

Scottish Borders Council Pension Fund

2017/18 Annual Audit Report



 AUDIT SCOTLAND

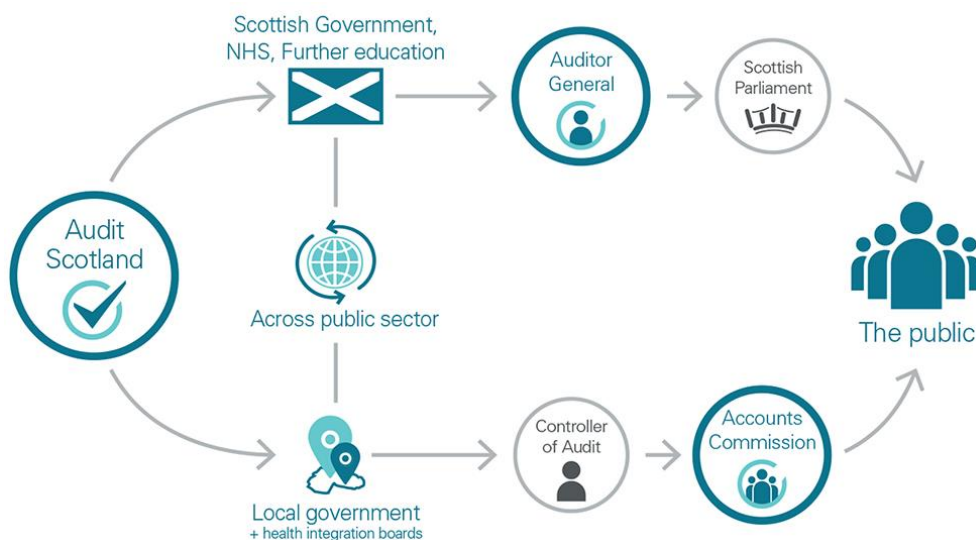
To Scottish Borders Council as administering authority for Scottish Borders Council Pension Fund
and the Controller of Audit

September 2018

Who we are

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

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



About us

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

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

- carrying out relevant and timely audits of the way the public sector manages and spends money
- reporting our findings and conclusions in public

- identifying risks, making clear and relevant recommendations.

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Key messages

2017/18 annual report and accounts

- 1 In our opinion Scottish Borders Council Pension Fund's (the 'Fund') annual report and accounts 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.

Financial management

- 3 The Fund has satisfactory arrangements in place for financial management. This includes comprehensive reporting of investment performance.
- 4 2017/18 saw positive investment returns of 5.6%, following the exceptional returns of 21.5% observed in 2016/17. The Fund is taking steps to reduce exposure to volatile equity investments and diversify into income generating inflation-linked assets by revising their investment strategy. This has resulted in significant one-off transaction costs in 2017/18.

Financial sustainability

- 5 The Fund's 2017 Triennial valuation shows a funding level of 114%, the highest in Scotland, an increase from 101% in 2014. This allows the main pool of employing bodies to maintain their employer contribution rate at 18%.
- 6 The continued increase in the Fund's pensioner membership will make funding future pension payments increasingly challenging. Cash flow projections show that the Fund will continue to rely on investment income to pay pensions. Management are taking measures to increase income from investments to ease cashflow pressures.

Governance and transparency

- 7 The Fund has effective governance arrangements in place that support scrutiny of decisions made by the Pension Fund Committee.
- 8 A dedicated externally hosted website went live during 2017/18 for the Fund, making available a wide range of important information relevant to members of the Fund.

Best Value

- 9 The Fund's investment performance is subject to regular review and scrutiny by the Fund's Investment Sub-Committee, which reports to the Pension Fund Committee.
- 10 There are satisfactory arrangements in place for monitoring investment performance and scrutinising investment management.

Introduction

1. This report is a summary of our findings arising from the 2017/18 audit of Scottish Borders Council Pension Fund (the 'Fund').
2. The scope of our audit was set out in our Annual Audit Plan presented to the March 2018 meeting of the Audit and Scrutiny Committee. This report comprises:
 - an audit of the Fund's annual report and accounts
 - consideration of the wider dimensions that frame the wider scope of public audit set out in the [Code of Audit Practice 2016](#) as illustrated in [Exhibit 1](#).

Exhibit 1

Audit dimensions



Source: Code of Audit Practice 2016

3. The main elements of our audit work in 2017/18 have been:
 - an audit of the Fund's 2017/18 annual report and accounts including the issue of an independent auditor's report setting out our opinions
 - consideration of the four audit dimensions
 - a review of the Fund's main financial systems.
4. Scottish Borders Council (the 'Council') is the administering authority for the Scottish Borders Council Pension Fund. The Council delegates this responsibility to the Pension Fund Committee (the 'Committee'). The Pension Fund Board (the 'Board') is responsible for establishing arrangements to ensuring the proper conduct of the affairs of the Fund in accordance with the law and the requirements of the Pensions Regulator.

5. The Committee and Board are responsible for establishing effective governance arrangements and ensuring that financial management is effective. The Council's Audit and Scrutiny Committee is required to review the effectiveness of internal control arrangements and recommending the annual report and accounts are approved by the Council.

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

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

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

9. This report raises matters from the audit of the annual report and accounts, risks or control weaknesses. 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 outstanding actions from last year and progress against these.

11. We can confirm that we comply with the Financial Reporting Council's Ethical Standard. We can also confirm that we have not undertaken any non-audit related services and the 2017/18 audit fee of £19,990 as set out in our Annual Audit Plan, remains unchanged. We are not aware of any relationships that could compromise our objectivity and independence.

Adding value through the audit

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

13. This report is addressed to both the members of the Scottish Borders Council and the Controller of Audit and will be published on Audit Scotland's website www.audit-scotland.gov.uk.

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

Part 1

Audit of 2017/18 annual accounts



Main judgements

In our opinion Scottish Borders Council Pension Fund's annual report and accounts 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.

Unqualified audit opinions

15. The annual report and accounts for the year ended 31 March 2018 were approved by the Council on 25 September 2018. We reported, within our independent auditor's report:

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

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

Submission of annual report and accounts for audit

16. We received the unaudited annual report and accounts on 26 June 2018, in line with the audit timetable set out in our 2017/18 Annual Audit Plan.

