



# Strathclyde Pension Fund

2015/16 Annual audit  
report to Members and  
the Controller of Audit

September 2016

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The Accounts Commission is a statutory body which appoints external auditors to Scottish local government bodies ([www.audit-scotland.gov.uk/about/ac/](http://www.audit-scotland.gov.uk/about/ac/)). Audit Scotland is a statutory body which provides audit services to the Accounts Commission and the Auditor General ([www.audit-scotland.gov.uk/about/](http://www.audit-scotland.gov.uk/about/)).

Gillian Woolman, Assistant Director, Audit Scotland, is the engagement lead for Strathclyde Pension Fund for the period 2011/12 to 2015/16.

This report has been prepared for the use of Strathclyde Pension Fund and no responsibility to any member or officer in their individual capacity or any third party is accepted.

The information in this report may be used for the Accounts Commission's annual overview report on local authority audits published on its website and presented to the Local Government and Regeneration Committee of the Scottish Parliament.

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# Key messages

## Audit of financial statements

- An unqualified auditor's report has been issued on the 2015/16 financial statements.

## Financial management and sustainability

- A good financial management framework is in place. However there is scope to further improve benchmarking of administration and management costs.
- Net assets increased by 1.9% to £16,058m.
- The March 2014 triennial valuation reports that the fund assets were sufficient to meet 94.3% of its liabilities. The interim valuation as at 31 March 2016 by the funds actuary, estimated that the funding deficit had deteriorated to 86.1% primarily due to the continuing trend of falling gilt yields which have pushed up liability values.
- The fund currently pays more out in benefits to pensioners than it receives in contributions from employers and members. The investment strategy was revised following the 2014 actuarial valuation to reflect this.
- The Investment Strategy objective is for the fund to be fully funded in 10 years.

## Governance and transparency

- The fund has coped well with the introduction of the new governance arrangements introduced by the Local Government Pension Scheme (LGPS) 2015.
- The pension board was established in March 2015 and meets concurrently with the pension fund committee.
- The fund has reviewed its own compliance with the Pension Regulator Public Sector Code. Overall compliance was assessed as being adequate and an action plan has been developed to address those areas in need of improvement.
- A training programme is in place for councillors and board members.
- The pension fund committee reviewed internal control arrangements in June 2016 along with the effectiveness of internal audit.

**Best Value**

- Arrangements for the prevention and detection of fraud and corruption are satisfactory.
- Satisfactory arrangements are in place for all stakeholders to access Committee and Board papers

- The fund outperformed its benchmark for the year and is slightly ahead over the 5 year period.
- The fund was the 2nd best performing fund in Scotland in terms of return on investment.
- Administration performance remains good although the performance in relation to administering retirals continues to be below target.

**Outlook**

- The outlook for local government and pension funds remains challenging as funding cuts continue to impact staff numbers in local government and across the public sector.
- There are ongoing administrative pressures due to the volume of work associated with severance and with changes to the LGPS and state pension arrangements.
- Investment performance and scheme management costs are likely to come under increasing scrutiny and Scottish Ministers have already expressed an interest in the views of the national Scheme Advisory Board on fund structure and asset pooling. The Scheme Advisory Board has convened a working group with a view to producing an options paper in December.

# Introduction

1. This report is a summary of our findings arising from the 2015/16 audit of Strathclyde Pension Fund. The report is divided into sections which reflect our public sector audit model.
2. The management of Strathclyde Pension Fund is responsible for:
  - preparing financial statements which give a true and fair view
  - implementing appropriate internal control systems
  - putting in place proper arrangements for the conduct of its affairs
  - ensuring that the financial position is soundly based.
3. Our responsibility, as the external auditor of Strathclyde Pension Fund, is to undertake our audit in accordance with International Standards on Auditing, the principles contained in the Code of Audit Practice issued by Audit Scotland in May 2011 and the ethical standards issued by the Auditing Practices Board.
4. An audit of financial statements is not designed to identify all matters that may be relevant to those charged with governance. It is the auditor's responsibility to form and express an opinion on the financial statements; this does not relieve management of their responsibility for the preparation of financial statements which give a true and fair view.
5. [Appendix III](#) is an action plan setting out our recommendations to address the high level risks we have identified during the course of the audit. Officers have considered the issues and agreed to take the specific steps in the column headed "Management action/response". We recognise that not all risks can be eliminated or even minimised. What is important is that Strathclyde Pension Fund understands its risks and has arrangements in place to manage these risks. The pension fund committee should ensure that they are satisfied with the proposed action and have a mechanism in place to assess progress and monitor outcomes.
6. We have included in this report only those matters that have come to our attention as a result of our normal audit procedures. Consequently, our comments should not be regarded as a comprehensive record of all deficiencies that may exist or improvements that could be made.
7. The cooperation and assistance afforded to the audit team during the course of the audit is gratefully acknowledged.
8. 2015/16 is the final year of the current five year audit appointment. From 2016/17 the auditor of Strathclyde Pension Fund will be a new team from Audit Scotland. In accordance with agreed protocols and International Standards on Auditing we will be liaising with the incoming audit team as part of this transition.

# Audit of the 2015/16 financial statements

<p><b>Audit opinion</b></p>	<ul style="list-style-type: none"> <li>• We have issued an unqualified independent auditor’s report.</li> </ul>
<p><b>Going concern</b></p>	<ul style="list-style-type: none"> <li>• The financial statements of Strathclyde Pension Fund have been prepared on the going concern basis. We are unaware of any events or conditions that may cast significant doubt on the pension fund’s ability to continue as a going concern.</li> </ul>
<p><b>Annual report &amp; other information</b></p>	<ul style="list-style-type: none"> <li>• We review the annual report and information published with the financial statements, including the management commentary and the annual governance statement. We have nothing to report as a result of our review.</li> </ul>

## Submission of financial statements for audit

9. We received the unaudited financial statements on 27 June 2016, in accordance with the agreed timetable. The working papers were of a good standard and both Glasgow City Council and Strathclyde Pension Fund staff provided good support to the audit team which assisted the delivery of the audit to deadline.

## Overview of the scope of the audit of the financial statements

10. Information on the integrity and objectivity of the appointed auditor and audit staff, and the nature and scope of the audit, were outlined in our Annual Audit Plan presented to the Strathclyde Pension Fund Committee in March 2016.
11. As part of the requirement to provide full and fair disclosure of matters relating to our independence, we can confirm that we have not undertaken non-audit related services. The 2015/16 agreed fee for the audit was set out in the Annual Audit Plan and, as we did not carry out any work additional to our planned audit activity, the fee remains unchanged.
12. The concept of audit risk is of central importance to our audit approach. During the planning stage of our audit we identified a number of key audit risks which involved the highest level of judgement and impact on the financial statements and consequently had the greatest effect on the audit strategy, resources and effort. We set out in our Annual Audit Plan the audit work we proposed to undertake to secure appropriate levels of

assurance. [Appendix I](#) sets out the significant audit risks identified during the course of the audit and how we addressed each risk in arriving at our opinion on the financial statements.

13. Our audit involved obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error.

## Materiality

14. Materiality can be defined as the maximum amount by which auditors believe the financial statements could be misstated and still not be expected to affect the decisions of users of financial statements. A misstatement or omission, which would not normally be regarded as material by amount, may be important for other reasons for example, an item contrary to law.
15. We consider materiality and its relationship with audit risk when planning the nature, timing and extent of our audit and conducting our audit programme. Specifically with regard to the financial statements, we assess the materiality of uncorrected misstatements, both individually and collectively.
16. We summarised our approach to materiality in our Annual Audit Plan. Based on our knowledge and understanding of Strathclyde Pension Fund and following receipt of the unaudited financial statements, we have revised our materiality for 2015/16 at £5.0m or 1% of benefits paid for the Fund 1 Account and £0.07m for the Fund 3 Account. For the Net Assets Statement, for Fund 1

materiality was set at £80.3m or 0.5% of net assets and £0.9m for Fund 3.

