

Fife Pension Fund

2016/17 Annual Audit Report



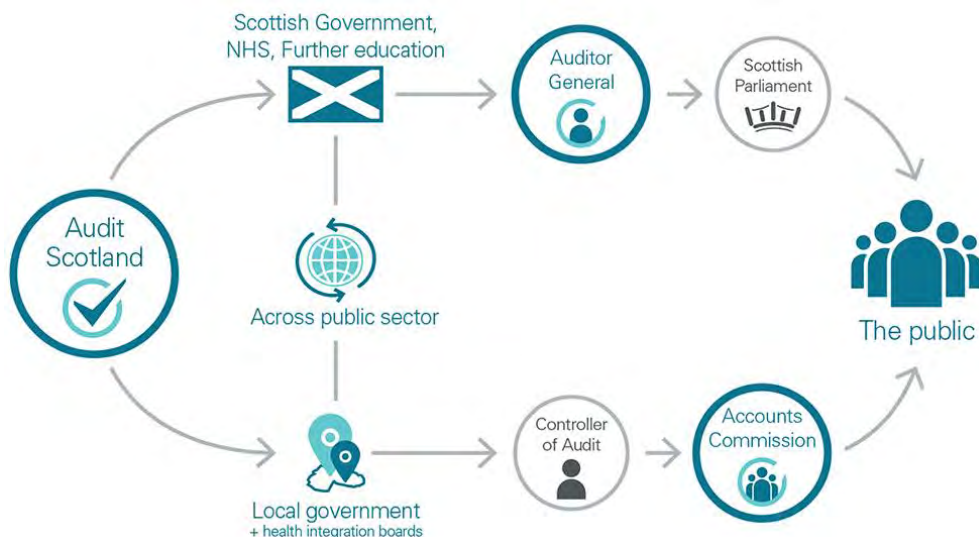
 AUDIT SCOTLAND

To Members of the Fife Council Standards & Audit Committee and the Controller of Audit
28 September 2017

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.



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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

2016/17 annual report and accounts

- 1 Unqualified opinions on the financial statements, management commentary, annual governance statement and governance compliance statement.

Financial management

- 2 The fund has effective arrangements in place for financial management. The fund performed well in the year, though the deficit has widened, due to a fall in the discount rate applied to liabilities.

Financial sustainability

- 3 The fund is under financial pressure, but is sustainable.
- 4 At 31 March 2014, assets covered 87.8% of liabilities. There is a long term recovery plan and employer contributions have risen by 1% a year over the last six years to address the deficit.
- 5 The fund's asset allocation has drifted away from its benchmark investment strategy which suggests it is time for a review of the benchmark.

Governance and transparency

- 6 There is scope to improve governance arrangements by reviewing committee remits, so as to give the sub-committee and pensions board a comprehensive remit over the affairs of the pension fund.
- 7 The Fund could improve current website arrangements with information about the fund and sub-committee / board proceedings.

Value for money

- 8 The fund's investment performance is subject to regular review and scrutiny by the Superannuation Fund and Pensions Sub Committee.
- 9 The Fund outperformed its benchmark in 2016/17 and for the 5 year period to 31 March 2017. The sub-committee has recently been considering proposals to collaborate with the Lothian Pension Fund over investment matters.

Introduction

1. This report is a summary of our findings arising from the 2016/17 audit of Fife Pension Fund (the Fund).
2. The scope of our audit was set out in our Annual Audit Plan presented to the March 2017 meeting of the Standards and Audit Committee. This report comprises:
 - an audit of the annual accounts
 - consideration of the wider dimensions 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 2016/17 have been:
 - an interim audit of the fund's main financial systems and governance arrangements
 - an audit of the fund's 2016/17 annual accounts including the issue of an independent auditor's report setting out our opinions.
4. Fife Council is the administering authority for the pension fund. The council delegates management of the investments and matters relating to the council as administering authority to the Superannuation Fund and Pensions Sub-Committee. The remit of the sub-committee does not include governance matters or approval of the annual accounts, and so this report is addressed to the members of the Standards and Audit Committee.

5. The council also has responsibility for establishing effective governance arrangements and ensuring that financial management is effective. It delegates supervision of governance, review of the effectiveness of internal control arrangements and approval of the annual accounts to the Standards and Audit committee.
6. Our responsibilities as independent auditor 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 provide independent opinions on the annual accounts. We also review and report on the arrangements within the Fund to manage its performance and use of resources such as money and assets. In doing this, we aim to support improvement and accountability.
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 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 action plan at [Appendix 1](#). It sets out specific recommendations, responsible officers and dates for implementation.
11. As part of the requirement to provide fair and full disclosure of matters relating to our independence, we can confirm that we have not undertaken non-audit related services. The 2016/17 audit fee was set out in our Annual Audit Plan and we did not carry out any work additional to our planned audit activity. The fee therefore remains unchanged.
12. This report is also addressed to the Controller of Audit and will be published on Audit Scotland's website www.audit-scotland.gov.uk.
13. We would like to thank all management and staff who have been involved in our work for their co-operational and assistance during the audit.

Part 1

Audit of 2016/17 annual accounts



Main judgements

Unqualified opinions were issued on the 2016/17 annual accounts

We worked with officers to revise and improve the format and layout of the accounts

Unqualified audit opinions

14. The annual accounts for the year ended 31 March 2017 were approved by the Fife Council Standards and Audit Committee on 28 September. We reported, within our independent auditor's report:
- an unqualified opinion on the financial statements;
 - unqualified audit opinions on the management commentary, annual governance statement and governance compliance statement.
15. Additionally, we have nothing to report in respect of those matters which we are required by the Accounts Commission to report by exception.

The annual report and accounts are the principal means of accounting for the stewardship resources and performance in the use of those resources.

Submission of annual accounts for audit

16. We received the unaudited annual accounts on 29 June 2017, in line with our agreed audit timetable.
17. The working papers provided with the unaudited accounts were of a good standard and finance staff provided good support to the audit team which helped ensure the final accounts audit process ran smoothly.

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.

Materiality

19. Materiality defines the maximum error that we are prepared to accept and still conclude that our audit objective has been achieved. The assessment of what is material is a matter of professional judgement. It involves considering both the amount and nature of the misstatement.

20. Our initial assessment of materiality for the annual accounts was undertaken during the planning phase of the audit. Specifically with regard to the financial statements, we assess the materiality of uncorrected misstatements, both individually and collectively.
21. The assessment of materiality was recalculated on receipt of the unaudited financial statements and is summarised in [Exhibit 2](#).