17. The use of Custodian accounting information was expected to improve the preparation of the accounts and provide an independent source of investment valuation information. Due to the complexity of Custodian accounting information, the working papers in this first year of use required the Custodian data to be analysed across the ledger's coding structure to ensure the ledger recorded the correct information. This was a significant task for management to undertake at year-end, resulting in a number of complex journals. Our substantive testing of significant transactions and balances identified no material issues.



Refer to Appendix 1, Recommendation 1.

Risks of material misstatement

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

Materiality

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

20. Our initial assessment of materiality for the annual accounts was carried out during the planning phase of the audit and was based on the audited 2016/17 annual report and accounts. With regards to the annual accounts, we assess the materiality of uncorrected misstatements both individually and collectively.

21. On receipt of the unaudited annual report and accounts we reviewed our planning materiality calculations. Performance materiality was revised downward from 70% (£1.5m) to 60% (£1.3m) to take account of issues experienced following the implementation of Business World, the Council's new ERP system which replaced the Ledger, HR, Payroll and Procurement systems on 1 April 2017.

Exhibit 2

Materiality values

| Materiality level | Amount |
|--|--------------|
| Overall materiality – This is the calculated figure we use in assessing the overall impact of audit adjustments on the financial statements. It was set at 10% of benefits payable and transfers out for the year ended 31 March 2018 based on the unaudited accounts. | £2.2 million |
| Performance materiality – This acts as a trigger point. If the aggregate of errors identified during the financial statements audit exceeds performance materiality this would indicate that further audit procedures should be considered. Using our professional judgement, we have calculated performance materiality at 60% of overall materiality. | £1.3 million |
| Reporting threshold – We are required to report to those charged with governance on all unadjusted misstatements greater than the 'reporting threshold' amount. This has been calculated at 5% of overall materiality (with a maximum level of £100,000). | £100,000 |

Source: Audit Scotland

How we evaluate misstatements

22. It is our responsibility to request that all misstatements above the reporting threshold are corrected, although the final decision on this lies with those charged with governance.

23. There were no material adjustments to the financial statements arising from our audit.

Significant findings from the audit in accordance with ISA 260

24. International Standard on Auditing 260 (UK & Ireland) requires us to communicate significant findings from the audit to those charged with governance. Where a finding has resulted in a recommendation to management, a cross reference to the Action Plan in [Appendix 1](#) has been included.

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

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

26. We identified that investment values provided by the Custodian did not use Fund Manager valuations as at 31 March 2018 for some assets. The valuations used were the best available at the time the Custodian accounting information was prepared. During the audit we compared Fund Manager valuations as at 31 March 2018 against the Custodian information and found that investments were understated by around £700k (1%) of approximately £70m of affected investments due to movements in the value of investments during the last quarter of financial year 2017/18. The accounts have not been adjusted to reflect this difference as management concluded that it was not material. We have not included this as an unadjusted error as it is an area of significant estimation and judgement. Although the difference in 2017/18 is not material, there is a risk that in future years there is a larger difference between the estimated and actual values.



Refer to [Appendix 1, Recommendation 2.](#)

27. We have no other significant findings to report under ISA 260.

Follow up of prior year recommendations

28. We have followed up recommendations previously reported and assessed progress with implementation, these are reported in [Appendix 1](#) and identified by the prefix b/f (brought forward). In total, 3 agreed actions were raised in 2016/17. Of these, two have been fully implemented and one is partially actioned.

29. Overall the Fund has made good progress in implementing these actions. For the action not yet fully implemented, revised responses and timescales have been agreed with management, as set out in [Appendix 1.](#)

Other findings

30. Our audit identified several presentational and disclosure issues which were discussed with management. These were adjusted and reflected in the audited annual accounts.

Pre-audit inspection and objections to the accounts

31. 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. The notice for Scottish Borders Council Pension Fund was published on the Council's website for the inspection period and no objections were received to the Scottish Borders Council Pension Fund accounts.

Part 2

Financial management



Main judgements

The Fund has satisfactory arrangements in place for financial management. This includes detailed investment performance reporting.

2017/18 saw positive investment returns of 5.6%, following the exceptional returns of 21.5% observed in 2016/17.

Our testing of the financial controls over significant risk areas confirmed that controls relating to financial systems and procedures are largely operating effectively, with some scope for improvement.





Financial performance in 2017/18

32. Pension Fund finances are independently assessed every three years by the Funds appointed actuary. This assessment determines the employer contribution rates and any required deficit funding payments for the upcoming three-year period and takes account of the strength of employer covenants and the Fund's investment strategy.

33. The Fund's performance in 2017/18 is summarised in [Exhibit 4](#).

Exhibit 4

Assets, liabilities, funding level and investment performance

| Increase in net assets | Decrease in estimated liabilities | Funding level | Investment performance |
|---|---|--|---|
|  |  |  |  |
| £31 million (+4.7%) | £63 million (-6.9%) | 114% 2017 Funding valuation | 5.6% Return on investments 2017/18 |
| £685 million Closing net assets | £844 million Closing liabilities | 101% 2014 Funding valuation | 8.6% Return on investments over 5 years |

Source: 2017/18 Scottish Borders Council Pension Fund Annual Report and Accounts

34. The net assets of the Fund increased to £685m at 31 March 2018 from £654m at 31 March 2017. This increase of £31 million reflected the buoyant market conditions experienced by investors during the year. It was adversely impacted by significant one-off transaction costs related to new, less volatile, investments following a review of the investment strategy. In contrast 2016/17 saw an increase of £112m largely driven by returns in equity markets which was an exceptional year.

35. During 2017/18 contributions to the Fund amounted to some £19.4 million (2016/17: £18.4 million). This was less than the benefits paid out which totalled £21.5 million (2016/17: £20 million). This is the fifth year of benefits paid exceeding contributions into the Fund, signalling a maturing of the Fund.

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

37. The actuarial present value of promised retirement benefits estimates the Fund's liabilities decreasing from £907 million at 31 March 2017 to £844 million at 31 March 2018 (£63 million decrease). It should be noted that not all Funds have liabilities assessed on the same prudential scales. The use of differing actuarial firms and assumptions creates difficulties in direct comparisons. It should also be noted that this valuation is an accounting estimate.

