

The Pensions Committee
The Highland Council as administering body for the Highland
Council Pension Fund

22 September 2016

The Highland Council Pension Fund 2015/16 Annual Audit Report

1. International Standard on Auditing (UK and Ireland) 260 (ISA 260) requires auditors to report specific matters arising from the audit of the financial statements to those charged with governance of a body in sufficient time to enable appropriate action. We are drawing to your attention matters for your consideration before the financial statements are approved and certified. We also present for your consideration our draft annual report on the 2015/16 audit which identifies significant findings from the financial statements audit. The section headed "Significant findings from the audit in accordance with ISA260" in the attached annual audit report sets out the issues identified. This report will be issued in final form after the financial statements have been certified.
2. Our work on the financial statements is now substantially complete. Subject to the satisfactory conclusion of any outstanding matters and receipt of a revised set of financial statements for final review, we anticipate being able to issue an independent auditor's report on 22 September 2016 which is unqualified. The proposed report is attached at Appendix A. There are no anticipated modifications to the audit report.
3. In presenting this report to the Pensions Committee we seek confirmation from those charged with governance of any instances of any actual, suspected or alleged fraud; any subsequent events that have occurred since the date of the financial statements; or material non-compliance with laws and regulations affecting the entity that should be brought to our attention.
4. We are required to report to those charged with governance all unadjusted misstatements which we have identified during the course of our audit, other than those of a trivial nature and request that these misstatements be corrected. There are no unadjusted misstatements to bring to your attention.
5. As part of the completion of our audit we seek written assurances from the Director of Finance on aspects of the financial statements and judgements and estimates made. A draft letter of representation under ISA580 is attached at Appendix B. This should be signed and returned by the Director of Finance with the signed financial statements prior to the independent auditor's opinion being certified.

Outstanding matters

6. There is one area where we still require additional information and this is identified below:
7. **Letter of representation:** This letter, otherwise known as the ISA 580 letter, is required before the approval of the financial statements by the Pensions Committee on 22 September 2016.

APPENDIX A: Proposed Independent Auditor's Report

Independent auditor's report to the members of The Highland Council as administering body for the Highland Council Pension Fund and the Accounts Commission for Scotland

I certify that I have audited the financial statements of the Highland Council Pension Fund for the year ended 31 March 2016 under Part VII of the Local Government (Scotland) Act 1973. The financial statements comprise the Pension Fund Account, the Net Assets Statement and the related notes. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union, and as interpreted and adapted by the Code of Practice on Local Authority Accounting in the United Kingdom 2015/16 (the 2015/16 Code).

This report is made solely to the parties to whom it is addressed in accordance with Part VII of the Local Government (Scotland) Act 1973 and for no other purpose. In accordance with paragraph 125 of the Code of Audit Practice approved by the Accounts Commission for Scotland, I do not undertake to have responsibilities to members or officers, in their individual capacities, or to third parties.

Respective responsibilities of the Director of Finance and auditor

As explained more fully in the Statement of Responsibilities, the Director of Finance is responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. My responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland) as required by the Code of Audit Practice approved by the Accounts Commission for Scotland. Those standards require me to comply with the Auditing Practices Board's Ethical Standards for Auditors.

Scope of the audit of the financial statements

An audit involves 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. This includes an assessment of: whether the accounting policies are appropriate to the Fund's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the Director of Finance; and the overall presentation of the financial statements. In addition, I read all the financial and non-financial information in the Annual Report and Annual Accounts to identify material inconsistencies with the audited financial statements and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by me in the course of performing the audit. If I become aware of any apparent material misstatements or inconsistencies I consider the implications for my report.

Opinion on financial statements

In my opinion the financial statements:

- give a true and fair view in accordance with applicable law and the 2015/16 Code of the financial transactions of the Fund during the year ended 31 March 2016, and of the amount and disposition at that date of its assets and liabilities;
- have been properly prepared in accordance with IFRSs as adopted by the European Union, as interpreted and adapted by the 2015/16 Code; and
- have been prepared in accordance with the requirements of the Local Government (Scotland) Act 1973, The Local Authority Accounts (Scotland) Regulations 2014, and the Local Government in Scotland Act 2003.

Opinion on other prescribed matter

In my opinion the information given in the Management Commentary for the financial year for which the financial statements are prepared is consistent with the financial statements.

Matters on which I am required to report by exception

I am required to report to you if, in my opinion:

- adequate accounting records have not been kept; or
- the financial statements are not in agreement with the accounting records; or
- I have not received all the information and explanations I require for my audit; or
- the Annual Governance Statement has not been prepared in accordance with Delivering Good Governance in Local Government; or
- the Governance Compliance Statement does not comply with guidance from the Scottish Ministers.

I have nothing to report in respect of these matters.

Stephen Boyle CPFA
Assistant Director
Audit Scotland
4th Floor South Suite
The Athenaeum Building
8 Nelson Mandela Place
GLASGOW
G2 1BT

September 2016

APPENDIX B: Letter of Representation (ISA 580)

Stephen Boyle, Assistant Director
Audit Scotland
4th Floor
8 Nelson Mandela Place
Glasgow
G2 1BT

22 September 2016

Dear Stephen

The Highland Council Pension Fund Annual Accounts 2015/16

1. This representation letter is provided in connection with your audit of the financial statements of the Highland Council Pension Fund for the year ended 31 March 2016 for the purpose of expressing an opinion as to whether the financial statements give a true and fair view of the financial position of the Highland Council Pension Fund, as at 31 March 2016 and its net increase in net assets for the year then ended.
2. I confirm to the best of my knowledge and belief, and having made appropriate enquiries of Pension Fund officers and the Pensions Committee, the following representations given to you in connection with your audit of the Highland Council Pension Fund for the year ended 31 March 2016.