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 0.5% of net assets for the year ended 31 March 2017, based on the latest set of audited accounts.	£22 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.	£13 million
Lower level performance materiality - This is a separate trigger point for the Fund Account (income and expenditure).	£0.7 million
Reporting threshold – We are required to report to those charged with governance on all unadjusted misstatements in excess of the 'reporting threshold' amount. This has been calculated at £100,000.	£100,000

Source: Audit Scotland 2017

Evaluation of misstatements

22. A number of adjustments were identified during the course of our audit. These were discussed with relevant officers, and one adjustment was made to the figures in the accounts. This covered the recognition of a debtor and resulted in an increase in contributions receivable of £0.8 million in the Fund Account. Net assets increased by the same amount in the balance sheet.
23. [Exhibit 3](#) details the significant findings from the audit and includes details of the misstatements identified.
24. In assessing the total error of £3.4 million, we recognised that this exceeded our performance materiality value of £0.7 million on the Fund Account. However we consider that the cessation of East of Scotland European Partnership (ESEP) was an isolated event. We are content that we have identified/estimated the entire error, have considered the impact on our planned audit procedures and decided that no further audit work is required.
25. It is our responsibility to request that all errors are corrected although the final decision on this lies with those charged with governance taking into account advice from senior officers and materiality. All the adjustments we requested have been made in the audited financial statements and we have no unadjusted errors to report.

Significant findings

- 26.** International Standard on Auditing 260 requires us to communicate to you significant findings from the audit. These are summarised below in [Exhibit 3](#). Where a finding has resulted in a recommendation to management, a cross reference to the Action Plan in [Appendix 1](#) has been included.

Exhibit 3

Significant findings from the audit of financial statements

Issue	Resolution
<p>1. Advertisement of the draft accounts</p> <p>The Local Authority Accounts (Scotland) Regulations 2014 provide for public inspection of draft accounts and accounting records.</p> <p>This year, the name of the appointed auditor was omitted and the period of inspection was 13 working days, instead of the statutory 15.</p>	<p>There were no requests to view the accounts and therefore the omission had no impact. Officers agreed to ensure the statutory requirements are followed in 2018/19.</p> <p>Action Plan (Appendix 1, point 1)</p>
<p>2. Disclosure of cessation debtor</p> <p>During the year, the East of Scotland European Partnership (ESEP) ceased to have active members. Under the terms of the LGPS (Scotland) Regulations 2014, the actuary provided a valuation of the net liabilities of ESEP. These amounted to £2,669,000.</p> <p>This sum was not initially recognised as a debtor in the Fund Account.</p>	<p>Recoverability of the debt will depend upon the funds available to ESEP to pay it. Discussions with management indicated that ESEP is unlikely to be able to pay the full amount.</p> <p>The debtor, together with a partial impairment was recognised. There is on-going discussion between the Fund and ESEP. This is disclosed in a note to the financial statements.</p> <p>The carrying amount of the debtor has been adjusted to £0.8 million in the audited financial statements and we have accepted this management estimate of the recoverable amount.</p>
<p>3. Disclosure of derivatives</p> <p>A fund manager makes use of futures contracts to manage risks relating to the bond market. Historically these were valued on a notional basis, rather than an actual basis, a treatment that is not in accordance with the Code.</p> <p>At 31 March 2017, contracts to buy bonds amounting to £2.574 million in three months time were disclosed on the net assets statement, offset by the same amount to indicate that the underlying transaction was not settled, i.e. was notional.</p>	<p>The revised accounts value these instruments according to their profit or loss at the year end. The notional value is disclosed by way of note.</p> <p>Entries in the Net Assets Statement and the notes that referred to the notional value as if it were a real asset were removed.</p> <p>There is no impact on net assets overall because the derivative gains and losses are already included within cash deposits.</p> <p>Action Plan (Appendix 1, point 2)</p>

Data Analytics

- 27.** In 2016/17 we made use of data analytics techniques as part of our audit approach. Data analytics is defined by the International Auditing and Assurance Standards Board (IAASB) as “the science and art of discovering and analysing patterns, deviations and inconsistencies... in the data underlying... an audit ...for the purpose of planning and performing the audit”. Such techniques provide ways

of dealing with high volumes of transactions as well as complexity. They also enhance audit quality and efficiency.

28. We obtained and analysed every general ledger transaction processed in 2016/17: There were 700 postings of which 92 were accounting adjustments. We also used the investment transaction and asset lists prepared by the global custodian.

Completeness and Accuracy: Assurances over member contributions

29. The monthly receipt of contributions from employers and employees created a consistent basis to establish outliers for investigation. Any identified deviations were raised with the administration team. Most of these variations arose from deficit recovery arrangements with employers or from changes to the scheme entry date agreed with employees, but this testing also identified the ESEP cessation which resulted in an adjustment to the audited accounts.

Valuation and classification: Assurances over investments

30. Data in the custodian reports, covering asset valuation and income, were used to compare the classification of investment types between years. This revealed minor areas of difference in disclosure which were adjusted in the audited financial statements.

Classification, cut-off and management bias: assurance over accounts preparation

31. The mapping of the ledger from Trial Balance to the Balance Sheet was confirmed via 100% re-performance.

32. Feeder system close-down (including payroll and the pensions system) was completed promptly at 31 March, with a handful of subsequent entries to complete year-end processing.

33. Manual journals continued after the year end and these were largely complete at the end of May with only 7 manual journals posted in June 2017.

Other Findings

34. Our audit identified a number of presentational and disclosure issues which were discussed with management. These were adjusted and reflected in the audited financial statements.

35. Although the draft financial statements were accurate and supported by good working papers, the disclosures were poorly organised. An historic decision to make disclosures on the face of the main statements had led to a data-heavy set of accounts which obscured key messages and made insufficient use of notes. We were pleased to find that management recognised these problems and were keen to work constructively to remedy them.

Objections to the accounts

36. No objections were received to the Fife Pension Fund accounts.

Part 2

Financial management



Main judgements

The fund performed well in the year, though the deficit has widened

Financial management arrangements are generally sound





Financial performance in 2016/17

37. Pension fund finances are independently assessed every three years by an actuary. This assessment determines the employer contribution rates and deficit funding payments for the upcoming three year period and takes account of the strength of employer covenants and the fund's investment strategy.
38. The Fund's performance in 2016/17 is summarised in [Exhibit 4](#).
39. The net assets of the fund increased to £2.3 billion at 31 March 2017 from £1.9 billion at 31 March 2016. This increase of £0.4 billion (22%) was largely due to strong growth in global stock markets, against a background of an improving world economy and a 12% fall in the value of the pound.

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

Exhibit 4

Assets, liabilities, funding level and investment performance

Increase in net assets	Increase in estimated liabilities	Funding level	Investment performance
			
£408 million (+22%)	£718 million (+29%)	87.8% 2014 Funding valuation	21% Return in 2016/17
£2,262 million Closing net assets	£3,194 million Closing liabilities	2017 triennial funding valuation due December 2017	10.4% Return over 5 years

Source: Fife Council Pension Fund: - Financial Statements 2016/17

40. During 2016/17 contributions to the fund amounted to some £93 million. This exceeded the benefits paid out, which totalled £78 million. After the deduction of administration and governance costs, £14 million was available for re-investment.
41. The financial statements include a figure for the actuarial present value of liabilities. This is calculated on a standard basis across funds that follow international financial reporting standards (IFRS) and allows comparison between funds.
42. As applied to this fund, pension liabilities rose from £2.5 billion at 31 March 2016 to £3.2 billion at 31 March 2017 (£0.8 billion increase). The increase is largely due to the fall in the discount rate, which is based on underlying bond prices. These rose in a response to Brexit and the US election, increasing the overall projected liability.
43. The triennial review is to be reported next year.

