Pension Board and Pensions Committee members to ensure that individuals' training needs are being met and members are supported in their monitoring and scrutiny role. Members should review their training needs to ensure they keep their pensions knowledge up to date. Specific training should be requested if required.</p> <p><a href="#">Paragraph 76</a></p>	<p>The officers of the Pension Fund will continue to support the Committee and Board members in their training and development through the plans that we have in place, including the new online facilities. The Pension Manager will write to the members of the Committee and Board offering to discuss gaps in knowledge and experience that they may have and help them identify opportunities to meet those needs. This will inform the annual training and development plans.</p> <p>Responsible officer – Pensions Manager</p> <p>Agreed date – 31 December 2022</p>

## Follow-up of prior year recommendations

Issue/risk	Recommendation	Agreed management action/timing
<b>b/f. Authorisation limits</b>	The Pension Fund should ensure that officers are familiar with their delegated authorisation limits and remain within those limits, escalating authorisation to more senior officers if required.	<b>Complete</b> Our 2021/22 testing identified no breaches of authorisation limits.
<b>b/f. Reconciliations</b>	The Pension Fund should ensure that reconciliations are prepared on a timely basis for all accounts.	<b>Complete</b> 2021/22 reconciliations were prepared on a timely basis.
<b>b/f. Member training and engagement</b>	The Pension Fund should work with Pension Board and Pensions Committee members to ensure that individuals' training needs are being met and members are supported in their monitoring and scrutiny role. Members should review their training needs to ensure they keep their pensions knowledge up to date. Specific training should be requested if required.	<b>Replaced by</b> <a href="#">Recommendation 1</a>



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# Appendix 2

Summary of national performance reports 2021/22 and briefing papers

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## May

[Local government in Scotland Overview 2021](#)

## June

[Covid 19: Personal protective equipment](#)

## July

[Community justice: Sustainable alternatives to custody](#)

## September

[Covid 19: Vaccination programme](#)

## January

[Planning for skills](#)

[Social care briefing](#)

## February

[NHS in Scotland 2021](#)

## March

[Local government in Scotland: Financial Overview 20/21](#)

[Drug and alcohol: An update](#)

[Scotland's economy: Supporting businesses through the Covid 19 pandemic](#)

# North East Scotland Pension Fund

## 2021/22 Annual Audit Report

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