17. Performance materiality was revised to £4.0m and £0.6m for Fund 1 Account and Fund 3 Account respectively and £52.2m and £0.6m for the respective Net Asset Statements. This reduces to an acceptable level the probability of uncorrected and undetected audit differences exceeding our planning materiality level. We also report all misstatements greater than £100,000.

## Evaluation of misstatements

18. A number of presentational adjustments were identified within the financial statements during the course of our audit. These were discussed with relevant officers who agreed to amend the unaudited financial statements.

## Significant findings from the audit

19. International Standard on Auditing 260 requires us to communicate to you significant findings from the audit, including:
- The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures.
  - Significant difficulties encountered during the audit.
  - Significant matters arising from the audit that were discussed, or subject to correspondence with management.
  - Written representations requested by the auditor.

- Other matters which in the auditor's professional judgment, are significant to the oversight of the financial reporting process.

20. During the course of the audit we identified the following significant issues that, in our view, require to be communicated:

**Table 1: Significant findings from the audit****Significant findings from the audit in accordance with ISA260****Investment management expenses**

In June 2016, CIPFA published revised guidance on local government pension scheme management expenses. This guidance sets out a framework for the reporting of local government pension scheme investment management costs and it was expected that this would be applied from the 2016/17 accounting year. Strathclyde Pension Fund have elected for early adoption and changed the financial statements in 2015/16.

The new guidance recommends that only expenses that can be directly controlled by the fund should be included. As such, Strathclyde Pension Fund has removed the 'fund of fund' expenses relating to private equity managers. We accept that this is in accordance with the revised guidance and that £87m in investment management expenses for Fund No 1 have been reported in 2015/16. Investment management expenses of £125m were disclosed in the 2014/15 audited financial statements and this has been restated to £90m based on the revised guidance.

We are satisfied with the accounting treatment applied in 2015/16 and with the restatement to the 2014/15 accounts, in this respect.

Whilst the change in guidance has reduced the value of investment management expenses reported, the value remains significant and the fund should continue to develop the use of benchmarking indicators to review and evaluate whether those expenses demonstrate value for money.

**Appendix III - Action 2**

## Significant findings from the audit in accordance with ISA260

### Assurance received from management experts

Under International Standard on Auditing 500, we assess management's reliance on Northern Trust, the Fund's global custodian, and investment managers used by the fund. Northern Trust maintains the core data of the pension investments system and provides the year end balances for the financial statements. Our assurance work considers the service auditor's report on internal controls in Northern Trust and we consider the service audit reports for all investment managers used by the fund. These service auditor reports are reported as a source of assurance in the Annual Governance Statement. No issues have been reported in the service auditor reports. However the service auditor's opinion for 2015/16 on Northern Trust's control environment specifically excludes giving an opinion on:

- the controls of third party service organisations used by Northern Trust to obtain information for the valuation of securities eg sub-custodians
- Northern Trust's approach to business continuity and disaster recovery.

These findings are in common with other investment managers. From discussion with management we are assured that they do not feel exposed in respect of the absence of such assurances: Northern Trust and investment managers are subject to regulation by the Financial Conduct Authority (FCA). This requires proper business continuity and disaster recovery arrangements to be in place. In addition, subsequent to year end, the service auditor's report for Northern Trust for the 6 months to June 2016 now provides positive assurance on business continuity and disaster recovery arrangements (although not for sub-custodians). It does not however cover the systems of 3<sup>rd</sup> party service organisations.

For the purpose of the 2015/16 audit we have adequate assurance that management can place reliance on these third parties but would encourage further development of the increasing assurance that has been provided post year end.

**Appendix III - Action 4**

## Significant findings from the audit in accordance with ISA260

### Business Continuity/Disaster Recovery

A major incident occurred in December 2015 when a fault in Glasgow City Council's primary data centre resulted in damage to servers and significant loss of ICT access for Strathclyde Pension Fund. Internal Audit has concluded that the control environment was unsatisfactory and that there are a number of serious control deficiencies where the potential operational risk exposure is significant.

In addition, there have continued to be delays in completing disaster recovery testing on the Altair system. This has been reported as an outstanding action since 2014/15.

From our audit work we are satisfied that there was no significant loss of data which would impact on the preparation of the financial statements. However it is important for this test to be completed as soon as possible.

**Appendix III - Action 3**

### Funding position

The financial statements show a net deficit of £14.8m (for both Fund 1 and Fund 3) from contributions received from members over benefits paid. Other than a likely improved short-term cashflow position due to auto-enrolment, a negative cashflow is predicted over the longer term. Strathclyde Pension Fund closely monitors the cash flow position at every meeting of the Pension Fund Committee. In addition, a 10 year cashflow projection is reviewed annually by the Pension Fund Committee.

The net cash flow predictions have informed the Fund's recent revised Investment Strategy. Strathclyde Pension Fund has the objective of achieving a funding target of 100% within 10 years. Careful management of investments and investment income will be required to ensure that this target is met.

**Appendix III - Action 1**

## Future accounting and auditing developments

### Code of Audit Practice

21. A new Code of Audit Practice will apply to all audits from financial year 2016/17. There will be a greater focus on four areas:
- Financial sustainability
  - Financial management
  - Governance and transparency; and
  - Value for money.
22. In addition, as well as the annual audit report, other significant outputs, such as the annual audit plan will be published on Audit Scotland's website.

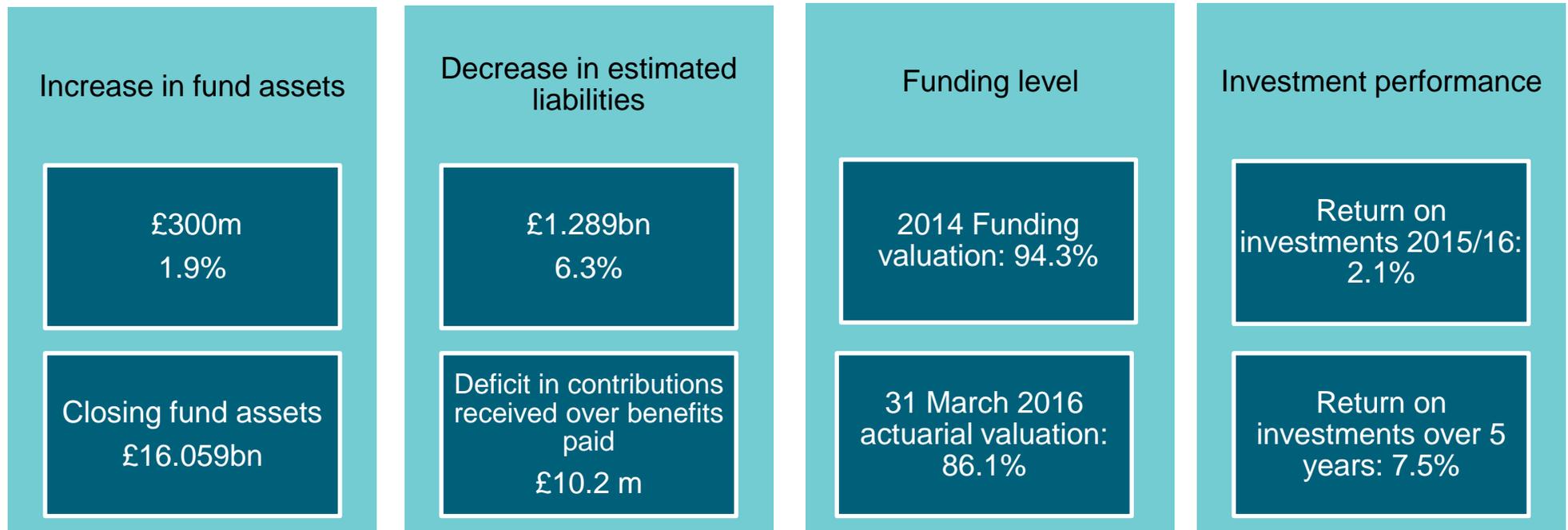
### Code of Practice on Local Authority Accounting

23. The financial statements of pension funds are prepared in accordance with the Code of Practice on Local Authority Accounting in the UK (the Code) which interprets and adapts International Financial Reporting Standards (IFRS) to the local authority context. There are amendments to the Code in respect of:
- Amendments to the format of the accounts to be consistent with the new Financial Reports of Pension Schemes – Statement of Recommended Practice 2015.
  - New disclosure requirements for investments measured at fair value.

- Recommendations for a new disclosure on investment management transaction costs.

24. Strathclyde Pension Fund have elected for early adoption of CIPFA Accounting for Local Government Pension Scheme Management Expenses 2016 guidance and this has been reflected in the 2015/16 financial statements. It has also resulted in a prior year adjustment to the 2014/15 statements for investment management expenses.

# Financial management and sustainability



Source: Strathclyde Pension Fund - Fund 1 2015/16 audited financial statements

## Financial management

25. In this section we comment on the pension fund's financial outcomes and assess financial management arrangements.
26. Pension fund finances are independently assessed every three years by the fund actuary. This assessment determines the employer contribution rates and deficit funding payments for the

upcoming 3 year period and takes account of the strength of employer covenants and the fund's investment strategy.

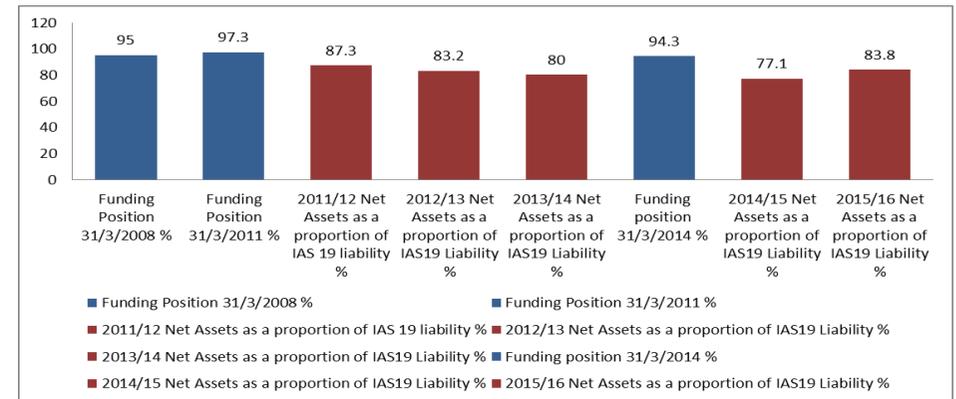
27. Setting the fund's investment strategy and monitoring performance against it are key aspects of financial management. Developing the investment strategy is a complex area and has to take account of factors such as the overall fund deficit, cash flows from dealing with members and the maturity of fund membership.

28. Following the 2014 valuation, Strathclyde Pension Fund Committee approved the diversification of the investment strategy to address the predicted (increasingly negative) cashflow of the fund in the long term. The change in strategy was to reduce the fund's equity exposure in favour of a more diversified strategy. This is being developed using a risk-based framework which was approved by Strathclyde Pension Fund Committee in March 2015.
29. One of the most notable changes in 2015/16 is the increase in value of the Direct Investment Portfolio (formerly the New Opportunities Portfolio). The committee agreed to increase the capacity from 3% to 5% of total Fund assets. Approved investment in DIP has increased from £328m in 2014/15 to £609m in 2015/16.

### Financial outcomes

30. In overall terms the Scottish LGPS funds remain better funded than English and Welsh counterparts. Exhibit 1 shows the funding position of Strathclyde Pension Fund since 2008.

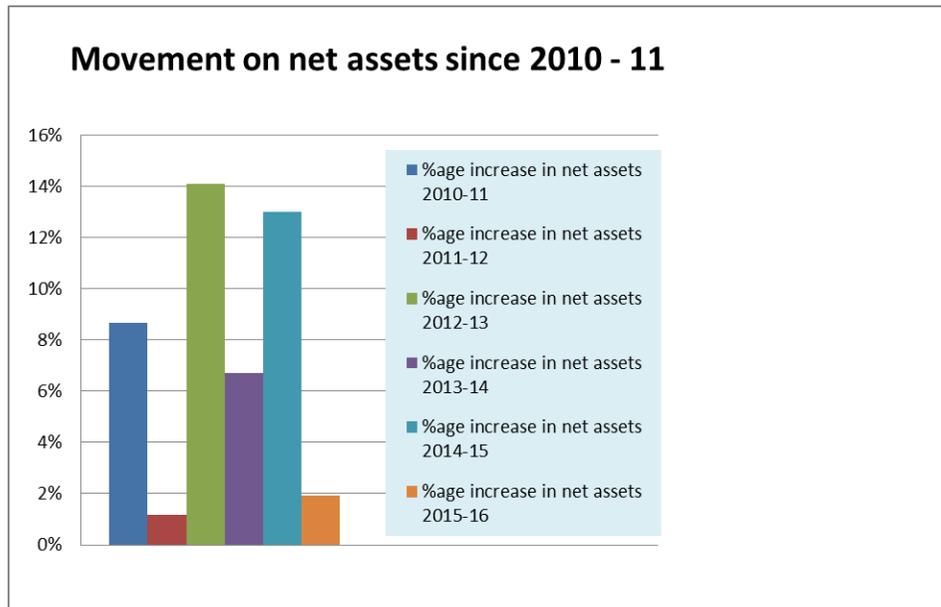
**Exhibit 1: Funding position – triennial and roll forward IAS 19**



Source: Strathclyde Pension Fund 2015/16 audited financial statements

31. The assets of the fund, compared to 31 March 2015, have increased by 1.9% and estimated pension liabilities have reduced by 6.3%. This is due to movements in the value of the real discount factor, used to estimate the current value of future pensions; the real discount factor has increased from 0.8% at March 2015 to 1.3% at March 2016. As a higher real discount rate results in lower value for pension liabilities, the increased rate from March 2016 has had a positive impact on the net assets value in the Fund Statement.
32. The pension fund received less income from its dealings with members than it paid out in benefits in 2015/16. The Fund Account for Fund 1 shows a net reduction in Dealings with Members of £10.2m. Investment income increased by 14.3%, relative to last year, and reported a total investment return of 2.1%. The overall increase in net assets is shown in Exhibit 2.

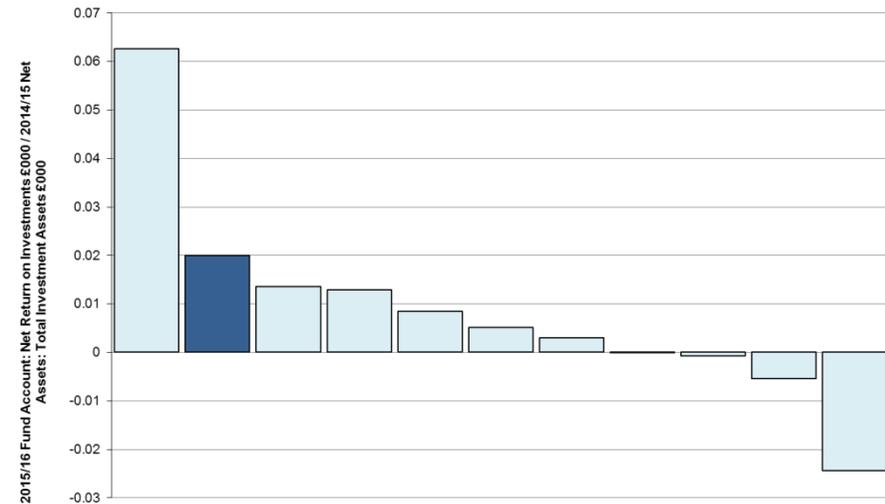
**Exhibit 2: Movement on net assets since 2010-11**



Source: Strathclyde Pension Fund 2015/16 audited financial statements

33. Investment performance is a key element in the movement in net assets. In terms of investment performance, 2015/16 has, for most LG schemes, not been a good year. Investment performance for Scottish Pension Funds is shown in Exhibit 3; Strathclyde Pension Fund is the shaded one.

**Exhibit 3: Net return on investments 2015-16**



Source: unaudited 2015/16 financial statements

- 34. Pension funds set a benchmark and Strathclyde Pension Fund investment return performance, at 2.1%, considerably exceeded its benchmark of 0.3%. Performance against the WM average of UK pension funds is 0.8%
- 35. Fund 3 reported a decline in net assets of £3.2m. It also reported a continuation of deficits from member dealings of £4.6m. Investment performance of the year was negative against benchmark, with a 0.8% return.
- 36. Performance over the 3 year, 5 year and 10 year benchmark for both Fund 1 and Fund 3 is shown in Exhibit 3a.

**Exhibit 3a: Performance against benchmark**

Fund 1	Benchmark	Performance
One Year	0.3%	2.1%
Three Years	6.6%	7.4%
Five Years	6.9%	7.5%
Ten Years	5.8%	5.7%
Fund 3	Benchmark	Performance
One Year	1.75%	0.8%
Three Years	8.0%	6.9%
Five Years	8.3%	9.1%
Ten Years	7.8%	8.1%

*Source: Strathclyde Pension Fund 2015/16 audited financial statements*

**Financial management arrangements**

37. As auditors, we need to consider whether the pension fund has established adequate financial management arrangements. We do this by considering a number of factors, including whether:
- the proper officer has sufficient status within the pension fund to be able to deliver good financial management
  - financial regulations are comprehensive, current and adhered to

- reports monitoring performance against budgets are accurate and provided regularly to members
- monitoring reports do not just contain financial data but are linked to information about performance
- members provide a good level of challenge on significant variances and under performance.

38. The Executive Director of Financial Services for Glasgow City Council is the proper office responsible for Strathclyde Pension Fund. During 2015/16, the Strathclyde Pension Fund Committee approved a change in management structure, appointing a director of Strathclyde Pension Fund Office. This was to recognise the size, complexity and increasing volume of scheme administration of the fund, following the introduction of the LGPS 2015 and the new governance requirements of the Pensions Regulator.
39. The financial regulations of Glasgow City Council, as administering authority, apply to the pension fund. We consider these to be sufficiently comprehensive and current and we have concluded that the pension fund's financial management arrangements are sound.
40. Investment and administration performance reports are submitted to the Strathclyde Pension Fund Committee on a quarterly basis. Reports are comprehensive and we have observed a good level of review and scrutiny by councillors and board members at meetings attended.

## Conclusion on financial management

41. The pension fund has effective financial management arrangements. Reports on funding and investment performance are actively monitored.

## Financial sustainability

42. The pension fund is a multi-employer fund with 12 Local Authorities, and around 200 other employers. Cessation costs and deficit payments are reported in the triennial actuarial report. Guarantees are required for all new employer bodies admitted to the scheme.
43. One of the fundamental aims of Strathclyde Pension Fund's revised Funding Strategy Statement is to ensure that there are sufficient funds to meet pension obligations. In line with the Investment Strategy, the fund has now begun to diversify its asset portfolio.
44. The split of employer contributions in 2015/16 between current service, strain on the fund, and deficit funding is shown in Exhibit 4.

### Exhibit 4: Employer contributions

	Current service £m	Deficit funding contributions £m	Strain on the fund £m
Contributions received	365.0	9.6	16.4

Source: Strathclyde Pension Fund 2015/16 audited financial statements

45. Employer rates and deficit funding are agreed with employers following a triennial actuarial valuation. The scheme rate for employers' contributions has been set at 19.3% and this has remained stable since 2011/12. This stability in the rate has assisted employers in their financial planning.
46. The pension fund has reported a net loss from dealings with members of £10.2m for Fund 1 and £4.6m for Fund 3. Membership of the fund increased by 5,397 to 216,274 members at 31 March 2016; an increase in active members of 2.9%. This increase is expected to continue with auto-enrolment, which is predicted to have a more significant impact in 2017/18.
47. Strathclyde Pension Fund actively monitors its cash-flow position and reports the position to every meeting of the Pension Fund Committee. A 10 year cash-flow forecast is prepared annually and is submitted to the Pension Fund Committee every March. The March 2016 report forecasts that the negative cash flows will be an

ongoing trend, although auto-enrolment is expected to have a positive impact on the cashflow position. It is likely that the Pension Fund will have to fund pension payments from investment income going forward for at least the next 10 years.

### Appendix III - Action 1

## Conclusion on financial sustainability

48. We have concluded that despite forecast cash flows being negative in the medium to long term, Fund management has taken this into account and revised the Investment Strategy moving away from growth generating assets such as equities to income generating assets, thus meeting the more immediate needs of the Fund.

## Outlook

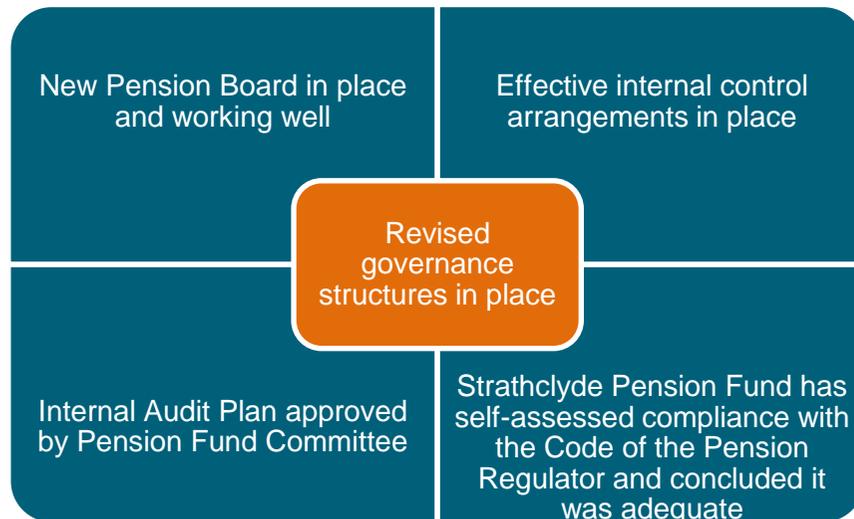
49. The 2015 LGPS includes a cost sharing arrangement which will cap employer costs in relation to current service and help ensure that the pension scheme remains affordable to employers. Additionally, the retirement age for most LGPS members going forward is linked to the state retirement age and this may also act to limit scheme liabilities for active members.

50. The impact of the outcome of the referendum on membership of the European Union has added uncertainty to the markets and it is recognised that this may have an impact on the values of both assets and liabilities held by the pension fund.

51. The financial outlook across the public sector remains challenging. Recent revisions to the LGPS aim to ensure that the scheme is affordable to employers going forward whilst the scheme remains attractive to employees.

52. Management costs and investment performance are likely to come under increasing scrutiny given the financial pressures faced by employers and employees alike. Pension funds may need to be more radical in their approaches to administration and investment going forward.

# Governance and transparency



53. Members and management of the council, supported by the pension board, are responsible for establishing arrangements to ensure the proper conduct of the affairs of the Strathclyde Pension Fund in accordance with the law and proper standards and for monitoring the adequacy and effectiveness of these arrangements.
54. As part of our work we reviewed various aspects of governance that apply to Strathclyde Pension Fund including Standing Orders, Financial Regulations, Codes of Conduct for officers and members, anti-fraud and corruption arrangements, and arrangements for reporting breaches of regulation to the Pension

Regulator. Overall, we concluded that there are open and transparent arrangements in place, although there are some areas where practices could be improved eg in reporting of compliance with Pension Regulator.

## Governance structure

55. 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 Pension Board is to support the Pension Committee in compliance with regulations imposed by the Pension Regulator. The Pension Committee and Pension Board met concurrently throughout 2015/16.
56. The Pension Board consists of 4 employer representatives and 4 union representatives and each side appoints a joint secretary. The chair is alternated between employer and union representatives and is currently an employer representative.
57. The governance structure of the pension fund is set out in Exhibit 5.

## Exhibit 5: Governance structure



## Pension Regulator Public Service Code

58. The Pension Regulator issued a code on the governance and administration of public service pension schemes in January 2015. The pension fund carried out a review against the code in 2015/16 which concluded there was general compliance with the code. An action plan has been developed by officers to achieve full compliance.
59. As reported in its 2015/16 annual report, the pension fund has not reported any breaches to the Pension Regulator during 2015/16. We have been advised that all member annual certificates were issued by the required date of 31 August 2016.
60. In order to achieve the statutory target of issuing all member benefit statements, Strathclyde Pension Fund had to rely on employers supplying actual salary details. From the initial returns received back, there was a rejection rate of 22.2% due to incomplete data. This level of error seriously impacts the pension fund's ability to achieve statutory targets.
61. Although no report has been made to the Pension Regulator on the employers not supplying the data, as it was the first year, should such failures occur in future years, Strathclyde Pension Fund should consider reporting breaches to the Pension Regulator.

## Internal control

62. The Local Authority Accounts (Scotland) Regulations 2014 require the Pension Fund Committee to consider the findings of an annual

review of the system of internal control and to approve the Annual Governance Statement for the pension fund.

63. As part of our audit we reviewed the high level controls in a number of systems fundamental to the preparation of the financial statements. Our objective was to obtain evidence to support our opinion on the pension fund's financial statements.
64. No material weaknesses in the accounting and internal control systems were identified which could adversely affect the ability to record, process, summarise and report financial and other relevant data so as to result in a material misstatement in the financial statements.

## Internal audit

65. Internal audit provides members and management with independent assurance on risk management, internal control and corporate governance processes for the pension fund.
66. We are required by international auditing standards to make an assessment of internal audit to determine the extent to which we can place reliance on its work. We have concluded that Internal Audit complies with the requirements of the Public Sector Internal Audit Standards. This enabled us to take assurance from their documentation and reporting procedures.
67. There was a separate 2015/16 Internal Audit Plan in respect of the pension fund which went to Pension Fund Committee in March 2015. The Internal Audit Plan included coverage of key financial systems used by the pension fund.

## ICT audit

68. The data centre incident that took place in December 2015 has highlighted the importance of strong business continuity arrangements. Internal audit reported in 2014/15 on the lack of business continuity testing undertaken on the Altair pension administration system. The testing remains outstanding.

**Appendix III -**

**Action 3**

69. The investments system is held on the global custodian's IT systems and the custodian supplies the data for the financial statements. The service auditor report for the global custodian does not include assurance on business continuity arrangements in place for the IT systems. Additional independent assurance should be obtained by Strathclyde Pension Fund on these arrangements.

**Appendix III - Action 4**

## Standards of conduct and arrangements for the detection and prevention of fraud and corruption

70. Councillors and board members have received training on council policies and have been directed to consider the Pension Regulator toolkit on regulations and conflicts of interest.
71. The National Fraud Initiative (NFI) in Scotland brings together data from councils, police and fire, health bodies and other agencies, to identify circumstances (matches) that might suggest the existence of fraud or error.

72. The fund actively follows up the results of the NFI exercises and work on investigating the matches identified progresses well.

## Transparency

73. The pension fund has a separate website which includes the various policies and strategies of the pension fund. Pension Fund Committee and Pension Board papers are available on the website and there is a good level of transparency around pension fund business.

74. The annual report and accounts is comprehensive and helps ensure a good level of financial scrutiny and accountability. Areas where transparency could be further improved, as reported in our 2015/16 controls report, include monitoring progress against compliance with Pension Regulator action plan and the recording of committee and board member training.

## Outlook

75. The change to Career Average Revalued Earnings (CARE) and the introduction of new governance arrangements have been major changes for the pension fund which demand ongoing investment in terms of governance and administration.

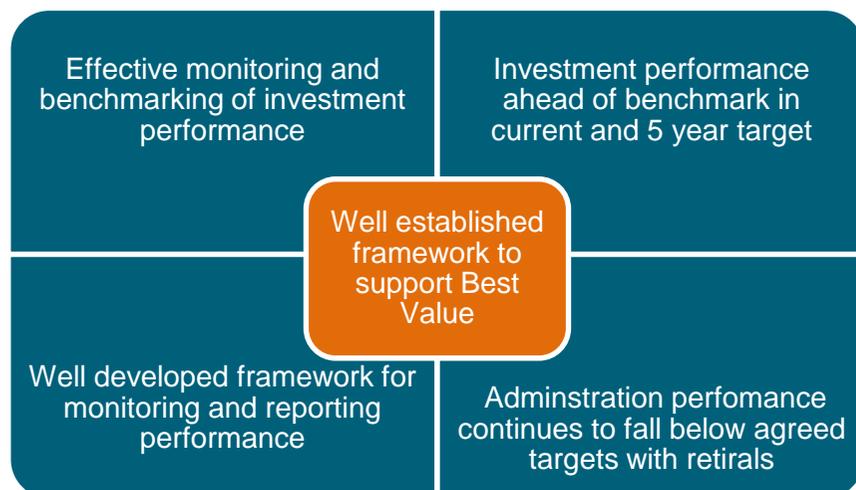
76. Changes to the state pension arrangements and the need for Guaranteed Minimum Pension reconciliations will also add to workloads.

77. Going forward the operation of cost sharing mechanisms will increase levels of interest and scrutiny in pension fund business.

We understand that the Government's Actuary Department (GAD) is currently undertaking a review in relation to cost sharing on behalf of Scottish Ministers.

78. There has been a move to the pooling of fund assets, through collective investment vehicles, in England and Wales. Scottish Ministers have indicated that this is an area where the views of the new national Scheme Advisory Board will be requested in due course.

## Best Value



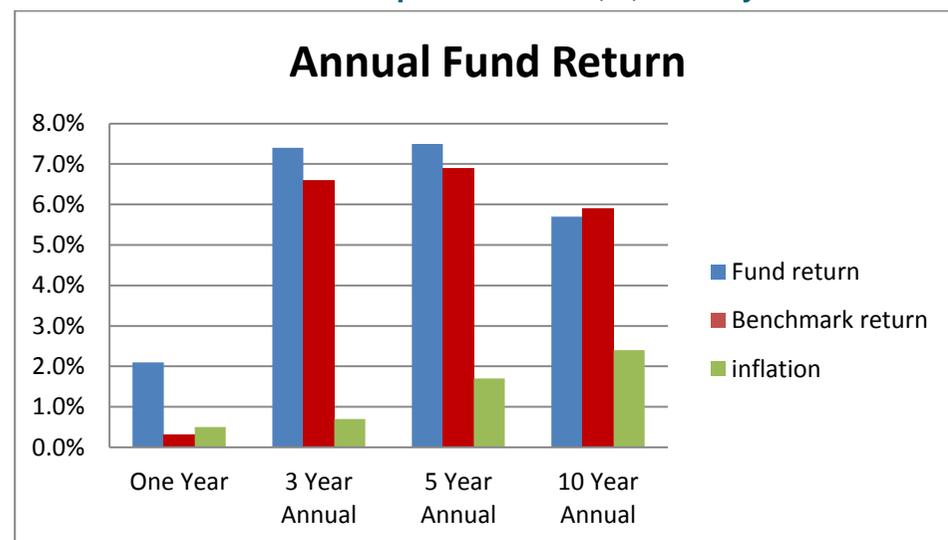
79. Strathclyde Pension Fund has a duty to ensure best value in the provision of services and to report performance publicly so that pension fund members, employers and other stakeholders know the quality of service being delivered and what they can expect in the future.
80. Overall, the pension fund has sound arrangements for supporting best value. There are clear strategic priorities in place for the Fund and there is a focussed approach to monitoring and reporting performance.

### Investment performance

81. As already identified the fund's investment outperformed its benchmark in 2015/16 and for the 5 year period to 31 March 2016. It fell

just short of the 10 year benchmark: 5.7% compared to 5.8%. Net investment performance compared favourably with other LGPS funds in Scotland.

82. Individual investment manager performance is reported on a quarterly basis to the Pension Committee. In addition all investment managers are subject to review at least annually by the Investment Advisory Panel.
83. 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. The asset allocation is largely in line with the strategy although the fund is still overweight in equities and is seeking to de-risk.
84. Under the new CARE scheme 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. As can be seen from Exhibit 5 investment returns have outperformed inflation over the past 10 years going some way to meeting increases in the historic liabilities.

**Exhibit 6: Fund investment performance 1, 3, 5 & 10 years**

Source: Strathclyde Pension Fund 2015/16 audited financial statements

## Direct Investment Portfolio

85. During 2015/16, investment commitments by the pension fund in the Direct Investment Portfolio (DIP), formerly known as the New Opportunities Fund, increased to £609m, with the actual amount drawn down being £269m.
86. The extension of DIP was part of the diversification strategy of the investment portfolio. Members approved, in November 2015, changes in the management structure within Strathclyde Pension Fund to reflect increased investments in the DIP.

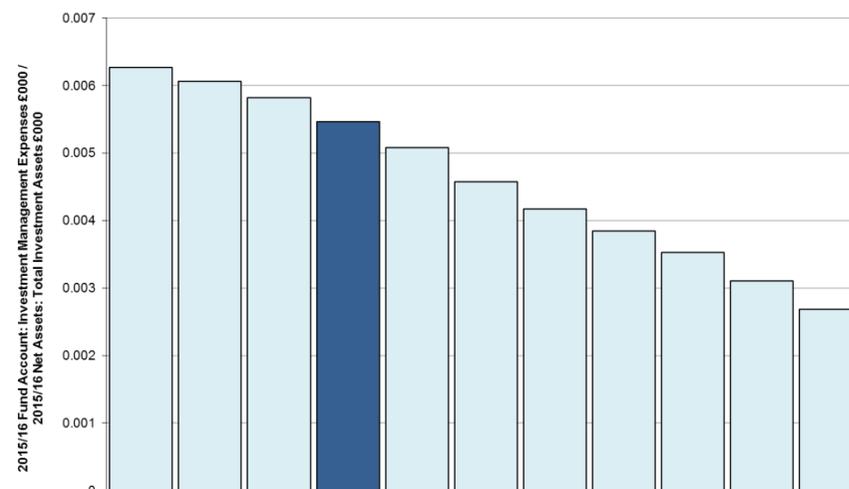
## Administrative performance

87. The fund's business plan sets out a range of service standards against which to monitor administration performance. These are measured on a regular basis and are reported to the Pension Fund Committee quarterly.
88. The fund continues to report high levels of member satisfaction and good performance against administrative targets. The impact of the introduction of CARE on administration workloads has been acknowledged by officers and targets for retirements continue to fall below the standards set.
89. Employers are required to submit year end contribution returns by 20 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 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 2015/16 have been received, although this was due to a significant amount of time and effort by Strathclyde Pension Fund officers.
90. As part of the Fund's governance assurance framework employers are also required to submit compliance certificates verifying compliance with a range of SPFO and regulatory requirements in relation to pension administration. In 2015/16 there has been an improved return rate of 82%. It has been confirmed that certificates were received from all the fund's major employers

## Management Expenses

91. 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.
92. Investment management costs of Fund 1 have decreased from £89.8m in 2014/15 (restated) to £87.6m in 2015/16.
93. Exhibit 7 shows figures for total management costs relative to net assets across the Scottish Local Government Pension Funds, with investment management costs for Strathclyde Pension Fund highlighted.
94. Strathclyde Pension Fund has reviewed the level of expenses of investment managers and should continue to benchmark performance. This should assist with management's evaluation of whether value for money is being achieved

### Exhibit 7: Investment Management Expenses



Source: unaudited 2015/16 financial statements

## Outlook

95. With financial austerity within the public sector set to continue and increased pressure coming from employers to keep costs and pension contributions down, it is imperative for funds to be able to demonstrate best value and continued improvement. Just as council's are having to look to new models of service delivery so pension funds may need to consider the costs and benefits of shared services and asset pooling.

**Appendix III - Action 2**

96. The Scheme Advisory Board in England and Wales has recommended more detailed reporting with regard to investment manager expenses for each individual manager. Should this be adopted, there will be increasing pressure on Scottish pension funds to also provide this level of transparency.

# Appendix I: Significant audit risks

The table below sets out the audit risks we identified and how we addressed each risk in arriving at our opinion on the financial statements.

Audit Risk	Assurance procedure	Results and conclusions
<b>Financial statement issues and risks</b>		
<p><b>New Local Government Pension Scheme</b></p> <p>The Local Government Pension Scheme changed on 1 April 2015 to a career average scheme (CARE). These new regulations mean a change in the way in which Strathclyde Pension Fund calculates members' retirement benefits from April 2015.</p> <p>Risk: that the pensions systems and processes cannot accommodate these new requirements leading to delays or errors in calculating benefits.</p>	<p>Procedures undertaken by officers on implementation</p> <p>Review of key controls within pensions administration system</p> <p>Procedures undertaken by officers on implementation</p>	<p>System review undertaken on new CARE system</p> <p>In September 2016, Internal Audit, as part of their 2016/17 plan reported 'reasonable assurance' for the CARE system</p> <p>We issued our internal controls report in June and our overall conclusion was the fund had adequate systems of internal control. However, we noted problems with manual re-calculations and councillor data required for employers annual reports having to be re-calculated manually.</p>
<p><b>Income</b></p> <p>Strathclyde Pension Fund receives a significant amount of investment income from third party sources.</p> <p>Risk: The extent and complexity of income means there is an inherent risk of fraud, in accordance with ISA240.</p>	<p>Internal controls for payroll and pension systems are subject to internal audit</p> <p>Management conducts reviews of actual receipts against budget</p> <p>Fraud reports are regularly monitored and information across Scotland routinely shared</p> <p>There are a range of measures in place to</p>	<p>We evaluated the effectiveness of systems of internal control for income recognition and recording</p> <p>We tested controls.</p> <p>We conducted analytical review of income streams</p> <p>We reviewed service auditor reports</p>

Audit Risk	Assurance procedure	Results and conclusions
	<p>prevent and detect fraud, including Standing Financial Instructions, Standing Orders and a Code of Conduct for Staff which incorporates both whistleblowing and fraud policies.</p> <p>The administering authority has a Corporate Fraud Policy in place and has established a Corporate Fraud Team staffed by experienced officers.</p> <p>Service auditor reports are received and reviewed.</p> <p>Contributions reconciliations performed with individual employers.</p>	<p>We reviewed reconciliations undertaken by officers.</p> <p>We agreed income to supporting documentation.</p> <p>No issues in relation to income were recorded.</p>
<p><b>Management override of controls</b></p> <p>As stated in ISA 240, there is a risk that management is in a unique position to perpetrate fraud because of management's ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively</p>	<p>Internal audit review a range of financial systems and related controls and provide an opinion on the control environment</p> <p>There are a range of measures in place to prevent and detect fraud, including Standing Financial Instructions, Standing Orders and a Code of Conduct for Staff which incorporates both whistleblowing and fraud policies</p>	<p>We carried out detailed testing of journals.</p> <p>We reviewed the accounting estimates used in the preparation of the financial statements for bias</p> <p>We evaluated significant transactions that are outside the normal course of business</p> <p>We have no issues to report</p>

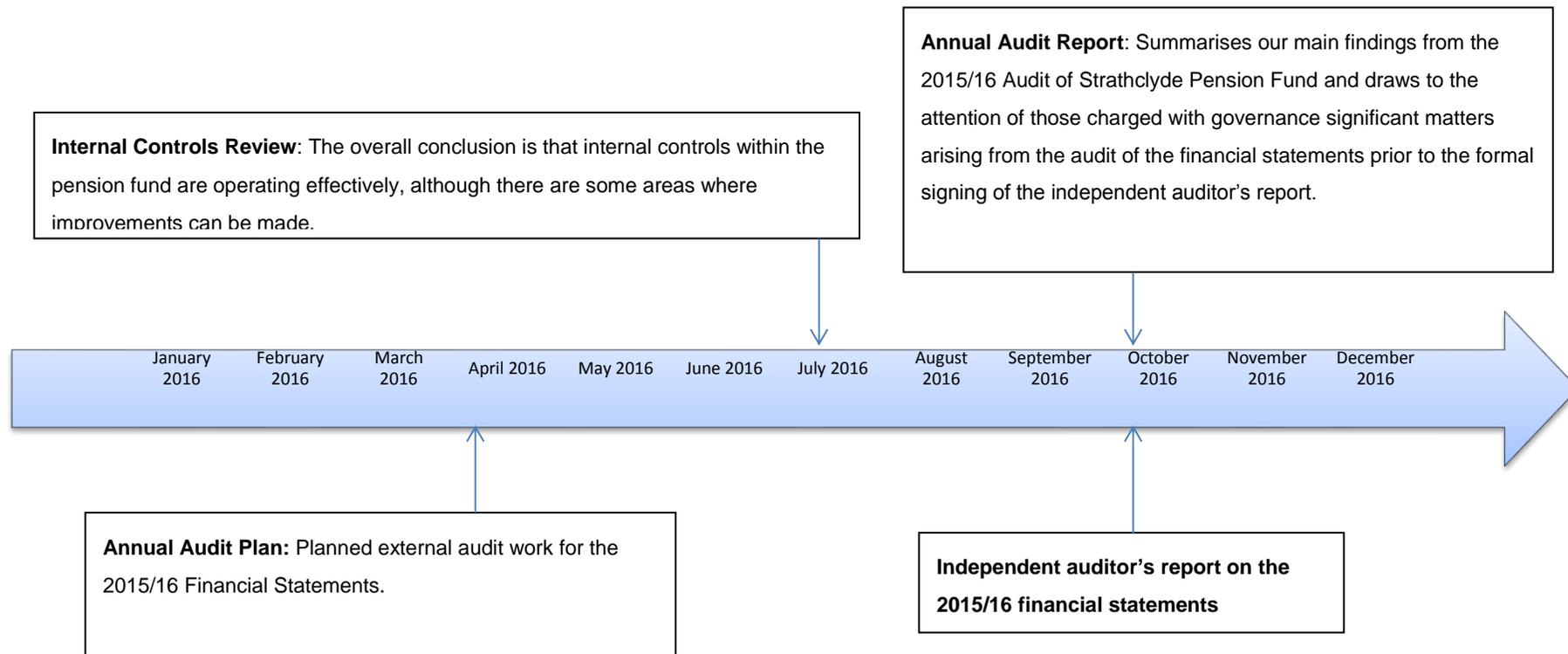
Audit Risk	Assurance procedure	Results and conclusions
<b>Wider dimension issues and risks</b>		
<p><b>Financial position</b></p> <p>Further funding cuts are predicted within public spending and local government funding in the medium term. It is clear that there will be the need for further budget savings and possibly further staff reduction schemes will be in place. The Fund's cash flow projections show that the Fund will rely on investment income to pay pensions within the next ten years.</p> <p>Risk: This will place additional demands on pension funds in terms of funding. The continued change in the Fund's membership will make funding pension payments increasingly challenging in the medium to long term as the proportion of retired members increases.</p>	<p>Cash flow projections and monitoring completed by officers</p> <p>Monitoring reports provided to the Pension Fund Committee</p> <p>Current development &amp; diversification underway of the Investment Strategy</p>	<p>We reviewed the membership position of the fund and reviewed changes made to the Investment Strategy to evaluate impact</p> <p>We sought to determine what considerations management have undertaken to protect assets to pay benefits to future pensioners</p> <p>We reviewed the financial position of the pension fund and the quality of financial reporting</p> <p>We note that there was a negative cash flow position in 2015/16 and that this is forecast to continue for the foreseeable future</p> <p style="text-align: right;"><b>Appendix III - Action 1</b></p>
<p><b>Local Government Pension Scheme Reform</b></p> <p>The new Local Government Pension Scheme introduced additional governance aspects nationally. A Scheme Advisory Board was established with effect from 1 April 2015 and additional powers have been granted to the Pensions Regulator. Strathclyde Pension Fund will be required to comply and participate in</p>	<p>Filling of vacant post to deal with compliance and correspondence with regulator</p> <p>Initial assessment of compliance completed</p>	<p>Reviewed the staff structure to confirm vacancies filled</p> <p>We reviewed the action plan prepared by the Fund as a consequence of conducting a self-assessment. We have previously reported on the need for target completion dates to enhance the effectiveness of this action plan.</p>

Audit Risk	Assurance procedure	Results and conclusions
<p>both.</p> <p>Risk: That Strathclyde Pension Fund do not comply with all the required guidance and that the increased workload impacts administration performance.</p>		
<p><b>Investment Management Expenses</b></p> <p>CIPFA issued guidance on Management expenses with the aim of improving transparency and consistency of reporting across the financial statements of Pension Funds. Strathclyde Pension Fund's financial statements disclosed management expenses of £130 million in 2014/15 which was the highest in Scotland.</p> <p>Risk: That Strathclyde Pension Fund do not make use of the additional information on management expenses to inform their reviews of investment managers' performance or to benchmark to ensure that value for money is being achieved.</p>	<p>Ongoing work on best value and benchmarking under-taken by officers</p> <p>We will review the calculation of the investment management costs and confirm to supporting evidence and records</p> <p>Determine what procedures management have adopted to ensure that it is able to demonstrate value for money.</p>	<p>Management has demonstrated to us that they are pro-active in striving to negotiate and secure cost effective services from third parties</p> <p>We sample tested management expenses reported in the financial statements.</p> <p>We examined supporting evidence obtained by the pension fund from the investment managers.</p> <p>We concluded that management expenses are correctly accounted for and are supported by appropriate evidence</p> <p style="text-align: right;"><b>Appendix III - Action 2</b></p>
<p><b>Cyber Attack</b></p> <p>Over the past year several public sector organisations have been victims of cyber attacks and related activities. If Strathclyde Pension Fund does not respond adequately to</p>	<p>Internal audit carry out a regular programme of ICT audits.</p> <p>The council have no recent history of disruption due to cyber attacks.</p>	<p>We carried out an over-view of Strathclyde Pension Fund's cyber attack arrangements, Many of the arrangements are hosted by Glasgow City Council as administering authority. The council external audit team</p>