38. 2017/18 has been a demanding year for the Finance Team in the Council with the introduction of Business World and the subsequent restructuring of the finance function. This has placed a significant burden on key team members at certain times. It will be important to review capacity periodically to ensure it continues to meet the increasing demands of regulation and financial reporting in public sector pensions schemes. Management should continue to review financial capacity.

Financial management arrangements

39. The Chief Financial Officer for Scottish Borders Council is the proper officer responsible for Scottish Borders Council Pension Fund. The financial regulations of Scottish Borders Council, as administering authority, apply to the Fund. We consider these to be comprehensive and promote good financial management.

40. Investment performance reports are submitted to the Pension Fund Committee on a quarterly basis, with administration performance reports submitted annually. Reports are comprehensive and well presented with sufficient narrative to describe issues to Councillors and other committee members. Through our attendance at the Pensions Committee we have observed adequate level of review and scrutiny by members. The Council has delivered training to members of the committee during the year including training on Financial markets and Investment Products, the role of the Fund Custodian, the general Pension Fund Regulatory Environment and the LGPS regulatory environment. It is important that Committee members undertake all given training to ensure knowledge and skills are kept current.

41. We have concluded that the financial management arrangements in place at Scottish Borders Council Pension Fund are sufficient to ensure the ongoing success of the Fund.

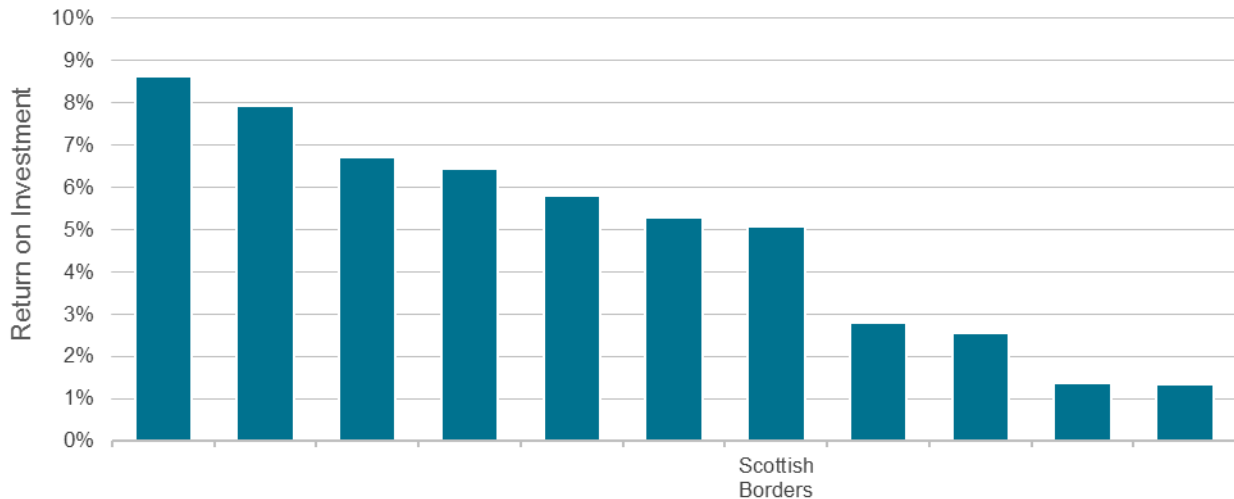
Financial management is about financial capacity, sound budgetary processes and whether the control environment and internal controls are operating effectively.

Financial outcomes

42. 2017/18 has been a positive year for investment performance for most Local Government Pension Schemes (LGPS) across Scotland as illustrated in [Exhibit 5](#).

Exhibit 5

LGPS pension funds – Net return on investment 2017/18 (unaudited figures)



Source: 2017/18 LGPS pension fund unaudited financial statements

43. In 2017/18 Scottish Borders Council Pension Fund achieved a return of 5.6% on its investments. This is 2.2% above the Fund's 2017/18 benchmark of 3.4%, with rolling three-year performance 1.4% above the benchmark of 7.2%.

44. We conclude that the Fund's overall performance is good. The Committee is taking advice from the Investment Consultant KPMG to diversify away from equity assets into income generating inflation-linked assets that are more resilient to the volatility of the equities markets, as well as provide cash to pay pensions.

Systems of internal control

45. Our objective is to gain assurance that the Fund has systems of recording and processing transactions which provide a sound basis for the preparation of the financial statements.

46. During 2017/18 management implemented a process of 'Annual Fund Manager Review' whereby questionnaires are submitted to all Fund Managers querying their compliance with laws and professional standards, as well as probing to determine potential issues that may affect valuations. This provides assurance that Fund Managers are acting in accordance with laws and professional standards.

47. We noted that the existence of overseas pensioners is not verified on a periodic basis. There is a risk that pensions are paid to deceased persons resulting in a loss to the Fund. We recommend that management reinstate controls to validate overseas pensioners.



Refer to Appendix 1, Recommendation 3.

48. A key source of information of the Fund to stop pension payments when required is through use of the Council's 'Tell Us Once' notification service, whereby next of kin inform the Council to close the affairs of the individual. This information

is passed to the Pension Fund administration team to stop pension payments in a timely manner. We identified that, whilst the administration team receive these notifications, no record or log is kept to ensure that all notifications are actioned. We recommend that these notifications are kept and reviewed by management to ensure pension payments are stopped timeously as a result of these notifications.



Refer to Appendix 1, Recommendation 4.

49. In addition to the above, we identified that controls over the pension payroll such as the investigation of exception reporting were in place. However, there was no evidence of management review of the control. We recommend that procedures are put in place to ensure controls are adequately reviewed and monitored by management to ensure their efficacy is maintained.



Refer to Appendix 1, Recommendation 5.

50. The Council implemented a new financial system, Business World, from April 2017. The introduction of the new system resulted in several issues with the operation of internal controls, including instances of records of changes to the system not being maintained and delays in the completion of bank reconciliations. This was reported in our interim report in June 2018. We concluded that we could not take assurance from some of the controls in operation. We modified our audit approach, and our testing did not identify material misstatements.