Financial management arrangements

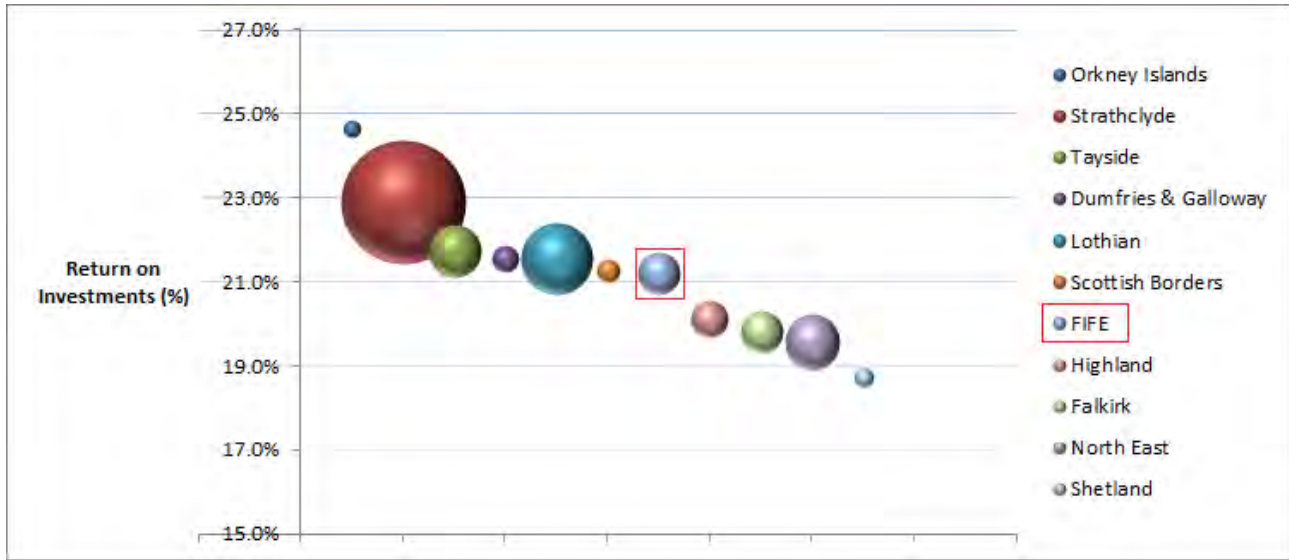
44. The Executive Director Finance and Corporate Services for Fife Council is the proper officer responsible for Fife Pension Fund. The financial regulations of Fife Council, as administering authority, apply to the pension fund. We consider these to be comprehensive, and current, and promote good financial management.
45. The sub-committee receives budget and monitoring reports relating to the pension fund, and periodic reports on administrative performance. It also receives a significant amount of information on investment management and risk. From our attendance at its meetings, there is a good quality of debate and constructive challenge and the sub-committee operates effectively. However, as noted in [Part 4 Governance & Transparency](#), the remit of the sub-committee does not correspond exactly with that required for pension fund governance.
46. We conclude that financial management arrangements are generally sound.

Financial outcomes

47. 2016/17 was a relatively good year for investment performance for most LGPS pension funds across Scotland as illustrated in [Exhibit 5](#). However, the financial outcome for investment management should be considered over a much longer period than just one year, and is a product of asset allocation, risk appetite and manager performance, as well as whether markets went up or down.

Exhibit 5

LGPS pension funds – Net return on investment 2016/17 (unaudited figures)



Source: 2016/17 LGPS pension fund unaudited financial statements

48. Performance against benchmark is a measure of manager performance against the market. Over one, three and five years, the fund has done better than its benchmark (Exhibit 6), though with the exception of last year, it has not reached its target of returning an excess of 1.5%. Over the last five years an average annual return of 10.36% was achieved against a benchmark of 9.41%.

Exhibit 6

Return on investment against benchmark 2016/17

	1 year	3 year	5 year	Since inception 30/06/2003
Fund Performance	21.05%	11.43%	10.36%	8.47%
Target (benchmark +1.5%)	19.91%	11.60%	10.91%	10.09%
Benchmark	18.41%	10.10%	9.41%	8.59%

Source: Northern Trust Investment Report at 31 March 2017

49. We conclude that the investment portfolio achieved its growth target for the year. Over three and five years, it is slightly behind target, due partly to historic under-performance following the 2008 financial crisis. The current trend for investment performance is positive.

50. The fund also achieved a surplus on its dealings with members. However, deficit recovery is a significant contributor to this; the actuary sets contributions at a level to generate surplus cash for investment, so as to eliminate the deficit over a period, which was set at twenty years in the 2014 valuation.

Internal controls

- 51.** As part of our audit we identify and inspect the key internal controls in those accounting systems which we regard as significant for the production of the financial statements. The fund uses a number of the financial systems of the administering authority, Fife Council, as well as its own systems for administering pensions and investments.
- 52.** We concluded that the controls were operating effectively. No significant internal control weaknesses were identified during the audit which could affect the fund's ability to record, process, summarise and report financial and other relevant data so as to result in a material misstatement in the financial statements.

Fraud prevention and detection

- 53.** We assessed the fund's arrangements for the prevention and detection of fraud. The fund relies on Fife Council's arrangements for the prevention and detection of fraud and corruption. These include the Code of Conduct for members and officers, whistleblowing policy and an anti-fraud strategy.
- 54.** We concluded that appropriate arrangements were in place for preventing and detecting fraud and corruption in 2016/17.

National Fraud Initiative

- 55.** The National Fraud Initiative (NFI) in Scotland is a counter-fraud exercise co-ordinated by Audit Scotland. It uses computerised techniques to compare information about individuals held by different public bodies, and on different financial systems, to identify 'matches' that might suggest the existence of fraud or error.
- 56.** NFI activity is summarised in [Exhibit 7](#). This year's matches were available to the council from March and investigated using procedures overseen by the Audit and Risk Management Services Manager. Reports that compare pensions to payroll and pensions to registered deaths are relevant to the pension scheme, and provided a number of leads for investigation.

Exhibit 7

NFI Activity

Total number of matches



555

Number recommended for investigation



216

Completed/closed investigations



138

Source: Fife Council (figures as at 31 July 2017)

- 57.** The number of discrepancies found this year was reported as low and were mostly due to minor delays in the reporting of deaths. The matching exercise remains an important control which provides a formal assurance that the council's records are consistent with those of other public bodies.