General

3. I acknowledge my responsibility, and that of the administering authority, for the financial statements. All the accounting records requested have been made available to you for the purposes of your audit. All material agreements and transactions undertaken by the Highland Council Pension Fund have been properly reflected in the financial statements. All other records and information have been made available to you, including minutes of all management and other meetings.
4. The information given in the Annual Report and Annual Accounts, including the Management Commentary, presents a balanced picture of the Highland Council Pension Fund and is consistent with the financial statements.
5. I confirm that the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole. I am not aware of any uncorrected misstatements other than those identified in the auditor's report to those charged with governance (ISA260).

Financial Reporting Framework

6. The financial statements have been prepared in accordance with Code of Practice on Local Authority Accounting in the United Kingdom 2015/16 (the 2015/16 Code), and in accordance with the requirements of the Local Government (Scotland) Act 1973, The Local Authority Accounts (Scotland) Regulations 2014, and the Local Government in Scotland Act 2003 including all relevant presentation and disclosure requirements.

7. Disclosure has been made in the financial statements of all matters necessary for them to show a true and fair view of the financial transactions of the Highland Council Pension Fund during 2015/16, and the amount and disposition at that date of its assets and liabilities.

Accounting Policies & Estimates

8. All material accounting policies adopted are as shown in Note 3 (Summary of Significant Accounting Policies) included in the financial statements. The continuing appropriateness of these policies has been reviewed since the introduction of IAS 8 and on a regular basis thereafter, and takes account of the requirements set out in the 2015/16 Code.
9. The significant assumptions used in making accounting estimates are reasonable and properly reflected in the financial statements. There are no changes in estimation techniques which should be disclosed due to their having a material impact on the accounting disclosures.

Contributions - Pension Strain

10. All contributions due to the fund have been properly identified and accounted for. In particular, the 'strain on the fund' costs have been properly recharged to relevant bodies.

Related Party Transactions

11. All transactions with related parties have been disclosed in the financial statements. I have made available to you all the relevant information concerning such transactions, and I am not aware of any other matters that require disclosure in order to comply with the requirements of IAS24, as interpreted by the 2015/16 Code.

Events Subsequent to the Date of the Net Assets Statement

12. I acknowledge the potential impact of the result of the EU Referendum on 23 June 2016 on the value of the Fund's investment. There have been no material changes in the value of investments since the date of the net assets statement, which necessitate revision of the figures in the financial statements or notes thereto including contingent assets and liabilities, other than those set out in Note 20.
13. Since the date of the Net Assets Statement no events or transactions have occurred which, though properly excluded from the financial statements, are of such importance that they should be brought to your notice.

Corporate Governance

14. I acknowledge, as Section 95 Officer, my responsibility for the corporate governance arrangements. I confirm that I have disclosed to the auditor all deficiencies in internal control of which I am aware.
15. The corporate governance arrangements have been reviewed and the disclosures I have made are in accordance with the 2015/16 Code. There have been no changes in the corporate governance arrangements or issues identified, since the 31 March 2016, which require disclosure.

Fraud

16. I have considered the risk that the financial statements may be materially misstated as a result of fraud. I have disclosed to the auditor any allegations of fraud or suspected fraud affecting the financial statements. There have been no irregularities involving management or employees who have a significant role in internal control or that could have a material effect on the financial statements.

Assets

Investments

17. For the year ended 31 March 2016, the amounts included in the net assets statement reflect investments managed/held both internally and externally by appointed fund managers and the global custodian on behalf of the Pension Fund. Amounts have been calculated in accordance with approved bases of valuation and fairly represent the values at 31 March 2016. In making these assertions I am reliant on the opinions of the appointed fund managers. As far as I can reasonably ascertain, all assets are free from lien, encumbrance or charge except as disclosed in the financial statements.

Banking and cash flow arrangements

18. The Pension Fund maintains separate bank accounts and while these accounts form part of The Highland Council's treasury management arrangements, the Pension Fund can demonstrate that there is no borrowing from the administering authority. Amounts due to the administering authority to cover daily cash flows such as payments through the council's systems are reimbursed on a regular basis.

Other Current Assets

19. Orphan liabilities are calculated by the scheme actuary and become due when an employer who is not backed by a guarantee leaves the Pension Fund. At 31 March 2016, all significant amounts have been identified and accrued.
20. On realisation in the ordinary course of the Pension fund's business, the other current assets in the balance sheet are expected, in my opinion, to produce at least the amounts at which they are stated. In particular, adequate provision has, in my opinion, been made against all amounts owing which are known or may be expected to be irrecoverable.

Liabilities

21. All liabilities have been provided for in the books of account, including the liabilities for all purchases to which title has passed prior to 31 March 2016.

Carrying Value of Assets and Liabilities

22. The assets and liabilities have been recognised, measured, presented and disclosed in accordance with 2015/16 Code. There are no plans or intentions that are likely to affect the carrying value of the assets and liabilities within the financial statements.

Provisions

23. Provisions have been made in the financial statements for all material liabilities which have resulted or may be expected to result, by legal action or otherwise, from events which had occurred by 31 March 2016 and of which the Highland Council Pension Fund could reasonably be expected to be aware.

Actuarial Assumptions

24. The pension assumptions made by the actuary in the International Accounting Standard 19 (Employee Benefits) report on the Highland Council Pension Fund have been reviewed and I confirm that they are consistent with management's own view.
25. The pension assumptions made by the actuary in the 2014 Triennial Valuation were reviewed and I confirm that they are consistent with management's own view.

Commitments

26. There are no significant commitments or obligations including financial guarantees and offers of financial support which might adversely affect the funds.

