

# Strathclyde Pension Fund

2016/17 Annual Audit Report



 AUDIT SCOTLAND

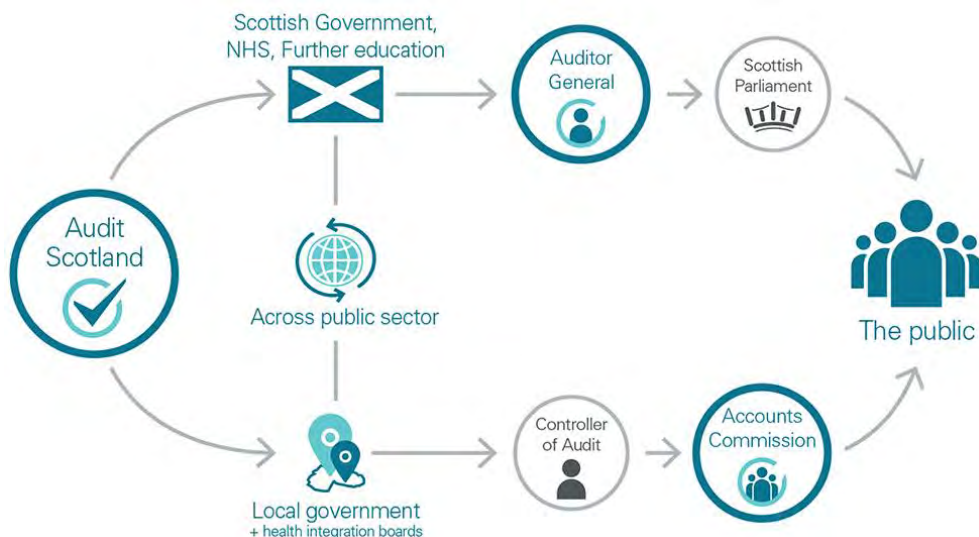
To members of Strathclyde Pension Fund Committee and the Controller of Audit

20 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.



## About us

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

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

- carrying out relevant and timely audits of the way the public sector manages and spends money
- reporting our findings and conclusions in public
- identifying risks, making clear and relevant recommendations.

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# Key messages

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## 2016/17 annual report and accounts

- 1 Unqualified opinions were issued 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. This includes comprehensive reporting of investment performance.
- 3 Local government pension schemes experienced improved annual returns on investments in 2016/17 with Strathclyde Pension Fund making a return of 23.1%.
- 4 Internal controls were found to be operating satisfactorily in the systems used to process the fund transactions.

## Financial sustainability

- 5 The continued increase in the Fund's pensioner membership will make funding pension payments increasingly challenging. Cash flow projections show that the Fund will continue to rely on investment income to pay pensions.
- 6 The deadlines for further implementation of automatic enrolment into the pension scheme will present the Fund with additional administrative pressures and challenges.

## Governance and transparency

- 7 The Fund has effective governance arrangements in place that support scrutiny decisions made by the Pension Fund Committee.
- 8 Decisions made by the Pension Fund Committee are transparent. Committee papers and detailed minutes of meetings of the Committee are available on the Strathclyde Pension Fund and Glasgow City Council websites.

## Value for money

- 9 The Fund's investment performance is subject to regular review and scrutiny by the Pension Fund Committee.
- 10 The Fund has adequate arrangements in place for monitoring investment performance and scrutinising investment management.

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# Introduction

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1. This report is a summary of our findings arising from the 2016/17 audit of Strathclyde 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 Strathclyde Pension Fund 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](#).

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## Exhibit 1 Audit dimensions



Source: Code of Audit Practice 2016

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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. Glasgow City Council is the administering authority for the Fund. The council delegates this responsibility to the Strathclyde Pension Fund Committee. It is responsible for establishing effective governance arrangements and ensuring that financial management is effective. Additionally, the Pension Fund Committee is required to review the effectiveness of internal control arrangements and approve the annual accounts.

- 5.** 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.
- 6.** 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.
- 7.** Further details of the respective responsibilities of management and the auditor can be found in the [Code of Audit Practice \(2016\)](#).
- 8.** 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.
- 9.** Our annual audit report contains an action plan at [Appendix 1](#). It sets out specific recommendations, responsible officers and dates for implementation.
- 10.** 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 as we did not carry out any work additional to our planned audit activity, the fee remains unchanged.
- 11.** This report is addressed to both the members of the Strathclyde Pension Fund Committee and the Controller of Audit and will be published on Audit Scotland's website [www.audit-scotland.gov.uk](http://www.audit-scotland.gov.uk).
- 12.** 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

**Our audit opinions were all unqualified. These covered the financial statements, management commentary, annual governance statement and governance compliance statement.**

#### Unqualified audit opinions

**13.** The annual accounts for the year ended 31 March 2017 were approved by the Strathclyde Pension Fund Committee on 20 September 2017. 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.