Part 3

Financial sustainability



Main judgements

At 31 March 2014, assets covered 87.8% of liabilities. There is a long term recovery plan and employer contributions have had to rise by 1% a year over the last six years to address the deficit

Interim calculations identify a funding ratio of 71% and an updated triennial valuation is due. We have concluded that the fund is under financial pressure, but is sustainable

The current holding of equities of 61% is above the investment strategy benchmark of 55% This may be due to significant increases in equity market valuations rather than changes in investment activity, but it suggests that the benchmark is now out of date and should be reviewed

Funding position

- 58.** The funding position is formally calculated every three years. The most recent, as at 31 March 2014, reported that fund assets were sufficient to meet 87.8% of its liabilities. The actuarial assumptions take into account the strength of the covenant with the lead employer, Fife Council, which is a tax-backed, long term public body. The assumptions are intended to balance recovery of the deficit over a reasonable period against the financial sustainability of the main employer.
- 59.** At the 2014 valuation, the actuary noted that the future service cost of the workforce implied an employers' normal contribution rate of 19.3%. However, as a consequence of the deficit, past service costs required additional employers' contributions of 4.4%. Since 2012, employer contributions rose by around 1% each year, and in 2017/18, will be 24.5% of pensionable salaries. In the current funding climate, the willingness of members to accept on-going increases may prove a challenge.
- 60.** Interim calculations by the fund's actuary indicate continuing pressure on the funding ratio. On the IAS 19 comparison basis for valuing liabilities to pay retirement benefits, Fife has a funding ratio of 71%, compared with the average of the five best-funded LGPS schemes in Scotland of 81% and the average of the five worst-funded schemes, of 68%.
- 61.** The current funding position is due to be determined by the actuary this year, using the 31 March 2017 membership figures. From the valuation, employer contribution rates will be set for the next three years and the funding strategy will be updated. As noted in paragraph 40 above, current contributions are exceeding current benefits, but on a crude and rather simple basis it will take 67 years to recover the existing deficit.
- 62.** We have concluded that the fund is under financial pressure, due to technical factors and to greater longevity of its members. It has a long term recovery

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

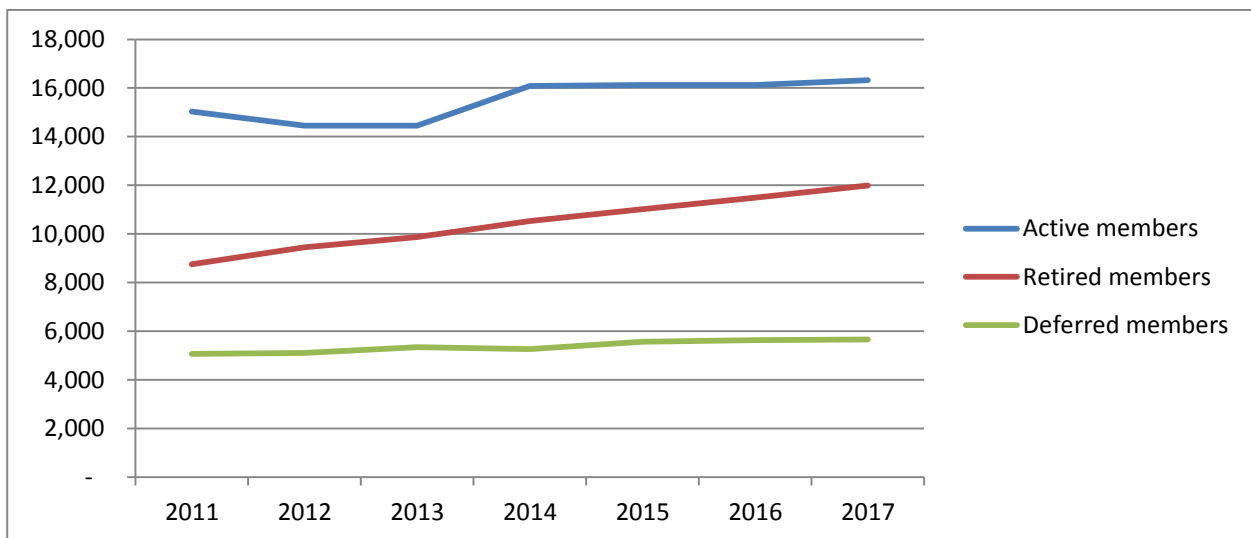
plan, under-pinned by increasing contributions from employers. Taking a long term view, and assuming employers' ability to sustain higher contributions for a period, the fund remains on a sustainable footing.

Membership levels

- 63.** The pension fund is a multi-employer fund with 30 employers. Apart from Fife Council, the largest employer is relatively small with 469 active members. The current membership profile is shown at [Exhibit 8](#). There are two notable features; the impact of auto-enrolment on the number of active members in 2014, and the continuing rise in the number of retired members. Longer life expectancy is a significant factor behind this trend.

Exhibit 8

Membership changes from 2011 to 2017



Source: Fife Pension Fund financial statements 2010/11 to 2016/17

- 64.** Membership of the fund increased by 725 to 33,975 members at 31 March 2017; an increase in active members of 1.2%.
- 65.** The fund gives its members a guarantee that in exchange for contributions during their employment, the fund will pay a pension until the end of each member's life.

Contributions

- 66.** Following the last triennial valuation in 2014, the actuary agreed employer contribution rates with individual employers for the period 2015 to 2018. The approximate split of all contributions received in year is set out at [Exhibit 9](#).

Exhibit 9**Contributions in 2016/17**

	Administering authority £m	Other scheduled bodies £m	Admitted bodies £m	Total £m
Employer contributions	59.7	3.9	5.9	69.5
Employee contributions	15.0	1.2	1.7	17.9
Strain Contributions	2.5	0.2	0.2	2.9