Other matters

27. Except as disclosed in the financial statements, the results for the period were not materially affected by:
- transactions of a sort not usually undertaken by the Pension Fund
 - circumstances of an exceptional or non-recurrent nature
 - charges or credits relating to prior periods
 - any change in the basis for accounting.

Yours sincerely

Derek Yule
Director of Finance, The Highland Council

The Highland Council Pension Fund

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

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Key contacts

Stephen Boyle, Assistant Director
sboyle@audit-scotland.gov.uk

Maggie Bruce, Senior Audit Manager
mbruce@audit-scotland.gov.uk

Jim Convery, Senior Auditor
jconvery@audit-scotland.gov.uk

Audit Scotland
4th floor (South Suite)
8 Nelson Mandela Place
Glasgow
G2 1BT

Telephone: 0131 625 1500

Website: www.audit-scotland.gov.uk

The Accounts Commission is a statutory body which appoints external auditors to Scottish local government bodies (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/).

Stephen Boyle is the engagement lead for the audit of The Highland Council Pension Fund for the period 2012/13 to 2015/16.

This report has been prepared for the use of The Highland Council 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

- The independent auditor's report on the 2015/16 financial statements is unqualified.
- The unaudited accounts were submitted for audit in line with the agreed timetable, and were of a good standard.
- The audited accounts were adjusted to reflect the dates of early departures of staff from The Highland Council in 2015/16, ensuring that these are recorded in the correct financial year.

Financial management and sustainability

- The pension fund's net assets increased by £20.5 million (1.4%) during 2015/16. Estimated pension liabilities have reduced by £105 million (5.3%) due to an increase in the discount rate from 3.2% to 3.5% used to estimate their current value.
- The pension fund is relatively well funded. It was 96.2% funded at the triennial valuation in March 2014 and deficits are being recovered over a 20 year period.

Governance and transparency

- The pension fund has coped well with the introduction of the new governance arrangements which arise from LGPS 2015 with the establishment of a Pensions Board in September 2015 which meets concurrently with the Pensions Committee.
- There was a satisfactory level of control in place within the pension investments and pension administration systems. Control weaknesses were identified within the pension fund's bank and intercompany reconciliation processes, and the general ledger and accounts payable modules of the new financial management system.

Best Value

- The pension fund outperformed its one, three and five year investment performance benchmarks.
- The pension fund's administration, oversight and governance costs as a proportion of its net assets were mid-table when compared to the other Scottish pension funds.



Outlook

- Overall, the fund has a relatively strong financial position that will allow it to meet both the current and future needs of its members. The potential impact of the UK's vote to leave the European Union on the fund is not yet clear. Ongoing monitoring by the Fund of the impact of the anticipated negotiations between the UK and EU will be a key part of its forward planning. It is clear that the outlook for public spending remains very challenging and the need for spending constraints and budget reductions will continue.

Introduction

1. This report is a summary of the findings arising from the 2015/16 audit of the Highland Council Pension Fund. The report is divided into sections which reflect our public sector audit model. These are:
 - audit of the 2015/16 financial statements
 - financial management and sustainability
 - governance and transparency
 - best value.
2. The management of The Highland Council, as administering authority for the Highland Council 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 the Highland Council 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. The significant audit risks identified at the planning stage and how we addressed each risk in arriving at our opinion for financial statements is set out in Appendix I. Local reports issued during the year are summarised at Appendices II.
6. 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 the Highland Council Pension Fund understand their risks and have arrangements in place to manage these. The Pensions Committee should ensure that they are satisfied with the proposed action and have a mechanism in place to assess progress and monitor outcomes.
7. 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.

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8. We are grateful for the cooperation and assistance we received during the course of the audit.
 9. 2015/16 is the final year of the current five year audit appointment. From 2016/17 the auditor of the Highland Council Pension Fund will be Grant Thornton. In accordance with agreed protocols and International Standards on Auditing we will be liaising with the incoming auditors as part of this transition.

Outlook

10. The financial outlook across the public sector, and in particular, local government, remains challenging. Recent revisions to the Local Government Pension Scheme should help ensure that the Highland Council's Pension Fund is affordable to employers whilst remaining attractive to employees.

11. The change to Career Average Revalued Earnings (CARE) and the introduction of new governance arrangements arising from the Public Service Pensions Act 2013 were major changes for the pension fund. Changes to the state pension arrangements and the need for Guaranteed Minimum Pension reconciliations have also added to workloads. These will demand ongoing attention as administration arrangements continue to evolve.
12. Financial challenges within the public sector are likely to continue and increased pressure from employers to keep costs and contributions down makes it essential for funds to be able to demonstrate best value. Just as councils are having to look to new models of service delivery, pension funds should also consider alternative ways to reduce costs and maximise benefits for their members.

Audit of the 2015/16 financial statements

<p>Audit opinion</p>	<ul style="list-style-type: none"> We have completed our audit and issued an independent auditor's report which is unqualified.
<p>Going concern</p>	<ul style="list-style-type: none"> The financial statements of the 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.
<p>Annual report & other information</p>	<ul style="list-style-type: none"> We reviewed the annual report and information published with the financial statements, including the management commentary, annual governance statement and governance compliance statement. We have nothing to report as a result of our review.

Submission of financial statements for audit

13. We received the unaudited financial statements on 20 June 2016, in accordance with the agreed timetable. The working papers were of a good standard and finance staff responded promptly to audit team queries which assisted the delivery of the audit by the deadline set out in the 2014 Accounts Regulations.

Overview of the scope of the audit of the financial statements

14. 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 Pension Fund Committee in February 2016.
15. 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.
16. 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.