51. Our testing of the contribution rates within the pension administration system, Heywoods Altair, identified errors in contribution rate standing data in the system. No contributing members were affected by this error on this occasion, however it is important that all standing data is subject to timely review.



Refer to Appendix 1, Recommendation 6.

52. Overall, we are satisfied that controls are operating satisfactorily, but there is scope for improvement as detailed in the paragraphs above.

Part 3

Financial sustainability



Main judgement

The Fund's 2017 Triennial valuation shows a funding level of 114%, the highest in Scotland. This allows the main pool of employing bodies to maintain their employer contribution rate at 18%.

The continued increase in pensioners in the Fund's membership will make funding future pension payments increasingly challenging. Cash flow projections show that the Fund will continue to rely on investment income to pay pensions.

The Fund is taking steps to reduce exposure to volatile equity investments and diversify into income generating inflation-linked assets by revising their investment strategy.

Funding position and financial planning

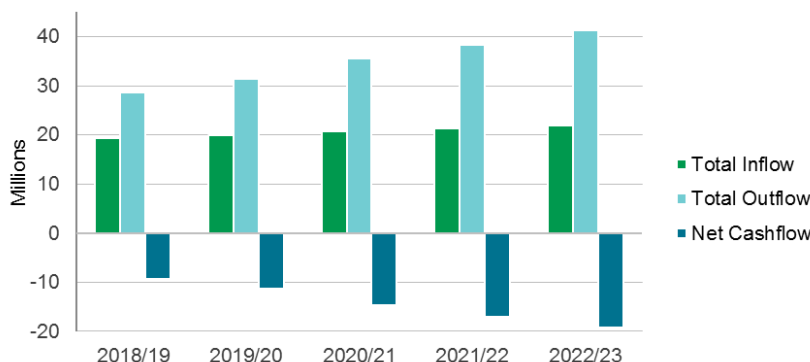
53. The March 2017 triennial valuation reports that the Fund assets were sufficient to meet 114% of its liabilities. The primary employer contribution rate was increased to 20.6%, however, on the actuary's advice, the Fund has utilised the over-funding to set the secondary rate at a level to maintain employer contributions at 18% for the next three years. Management reviewed and updated the Funding Strategy Statement which was presented to the June 2018 Pension Fund Committee meeting.

54. The Fund reported net withdrawals of £2.6m in 2017/18. Management actively monitors its cashflow and reports the position to the Pension Fund Committee. A 5-year cashflow forecast has recently been prepared by the investment consultant KPMG. This forecasts that negative cash flows will be an ongoing trend. The Fund recognises it will have to utilise some investment income to pay pensions for the foreseeable future. Cash flows are visualised in [Exhibit 6](#).

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.

Exhibit 6

Analysis of cash flows by the independent investment consultant



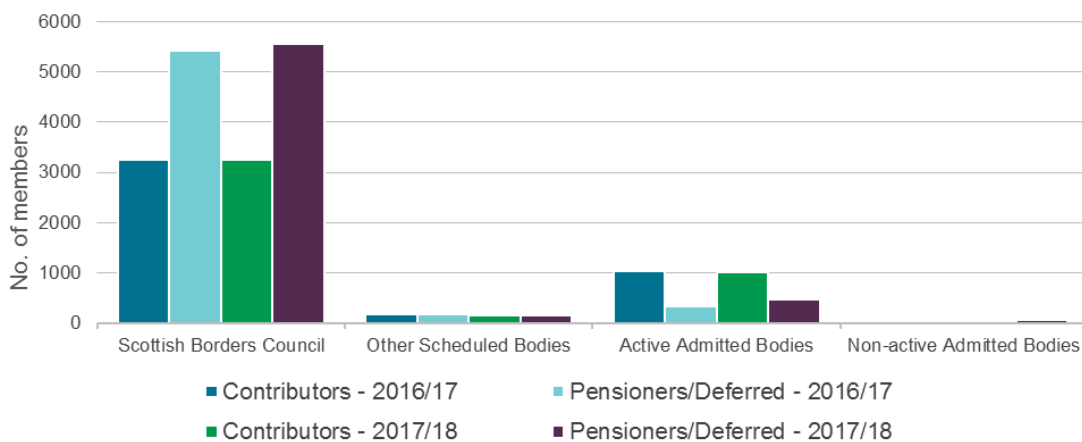
Source: KPMG Cashflow analysis June 2018

55. Management has considered the negative cash flow reality of the Fund and revised the Investment Strategy. This has resulted in a move away from growth generating assets such as equities to income generating and inflation-linked assets providing cash flows to the Fund to pay pensions.

Membership levels

56. The Fund is a multi-employer fund with 1 Local Authority, and 17 other employers. The proportion of pensioners relative to active contributing members further increased in 2017/18. The current membership profile is shown at [Exhibit 7](#).

Exhibit 7 Fund membership



Source: Scottish Borders Council Pension Fund 2017/18 audited financial statements

57. Membership of the Fund increased from 10,432 to 10,667 members at 31 March 2018; an increase in active members of 2.3%.

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

Contributions

59. Following the latest triennial valuation in 2017, the Actuary agreed employer contribution rates with individual employers for 2018/19 onwards. The approximate split of all contributions received in year is set out at [Exhibit 8](#).

Exhibit 8 Contributions in 2017/18

| | Administering authority £m | Other scheduled bodies £m | Admitted bodies £m | Total £m |
|----------------------------|-------------------------------|------------------------------|-----------------------|-------------|
| Total contributions | 13.3 | 0.7 | 5.3 | 19.3 |

Source: Scottish Borders Council Pension Fund 2017/18 audited financial statements

EU withdrawal

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

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

61. Management recognises the difficulty of planning for Brexit amid considerable uncertainty. In terms of the market implications for investment performance, the Fund is taking a diversified, balanced approach to mitigate against the risk. For example, reducing equity investment and increasing investment in infrastructure, which is not as tied to global events. Additionally, the Fund is diversified geographically with investment in overseas equities and other investments, reducing dependency on UK and EU investments. Management are aware of the currency fluctuation risk and are working with their investment consultant to determine ways to mitigate that risk.

Part 4

Governance and transparency



Main judgements

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

A dedicated externally hosted website went live during 2017/18, making available a wide range of important information relevant to members of the Fund.