Source: Fife Pension Fund 2016/17 unaudited financial statements

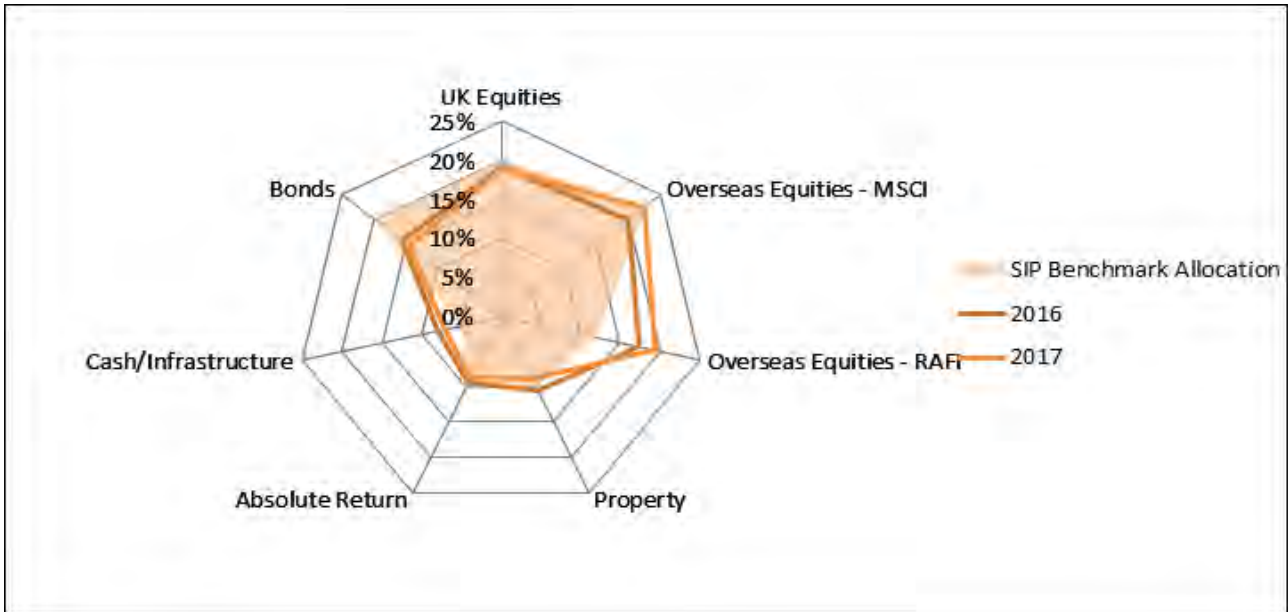
Investment strategy

- 67.** Investment strategy is concerned with achieving growth while incurring an acceptable level of risk. Asset allocation is the main tool available to the fund to manage risk and returns. The asset allocation is set each year in the Statement of Investment Principles. Pension funds typically hold a mixed portfolio, with substantial holdings of assets such as equities, whose values are volatile but potentially grow with inflation, and bonds, which generate predictable levels of income, the value of which is eroded by inflation.
- 68.** For a number of years, Fife Pension Fund has reduced the proportion of more volatile investments (equity has fallen from 71% to 61% since 2010) and increased its holdings of potentially lower risk / lower return investments, such as absolute return funds.
- 69.** The current holding of equities of 61% is above the investment strategy benchmark of 55% (Statement of Investment Principles, Superannuation Fund & Pensions Sub-Committee – November 2016) and the relative holding of bonds is less than the benchmark. This may be due to significant increases in equity market valuations rather than changes in investment activity, but it suggests that the benchmark is now out of date (see [Exhibit 10](#)).

[Action Plan \(Appendix 1, point 3\)](#)

Exhibit 10

Asset allocation against the statement of investment principles Benchmark in 2015/16 and 2016/17



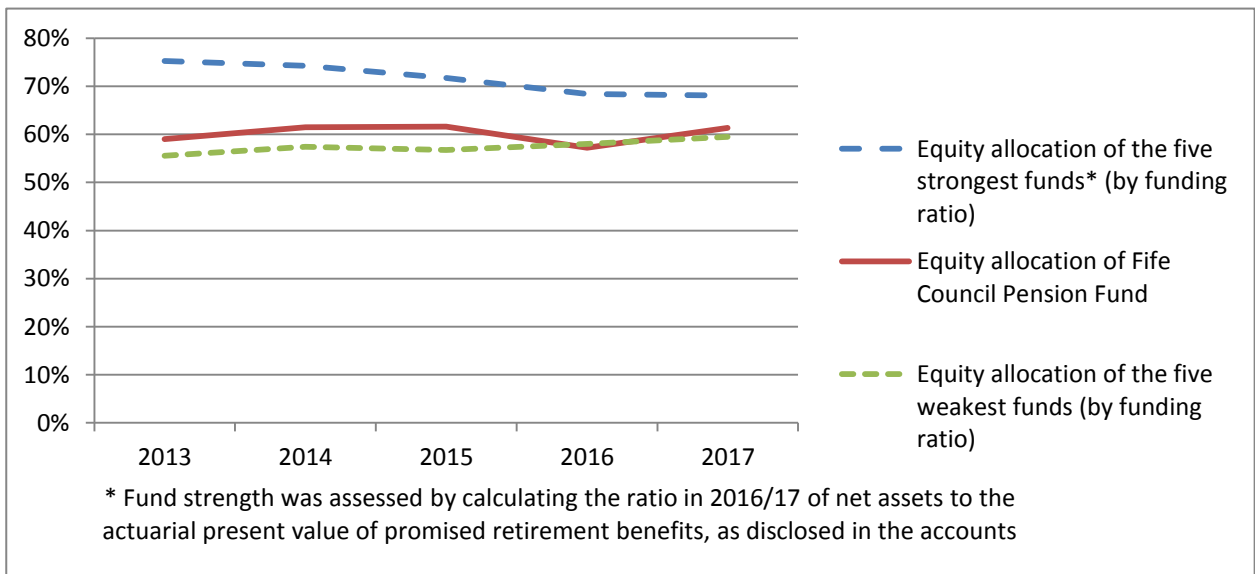
Source: Fife Pension Fund custodian reports and the Statement of Investment Principles (Audit Scotland)

70. There is some evidence that in recent years, across LGPS Scotland as a whole, a low weighting to equities is associated with more acute funding difficulties (see [Exhibit 11](#)). Most funds have reduced their exposure to quoted equities.

Exhibit 11

Percentage of investments allocated to quoted equities

71.



Source: Audit Scotland and published financial statements of funds in the LGPS Scotland

Part 4

Governance and transparency



Main judgements

There is scope to improve governance arrangements by reviewing committee remits, so as to give the sub-committee and pensions board a comprehensive remit over the affairs of the pension fund

The Fund could improve current website arrangements with information about the fund and sub-committee / board proceedings

Governance arrangements

- 72.** Under the [Local Government Pension Scheme \(Scotland\) Regulations 2014](#), Fife Council is required to operate a pension fund and is an administering authority.
- 73.** Fife Council's [scheme of administration](#) establishes a Superannuation Fund and Pensions Sub-Committee and a Pensions Board, which meet quarterly. The sub-committee has a remit "to arrange for the supervision of the management and administration of the investments ...and to..... appoint....fund managers...; and to consider and determine... all matters relating to pensions administered by the Council including:-
- the effect for the Council of early retirals;
 - the effect of "strains on the fund" costs;
 - any matter ... as administering authority for the Superannuation Fund under the Superannuation Regulations;
 - actuarial valuation reports;
 - best value/service efficiency
 - review of contribution rates and admission of new employers."
- 74.** As described above, as well as administration of the fund, the remit of the Superannuation Fund and Pensions Sub-Committee includes additional duties to act on behalf of the council as an employer, for example monitoring the effect for the Council of early retirals and strain on fund costs.
- 75.** The unusual combination of roles probably originated as Fife Council is the employer of the vast majority of active members (86%) as well as scheme administrator.
- 76.** The sub-committee remit contains no direct reference to governance, risk management and audit of the pension fund, which are covered in the remits of

Governance and transparency is concerned with the effectiveness of scrutiny and governance arrangements, leadership and decision-making and transparent reporting of financial and performance information

the Standards and Audit Committee. Although the remit of the Pensions Board includes governance, it has no mechanism to take reports. When a new employer is admitted to the scheme, and when an employer ceases to have active members, the sub-committee may not be informed.