17. 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

18. 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).
19. 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.
20. We summarised our approach to materiality in our Annual Audit Plan. We revised our planning materiality for 2015/16 on receipt of the unaudited accounts to £5.8 million (10% of contributions receivable).

21. We also set a lower level, known as performance materiality, when defining our audit procedures. This is determined to ensure that uncorrected and undetected audit differences do not exceed our materiality level. Performance materiality was set at £2.9 million (50% of materiality).
22. We report all misstatements greater than £100,000.

Evaluation of misstatements

23. All misstatements identified during the audit, which exceeded our misstatement threshold, have been amended in the audited financial statements. The effect of these adjustments is to reduce contributions receivable and debtors by £3.178 million; and to reduce benefits payable and creditors by £5.810 million. A number of amendments were also made to improve the presentation of the audited financial statements.
24. As the total value of misstatements identified (£8.988 million) exceeded our performance materiality level, we considered whether we needed to revise our audit approach and undertake additional audit testing. We concluded that further testing was not required as we had identified the full extent of the misstatements set out above (see paragraphs 27 and 28 for further details).

Significant findings from the audit

25. 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.
26. The following table details those issues or audit judgements that, in our view, require to be communicated to those charged with governance in accordance with ISA 260.

Table 1: Significant findings from the audit

Significant findings from the audit in accordance with ISA260

Contributions receivable

27. Contributions receivable and debtors were overstated by £3.178 million in the unaudited accounts as strain on the fund costs for all staff leaving under The Highland Council’s voluntary release scheme were included within the 2015/16 statements. Strain on the fund costs should only be included within the pension fund’s accounts for those staff leaving the council’s employment on or before 31 March 2016. The audited accounts have been amended to correct this misstatement. Strain on the fund costs in respect of employees leaving Highland Council in 2016/17 will be recorded in that year’s financial statements.

Benefits payable

28. Benefits payable and creditors were overstated by £5.810 million in the unaudited accounts as benefits payable to all staff taking early retirement under The Highland Council’s voluntary release scheme were included within the 2015/16 statements. Benefits payable should only be included within the pension fund’s accounts for those staff retiring from the council’s employment on or before 31 March 2016. The audited accounts have been amended to correct this misstatement. Benefits payable to staff leaving in 2016/17 will be recorded in that year’s financial statements.

Intercompany accounts

29. In previous years we have reported concerns regarding the operation and reconciliation of the intercompany accounts used to manage transactions between the council and the pension fund. The February reconciliation contained an unexplained difference of £0.836 million, and we were advised that this would be resolved as part of the accounts preparation process. In August 2016, we were advised that the £0.836 million could now be explained. The nature of the underlying transactions making up this difference reinforces the importance of keeping these reconciliations up to date and promptly investigating all unexplained differences.

Action Plan No. 1

Future accounting and auditing developments

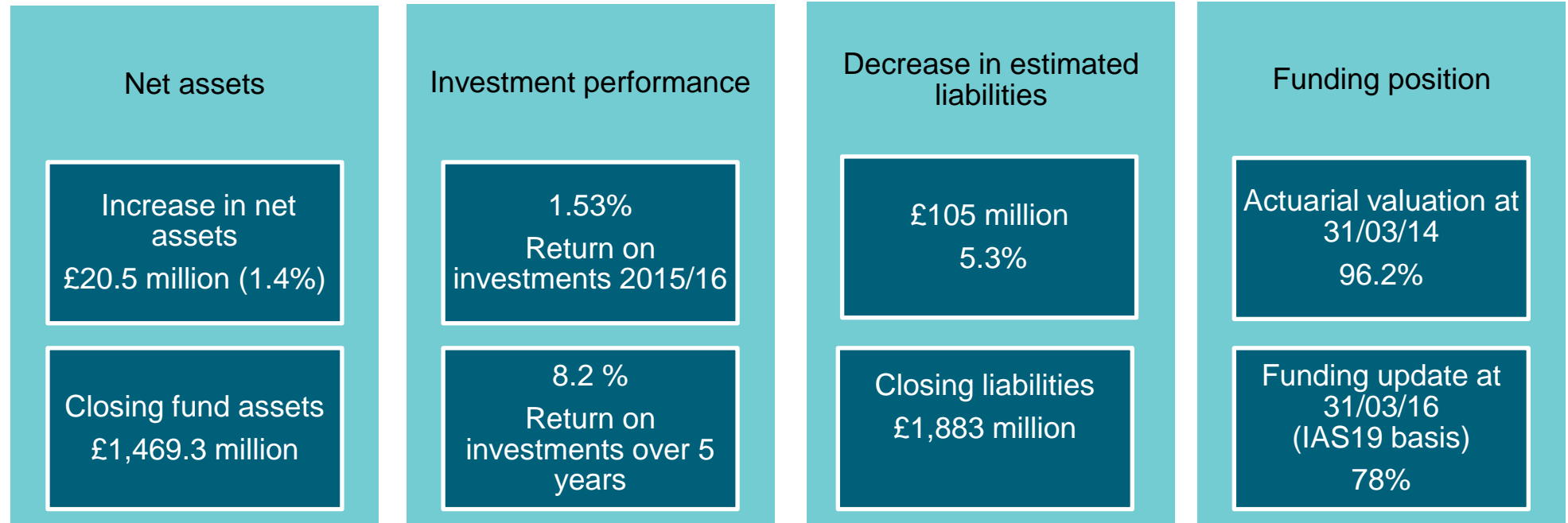
Code of Audit Practice

30. A new Code of Audit Practice applies to public sector audits for financial years starting on or after 1 April 2016. It replaces the Code issued in May 2011 and outlines the objectives and principles to be followed by auditors. It is part of the overall framework for the conduct of public audit in Scotland.
31. The new Code increases the transparency of our work by making more audit reports available on Audit Scotland's website. In addition to publishing all annual audit reports, annual audit plans and other significant audit outputs will be put on the website for all audited bodies. This is irrespective of whether the body meets in public or makes documents such as audit committee papers routinely available on its own website.
32. Also, under the new Code, appointed auditors are required to provide conclusions on the four dimensions of wider-scope public audit: financial sustainability; financial management; governance and transparency; and value for money

Code of Practice on Local Authority Accounting

33. 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 – A Statement of Recommended Practice 2015
 - new disclosure requirements for investments measured at fair value
 - recommendations for a new disclosure on investment management transaction costs.