Decisions are transparent with committee papers and detailed minutes of meetings of the Pension Fund Committee available on the Scottish Borders Council's website.

Governance arrangements

62. Scottish Borders Council is the administering body of the Pension Fund. The Council has delegated responsibility for governance to the Pension Fund Committee. This committee, supported by the Board (made up of four scheme employer representatives and four trade union representatives), is responsible for establishing arrangements that ensure the proper conduct of the affairs of the Fund. It is also responsible for ensuring that decisions are made within the terms of the LGPS.

63. Members are provided with adequate training so that they are clear about their roles and responsibilities and are kept up to date on current issues so that they can scrutinise papers effectively.

64. We saw evidence of good quality information being made available to the committee by management and advisers, enabling challenge and scrutiny to be undertaken by members.

65. The Fund is supported by good governance arrangements including effective controls over the Council's systems upon which the Fund depends for financial reporting.

Transparency

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

67. The Pension Fund Committee and Board meetings are held in public with commercially sensitive information dealt with in private sessions. Minutes of the public meetings are available on the Scottish Borders Council website.

68. Management procured a stand-alone website for the Fund which went live during 2017/18. This makes available a wide array of important information to members. A module will be added in future for members to run their own pension calculations.

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.

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

Other aspects of governance

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

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

Pensions Regulator Public Service Code

72. The Public Service Pension Act 2013 introduced new governance arrangements for LGPS pension funds and from 1 April 2015 funds were required to introduce local pension boards. The remit of the Board is to support the Pension Fund Committee in compliance with regulations and with requirements imposed by the Pension Regulator which includes the administration of the Fund and investments, as well as the responsibility for preparing, publishing and maintaining the funding strategy statement and the statement of investment policies.

73. There was one breach of the Code that required to be reported to the Pensions Regulator in 2017/18. The Fund was unable to issue all benefits statements to members by the deadline of 31 August 2017. This was reported to the Pension Regulator in a timely manner and no enforcement action was taken. The benefits statements were issued by 07 September 2017.

74. An important legal requirement of the Code concerns the knowledge and understanding by Pension Committee and Board members. We find that the Fund has good governance arrangements in place to assess the learning needs of members and to ensure good uptake of training.

Internal audit

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

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

77. To avoid duplication of effort we use the work of internal audit wherever possible. In 2017/18 we used internal audit's work on the controls in place over Business World. We also considered internal audit report findings on Governance as part of our wider dimension work.

Management commentary, annual governance statement and governance compliance statement

78. The applicable legislation and regulations require pension funds to prepare and publish, along with their financial statements, a management commentary, an annual governance statement, and a governance compliance statement that are consistent with the disclosures made in the financial statements. The management commentary should be fair, balanced and understandable.

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

Standards of conduct for prevention and detection of fraud and error

80. We assessed the Fund's arrangements for the prevention and detection of fraud. The Fund relies on the Council's arrangements for the prevention and detection of fraud and corruption. These include a Code of Conduct for members and officers, a whistleblowing policy and an anti-fraud strategy.

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

Cyber security

82. The Scottish Government issued a [Public Sector Action Plan on Cyber Resilience](#) in November 2017 which requires all public sector bodies to carry out a review to ensure their cyber security arrangements are appropriate.

83. As administering authority of the Fund, the Council has outsourced its ICT arrangements to CGI as part of a 13-year contract. Under this agreement, CGI are responsible for cyber security arrangements and the Council relies on their expertise in addressing cyber security risks.

Part 5

Best Value



Main judgements

The Fund's investment performance is subject to regular review and scrutiny by the Fund's Investment and Performance Sub-Committee.

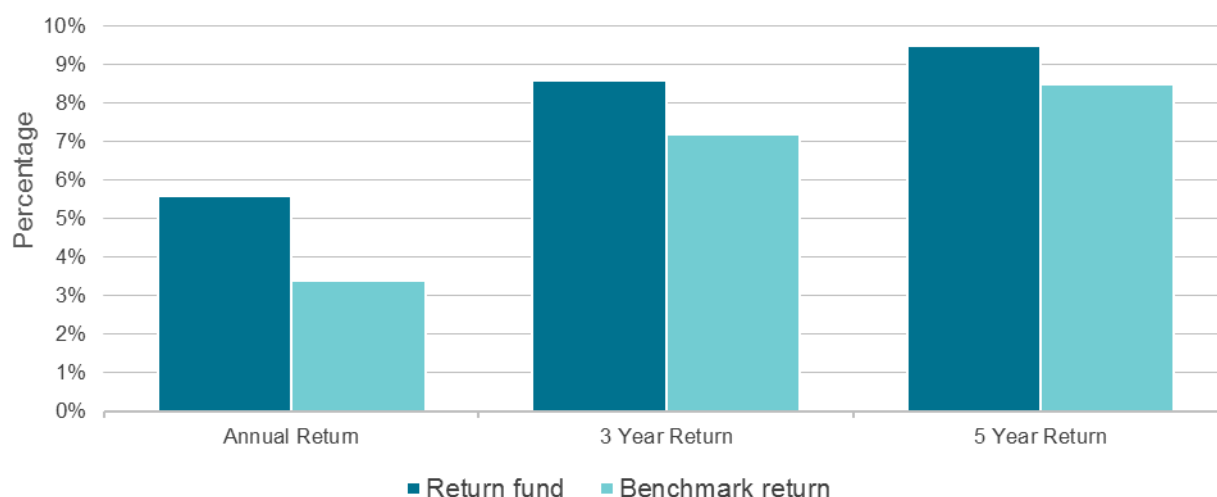
There are satisfactory arrangements in place for monitoring investment performance and scrutinising investment decisions.

Investment performance

84. The Pension Fund Investment and Performance Sub-Committee meets twice a year. 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.

Exhibit 9

Fund investment performance



Source: KPMG 2018 Quarter 1 Investment Performance Report

85. Exhibit 9 shows that over the year, the Fund generated a return of 5.6% against a benchmark of 3.4%. Equity investments were the most significant contributor to this increase.

86. The three-year rolling return of 8.6% is also above benchmark of 7.2%.

87. Under the career average pension scheme (CARE), accrued benefits are indexed at Consumer Price Index (CPI). Benefits earned under the old final salary scheme will continue to increase in line with earnings.