[Action Plan \(Appendix 1, point 4\)](#)

- 77.** As part of our Role of Boards performance study, 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.
- 78.** Employers are required to submit year end contribution returns by May 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. All year end contribution returns relating to 2016/17 have been received.
- 79.** As part of the Fund's governance assurance framework, employers are also required to submit compliance certificates verifying compliance with a range of pension fund and regulatory requirements in relation to pension administration. It has been confirmed that certificates were received from all the fund's major employers.
- 80.** Our work on governance showed that with the exception of the weaknesses discussed above, the arrangements are appropriate and adequate. The sub-committee and board demonstrate constructive engagement with regard to investment and actuarial matters.

Pensions Regulator Public Service Code

- 81.** The council reported the fund's compliance with Code of Practice 14 to the sub-committee on 23 August 2016. One breach was noted; a missed statutory deadline for issuing annual benefits statements to members by 31 August 2016. This year the deadline for issuing annual benefits statements was achieved. However, administration performance is not reported regularly to the sub-committee.

[Action Plan \(Appendix 1, point 5\)](#)

Internal audit

- 82.** Internal audit provides the Standards and Audit Committee with independent assurance on the Fund's overall risk management, internal control and corporate governance processes.
- 83.** The internal audit function is carried out by Fife Council's Audit & Risk Management Services. We carried out 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.
- 84.** To avoid duplication of effort we place reliance on the work of internal audit wherever possible. In 2016/17 we considered internal audit report findings on pension fund governance.

Transparency

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

- 86.** There is evidence from a number of sources which demonstrate the Fund's commitment to transparency. For example, the Superannuation Fund and Pensions Sub Committee and Pensions Board meetings are held in public with commercially sensitive information dealt with in private session and the Fund's annual accounts are available on the council's website.
- 87.** The publication of pension fund documents on the council's website is sometimes unclear or incomplete. Some can be found on the web-page headed Local Government Pension Scheme on the Fife Council web-site. Others are contained within sub-committee papers. The annual report refers to various governance-related documents, but some of these are not easy to find. Though a place-holder page exists, there is very little information about the Pensions Board.

[Action Plan \(Appendix 1, point 6\)](#)

- 88.** Overall, we concluded that the Fund conducts its business in an open and transparent manner but we believe that the Fund could improve current website arrangements by improving accessibility to information about the fund and sub-committee / board proceedings

Part 5

Value for money



Main judgements

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

The Fund outperformed its benchmark in 2016/17 and for the 5 year period to 31 March 2017

External investment manager fees decreased from £7.8 million in 2015/16 to £7.3 million in 2016/17

The sub-committee has recently been considering proposals to collaborate with the Lothian Pension Fund over investment matters

Investment performance

- 89. The Superannuation Fund and Pensions Sub Committee meet on a quarterly basis. A review of fund managers' performance is a standing item on the sub committee's agenda. At each meeting, committee members receive a report outlining overall fund performance including an analysis of risks and returns. They also consider the performance of individual investment managers.
- 90. The fund held cash balances at 31 March 2017 of £116 million, compared with £109 million the year before, which is around 5% of total assets. Other funds hold between <1% and 6% in cash, though the figures vary from year to year.

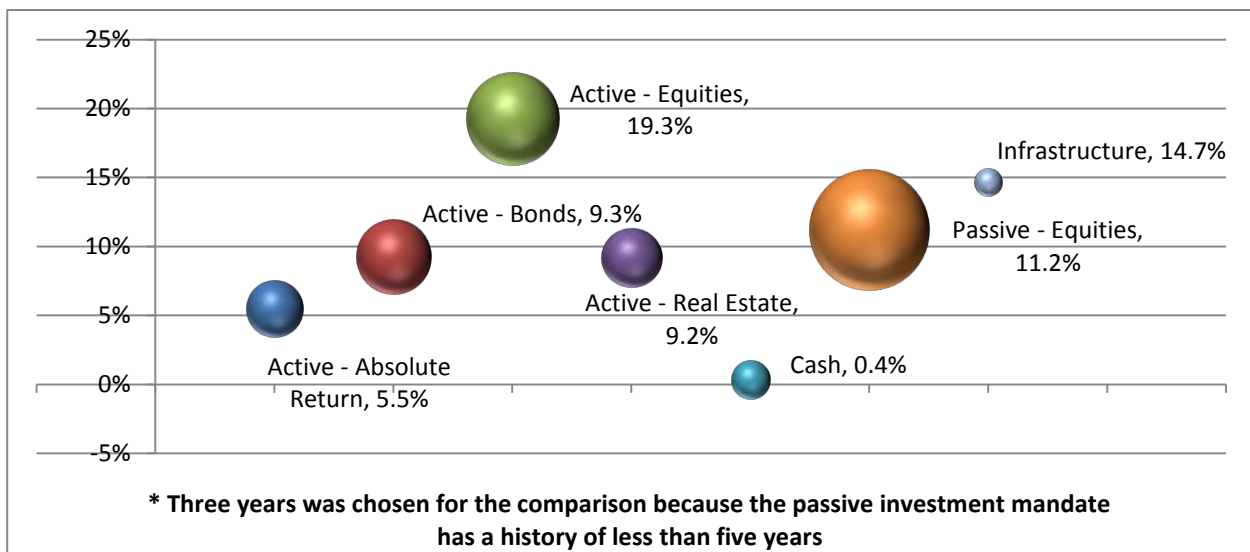
Action Plan (Appendix 1, point 3)

- 91. As shown in paragraph 39 ([Exhibit 6](#)), the Fund outperformed its benchmark in 2016/17 and for the 5 year period to 31 March 2017. The current managers have performed close to the benchmark over their terms of appointment.
- 92. To reduce market risk, the fund holds a diversified portfolio of asset classes, chosen for their different performance characteristics. As shown in [Exhibit 12](#), active equity mandates have outperformed other asset classes over the last three years.