Financial management and sustainability



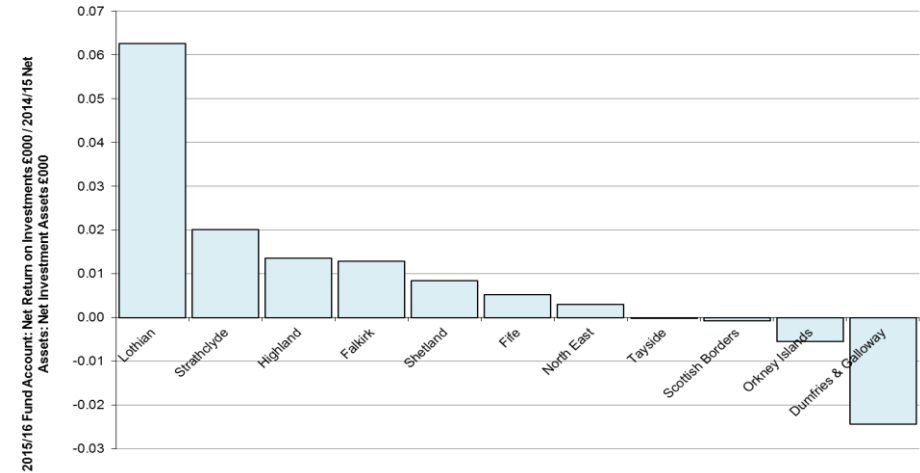
Financial management

34. 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.
35. Setting the fund’s investment strategy and monitoring performance against it are key aspects of financial management. 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. Balancing the risks and rewards from various asset types and approaches is something that the fund takes advice on from professional advisors.

Financial outcomes

36. The net assets of the pension fund grew by £20.5 million during 2015/16 to £1,469.3 million as at 31 March 2016. This is mainly due to net investment income of £26.1 million offset by management expenses of £7.9 million.
37. Although 2015/16 was not a particularly strong year for investment returns, the pension fund’s investment performance compares well against the other Scottish pension funds as set out in Exhibit 1.

Exhibit 1: Net return on investments as a proportion of opening investments 2015-16



Source: Audit Scotland analysis of unaudited pension fund accounts

38. Dealings with members are down £1.6 million from last year, mainly due to increased payments to and on account of leavers from the scheme (£1.1 million) and reductions in amounts transferred in (£0.5 million). Contributions, however, continued to exceed benefits payable in 2015/16.

Financial management arrangements

39. 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 and fund manager have sufficient status within the council 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.
40. The Director of Finance, as section 95 officer, is part of the council's Executive Leadership Team and the Payroll and Pension Fund manager reports directly to the Pensions Committee. These arrangements ensure that pension fund issues receive appropriate management attention.
41. The financial regulations of the administering authority, The Highland Council, apply to the pension fund. These are reviewed regularly and are available on the council's website. We consider them to be sufficiently comprehensive and up to date.
42. Regular monitoring of expenditure and income against agreed budgets is central to effective financial management. The pension fund does not prepare a separate annual budget for its administration costs or management fees. These are instead subsumed within the Finance Service's revenue budget.
43. Performance against the annual staffing budget for Pensions Administration is regularly reported to the Pensions Committee along with actual costs to date for actuarial, investment advisor and external fund management fees. We have recommended previously that separate budgets should be set for administration costs and management fees but were advised that a significant change in the council's budgetary control arrangements would be required to achieve this.

Conclusion on financial management

44. We have concluded that the pension fund's financial management arrangements are generally sound. These could be enhanced by the setting of separate budgets for administration costs and management fees. We understand that the pension fund plans to use its 2015/16 actual costs as a budget against which to monitor 2016/17 administration costs and management fees.

Financial sustainability

45. The pension fund gives its members a guarantee that in exchange for contributions during their employment, the pension fund will pay a pension until the end of each member's life. There is a timing difference of many years between the receipt of contributions and the payment of pensions. Financial sustainability means that the pension fund maintains the capacity to meet the current and future needs of its members, despite changes in investment performance and life expectancy.
46. In assessing financial sustainability we are concerned with whether:
- the pension fund's liabilities are greater or smaller than the fund's assets (the actuarial position)
 - contribution rates strike an appropriate balance between the needs of the scheme and the needs of employers
 - where there is a deficit, long term recovery measures are in place
 - the pension fund's investments have a profile of risk that is consistent with expected cash flows.
47. Effective investment strategy, investment management and regular actuarial review are crucial to sustainability.
48. The pension fund is a multi-employer fund with 12 scheduled bodies and 20 admitted bodies. Given the nature of these employers the funding risk associated with default is seen as relatively low and the fund currently plans to recoup deficits over a 20 year period for most employers.

49. The new local government pension scheme (LGPS) includes a cost sharing arrangement which will cap employer costs in relation to current service and help ensure that the schemes remains affordable for 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.