**14.** Additionally, we have nothing to report in respect of those matters which we are required by the Accounts Commission to report by exception.

#### Submission of annual accounts for audit

**15.** We received the unaudited annual accounts on 28 June 2017, in line with our agreed audit timetable.

**16.** 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

**17.** [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. Also, included within the appendix are wider dimension risks, how we addressed these and conclusions.

#### Materiality

**18.** 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.

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

**19.** Our initial assessment of materiality for the annual report and accounts was undertaken during the planning phase of the audit and was reported in our annual audit plan. Upon receipt of the unaudited accounts, materiality levels were revised, as summarised in [Exhibit 2](#). Specifically with regard to the financial statements, we assess the materiality of uncorrected misstatements, both individually and collectively.

**20.** Following completion of audit testing we reviewed our original materiality calculations and concluded that they remained appropriate.

**21.** In accordance with International Standard on Auditing (UK and Ireland) 315, when establishing the audit approach, materiality for the financial statements is determined as a whole. However in certain circumstances it is appropriate to apply a lower level of materiality to one or more particular classes of transactions, account balances or disclosures, where misstatements of lesser amounts could influence the economic decisions of users taken on the basis of the financial statements. In the case of a pension fund we use a lower materiality level when assessing particular income and expenditure streams.

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## Exhibit 2

### Materiality values

Materiality level	Amount
<b>Overall materiality</b> – 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.	Fund No.1 £98.497 million
	Fund No.3 £1.054 million
<b>Performance materiality</b> – 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 80% of overall materiality.	Fund No.1 £78.797 million
	Fund No.3 £0.843 million
<b>Reporting threshold (i.e clearly trivial)</b> – 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 1% of overall materiality. (With a maximum level of £100,000).	£ Fund No.1 £100,000
	Fund No.3 £10,000

### Evaluation of misstatements

**22.** There were no material adjustments to the unaudited financial statements arising from our audit.

### Significant findings

**23.** International Standard on Auditing (UK and Ireland) 260 requires us to communicate to you significant findings from the audit. In our view, there are no significant findings to be communicated to those charged with governance, in accordance with ISA 260.



## Other findings

**24.** Our audit identified a number of presentational and disclosure issues which were discussed with management, including potential changes to the document structure to improve the flow of the financial statements sections within the annual report. A number of adjustments have been reflected in the financial statements as a result of these discussions.

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## Recommendation 1

**The Fund should review the existing structure and presentation of the annual report to identify opportunities for streamlining the presentation of information.**

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## Pre audit inspection and objections to the accounts

**25.** The Local Authority Accounts (Scotland) Regulations 2014 require local government bodies to publish a public notice on their website that includes details of the period for inspecting and objecting to the accounts. This must remain on the website throughout the inspection period. The notice for Strathclyde Pension Fund was published on the website of the administering authority (Glasgow City Council), therefore complying with the regulations. No objections were received to the Strathclyde Pension Fund accounts.

# Part 2

## Financial management



### Main judgements

The Fund has effective arrangements in place for financial management, including comprehensive reporting of investment performance.

Local government pension schemes experienced improved annual returns on investments in 2016/17 with Strathclyde Pension Fund making a return of 23.1%.





Internal controls were found to be operating satisfactorily in the systems used to process the fund transactions.

### Financial performance in 2016/17

26. 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. The performance of Fund No.1 in 2016/17 is summarised in [Exhibit 3](#).

### Exhibit 3

Assets, liabilities, funding level and investment performance

Increase in net assets (Fund No.1)	Increase in estimated actuarial liabilities (Fund No.1)	Funding level (Fund No.1)	Investment performance
 <p><b>£16.059 billion</b></p> <p>Opening net assets at 1 April 2016 (+22.7%)</p>	 <p><b>£19.152 billion</b></p> <p>Liability at 31st March 2016 (+31.2%)</p>	 <p><b>94.3%</b></p> <p>2014 Funding valuation</p>	 <p><b>23.1%</b></p> <p>Return on investments 2016/17</p>
<p><b>£19.699 billion</b></p> <p>Closing net assets at 31 March 2017</p>	<p><b>£25.136 billion</b></p> <p>Liability at 31 March 2017 based on roll forward approximation from 2014 valuation</p>	<p><b>87.6%</b></p> <p>31 March 2017 Interim valuation (2017 Triennial funding valuation due Dec 2017)</p>	<p><b>11.8%</b></p> <p>Return on investments over 5 years</p>

Source: 16/17 Strathclyde Pension Fund unaudited financial statements

**27.** The combined net assets of Fund No.1 and Fund No.3 increased to £19.910 billion at 31 March 2017 from £16.242 billion at 31 March 2016. The increase of over £3.6 billion reflects a strong investment performance in year. The increase was largely due to strong growth in global stock, against a backdrop of an improving world economy and a fall in the value of the pound. Equity markets in particular performed well in 2016/17.

**28.** During 2016/17, benefits paid out by Fund No.1 amounted to £526 million. This was in excess of the contributions received which totalled £557 million.

**29.** At the same time, the Fund's actuary, Hymans Robertson estimated that pension liabilities for Fund No.1 had risen from £19.152 billion at 31 March 2016 to £25.136 billion at 31 March 2017. The liabilities have been estimated by rolling forward cash flows and investment returns from the 2014 triennial valuation.

**30.** Based the interim valuation by the actuary, the Fund's funding level is estimated to be 87.6% as at 31 March 2017.

### Financial management arrangements

**31.** The Acting Executive Director of Financial Services for Glasgow City Council is the proper officer responsible for Strathclyde Pension Fund. The financial regulations of Glasgow City Council, as administering authority, apply to the pension Fund. We consider that these are comprehensive and current, and promote good financial management.

**32.** Comprehensive investment and administration performance reports are submitted to the Pension Fund Committee on a quarterly basis. Through our attendance at the Committee we have observed a good level of review and scrutiny by members.

**33.** Based on evidence reviewed, we conclude that the Fund has effective financial management arrangements in place. This includes comprehensive reporting of investment performance.

### Financial outcomes

**34.** 2016/17 was a positive year for investment performance for most LGPS pension funds across Scotland as illustrated in [Exhibit 4](#). 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 moved up or down.

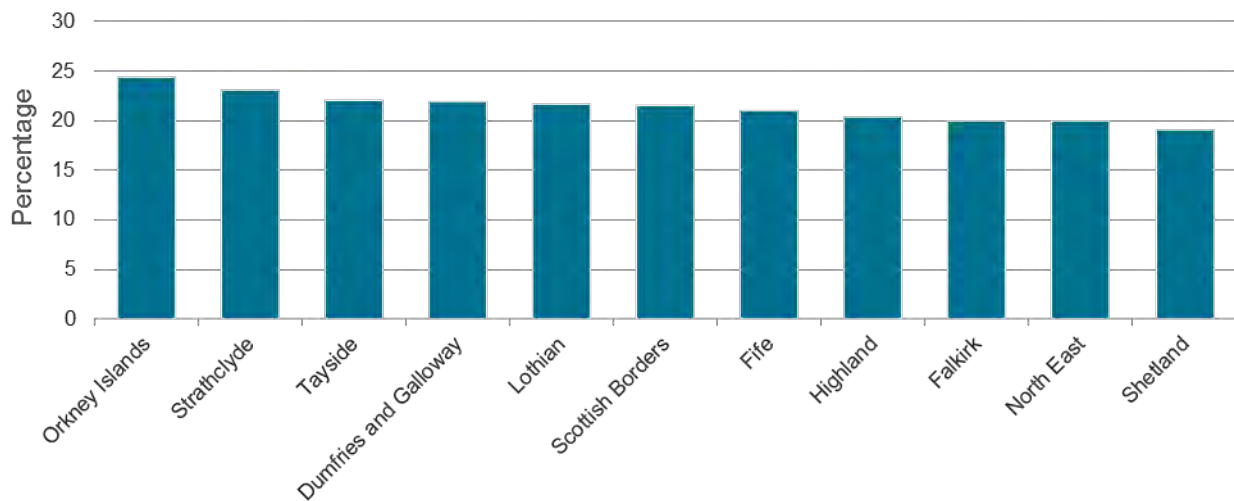
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Financial management is about financial capacity, sound budgetary processes and whether the control environment and internal controls are operating effectively.

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## Exhibit 4

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



Source: 2016/17 LGPS unaudited financial statements

**35.** The Fund achieved a return of 23.1% on its investments. This was above the Fund benchmark of 22% for 2016/17. The three and five year performance returns were 12.6% and 11.8% respectively.

### Internal controls

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

**37.** The Fund uses a number of the financial systems of the administering authority such as the financial ledger system as well as its own systems for administering pensions and investments.

**38.** Our findings were included in an interim audit letter presented to the Pension Fund Committee on 19 June 2017. 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

**39.** We assessed the Fund's arrangements for the prevention and detection of fraud. The Fund relies on the arrangements of the administering authority, Glasgow City Council for the prevention and detection of fraud and corruption. These include codes of conduct for members and officers, whistleblowing policy and anti-fraud strategy and response plan.

**40.** We concluded that appropriate arrangements were in place for preventing and detecting fraud and corruption in 2016/17.

## National Fraud Initiative

**41.** 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. NFI activity is summarised in [Exhibit 5](#).

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### Exhibit 5 NFI activity

#### Total number of matches



**2,989**

#### Number of matches recommended for investigation



**1,104**

#### Completed/closed investigations (recommended and others)



**1,834**

Source: Strathclyde Pension Fund administration section

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- 42.** A range of reports are produced, comparing pension data to payroll information and registers of deaths from a variety of sources. Matches identified through the exercise are prioritised and investigated by Strathclyde Pension Fund staff. Work is continuing to review recommended and other matches. As at September 2017, no frauds have been identified as part of this year's exercise, although a small number of errors amounting to around £8,000 have been discovered.
- 43.** The matching exercise remains an important control which provides assurance that the Fund's records are consistent with those of other public bodies. The Fund is proactive in participating in the NFI exercise and ensures that matches are investigated on a timely basis.

# Part 3

## Financial sustainability



### Main judgement

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

**The deadlines for further implementation of automatic enrolment into the pension scheme will present the Fund with additional administrative pressures and challenges.**

### Funding position

**44.** The March 2014 triennial valuation reported that the Fund assets were sufficient to meet 94.3% of its liabilities. The interim valuation by the Fund's actuary estimated that the funding deficit had deteriorated to 87.6%. This interim valuation, required under International Accounting Standard (IAS) 26, uses the same base data as the triennial funding valuation, rolled forward to take account of changes in membership and updated assumptions. However is not directly comparable to the triennial funding valuation, as it not carried out on the same basis as that used for setting employer contribution rates.

**45.** At the 2014 valuation, the actuary noted that the future service cost of the workforce implied an employers' normal contribution of 19.3%. The current funding position is due to be determined by the actuary this year, using the 31 March 2017 membership data. Arising from the valuation, employer contribution rates will be set for the next three years. Following this, officers will review and update the Funding Strategy Statement.

**46.** The 2017 valuation process is ongoing and progress is reported to the Pension Fund Committee. Planning and preliminary discussions with the actuary are now complete, with the first employer communications issued in June and July 2017. The data required to inform the triennial valuation was submitted to the actuary during August 2017. As part of the valuation exercise a full employer covenant assessment is also being carried out.

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.

### Membership levels

**47.** The pension Fund is a multi-employer fund with 12 local authorities and 171 other employers. Glasgow City Council (the administering authority) is the largest scheme employer. The current membership profile is shown at [Exhibit 6](#). The number of active members continues to outweigh the number of pensioners.

## Exhibit 6

### Strathclyde Pension Fund membership



Source: Strathclyde Pension Fund 2016/17 unaudited financial statements

**48.** Membership of the Fund increased by 6,586 to 222,860 members at 31 March 2017, an increase in active members of 3% from the previous year.

**49.** 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. It is important that the Fund maintains the capacity to meet the current and future needs of its members.

**50.** Under the Pensions Act 2008, employers are required to comply with new pension duties which have been introduced in stages from October 2012. New legislation means that by October 2018, all employers must offer workplace pension schemes to eligible workers.

**51.** Employer members of the Fund, who opted to use the transitional delay provisions within the legislation, are required to enrol employees into the Strathclyde Pension Fund scheme during a six week window commencing from the end of the transitional period.

**52.** The Fund is required to provide basic scheme information (such as welcome packs) to automatically enrolled members within one month of the date employee information was received. Failure to comply with this requirement may lead to action being taken by the Pensions Regulator.

**53.** Employers have the choice to apply a postponement to automatic enrolment of up to three months from the end of the original transitional period of 1 October 2017, delaying the enrolment of the employee. This postponement extends the transitional period to 1 January 2018.

**54.** New transitional delay guidance, issued in June 2017, has indicated that employers cannot automatically enrol employees who opted out more than 12 months before the original transitional delay assessment date of 1 October 2017. Although this will lessen the anticipated administrative burden in the coming year, automatic enrolment continues to present the Fund with increased administration pressures and challenges going forward.

## Recommendation 2

**The Fund should ensure that business plans address the resource and administrative challenges that automatic enrolment will present.**

### Contributions

55. Following the last triennial valuation in 2014, the employer contribution rates for individual employers were set for the period 2015 to 2018. An element of these employer costs includes deficit recovery contributions to support employers' financial planning. The approximate split of all contributions received in year is set out at [Exhibit 7](#).

### Exhibit 7

Contributions and Benefits Paid in 2016/17 (Fund No.1)

	Administering authority £m	Other scheduled bodies £m	Admitted bodies £m	Total £m
Employer contributions including strain costs	50,978	250,830	96,471	398,279
Employee contributions	16,758	75,965	29,354	122,077
Benefits paid	75,151	375,855	80,883	531,889

Source: Strathclyde Pension Fund 2016/17 unaudited financial statements – note 12

56. Over the past few years the Fund has incurred a deficit in its dealings with members. This means that pension benefits paid have exceeded contributions received. When taking into account employee transfers to and from the Fund, there was a deficit from dealing with members of £31.115 million for Fund No.1 and £3.671 million for Fund No.3. The Fund relied on investment income to meet this deficit.

57. The Fund actively monitors its cash flow position and reports the position to every meeting of the Pension Fund Committee. A ten year cash flow forecast is prepared annually and is submitted to the Pension Fund Committee at the March meeting.

58. The cash flow forecast published in the 2017/18 Annual Business Plan indicated that negative cash flows should come to an end in 2017/18. However the most recent cash flow monitoring report presented to the Strathclyde Pension Fund Committee on 6 September 2017 forecasts a deficit outturn of £32.515 million.

59. The current projection is that income for the year will be lower than originally estimated, with expenditure on pension benefits being higher. This change in forecast has resulted from an expectation that employers will delay automatic enrolment from October 2017 to January 2018, and also an increase in actual lump sum payments made in the year.



**60.** Although cash flow projections indicate that cash flows from dealings with members for Fund No.1 will return positive in the medium to long term, there is a risk that the continued rise in pensioner numbers will make funding pension payments increasingly challenging.

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### **Recommendation 3**

**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.**

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# Part 4

## Governance and transparency



### Main judgements

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

**Decisions made by the Pension Fund Committee are transparent. Committee papers and detailed minutes of meetings of the Committee are available on the Strathclyde Pension Fund and Glasgow City Council websites.**

### Governance arrangements

**61.** Glasgow City Council is the administering authority for Strathclyde Pension Fund. The council has delegated responsibility for governance to the Executive Director of Financial Services. The Pension Fund Committee is the main decision making body of the Fund. It is supported by the Pension Board and is responsible for establishing arrangements that ensure the proper conduct of the affairs of the Fund. It is also responsible for ensuring that decisions are made within the terms of the Local Government Pension Scheme.

**62.** The responsibilities of the Executive Director of Financial Services, Pension Fund Committee and Pension Board are set out in the Statement of Investment Principles.

**63.** The main functions of the Fund are management of investments and administration of scheme benefits. These functions are carried out in accordance with the Local Government Pension Scheme (Scotland) regulations which are statutory instruments made under the Superannuation Act 1972 and Public Service Pensions Act 2013.

**64.** As noted in our 2016/17 annual audit plan, we carried out a follow up review of Audit Scotland's 2011 *Role of Boards* report. This work involved reviewing the role of the Pension Fund Committee and the effectiveness of governance, decision making and scrutiny arrangements. We also reviewed arrangements for member training and development.

**65.** From our work we concluded that effective arrangements were in place for governance, decision making and scrutiny during the financial year. Following the local government elections in May 2017, the new Pension Fund Committee met for the first time on 19<sup>th</sup> June 2017. A training policy and practice statement for the Fund together with a training plan for 2017/18 was taken to the Committee. We concluded that effective arrangements are in place for member training and development.

**66.** In addition to the Pension Fund Committee and Pension Board, an Investment Advisory Panel (IAP) is also in place which comprises of investments officers from the Fund and representatives from Hymans Robertson as the Fund's actuary and investment consultant. The panel also includes three independent expert advisors.

The IAP supports the Pension Fund Committee and is responsible for developing investment strategy and monitoring investment performance.

**67.** Overall we concluded that the Fund has adequate governance arrangements in place which support good governance and accountability.

### Other aspects of governance

**68.** 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.

**69.** Overall, we concluded that there are open and transparent arrangements in place for scrutiny and decision making.

### Pensions Regulator Public Service Code

**70.** The Fund maintains a register of breaches of the pensions regulations during the year, and is required to report any significant breaches to the Pensions Regulator. During 2016/17 there were no instances of late payment of member contributions or other breaches which were considered to be of material significance such that they required to be reported.

**71.** The Fund continues to work to improve the quality of member data. The 2016/17 annual report notes that substantial progress has been made to date. The Pension Regulator's guidance sets a target of 100% accuracy for new common data received after June 2010.

**72.** At 31 March 2017, the Fund came close to this benchmark for most key data, however information on member addresses was assessed as only 93% accurate. This relates to deferred members, and the Fund has put a strategy in place to trace these members prior to their benefits becoming due.

**73.** Given the complexities of the administration of the LGPS, the Fund relies on employers to provide timely and accurate data returns. The Fund continues to implement its Iconnect module which enables electronic submission of member data from employers.

### Internal audit

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

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

**76.** To avoid duplication, we place reliance on the work of internal audit wherever possible. In 2016/17 we placed formal reliance on internal audit's work on investment management expenses. Also, we considered internal audit report findings on Career Average Scheme Administration, Governance Arrangements and the Fund Assurance Mapping exercise as part of our wider dimension work.

### Transparency

**77.** 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.

**78.** The Pension Fund Committee is held in public and the minutes of these meetings are publicly available on the Fund's website.

**79.** The Fund has a separate website which includes various policies and strategies of the Fund. Pension Fund Committee papers are available on the website prior to the meeting date and there is a good level of transparency around pension fund business.

**80.** The Fund held an annual general meeting on 23 June 2017. The meeting was attended by over 100 stakeholders. The Fund's leadership team presented an overview of the Fund's business for 2016/17 and the appointed actuary delivered an update on the 2017 triennial valuation.

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

# Part 5

## Value for money



### Main judgements

The Fund's investment performance is subject to regular review and scrutiny by the Pension Fund Committee.

The Fund has adequate arrangements in place for monitoring investment performance and scrutinising investment management expenses.

### Investment performance

82. The Strathclyde Pension Fund Committee meets on a quarterly basis. A review of fund managers' performance is a standing item on the Committee's agenda. At each meeting, Committee members receive a report outlining overall fund performance including an analysis of risks and returns.

### Exhibit 8

#### Fund investment performance (Fund No.1)



Source: Strathclyde Pension Fund 2016/17 audited financial statements

83. [Exhibit 8](#) shows that over the year, the Fund generated a return of 23.1% against a benchmark of 22%. Equity portfolios were the most significant contributor to this increase.

84. Over the medium to longer term the Fund has outperformed its benchmark over three, five and ten years.

**85.** As shown earlier in [Exhibit 4](#), investment performance compared favourably with other LGPS Funds in Scotland.

**86.** Under the career average pension scheme (CARE), accrued benefits are indexed at Consumer Price Index (CPI). Benefits earned under the old final salary scheme will continue to increase in line with earnings. As can be seen from [Exhibit 8](#), investment returns have outperformed inflation over the past 10 years, going some way to meeting increases in the historic liabilities.

**87.** The Fund appoints a number of external investment managers. Individual investment manager performance is reported on a quarterly basis to the Pension Fund Committee. In addition, all investment managers are subject to review at least annually by the Investment Advisory Panel (IAP). Investment managers are required to complete annual compliance checklists. The Fund's investments team also carry out annual diligence reviews for each appointed fund manager.

**88.** The investment strategy of the Fund is included in the Statement of Investment Principles which was updated in April 2017. The Fund has adopted a risk/return asset framework as the basis for modelling and agreeing the investment strategy. The Fund is largely equity based which provided a strong investment return in 2016/17. The Fund continues to invest in other assets classes such as hedging/insurance, credit and short term enhanced yield.

**89.** The Fund also continues to invest in long term enhanced yield assets, such as UK and overseas property. At 31 March 2017 the Fund held direct property assets with a value of £1.671 billion. The objective of holding such investments is to provide a long term income stream and a degree of inflation protection. Maintaining long term investment income is important to ensuring the Fund has available funding to meet any deficit resulting from dealings with members.

**90.** Investment return and risk are inextricably linked and it is not possible for us to comment on the relative performance of the Fund's investments given the risk exposure of the asset allocation and investments made. Although asset allocation is largely in line with the Fund's investment strategy, the Fund is still overweight in equities (68.6% at 31 March 2017 against a target of 62.5%) and underweight in both short-term enhanced yield investments and long term enhanced yields.

**91.** A re-balancing strategy is in place with the objective of ensuring that the Fund does not diverge too far from the long-term investment strategy and structure agreed by the Pension Fund Committee. The current re-balancing strategy was approved by the Pension Fund Committee at its meeting in March 2017. The Investment Advisory Panel continues to monitor asset allocation and the re-balancing strategy and provide a quarterly report to the Pension Fund Committee.

## Direct Investment Portfolio

**92.** The Direct Investment Portfolio (formerly known as the New Opportunities Portfolio) has been gradually increased since its inception in 2009. During 2016/17 a number of further commitments were made to the Fund. The Direct Investment Portfolio has a capacity of 5% of the Fund's overall value.

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

the Fund should be included. The Fund implemented compliance with these disclosure requirements a year earlier than required by meeting them in 2015/16.

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

**96.** Strathclyde Pension Fund has 13 appointed investment managers with a further 26 managers managing investments for the Direct Investment Portfolio. Fees payable to investment managers are set as a percentage of the value of the investments under their management. The value varies depending on the performance level achieved by the investments and therefore increases or reduces as the value of these investments change.

**97.** Investment management expenses for Fund No.1 have increased to £96.353 million in 2016/17 from £87.629 million in 2015/16. The increased amount is reflective of the strong equity returns achieved by investment managers in 2016/17 and the large increase in investment value.

**98.** As part of their 2016/17 audit plan, Glasgow City Council's internal audit team carried out a review of the arrangements currently in place for review and scrutiny of investment manager fees. Internal audit reported that the key controls in place are generally operating effectively. A process is in place operationally to review and negotiate the fees that are paid to investment managers to help secure value for money for the Fund. Negotiations on fees are undertaken as part of investment manager contract changes and also on an ad hoc basis by the investments team as part of the regular discussions that they hold with the investment managers.

**99.** Two recommendations were identified by internal audit in their report:

- improvements could be made around the documentation and recording of evidence around the negotiation of fees and fee savings
- the work that is being undertaken by the Fund in relation to the Scheme Advisory Board code of transparency (adopted in England and Wales) and accounting for investment management costs is in the early stages. Despite this, internal audit made some observations which should be considered to ensure that value for money in relation to investment manager fees can be demonstrated.

**100.** We concluded that the Fund has adequate arrangements in place for monitoring investment performance and scrutinising investment management expenses. However, CIPFA guidance on management expenses has enabled greater transparency in investment management fee information including the development of benchmarking information. 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.

## Administrative expenses

**101.** 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 such as automatic enrolment.

**102.** The Fund's Annual Business Plan sets out a range of service standards against which administration performance is monitored. These are measured on a regular basis and are reported to the Pension Fund Committee quarterly.

**103.** The Fund uses a rolling customer survey to enable it to measure members' satisfaction with the quality of service delivery. Members receive a questionnaire when each significant transaction is processed. The Fund continues to achieve reasonably good member feedback, with a level of satisfaction amongst retirees of 88.2% in 2016/17.

**104.** 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 2016/17 have now been received.

**105.** As part of the Fund's governance assurance framework employers are also required to submit compliance certificates verifying compliance with a range of Strathclyde 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.

### **National performance audit reports**

**106.** 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 4](#) which accompanies this report.

**107.** 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><b>1. Annual report</b></p> <p>Our audit identified a number of presentational and disclosure issues which were discussed with management, including potential changes to the document structure to improve the flow of the financial statements sections within the annual report.</p> <p><b>Risk</b></p> <p>Information in the annual report is unclear, and does not assist the user in understanding the accounts.</p>	<p>The Fund should review the existing structure and presentation of the annual report to identify opportunities for streamlining the presentation of information.</p>	<p>The structure and presentation are reviewed each year and improvements are introduced. The adjustments suggested by Audit Scotland will be implemented in next year's report.</p> <p>Director of Strathclyde Pension Fund</p> <p>December 2017</p>
16	<p><b>2. Automatic enrolment</b></p> <p>The end of the transitional period will result in the automatic enrolment of employees who have been eligible to participate in the fund but have previously not chosen to join.</p> <p>The Fund is required to provide basic scheme information (welcome packs) to automatically enrolled members within one month of the date employee information was received from the employer.</p> <p><b>Risk</b></p> <p>Implementing legislation on automatic enrolment will present the Fund with additional administration pressures and challenges.</p> <p>Failure to comply with requirements may lead to action being taken by the Pensions Regulator.</p>	<p>The Fund should ensure that business plans address the resource and administrative challenges that automatic enrolment will present.</p>	<p>Preparation for the end of the automatic enrolment transitional delay period is listed as a business priority in the Fund's 2017/18 Business Plan. A project plan has been developed and is being implemented to ensure that appropriate procedures and resources are in place. Internal audit has completed an initial review of the preparations.</p> <p>Pension Scheme Manager</p> <p>September 2017</p>



**Page  
no.**

**Issue/risk**

**Recommendation**

**Agreed  
management  
action/timing**

17

**3. Funding Position**

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 in 2017/18.

**Risk**

A mismatch between the Fund's funding and investment strategies leads to insufficient cash flow to pay pensions.

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.

Reviews of both the funding and investment strategies are listed as business priorities in the Fund's 2017/18 Business Plan. Work is underway on both. The investment review will include asset-liability modelling based on cash flows from the actuarial valuation of the Fund to be carried out as at 31<sup>st</sup> March 2017. Short term cash flow will continue to be monitored and reported to the Board and Committee.

Director of Strathclyde Pension Fund.

March 2018.

# 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 our wider responsibility under the [Code of Audit Practice 2016](#).

Audit risk	Assurance procedure	Results and conclusions
<b>Risks of material misstatement in the financial statements</b>		
<p><b>1 Risk of management override of controls</b></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>	<p>Detailed testing of journal entries.</p> <p>Review of accounting estimates.</p> <p>Evaluation of significant transactions that are outside the normal course of business.</p>	<p>A sample of journals was tested as part of our financial statements audit.</p> <p>We reviewed the accounting estimates used in preparation of the financial statements.</p> <p>We concluded was no evidence of management override of controls.</p>
<p><b>2 Risk of fraud over income and expenditure</b></p> <p>ISA 240 presumes a risk of fraud over income which is expanded to include fraud over expenditure in the public sector by the Code of Audit Practice</p> <p>Strathclyde Pension Fund receives a significant amount of investment income from third party sources. This presents a risk due to the extent and complexity of income.</p> <p>The Pension Fund also makes a range of high value payments, which can constitute a risk of misstatement of expenditure.</p>	<p>Evaluating the effectiveness of systems for income recognition and recording.</p> <p>Analytical procedures on income and expenditure streams.</p> <p>Agree income to third party confirmation.</p> <p>Substantive testing of expenditure.</p>	<p>We reviewed the controls in place for income recognition and recording.</p> <p>Income and expenditure streams were satisfactorily agreed to custodian reports.</p> <p>Substantive testing of income and expenditure did not identify any misstatement issues.</p>
<p><b>3 Estimation and judgements</b></p> <p>There is a significant degree of subjectivity in the measurement and valuation of investments.</p> <p>This includes level 3 investments such as unquoted equity where valuations use</p>	<p>Completion of 'review of the work of an expert' in accordance with ISA 500 for the professional valuer.</p> <p>Test valuations to valuation reports and/or other supporting documentation.</p>	<p>Completed 'review of the work of an expert'.</p> <p>Verified level three investment balances to custodian reports.</p> <p>We did not identify any issues in relation to this risk.</p>

Audit risk	Assurance procedure	Results and conclusions
<p>techniques that require significant judgement in determining appropriate assumptions.</p> <p>This subjectivity represents an increased risk of misstatement in the financial statements</p>		
<p><b>4</b> Changes to financial reporting</p> <p>There are changes to the accounting code for the 2016/17 financial statements:</p> <ul style="list-style-type: none"> <li>• presentational changes to the format of the fund account</li> <li>• application of IFRS 13 Fair value measurement has been applied to pension fund investments</li> <li>• new recommended disclosures in respect of management expenses.</li> </ul> <p>There is a risk that these changes are not properly reflected in 2016/17 financial statements presented for audit.</p>	<p>Communication with officers on the technical details of the changes.</p> <p>Review disclosures as part of our financial statements audit.</p>	<p>Disclosures were reviewed as part of our financial statements work.</p> <p>No issues were identified.</p>

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

<p><b>5</b> <b>Financial sustainability</b></p> <p>The Fund reported a deficit in dealings with members in 2015/16. The cash flow projection for 2016/17 shows a continuing deficit position, which will be funded through use of investment income. Although the medium term projection is for move back to a positive cash flow, there is a risk that the continued increase in pensioners will make funding pension payments increasingly challenging.</p>	<p>Review the financial position of the Fund and the quality of the financial reporting.</p> <p>Monitoring of cash flow forecasting</p>	<p>We reviewed the financial position of the Fund and the quality of financial reporting as part of our financial statements audit.</p> <p>We note that there was a negative cash flow position in 2016/17 and this is forecast to continue in 2017/18.</p>
<p><b>6</b> <b>Local government elections</b></p> <p>The 2017 local government elections will result in changes in the elected members. There is a risk that there is a loss of skills and experience amongst members. To ensure members understand their roles and have the necessary skills to make informed decisions and provide effective scrutiny, development</p>	<p>Review the arrangements for the induction and training of new members.</p> <p>Follow up work on our 2011 national report on the role of boards.</p>	<p>Reviewed the training policy and practice statement.</p> <p>Carried out our follow up work on role of boards report.</p> <p>We concluded that adequate arrangements were in place.</p>





















Audit risk	Assurance procedure	Results and conclusions
and training will be required. The Audit Scotland publication 'How Councils Work' on the role of councillors provides guidance in this area.		

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# 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.

# Strathclyde Pension Fund

## 2016/17 Annual Audit Report

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