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

Exhibit 12

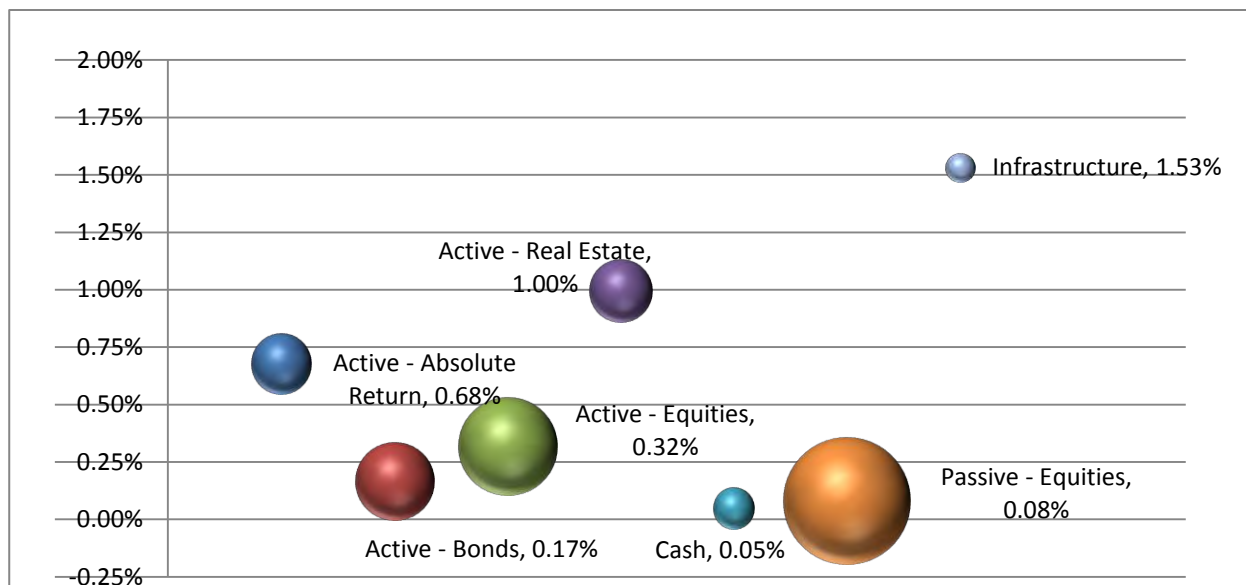
Performance over three years* of the asset classes within the fund as at 31 March 2017



Source: Fife Pension Fund / Audit Scotland

Management expenses

- 93.** There are three main categories of management expense, with the largest being investment management costs. Other expenses are the cost of the administration services provided by the council and the governance fees for actuarial and audit services.
- 94.** CIPFA 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. This means that fees associated with a fund manager's own investment vehicles are included, but those of external funds are not.
- 95.** As shown in [Exhibit 13](#), the level of fees depends on the intensity of investment management; passive funds have the lowest level of fees, while specialist actively managed funds are highest. Around 38% of the fund's assets are in passive equity funds, with an average annual charge of 0.08%.
- 96.** External investment manager fees are agreed in the respective mandates governing their appointments, and decreased from £7.8 million in 2015/16 to £7.3 million in 2016/17. Officers achieved a reduction in fees, despite the rise in market value of assets under management. This reflects downwards pressure on fees across the investment industry, driven by increasing transparency and efficiency.

Exhibit 13**Fund management fees in 2016/17, as percentage of funds under management**

Source: 2016/17 Fife Pension Fund – Audit Scotland

97. We concluded that the Fund has adequate arrangements in place to monitor investment performance and scrutinise investment management expenses.

Administrative expenses

98. 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 further implementation of modules on the Altair (pension administration) system.

99. The Fund's administration strategy sets out a range of service standards against which administration performance is monitored. As noted above, reporting to the sub-committee is limited and could be improved.

[Action Plan \(Appendix 1, point 5\)](#)

Shared services / collaboration

100. The sub-committee has recently been considering proposals to collaborate with the Lothian Pension Fund over investment matters

National performance audit reports

101. Audit Scotland carries out a national performance audit programme on behalf of the Accounts Commission and the Auditor General for Scotland. During 2016/17, we published a number of reports which are of direct interest to the Fund. These are outlined in [Appendix 3](#) accompanying this report.

102. The Local Government Overview report 2015/16 contains a supplement on the LGPS which provides a view of the national picture.

Appendix 1

Action plan 2016/17

2016/17 recommendations for improvement

Page no.	Issue/risk	Recommendation	Agreed management action/timing
9	<p>1. Advertisement of the draft accounts</p> <p>The Local Authority Accounts (Scotland) regulations 2014 make various requirements for the advertisement of accounts and accounting records.</p> <p>This year, there were two deficiencies; the name of the appointed auditor was omitted and the council undertook to make working papers available for 13 working days, instead of the statutory 15</p>	<p>The name of the appointed auditor should be taken from the Annual Audit Plan.</p> <p>The period over which working papers are available to the public should be 15 days, and should not include weekends and holidays.</p>	<p>Processes for the advertisement will be reviewed and included in the year end timetable to ensure the guidelines are complied with.</p> <p>Finance Operations Manager March 2018</p>
9	<p>2. Disclosure of derivatives</p> <p>Historically derivatives have been disclosed on the net assets statement as if futures contracts had been settled and cancelled. This is incorrect under the Code.</p>	<p>The profit or loss on derivative transactions at the year end should be used as the basis for disclosing derivative assets and liabilities. A fuller explanation of the notional values and reasons for the contracts should be given in the notes.</p>	<p>Financial Statements were amended to correct and comply with Code.</p> <p>Finance Operations Manager Complete</p>
17, 22	<p>3. Asset allocation benchmark</p> <p>The Statement of Investment Principles specifies a target asset allocation for investments. We have noted actual holdings are out of line with the benchmark and that cash and infrastructure are treated as identical asset classes.</p> <p>Risk</p> <p>That actual holdings do not reflect SIP benchmarks</p>	<p>The SIP should review its benchmark allocations including the level of cash proposed for the coming year.</p>	<p>The intention is to review the investment strategy, including target asset allocations, following publication of the triennial actuarial valuation.</p> <p>Head of Finance December 2018</p>



Page no.	Issue/risk	Recommendation	Agreed management action/timing
20	<p>4. Sub-committee remit - Governance</p> <p>The agenda for sub-committee and board meetings include items which are the responsibility of the council, while excluding aspects of governance that should relate to the pension fund.</p> <p>Risk</p> <p>Members are not aware of, or do not have an opportunity to consider, significant areas of governance and compliance, relating to the pension fund.</p>	<p>The sub-committee should review its remit.</p>	<p>It is for Fife Council as administering authority to determine the most appropriate governance arrangements, However, a review of the area will be carried out.</p> <p>Head of Finance/Head of Legal Services</p> <p>November 2017</p>
20	<p>5. Sub-committee remit – Administration</p> <p>The sub-committee do not receive information to enable them to monitor the membership of the scheme and compliance with administration targets.</p> <p>Risks</p> <p>Members are not informed about trends in administrative performance which may lead to breaches of pensions' regulations.</p>	<p>The remit of the sub-committee should reflect the importance of pensions' administration and performance monitoring.</p>	<p>Performance measures which reflect the administration function will be submitted to the sub-committee for monitoring</p> <p>Head of Revenues</p> <p>November 2017</p>
21	<p>6. Transparency – Web-site</p> <p>The publication of pension fund documents on the council's website is sometimes unclear or incomplete.</p> <p>Risk</p> <p>Member and the public would be unable to access information</p>	<p>The Pensions site should be expanded to include all current publications, as well as the minutes of sub-committee / board meetings.</p>	<p>As part of the internal audit report it was agreed to update the pension website with the appropriate information</p> <p>Head of Democratic Services</p> <p>November 2017</p>