Audit Risk	Assurance procedure	Results and conclusions
<p>such attacks this could result in disruption to services. It could also have a financial impact through fraud and financial penalties for data protection breaches.</p> <p>Risk: Loss of services and financial penalties for data losses.</p>		<p>concluded that the council has a good awareness of the threat of cyber attacks and has put in place arrangements to prevent these and to mitigate their impact where they cannot be prevented.</p> <p>We have previously recommended that the risk of the cyber attack should have more recognition within the risk register.</p>
<p><b>Business Continuity/Disaster Recovery</b></p> <p>The council's internal network which hosts Strathclyde Pension Fund went down for four days in December 2015 after an incident affecting servers at its data centre. Damage was caused to equipment hosting data for many systems.</p> <p>Risk: This incident indicates a weakness in the business continuity arrangements.</p>	<p>Internal audit is planning to review business continuity arrangements.</p> <p>A report on the incident is being prepared by ACCESS to be submitted to Glasgow City Council's Operational Delivery Scrutiny Committee</p>	<p>We reviewed the reports on the data incident</p> <p>We reviewed reconciliations of system data and were satisfied with the integrity of the data</p> <p>We note, however, the residual action for disaster recovery testing.</p> <p style="text-align: right;"><b>Appendix III - Action 3</b></p>
<p><b>Orphaned liabilities</b></p> <p>Due to continued economic and funding pressures on employers, there remains the potential for employer defaults and significant orphaned liabilities to arise within the Fund</p> <p>Risk: There is a risk that there will be increasing cessation liabilities that are not</p>	<p>Monitoring reports provided to Pension Fund committee</p> <p>Review of orphaned liabilities and any required accounting disclosures</p>	<p>We reviewed the triennial actuary report relating to orphaned liabilities</p> <p>We reviewed committee reports for employer cessations</p> <p>We reviewed admittance procedures for new employers to ensure all have supporting guarantees</p>

Audit Risk	Assurance procedure	Results and conclusions
settled by employers. This will impact other pension fund member employers and require appropriate disclosure in the financial statements.		We have no issues to report

# Appendix II: Summary of Strathclyde Pension Fund local audit reports 2015/16



## Appendix III: Action plan

No.	Para ref.	Issue/risk/Recommendation	Management action/response	Responsible officer / Target date
1.	47	<p><b>Funding position</b></p> <p>The fund has reported a deficit in dealings with members and although active membership has increased, the continued increase in pensioners in the Fund's membership will make funding pension payments increasingly challenging. The Fund's cash flow projections show that the fund will rely on investment income to pay pensions.</p> <p><b>Risk</b></p> <p>A mismatch between the fund's funding and investment strategies leads to insufficient cash flow to pay pensions.</p> <p><b>Recommendation</b></p> <p>The Fund should continue to closely monitor the implementation of the Funding and Investment Strategies and the impact on the Fund's cash flow position.</p>	<p>As noted in response to previous audit reports, the Fund is keenly aware of this issue. It is natural for any pension fund to see its liabilities mature over time. With regard to Strathclyde, this process was accelerated by significant reductions in workforce by the Fund's employers, the impact of which was apparent in the 2011 valuation. The 2014 valuation adopted a more probability based focus and a risk-based investment framework, which models a more diversified strategy for the Fund going forward, was agreed in the subsequent review of investment strategy. These revised approaches will both be important in managing the Fund going forward.</p> <p>The Fund monitors its cash flow position closely in the short, medium and long term. This includes reporting a quarterly cash flow position to Committee, and an annual budget and a 10 year cash flow to Committee annually. The 10 year cash flow submitted to committee first identified the expected deficit position in 2014; meanwhile the 10 year cash flow submitted to Committee in March 2016 shows that the onset of auto-enrolment from October 2017 is currently anticipated to return the Fund account to a surplus position for financial year and subsequent years. The fund will continue to monitor cashflow.</p>	<p>Director of Pensions</p> <p>Ongoing/ actuarial valuation as at 31 March 2017</p>

No.	Para ref.	Issue/risk/Recommendation	Management action/response	Responsible officer / Target date
2.	95	<p><b>Investment Management expenses</b></p> <p>The revised CIPFA guidance on management expenses is to be applied from 2016/17 and Strathclyde Pension Fund elected to adopt this early, in 2015/16. Now that information is transparent, the Pension Fund should review the level of management expenses including the development of bench-marking information and in the context of returns achieved, to ensure that value for money is being secured.</p> <p><b>Risk</b></p> <p>Investment management expenses do not represent value for money.</p> <p><b>Recommendation</b></p> <p>Management should make use of the additional information now available on the cost of investment management services to make informed decisions on value for money, as well as the performance of managers.</p>	<p>The Fund has always been conscious of costs and reviews the value for money it receives from its investments on an on-going basis through monitoring of investment performance and participation in fee and performance benchmarking surveys. Fees are also an integral part of initial manager appointments and are reviewed throughout the duration of a contract; in the latest financial year, the Fund has agreed a number of more beneficial fee arrangements for both existing and new investments. The Fund is prepared however, to incur higher costs where they are proven to add value, as has been the case, for example, with its long-standing private equity programme.</p> <p>The Fund will continue to consider costs very carefully and to develop its review and benchmarking of fee and expenses.</p>	<p>Chief Investment Officer</p> <p>Ongoing</p>

No.	Para ref.	Issue/risk/Recommendation	Management action/response	Responsible officer / Target date
3.	68	<p><b>Disaster Recovery/Business Continuity</b></p> <p>A major incident occurred in December 2015 when a fault in the council's primary data centre resulted in damage to servers and a significant loss of ICT access for Strathclyde Pension Fund.</p> <p>In addition, Internal Audit continues to report on the delays for the implementation of disaster recovery testing on the Altair system, a business critical system for the Fund. This has been reported as an outstanding action since 2014/15.</p> <p><b>Risk</b></p> <p>The pension fund suffers loss of data as a result on inadequate disaster recovery procedures</p> <p><b>Recommendation</b></p> <p>The pension fund should complete implementation and testing of the updated disaster recovery system.</p>	<p>This matter has been escalated with ACCESS. The implementation of disaster recovery testing is currently scheduled for 27th September. The Fund's disaster recovery arrangements are an area of on-going review for GCC's Internal Audit team and progress and conclusions of testing will be reported to Committee.</p>	<p>Service Manager (Systems &amp; Compliance)</p> <p>30 September 2016</p>

No.	Para ref.	Issue/risk/Recommendation	Management action/response	Responsible officer / Target date
4.	69	<p><b>Assurance received from management experts</b></p> <p>We assess management's reliance on Northern Trust as the Fund's global custodian and other investment managers that the pension fund contracts with. Our assurance work considers service auditors reports for the year to 31 March 2016. For Northern Trust and several investment managers these specifically exclude giving an opinion on the controls of third party service organisations eg sub-custodians, and also on business continuity and disaster recovery.</p> <p><b>Risk</b></p> <p>The Pension Fund does not have sufficient assurance on systems of internal control at sub-custodians nor in respect of business continuity/disaster recovery arrangements of the global custodian and other investment fund managers.</p> <p><b>Recommendation</b></p> <p>The pension fund should specify where additional third party assurances are required.</p>	<p>The Fund conducts on-going diligence on all its investment managers and its global custodian. In particular it reviews internal controls reports on an annual basis. With regard to Northern Trust, all review measures by them in respect of service, due diligence and credit worthiness of sub-custodians are in accordance with the requirements of the Financial Conduct Authority (FCA). In addition Northern Trust's internal controls report includes assurance on their sub-custodian review process. Robust business continuity and disaster recovery arrangements are requirements of FCA (or other country equivalent) registration. Northern Trust's internal controls report to the end of June 2016, the latest available, includes assurance on BCP arrangements. Future internal controls reports will also cover BCP and disaster recovery.</p> <p>The Fund will continue to seek assurances on investment manager/ custodian processes for review of 3<sup>rd</sup> party service organisations and business continuity and disaster recovery arrangements.</p>	<p>Chief Investment Officer</p> <p>On going</p>