88. The Fund appoints several external fund managers. Individual investment manager performance is reported on a quarterly basis to the Pension Fund

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

Committee by the investment consultant, KPMG. In addition, all investment managers are subject to review at least annually by the Investment and Performance Sub-Committee, and again by management to discuss operational issues. Fund managers are required to complete annual compliance checklists which are reviewed by management for instances of non-compliance with laws and professional standards.

89. The investment strategy of the Fund is included in the Statement of Investment Principles which was updated in September 2017. The Fund has adopted a risk/return asset framework as the basis for modelling and agreeing the investment strategy. The Fund is made up of 58.5% equities which provided a positive return in 2017/18. The Fund continues to invest in other assets classes such as long-lease property, private credit and infrastructure, by partnering with Lothian Pension Fund.

90. Investment return and risk are inextricably linked, and it is not possible for us to comment on the relative performance of the Fund's investments given the risk exposure of the asset allocation and investments made. Although asset allocation is largely in line with the Fund's investment strategy, the Fund is still overweight in equities (58.5% at 31 March 2018 against a target of 50%). This is because of the continuing rise in equity values globally. The Fund is underweight in Infrastructure by 4.7%, Private Credit by 2.7% and Long-lease Property by 1.2%. Management are working with the Investment Consultant to identify appropriate opportunities to invest in line with the agreed strategy.

Budgeting arrangements

91. 2017/18 was the first year a budget was set for those significant costs within the Fund's control, being:

- Investment management expenses
- Administration.

Investment management expenses

92. There are three main categories of management expense, with the largest being investment management costs. Other expenses are the cost of the administration services provided by the Council and the governance fees for actuarial and audit services.

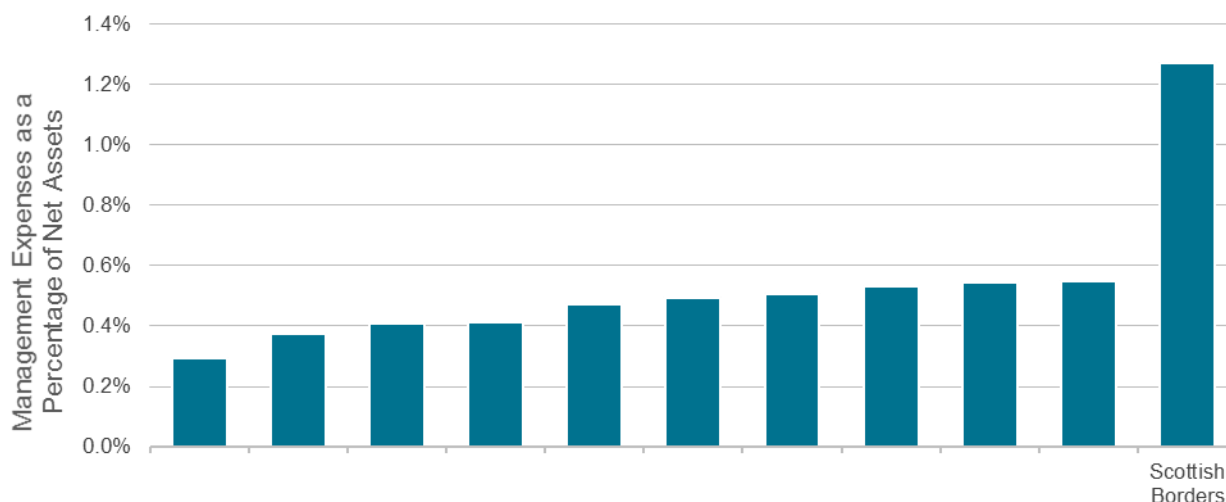
93. CIPFA published revised guidance on local government pension scheme management expenses. This guidance sets out a framework for the reporting of investment management costs and was applied from 2016/17. The new guidance recommends that only expenses that can be directly controlled by the fund should be included.

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

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

96. Investment management expenses have increased from £3.1 million in 2016/17 to £8.2 million in 2017/18, significantly higher than other Scottish Pension Funds as illustrated by [Exhibit 10](#).

Management expenses as a percentage of closing net assets



Source: Unaudited Scottish LGPS 2017/18 accounts

97. There has been significant movement between the initial budgeted investment management expenses of £3.3 million and the final outturn amount of £8.2 million. This is largely because of one-off transaction costs associated with investment in Long-Lease Property, which is seen as a key part of the investment strategy agreed with KPMG the Fund's investment consultants. KPMG are confident this cost will be recouped through investment performance. Management are aware of the increased transparency agenda and scrutiny of transactions costs and are taking steps to ensure transaction costs reported to the Committee as part of the budget process are complete and accurate.

98. We have concluded that the Fund has satisfactory arrangements in place for monitoring investment performance and scrutinising investment management expenses.

Administrative expenses

99. The workload of the pension administration section continues to grow primarily due to the introduction of the career average pension scheme (CARE) from 1 April 2015. Other factors impacting on the administration workload include auto enrolment, freedom of choice and implementation of Business World, the new accounting and payroll system of Scottish Borders Council.

100. The Fund's administration strategy 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 Pension Fund Committee and Board.

101. Employers are required to submit year end contribution returns by June for the preceding 31 March year end. This is an important control over the accuracy of pension contributions received and recorded in the pensions systems and is of increased importance following the introduction of CARE as the member benefit statement requires actual salary data from all employers. All year end contribution returns relating to 2017/18 have been received by the end of June.

National performance audit reports

102. Audit Scotland carries out a national performance audit programme on behalf of the Accounts Commission and the Auditor General for Scotland. During 2017/18, we published our report, 'Local Government in Scotland: Financial Overview 2016/17', which contains analysis of Scottish Local Government Pension Funds. These are outlined in [Appendix 3](#).

Appendix 1

Action plan 2017/18

2017/18 recommendations for improvement

| No. | Issue/risk | Recommendation | Agreed management action/timing |
|-----|--|---|--|
| 1 | <p>Quality of Accounts Working Papers</p> <p>Due to the complexity of Custodian accounting information, the working papers required the Custodian data to be analysed across the ledger's coding structure to ensure the ledger recorded the correct information. This resulted in complex journals. Working papers were not referenced or linked to the Custodian data.</p> <p>Risk</p> <p>Without high quality working papers, journals into the ledger may be incorrect, resulting in misstated financial statements.</p> | <p>Officers should prepare working papers directly within the Custodian spreadsheet that allows for linking of data. Where external sources of information are required, this should be clearly referenced.</p> <p>Paragraph 17</p> | <p>Agreed.</p> <p>Chief Financial Officer</p> <p>31 March 2019</p> |
| 2 | <p>Investment Valuations</p> <p>The Custodian did not use Fund Manager valuations as at 31 March 2018 for some assets. The valuations used were the best available at the time the Custodian accounting information was prepared.</p> <p>Risk</p> <p>Without adequate review of investment movements by management, the values reported in the accounts may be materially misstated.</p> | <p>Management should ensure that investment asset values reported are as accurate as possible and that any potential differences due to timing of information are adequately considered.</p> <p>Paragraph 26</p> | <p>Agreed.</p> <p>Chief Financial Officer</p> <p>31 March 2019</p> |



| No. | Issue/risk | Recommendation | Agreed management action/timing |
|-----|---|--|--|
| 3 | <p>Validation of overseas pensioners</p> <p>Validation of pensioners is considered a key control that should be in place to ensure that pensioners in receipt of pensions are still eligible to receive payment.</p> <p>We identified that, whilst letters and statements are issued to overseas pensioners, there is no process to evidence their existence.</p> <p>Risk</p> <p>There is a risk that without adequate controls being in place to validate the existence of pensioners, pensions are paid to deceased pensioners.</p> | <p>A process should be developed to ensure the existence of overseas pensioners can be validated.</p> <p>Paragraph 47</p> | <p>Agreed.</p> <p>Service Director HR</p> <p>31 October 2018</p> |
| 4 | <p>Completeness of 'Tell Us Once' processing</p> <p>One of the key processes in place to ensure deceased pensioners payments are stopped timeously is using the Council's 'Tell Us Once' service, whereby the next of kin inform the Council to ensure Council Tax and other payments are stopped.</p> <p>We found that no complete record is kept of these notifications to evidence that all notifications had been actioned timeously.</p> <p>Risk</p> <p>There is a risk that not all 'Tell Us Once' notifications are actioned resulting in overpayment of pensions.</p> | <p>All notifications into the Council should be kept and recorded to ensure that all pension payments are stopped timeously when required.</p> <p>Paragraph 48</p> | <p>Agreed.</p> <p>Service Director HR</p> <p>31 October 2018</p> |



| No. | Issue/risk | Recommendation | Agreed management action/timing |
|-----|--|---|--|
| 5 | <p>Evidence of review of exception reporting</p> <p>Controls over the pension payroll such as the investigation of exception reporting were in place. However, there was no evidence of management review of the control.</p> <p>Risk</p> <p>There is a risk that without evidence of review, the quality key control processes deteriorates to a point where the control is no longer effective.</p> | <p>Procedures should be put in place to ensure controls are adequately reviewed and monitored by management to ensure their efficacy is maintained.</p> <p>Paragraph 49</p> | <p>Agreed.</p> <p>Service Director HR</p> <p>31 October 2018</p> |
| 6 | <p>Pension Administration System Standing Data</p> <p>We identified errors in the contribution rate standing data in the pension administration system. No contributing members were affected by this error on this occasion, however it is important that all standing data is subject to timely review.</p> <p>Risk</p> <p>There is an inherent risk of error when inputting standing data into key systems.</p> | <p>Sufficient review of standing data input into systems should be carried out to ensure errors are identified and rectified.</p> <p>Paragraph 51</p> | <p>Agreed.</p> <p>Service Director HR</p> <p>31 October 2018</p> |

Follow up of prior year recommendations

| | | | |
|-------|--|---|--|
| b/f 1 | <p>Financial & HR Capacity</p> <p>We found that staff capacity was showing signs of pressure. There is dependency on key staff in Finance and in HR. Staff absence has meant key reconciliations and working papers were not available or prepared to a level suitable for audit.</p> | <p>Resource requirement of the Pension Fund should be assessed and addressed to ensure administration of the Fund is efficient and effective.</p> | <p>An assessment of Pension Fund resources will be undertaken following the audit to ensure the Council retains sufficient capacity and expertise to continue to support the pension effectively. This in-house expertise will be augmented by the cost-effective use of external resources to provide specialist services where required.</p> |
|-------|--|---|--|



| No. | Issue/risk | Recommendation | Agreed management action/timing |
|--------------|--|--|---|
| | | | <p>Chief Financial Officer and Service Director Human Resources</p> <p>31 December 2017</p> <p>Update</p> <p>Consider this action partly complete.</p> <p>Whilst steps have been taken to ease the administrative burden on staff, such as outsourcing the GMP reconciliation, we find that unfilled vacancies and system issues are impeding the ability of staff to perform their duties. Paragraph 38</p> |
| b/f 2 | Governance | | |
| | <p>Our review of the Annual Governance Statement of the Fund found that Internal Audit perform an assessment of Governance and Controls in place over the Pension Fund. However, the Internal Audit Annual Report makes no specific reference to the assurance provided for the Pension Fund.</p> | <p>The Internal Audit Annual Report should include a specific reference to Scottish Borders Council Pension Fund, as their work over the systems and controls in place at Scottish Borders Council covers the same systems for the Pension Fund, and the Pension Fund Governance statement refers to Internal Audit assurance over their controls and systems.</p> | <p>The Internal Audit Annual Report is the internal audit assurance report for the Council. A separate Internal Audit assurance report will be prepared for and presented to the Pension Fund from 2017/18.</p> <p>Chief Officer Audit and Risk</p> <p>31 March 2018</p> <p>Update</p> <p>Consider this action now complete.</p> |
| b/f 3 | Financial Statement Disclosures | | |
| | <p>Our review of the unaudited annual report and financial statements identified disclosures that were incomplete. These include disclosures relating to debtors, creditors and investment fair values. Including these will improve transparency and understanding of the financial statements.</p> | <p>CIPFA disclosure checklist and example accounts guidance should be used to ensure disclosures are complete.</p> | <p>Noted, a review of the disclosures recommended by the CIPFA checklist will be undertaken and these will be included in the 2017/18 Pension Fund accounts where they are considered to add value and enhance transparency.</p> <p>Chief Financial Officer</p> <p>31 March 2018</p> |



No. Issue/risk



Recommendation



Agreed management action/timing

Update

Consider this action now complete.

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 Risk of management override of controls</p> <p>Although we have not identified any specific risks of management override relating to the Fund, ISA 240 requires that audit work is planned to consider the risk of fraud, which is presumed to be a significant risk in any audit. This includes consideration of the risk of management override of controls in order to change the position disclosed in the financial statements.</p> | <p>Detailed testing of journal entries</p> <p>Review of accounting estimates</p> <p>Evaluation of significant transactions that are outside the normal course of business.</p> | <p>Based on our substantive 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 Risk of fraud over expenditure</p> <p>Practice Note 10 (Audit of financial statements of public sector bodies in the UK) and the Code of Audit Practice expands the ISA 240 requirements to aspects of expenditure such as pension payments and investments</p> | <p>Analytical procedures on payment streams.</p> <p>Focussed substantive testing of expenditure from areas of greatest risk.</p> | <p>Interim controls testing results were satisfactory.</p> <p>We carried out a review of 'experts work' for the custodian and the actuary and concluded that we could place reliance on these parties.</p> <p>Substantive testing identified no issues.</p> |
| <p>3 Estimation and judgements</p> <p>There is a significant degree of subjectivity in the measurement and valuation of investments.</p> <p>This includes level 3 investments such as unquoted equities where valuers use techniques that require significant judgement in determining appropriate assumptions for valuation.</p> <p>In addition, the actuarial valuation depends on several assumptions</p> | <p>Completion of 'review of work by service auditors' in accordance with ISA 402, for significant unquoted investments</p> <p>Test valuations to valuation reports and/or other supporting documentation.</p> <p>Completion of 'review of the work of an expert' in accordance with ISA500 for</p> | <p>Reviewed the 'Fund Manager Annual Reviews' carried out by Fund Officers to gain assurance that Fund Managers were acting in accordance with laws and professional standards.</p> <p>We carried out reviews of 'experts work' on the custodian and the actuary. This included review of the PwC report on actuarial assumptions. We concluded that we could place</p> |











| Audit risk | Assurance procedure | Results and conclusions |
|---|--|--|
| <p>about the future, including investment returns, contribution rates, pensioner mortality and discount rates.</p> <p>This subjectivity represents an increased risk of misstatement in the financial statements.</p> | <p>the work of the actuary.</p> <p>Consideration of the report by PwC in their capacity as consulting actuary to Audit Scotland on actuarial assumptions in use in 2017/18</p> <p>Consideration of Government Actuary's Department (GAD) reports under Section 13 of the Local Government Pension Scheme (Scotland) of LGPS Scotland funding valuations and employer contribution rates.</p> | <p>reliance on the custodian and the actuary.</p> <p>Reviewed procedures by Fund Officers to ensure Level 2 and 3 investments were valued appropriately. Refer to Action Point 2</p> |
| <hr/> | | |
| 4 Reporting Disclosures | | |
| <p>The Code of Practice on Local Authority Accounting now requires Funds to disclose transaction costs broken down by major asset classes to increase transparency.</p> <p>A change to accounting disclosures raises a risk that the required disclosures are not made appropriately.</p> | <p>Review the transaction cost disclosures against the Code, and available data to determine the completeness of disclosures and costs.</p> | <p>Ensured that the CIPFA Disclosure Checklist was completed accurately, and that all disclosures appropriate to the Fund were made.</p> |
| <hr/> | | |
| 5 New Financial System | | |
| <p>Scottish Borders Council introduced a new financial system, Business World ERP, in April 2017. Some issues have been experienced with the operation of the system since its implementation, including manual intervention required to process some transactions.</p> <p>There is a risk that financial information may not be robust, which could impinge on members' scrutiny role. There may also be an adverse impact on the Council's system of internal controls and the preparation and audit of the financial statements.</p> | <p>Review of internal work on the systems of internal control.</p> <p>Testing of the operation and effectiveness of the controls in place over the system.</p> <p>Review the governance arrangements over the implementation of Business World.</p> | <p>We tested the controls in place over the new financial system, including using the work of internal audit. Findings of this work were reported to the Audit and Scrutiny Committee in June 2018 in the Scottish Borders Council interim report.</p> |

| Audit risk | Assurance procedure | Results and conclusions |
|---|--|---|
| Risks identified from the auditor's wider responsibility under the Code of Audit Practice | | |
| <p>6 Financial sustainability</p> <p>In 2016/17, benefits paid out exceeded contributions paid into the Fund. The recently established cash flow models for 2017/18 shows a continuing deficit position, which will be funded using investment income.</p> <p>Furthermore, the triennial valuation of the Fund can have a significant impact on the financial position of the Fund and of its member bodies and there is a risk that the 2017 valuation will cause member bodies to reassess the financial sustainability of membership.</p> | <p>Monitor the financial position of the Fund and the quality of the financial reporting</p> <p>Review of cash flow forecasting.</p> | <p>Reviewed Committee papers and minutes to determine the adequacy of financial sustainability information submitted to members.</p> <p>Reviewed the cashflow forecasting exercise carried out by the Investment Consultant to understand the expected future cashflows of the Fund.</p> <p>Refer to Paragraph 54</p> |

Appendix 3

Summary of national performance reports 2017/18



| | | 2017/18 Reports | |
|--|---|-----------------|--|
| | | Apr | |
| | | May | |
| Common Agricultural Policy Futures programme: further update |  | Jun |  Scotland's colleges 2017 |
| | | Jul |  NHS workforce planning |
| Self-directed support: 2017 progress report |  | Aug | |
| Equal pay in Scottish councils |  | Sept | |
| Transport Scotland's ferry services |  | Oct |  NHS in Scotland 2017 |
| Local government in Scotland: Financial overview 2016/17 |  | Nov | |
| | | Dec | |
| | | Jan | |
| Early learning and childcare |  | Feb | |
| Managing the implementation of the Scotland Acts |  | Mar | |

Scottish Borders Council Pension Fund

2017/18 Annual Audit Report

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