Appendix 2

Significant audit risks identified during planning

The table below sets out the audit risks we identified during our planning of the audit and how we addressed each risk in arriving at our conclusion. The risks are categorised between those where there is a risk of material misstatement in the annual report and accounts and those relating to 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>ISA 240 requires that audit work is planned to consider the risk of fraud, which is presumed to be a significant risk in any audit. This includes consideration of the risk of management override of controls in order to change the position disclosed in the financial statements.</p>	<ul style="list-style-type: none"> Detailed testing of journal entries and analysis of their nature and distribution. Review of accounting estimates. Focused testing of accruals and prepayments. Evaluation of significant transactions that are outside the normal course of business. 	<p>We reviewed all ledger transactions using data analytics.</p> <p>We confirmed the validity of a sample of 25 journals posted in the year and established the extent and nature of routine journal processing.</p> <p>We confirmed that estimates are supported by third party evidence.</p> <p>Our testing of accruals and prepayments revealed no material errors.</p> <p>We considered no transactions to be outside the normal course of business.</p> <p>There was no evidence for management override of controls.</p>
<p>2 Risk of fraud over income</p> <p>ISA 240 also assumes a risk that income receivable may be misstated.</p>	<ul style="list-style-type: none"> Analytical procedures on income streams. Detailed testing of revenue transactions focusing on the areas of greatest risk. 	<p>All year end contribution returns relating to 2016/17 have been received.</p> <p>Compliance certificates were received from all the fund's major employers.</p> <p>Our analytical procedures revealed income streams that had changed significantly in the year and contribution rates that were higher or lower than expected.</p> <p>Investigation showed that the exceptions were mostly due to actuarial factors, such as deficit contributions and the timing of entry of new admitted bodies.</p> <p>We found no evidence for fraud over income.</p>
<p>3 Accounts preparation</p> <p>The Finance Operations</p>	<p>On-going communication with finance staff to ensure they are aware of</p>	<p>The CIPFA Example Accounts and Disclosure Checklist 2016/17 were used to review the financial statement</p>





















Audit risk	Assurance procedure	Results and conclusions
<p>Division, which is responsible for preparation of the financial statements, was restructured in 2016/17. This resulted in changes to the key staff involved in the accounts preparation process.</p> <p>As staff involved are new to the process there is a risk of omissions or errors which could impact on the completeness and accuracy of the financial statements.</p>	<p>changes impacting on the 2016/17 accounts.</p> <p>Review of disclosure checklists.</p> <p>Review of account closedown procedures.</p>	<p>disclosures.</p> <p>The accounts preparation followed established procedures and management updated them where necessary.</p>
<p>4 Lack of quality review of information in draft Annual Report</p> <p>The previous year's audit report identified that a number of the other statements contained in the draft Annual Report e.g. the Management Commentary, the Market Commentary and the Performance Commentary would have benefited from a quality assurance review and management has agreed to reconsider the content of these in 2016/17 to mitigate the risk of non-compliance and to ensure open and transparent reporting.</p>	<ul style="list-style-type: none"> • On-going discussions with officers about disclosure requirements. • Review of disclosure checklists. • Review of account closedown procedures 	<p>We suggested that readability could be improved by restructuring the annual report and the notes to the financial statements.</p> <p>Management agreed to make significant changes to the layout and also took the opportunity to create a linked, integrated source document for the accounts. This helped eliminate inconsistencies and will assist accounts preparation in future years.</p>
<p>5 Investment valuation</p> <p>Investments include assets, such as property where quoted market prices are not available. The assumptions and judgements behind such valuations may have a significant effect on the fund's net asset value.</p> <p>There is a risk that insufficient consideration is given to the judgements and valuations applied to these investments.</p>	<ul style="list-style-type: none"> • Evaluate the use of experts in performing valuations. • Ensure that disclosure guidelines are appropriately followed. • Evaluate the significant assumptions and judgements made in the valuation of unquoted assets and liabilities. 	<p>We reviewed independently prepared service audit reports detailing internal controls and tests of controls at fund managers and the global custodian.</p> <p>We reviewed the valuation methods used by the global custodian.</p> <p>For the £170 million of funds that are not quoted on an exchange. We used income yield where possible to assess the valuations and concluded they are reasonable.</p>
<p>6 Investment management expenses</p> <p>Investment management costs are subject to increased scrutiny. For example, disclosure is now required for trading taxes, which previously were absorbed within valuation at purchase. Investment management costs have a</p>	<ul style="list-style-type: none"> • Review the calculation of investment management costs and confirm to supporting evidence. • Confirm trading costs are included, as required by current CIPFA / LASAAC 	<p>We reviewed management's analysis of direct and indirect investment management costs and confirmed they were in line with the level of fee stated in the Investment Management Agreements.</p> <p>We confirmed that trading and other costs were correctly calculated, amended the disclosure to agree more</p>

Audit risk	Assurance procedure	Results and conclusions
<p>direct impact on investment performance and expense ratios are commonly compared between funds.</p> <p>There is a risk that measurement errors give a misleading view of costs and performance.</p>	<p>guideline.</p> <ul style="list-style-type: none"> Assess whether costs are grossed up where appropriate, and not subsumed within valuations. 	<p>closely with the Code.</p> <p>We concluded that investment management costs are stated in accordance with the Code.</p>

Appendix 3

Summary of national performance reports 2016/17



Apr			
May		Common Agricultural Policy Futures programme: an update	
Jun		South Ayrshire Council: Best Value audit report	 The National Fraud Initiative in Scotland
Jul		Audit of higher education in Scottish universities	 Supporting Scotland's economic growth
Aug		Maintaining Scotland's roads: a follow-up report	 Superfast broadband for Scotland: a progress update
			 Scotland's colleges 2016
Sept		Social work in Scotland	 Scotland's new financial powers
Oct		Angus Council: Best Value audit report	 NHS in Scotland 2016
Nov		How councils work – Roles and working relationships in councils	 Local government in Scotland: Financial overview 2015/16
Dec		Falkirk Council: Best Value audit report	 East Dunbartonshire Council: Best Value audit report
Jan			
Feb		Scotland's NHS workforce	
Mar		Local government in Scotland: Performance and challenges 2017	 i6: a review
			 Managing new financial powers: an update

Pension fund relevant reports

[Local Government in Scotland Financial Overview 2015/16 – LGPS Supplement](#) – November 2016.

Fife Pension Fund

2016/17 Annual Audit Report

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Audit Scotland, 4th Floor, 102 West Port, Edinburgh EH3 9DN
T: 0131 625 1500 E: