

## 2016/17 Annual Audit Report to the Members and Controller of Audit

22 September 2017

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# Director introduction

## The key messages in this report

I have pleasure in presenting our Annual Audit Report to the Members and Controller of Audit for the 2016/17 audit of the Shetland Islands Council Pension Fund ("the Fund"). I would like to draw your attention to the following key messages:

Audit quality is our number one priority. We plan our audit to focus on audit quality with the following objectives:

- A strong understanding of your internal control environment.
- A well planned and delivered audit that raises findings early with those charged with governance.
- Use of pension audit specialists where appropriate.
- A robust challenge of the key judgements taken in the preparation of the financial statements.

### **Audit scope**

As communicated in our planning report dated 9 February 2017, our main reporting responsibilities are to:

- Provide the Independent Auditor's Report on the annual accounts;
- Provide the annual report on the audit addressed to the Members and Controller of Audit; and
- To provide reports to management, as appropriate, in respect of the auditor's responsibilities in the 2016/17 Code of Audit Practice ("2016/17 Code").

We have also read the content of the draft annual report and the governance statement to confirm their consistency with the financial statements and our understanding of the business.

### **Significant audit risks and areas of audit focus**

As communicated in our planning report we identified management override of controls as our significant audit risk. This is in line with Auditing Standards which require us to assume that management override of controls is an audit risk for all of our audits.

In addition we identified the following areas of audit focus:

1. Accuracy of contributions payable to the Fund;
2. Valuation of investments; and
3. Compliance of the financial statements with the amendments made by the 2016/17 Code.

We have not amended the significant audit risk and areas of audit focus during our testing and further details of our work performed and findings can be found on pages 6 to 10.

### **Wider Scope Requirements**

The 2016/17 Code sets out four audit dimensions which set a common framework for all public sector audits in Scotland. These dimensions are:

1. Financial Sustainability;
2. Financial Management;
3. Governance and Transparency; and
4. Value for Money.

Our conclusions on the audit dimensions can be found on pages 11 and 12 of this report.

# Director introduction (continued)

## The key messages in this report (continued)

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<b>Insights</b>	We have included in this report details of any uncorrected misstatements above our reporting threshold and material disclosure deficiencies on page 15. In addition we have included any insights found as a result of our audit testing. These can be found on page 16.
<b>Status of the audit</b>	The audit is now complete.
<b>Our conclusion</b>	Based on our work performed to date, and subject to the satisfactory completion of the outstanding items listed above, we anticipate issuing an unmodified audit opinion on the financial statements.

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**Pat Kenny**  
**Audit Director**

# Our audit explained

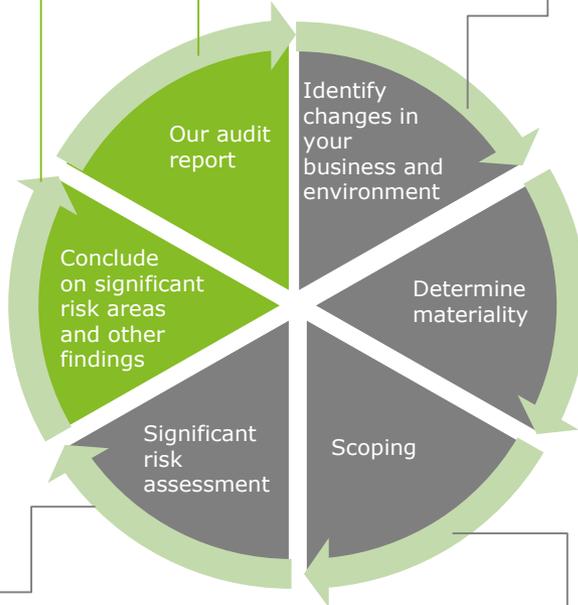
## Area dimensions

In accordance with the 2016 Code of Audit Practice, we have considered how you are addressing the four audit dimensions, being:

- Financial sustainability
- Financial management
- Governance and transparency
- Value for money

## Significant audit risks and areas of audit focus

Our risk assessment process is a continuous cycle throughout the year. Page 6 provides a summary of our risk assessment of your significant audit risk and areas of audit focus.



## Final audit report

In this report we have concluded on the significant audit risk and areas of audit focus identified in our planning report and any other key findings from the audit.

## Key developments in your Fund

As noted in our planning report, there have been no significant changes to the Fund itself during the year. The 2016/17 Code was amended for pension funds from financial year 2016/17 and requires additional disclosures to be included in the financial statements.

## Materiality

We have determined materiality based on 1% of the Fund's net assets at 31 March 2017 to be £4,490,000. We have determined performance materiality as £4,041,000 based on total anticipated uncorrected misstatements amounting to 10% of materiality. Our reporting threshold of misstatements in the financial statements is £224,500 based on 5% of materiality.

## Scope of the audit

We have audited the financial statements for the year ended 31 March 2017 of the Shetland Islands Council Pension Fund. The scope of our audit remains consistent with that in our planning report. We have embedded specialists into our audit team where appropriate, including a financial instruments specialist to review our work performed on the Fund's investment assets.

## Timeline 2017

**November 2016 – February 2017**

Meetings with management and other staff to understand the processes and controls.

**July – August 2017**

Review of draft accounts, testing of significant risk and performance of substantive testing of results.

**March 2017**  
Year end

**20 September 2017**

Audit committee meeting

**20 September 2017**  
Accounts sign off

## Quality and Independence

We confirm we are independent of Shetland Islands Council Pension Fund. We take our independence and the quality of the audit work we perform very seriously. Audit quality is our number one priority.

# Significant audit risks and areas of audit focus

## Dashboard

Significant audit risk	Risk Level	Fraud Risk	Approach to Controls Testing	Level of Judgement
<b>Management override of key controls</b>			D&I	
<b>Areas of audit focus</b>				
<b>Accuracy of contributions payable to the Fund</b>			D&I	
<b>Valuation of investments</b>			D&I	
<b>Compliance of the financial statements with the amendments made by the 2016/17 Code</b>			D&I	

	Low levels of judgement/management involvement		Not a Fraud Risk		Significant Audit Risk
	Medium levels of judgement/management involvement		Fraud Risk		Area of Audit Focus
	High degree of judgement/management involvement	<b>D &amp; I</b>	Design and Implementation		

# Significant audit risk

## Management override of controls

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### Description

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International Standards on Auditing requires auditors to identify a presumed risk of management override of controls. This presumed risk cannot be rebutted by the auditor. This recognises that management may be able to override controls that are in place to present inaccurate or even fraudulent financial reports.

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### Deloitte Response

In order to address this significant audit risk, we performed the following audit procedures:

- Made enquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments;
- Performed testing on the design and implementation of controls surrounding the financial reporting process and the controls over journal entries and other adjustments posted in the preparation of the financial statements;
- Tested the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements. As part of our work in this area, we performed an analysis of journal entries which enabled us to focus on journals meeting specific pre-determined parameters determined during our audit planning;
- Reviewed the financial statements for any accounting estimates which could contain management bias, and assessed the judgements taken against supporting evidence;
- Confirmed that there is an appropriate level of segregation of duties over processing journal entries to the financial statements throughout the year; and
- Made enquiries of management in relation to the identification of related party transactions.

### Deloitte view

We have no issues to report to the Members and the Controller of Audit from the testing we have performed.



# Areas of audit focus

## Accuracy of contributions payable to the Fund

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### Description

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The correct deduction of contributions depends on systems-based processing of membership data and salary details, together with a robust internal control framework. Errors in processing contributions can lead to issues such as non-compliance with the Funding Strategy Statement and deducting incorrect amounts from active members' payroll which can be costly to rectify and cause reputational damage.

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### Deloitte Response

In order to address this area of audit focus we performed the following audit procedures:

- Reviewed the design and implementation of key controls over the contribution process;
  - Performed an analytical review of the employer normal contributions received in the year, basing our expectation on the prior year audited balance, adjusted for the movement in active member numbers, contribution rate changes and any average pay rise awarded in the year;
  - For a sample of active members, we recalculated individual contribution deductions to ensure that these are being calculated in accordance with the rates stipulated in the Local Government Pension Scheme (Scotland) Regulations 2014 ("LGPS Regulations") for employee contributions and in the Funding Strategy Statement for employer contributions; and
  - Tested that the correct definition of pensionable salary is being used per the LGPS Regulations to calculate contribution deductions.
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### Deloitte view

We have no issues to report to the Members and the Controller of Audit from the testing we have performed.



# Areas of audit focus

## Valuation of investments

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### Description

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There is a risk that investments are not valued accurately in the Pension Fund's financial statements due to the levels of judgement involved in pricing such investments.

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### Deloitte Response

In order to address this area of audit focus, we performed the following audit procedures:

- Reviewed the design and implementation of key controls over the valuation of these investments by obtaining investment manager and custodian internal control reports and evaluating the implications for our audit of any exceptions noted;
  - Agreed year end valuations, sales proceeds and purchases in the financial statements to the reports received directly from the investment managers and the Fund's custodian;
  - Agreed the valuations as at 31 March 2016 to the reports received directly from the investment managers and the Fund's custodian;
  - Performed valuation testing on the valuation of the investments at 31 March 2016 and 2017 by using a range of techniques depending on the type of investment. Where the investment was not directly quoted on an exchange we confirmed if it is a registered fund and obtained an independent price. Where this was not the case we confirmed if the fund was structured as a unitised insurance policy or used sales transactions close to year end as an estimate of the price. Where none of these options are available we obtained audited financial statements and rolled forward the audited value to the year end using an appropriate benchmark and Pension Fund transactions where the audited accounts are not coterminous with the Pension Fund's year end; and
  - Engaged our financial instrument specialists to review the audit work performed in relation to these assets.
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### Deloitte view

We have no issues to report to the Members and the Controller of Audit from the testing we have performed.



# Areas of audit focus

## Compliance of the financial statements with the amendments made by the 2016/17 Code

### Description

There is a risk that the Pension Fund's financial statements are not in compliance with the amendments made by the 2016/17 Code of Practice on Local Authority Accounting in the UK. These changes include:

- Amendments to the format of the accounts to be consistent with the new Financial Reports of Pension Schemes – A Statement of Recommended Practice 2015;
- Additional disclosure requirements for investments measured at fair value e.g. fair value hierarchy;
- Disclosure requirements in respect of investment management expenses; and
- An annex that provides an overview of how the other sections of the Code apply to pension funds.

### Deloitte

### Response

In order to address this area of audit focus, we performed the following audit procedures:

- Assessed the design and implementation of key controls over the financial reporting process and, in particular, in relation to the implementation of the provisions of the revised Code;
- Agreed the classification of the investment assets within the fair value hierarchy to independently received investment manager and custodian reports and the reconciliation of those reports as prepared by the finance team;
- Confirmed that the recommended disclosures in respect of investment management expenses comply with the requirements of the Code;
- Obtained a copy of the annex to confirm that the other sections of the Code have been considered where they apply to the Pension Fund; and
- Benchmarked the financial statements to the CIPFA checklist to confirm all appropriate disclosures were included.

### Deloitte view

From our testing we noted that the first version of the accounts did not contain a Fair Value Hierarchy disclosure of the investment assets as required by the 2016/17 code and IFRS 13. This has since been updated in the final version of the financial statements.



# Wider Scope Requirements

## Audit Dimensions

The Code of Audit Practice sets out four audit dimensions which set a common framework for all public sector audits in Scotland. We have considered how the Pension Fund addresses these areas as part of our audit work as follows:

Audit dimension	Audit work completed	Audit Conclusion
<p><b>Financial sustainability</b> considers the going concern assumption used in the financial statements to consider whether the Pension Fund is planning effectively to continue to deliver its benefit services over the medium to long term.</p>	<p>We reviewed the arrangements and financial planning systems in place by the Pension Fund to ensure that its services can continue to be delivered. This included:</p> <ul style="list-style-type: none"><li>• a review of the latest actuarial valuation of the Pension Fund and the plans in place to reduce the deficit over the shorter and medium term; and</li><li>• A review of the funding policy as set out in the Shetland Islands Council Pension Fund Investment Strategy 2014-2027 (“Investment Strategy”), which aims to ensure the long-term solvency of the Pension Fund, so that there are sufficient funds available to meet all benefits as they fall due.</li></ul>	<p>From our work completed we are satisfied the Fund has sufficient plans in place to continue to be financially sustainable in the medium and long term. We did not identify any issues regarding non-payment of contributions due from the Scheduled and Admitted Bodies which would have an impact on the financial sustainability of the Fund. In addition from our review of the Investment Strategy, the Fund has taken investment advice on how best to use its resources appropriately to ensure future benefits can be settled when the liability arises and the Fund will be 100% funded by 2027.</p>
<p><b>Financial management</b> is concerned with financial capacity, sound budgetary processes and whether the control environment and internal controls are operating effectively.</p>	<ul style="list-style-type: none"><li>• We reviewed the budget and monitoring reporting by the Pension Fund during the year to assess whether financial management and budget setting is effective; and</li><li>• We ensured that there is a proper officer and fund manager who have sufficient status to be able to deliver good financial management, that monitoring reports contain information linked to performance as well as financial data, and that members have the opportunity to provide a sufficient level of challenge around variances and under-performance.</li></ul>	<p>From our testing completed we can confirm that an Executive Manager – Finance has been appointed who has the appropriate status to act in that role and complies with the five principles outlined in the CIPFA guidance. From our review of the budget process we are satisfied that appropriate financial reports are provided to the Pension Fund Committee to challenge variances and underperformance and that this is performed.</p>

# Wider Scope Requirements (continued)

## Audit Dimensions (continued)

Audit dimension	Audit work completed	Audit Conclusion
<p><b>Governance and transparency</b> is concerned with the effectiveness of scrutiny and governance arrangements, leadership and decision making, and transparent reporting of financial and performance information.</p>	<ul style="list-style-type: none"> <li>• We reviewed the Pension Committee meeting minutes to assess the effectiveness and scrutiny of governance arrangements.</li> <li>• We reviewed other aspects of governance around the Pension Fund including Codes of Conduct for officers and members, fraud and corruption arrangements, and arrangements for reporting regulatory breaches to the Pensions Regulator.</li> <li>• In addition we reviewed the Annual Governance Statement and Governance Compliance Statement to confirm the governance arrangements observe the guidance issued by Scottish Ministers.</li> </ul>	<p>From our testing performed we have no issues to note. The Annual Governance Statement and Governance Compliance Statement contains the required information.</p> <p>The procedures and policies around governance, Codes of Conduct, etc. are clear and transparent and available for all Members to read on the Shetland Island Council website.</p>
<p><b>Value for money</b> is concerned with using resources effectively and continually improving services.</p>	<ul style="list-style-type: none"> <li>• We gained an understanding of how the Pension Fund demonstrates value for money in the use of resources and the linkage between money spent and outputs and outcomes delivered.</li> <li>• We reviewed the scrutiny that is in place to challenge the Pension Fund's investment managers on fees and performance.</li> </ul>	<p>From our review of the budget process we are satisfied that there is sufficient scrutiny over expenditure of the Fund, in particular investment management fees. We noted, that despite an increase of £48k in investment management fees during the year, by in large the remainder of administration expenses for the Fund were in line with the prior year.</p> <p>In addition the Investment Strategy document outlines how the Fund will achieve value for money in where the assets are invested, ultimately aiming for 100% funding by 2027.</p>

# Purpose of our report and responsibility statement

Our report is designed to help you meet your governance duties

## What we report

Our report is designed to help the Pension Fund Audit Committee to discharge their governance duties. It also represents one way in which we fulfil our obligations under ISA 260 (UK and Ireland) to communicate with you regarding your oversight of the financial reporting process and your governance requirements. Our report includes:

- Results of our work on key audit judgements and our observations on the quality of your Annual Report.
- Our internal control observations.
- Other insights we have identified from our audit

## What we don't report

As you will be aware, our audit was not designed to identify all matters that may be relevant to the Fund.

Also, there will be further information you need to discharge your governance responsibilities, such as matters reported on by management or by other specialist advisers.

Finally, our views on internal controls and risk assessment should not be taken as comprehensive or as an opinion on effectiveness since they have been based solely on the audit procedures performed in the audit of the financial statements and the other procedures performed in fulfilling our audit plan.

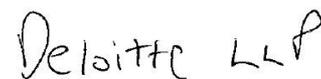
We welcome the opportunity to discuss our report with you and receive your feedback.

## The scope of our work

Our observations are developed in the context of our audit of the financial statements.

We described the scope of our work in our audit plan and the supplementary "Briefing on audit matters" circulated to you in February 2017.

This report has been prepared for the Pension Fund Audit Committee, as a body, and we therefore accept responsibility to you alone for its contents. We accept no duty, responsibility or liability to any other parties, since this report has not been prepared, and is not intended, for any other purpose.



**Deloitte LLP**

Glasgow

22 September 2017

# Appendices



# Audit adjustments

## Corrected and uncorrected misstatements

We are required to report any corrected and uncorrected misstatements which are more than 5% of our materiality threshold to the Members and Controller of Audit.

For the avoidance of doubt we have no corrected or uncorrected misstatements to report to the Members and the Controller of Audit.

In addition we are required to report any material disclosure deficiencies in the financial statements. From our testing we noted that the first version of the accounts did not contain a Fair Value Hierarchy disclosure of the investment assets as required by the 2016/17 code and IFRS 13. This has since been updated in the final version of the financial statements and we have no further disclosure misstatements to report.

# Insights

## Recommendations for improvement

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Area	Observation	Recommendation
Reporting to the Actuary	During our testing over the information that the Fund provides to the Actuary we noted that reviews are performed before any documentation is sent to the Actuary, however these reviews are not evidenced by way of signature.	We recommend that the reviews of the reports and information sent to the Actuary are signed by way of dated signature so that evidence of the control can be obtained.

# Fraud responsibilities and representations

## Responsibilities explained



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### Your Responsibilities

The primary responsibility for the prevention and detection of fraud rests with management and the Audit Committee, and includes establishing and maintaining internal controls over the reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations.

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### Our Responsibilities

We are required to obtain representations from the Committee regarding internal controls, assessment of risk and any known or suspected fraud or misstatement. As the Pension Fund's auditor, we obtain reasonable, but not absolute, assurance that the financial statements as a whole are free from material misstatement, whether caused by fraud or error. As set out in the significant risk section of this document, we have identified management override of controls as a significant audit risk for your Fund.

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### Fraud Characteristics

Misstatements in the financial statements can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional. Two types of intentional misstatements are relevant to us as auditor – misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets.

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### We will request the following to be stated in the representation letter signed on behalf of the Committee:

- We acknowledge our responsibilities for the design, implementation and maintenance of internal controls to prevent and detect fraud and error.
  - We have disclosed to you the results of our assessment of the risk that the financial statements may be materially misstated as a result of fraud.
  - We are not aware of any fraud or suspected fraud / We have disclosed to you all information in relation to fraud or suspected fraud that we are aware of and that affects the Pension Fund and involves:
    - (i) management;
    - (ii) employees who have significant roles in internal control; or
    - (iii) others where the fraud could have a material effect on the financial statements.
  - We have disclosed to you all information in relation to allegations of fraud, or suspected fraud, affecting the Pension Fund's financial statements communicated by employees, former employees, analysts, regulators or others.
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# Independence and fees

As part of our obligations under International Standards on Auditing (UK and Ireland), we are required to report to you on the matters listed below:

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## Independence confirmation

We confirm that we comply with APB Ethical Standards for Auditors and that, in our professional judgement, we and, where applicable, all Deloitte network firms are independent and our objectivity is not compromised.

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## Fees

The audit fee for 2016/17 is £30,238 as detailed in our Audit Plan.

No non-audit services fees have been charged by Deloitte in the period.

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## Non-audit services

In our opinion there are no inconsistencies between APB Ethical Standards for Auditors and the company's policy for the supply of non-audit services or any apparent breach of that policy. We continue to review our independence and ensure that appropriate safeguards are in place including, but not limited to, the rotation of senior partners and professional staff and the involvement of additional partners and professional staff to carry out reviews of the work performed and to otherwise advise as necessary.

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## Relationships

We are required to provide written details of all relationships (including the provision of non-audit services) between us and the organisation, its board and senior management and its affiliates, including all services provided by us and the DCTL network to the audited entity, its board and senior management and its affiliates, and other services provided to other known connected parties that we consider may reasonably be thought to bear on our objectivity and independence.

We are not aware of any relationships which are required to be disclosed.

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