Funding position

50. Every three years an actuarial review is undertaken. The result of the most recent review showed a funding level of 96.2%, a reduction of 0.6% from the 2011 funding level of 96.8%.
51. The funding level set out in the 2015/16 financial statements is an interim valuation for accounting purposes which uses different actuarial assumptions from those used in the triennial valuation to estimate the present value of the pension fund's liabilities.

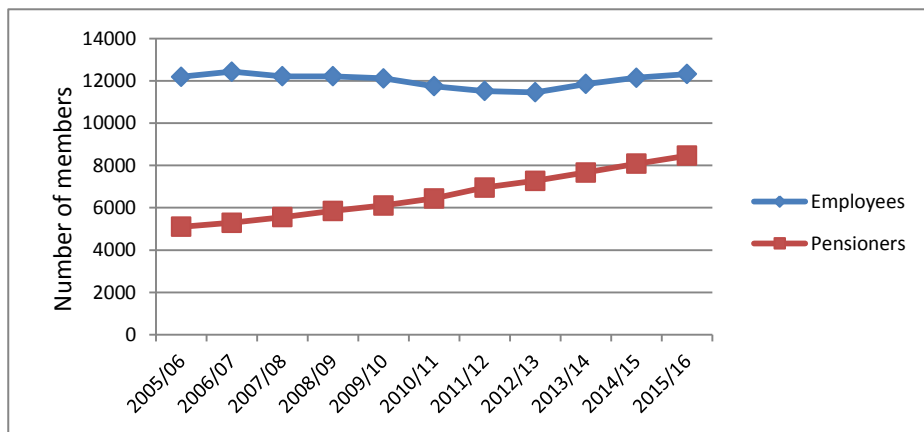
Exhibit 2: Snap-shot of assets and liabilities (IAS19 basis)

	2016 £m	2015 £m	2014 £m
Assets	1,469	1,447	1,276
Liabilities	1,883	1,988	1,779
Net surplus/(liability)	(414)	(541)	(503)
Funding Level	78%	73%	72%

Source: Highland Council Pension Fund financial statements

- 52. Exhibit 2 shows that valued on an IAS19 basis the funding level has improved compared to the previous year. This is due to an increase in the discount rate used by the actuary to calculate the present value of the estimated pension liabilities from 3.2% to 3.5%.
- 53. The pension fund’s membership profile (Exhibit 3) shows increases in both the number of pensioners and active members during 2015/16. Contributions receivable continue to exceed benefits payable, and so there continues to be net investment into the pension fund.

Exhibit 3: trends in membership

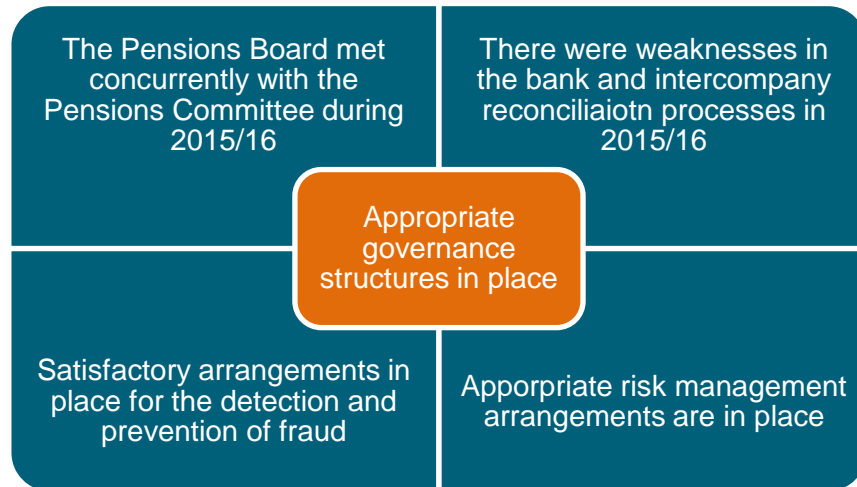


Source: Highland Council Pension Fund financial statements

Conclusion on financial sustainability

- 54. The pension fund’s financial position is secure for the medium to longer term. Regular triennial valuations set the employers’ contributions level to recover any deficit over the following 20 years. In addition, the membership profile of the pension fund means that contributions continue to exceed pension payments enabling more investment into the pension fund.
- 55. As the scheme matures, and the value of pensions in payment continues to rise, there will come a point when the investment strategy may have to be altered to stabilise income. This is likely to be many years in the future.

Governance and transparency



56. Pensions Committee members and management of the pension fund, supported by the Pensions Board, are responsible for establishing arrangements to ensure the proper conduct of the affairs of the Highland Council Pension Fund in accordance with the law and proper standards, and for monitoring the adequacy and effectiveness of these arrangements.

57. As part of our work we reviewed various aspects of governance that apply to the pension fund including standing orders, financial regulations, codes of conduct for officers and members, anti-fraud and corruption arrangements, and arrangements for reporting to the Pension Regulator on breaches of regulation. Overall, we concluded that there are satisfactory arrangements in place.

Governance structure

58. 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.

59. The inaugural meeting of the Highland Council Pension Fund was held on 4 September 2015. The Pension Board consists of 4 employer representatives and 4 union representatives. The remit of the Pension Board is to support the Pension Committee in compliance with regulations and with requirements imposed by the Pension Regulator. The Pension Committee and Pension Board met concurrently throughout 2015/16.

60. If at least half of the members of the Pension Board disagree with a decision of the Pensions Committee they can request in writing that the Pensions Committee review that decision. There were no requests to review decisions in 2015/16.

Pension Regulator public service code

61. The Pension Regulator issued a code on the governance and administration of public service pension schemes in January 2015. Officers undertook a review of the pension fund's compliance with the code using the guidance and checklist on the Pension Regulator website, and concluded that the pension fund was compliant in all areas.

Internal control

62. The Accounts Regulations 2014 require the Pensions 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. The pension fund's financial transactions are processed through The Highland Council's financial systems. Our review of the controls in operation within the council's new financial management system concluded that there were weaknesses within the controls in operation within the general ledger and accounts payable systems during 2015/16. These included the lack of authorisation of journal entries processed by finance staff and the failure to timeously reconcile the purchase ledger control account. We amended our audit approach and undertook more substantive testing on these areas as part of our audit of the 2015/16 financial statements.
64. In addition, we identified weakness in the pension fund's bank and intercompany reconciliation processes (refer paragraph 29) and adopted a substantive approach to the audit of these areas.

65. We also reviewed the key controls in operation within the pension investments, payroll and administration systems. We relied on the work done by internal audit for our assurances on the contributions system (see paragraph 67 below). Overall we concluded that the pension fund has a satisfactory level of control in place within its pension investments and pension administration systems.

Internal audit

66. Internal audit provides members and management with independent assurance on risk management, internal control and corporate governance processes. 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. To avoid duplication, we place reliance on internal audit work where possible.
67. Our review of internal audit concluded that the pension fund's internal audit service operates in accordance with the majority of the Public Sector Internal Audit Standards. In order to achieve full compliance an external assessment is required to take place at least every five years. The Scottish Local Authorities Chief Internal Auditors Group has developed a framework for this assessment and plans are in place for West Dunbartonshire Council to assess the council's internal audit service during 2016/17.
68. We placed formal reliance on internal audit's work on pensions contributions and on the focused testing undertaken by internal audit to support the Audit and Risk Manager's opinion that *'the system of internal control is reliable'*.

Risk management

69. Risk management is an essential part of the pension fund's approach to corporate governance. The Financial Strategy Statement identifies the key risks which could impact on the achievement of the pension fund's objectives.
70. The pension fund has satisfactory arrangements in place for risk management. A risk register, based on the CIPFA guidance '*Management of Risks in the Local Government Pension Scheme*', is in place and a risk management strategy has been approved by the Pensions Committee (September 2015).

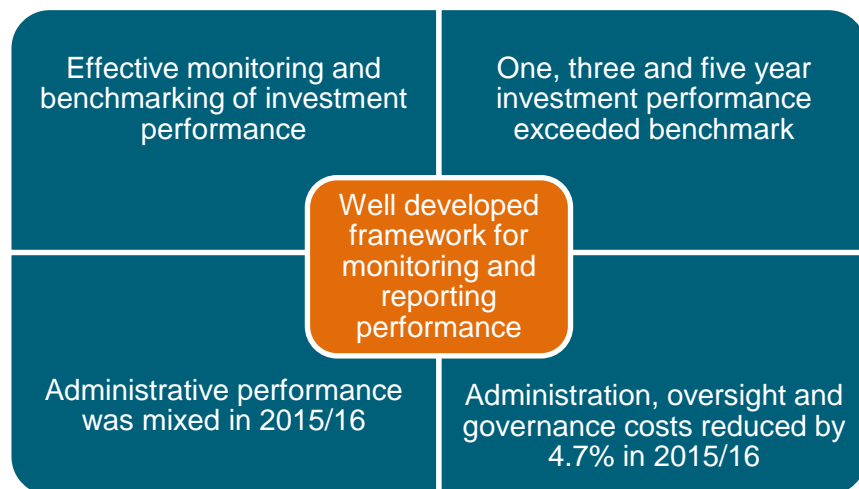
Standards of conduct and arrangements for the prevention and detection of fraud and corruption

71. Audited bodies are responsible for ensuring that their affairs are managed in accordance with proper standards of conduct and for having proper arrangements in place for implementing and monitoring compliance with standards and codes of conduct, standing orders and financial instructions. Auditors consider whether bodies have adequate arrangements in place. In our opinion, the overall arrangements in place are satisfactory, although it should be noted that no system can eliminate the risk of fraud entirely.

Transparency

72. Meetings of the Pensions Committee are advertised on the council's website and agendas, supporting papers and minutes are made available in advance of all meetings. Pensions Committee meetings are filmed and broadcast over the internet on The Highland Council's website, and are available for viewing for 12 months after the date of the meeting.
73. The pension fund has a website for communication and interaction with members. A newsletter is also produced. We have not encountered any evidence to suggest that information is routinely and unjustifiably withheld from public scrutiny.
74. Overall, we concluded that the pension fund is open and transparent.

Best Value



- 75. Administering authorities have 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.
- 76. Best value requires clear strategic goals and priorities and these are well developed and articulated in the pension fund’s Statement of Investment Principles and Funding Strategy Statement.

Investment performance

- 77. The main mechanism for measuring investment performance is through the analysis of returns achieved by the pension fund’s 7 external fund managers. The managers’ performance, in terms of achieving benchmarks, is subject to independent verification by the appointed advisers (AON Hewitt) and managed through the investment mandates held by the specialist fund managers.
- 78. Performance monitoring is provided by the pension fund’s global custodian, Northern Trust. Performance against benchmarks is reviewed quarterly by the council’s finance staff and reported to the Investment Sub-Committee.
- 79. During 2015/16 there was continued uncertainty in the global economy, and volatility in the financial markets. Despite this, the pension fund has outperformed its benchmark targets over a one, three and five year period as set out in Exhibit 4 below.

Exhibit 4: Investment performance

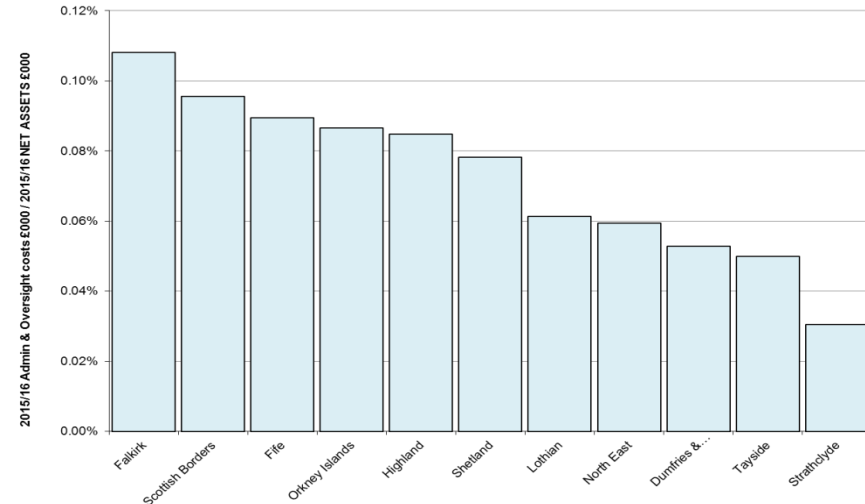
	Year 1	Year 3	Year 5
Pension Fund	1.53%	7.4%	8.2%
Benchmark	-0.17%	6.7%	7.5%

Source: AON Hewitt Quarterly report at 31 March 2016

Administrative performance

80. The pension fund has a Pensions Administration Strategy which includes service level standards for the performance of the administering authority based on industry standard performance indicators. Performance against each of the 12 targets is set out in the audited financial statements. Performance was mixed in 2015/16: two indicators improved, 6 declined and 4 stayed the same when compared to the previous year.
81. Administration, oversight and governance costs have reduced from £1.304 million to £1.243 million, a decrease of £0.061 million (4.7%). This is due to increased actuarial fees in 2014/15 as a result of the triennial valuation.
82. Exhibit 5 shows how the pension fund's administration, oversight and governance costs as a proportion of net assets compares with the other Scottish pension funds.

Exhibit 5: Admin, oversight and governance costs as a proportion of net assets 2015/16



Source: Audit Scotland analysis of unaudited pension fund accounts

Appendix I: Significant audit risks

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

Audit Risk	Management assurance and audit procedures	Results and conclusions
Financial statements issues and risks		
<p>New corporate financial management system: the pension fund's 2015/16 accounts will be produced from the Highland Council's new corporate financial management system (INTEGRA) which was introduced on 1 April 2015. The effective operation of this new system is fundamental to the preparation of the 2015/16 accounts and our audit opinion. As with any new system, there is a risk that it is not operating as expected. Finance staff will need to review and revise any working papers which rely on ledger reports generated from the system to ensure that they continue to produce accurate figures for inclusion within the 2015/16 accounts.</p>	<p>Management assurance</p> <ul style="list-style-type: none"> daily trial balance reports are produced from INTEGRA which are checked to ensure that the system is in balance. Error reports are also reviewed on a daily basis and corrective action taken where necessary. Daily transaction reports are taken from control accounts and reconciled to the nominal ledger and we are working towards bringing all reconciliations up to date. <p>Audit procedures</p> <ul style="list-style-type: none"> increased audit testing of opening balances review of controls operating within the new system review of intercompany accounts reconciliations review of revised working papers. 	<p>We agreed the opening balances entered on the new financial management system to the audited 2014/15 accounts.</p> <p>Our review of the controls in operation within the council's new financial management system concluded that there were weaknesses within the controls in operation within the general ledger and accounts payable systems during 2015/16 (refer to paragraph 63 for details). We amended our approach to the audit of the financial statements in response to these findings.</p> <p>Refer to paragraph 29 for the results of our review of the intercompany reconciliations.</p> <p>We reviewed the working papers provided to audit and confirmed that they provided accurate figures for inclusion within the 2015/16 financial statements.</p>

Audit Risk	Management assurance and audit procedures	Results and conclusions
<p>Prior year issue (management review of the unaudited accounts): the 2014/15 financial statements submitted for audit did not comply with the requirements of the Local Authority Accounts (Scotland) Regulations 2014. In our opinion, a more robust and challenging review process needs to be put in place to improve the quality of the financial statements submitted for audit.</p>	<p>Management assurance</p> <ul style="list-style-type: none"> the review process will be improved and working papers will be reviewed by a senior member of staff. <p>Audit procedures</p> <ul style="list-style-type: none"> early financial statements planning meeting early discussion of emerging issues. 	<p>The unaudited accounts submitted for audit were of a good standard and we did not identify any instances where the 2015/16 financial statements did not comply with the Local Authority Accounts (Scotland) Regulations 2014.</p>
<p>Stock lending: the pension fund plans to enter into a stock lending relationship with the Northern Trust. By lending on its investment portfolio the pension fund expects to increase its return beyond that available by holding the investments themselves. Current estimates are that additional income of £0.350 million per annum will be generated by stock lending. There is a risk that the pension fund's stock lending arrangements may not be properly accounted for and disclosed within the 2015/16 financial statements.</p>	<p>Management assurance</p> <ul style="list-style-type: none"> the example accounts compiled by CIPFA will be followed and disclosures for stock lending will be in line with these. <p>Audit procedures</p> <ul style="list-style-type: none"> review of stock lending arrangement against the requirements of the Local Authority Pension Scheme (Management and Investment of Funds) Regulations 2010 review of stock lending disclosures within the 2015/16 financial statements for compliance with the guidance. 	<p>No stock was released to a third party under a securities lending agreement during 2015/16 as the agreement was not concluded until May 2016. The year end position was adequately disclosed at note 14.7 in the accounts. Arrangements are in place to enable the pension fund to undertake stock lending in future financial years</p>

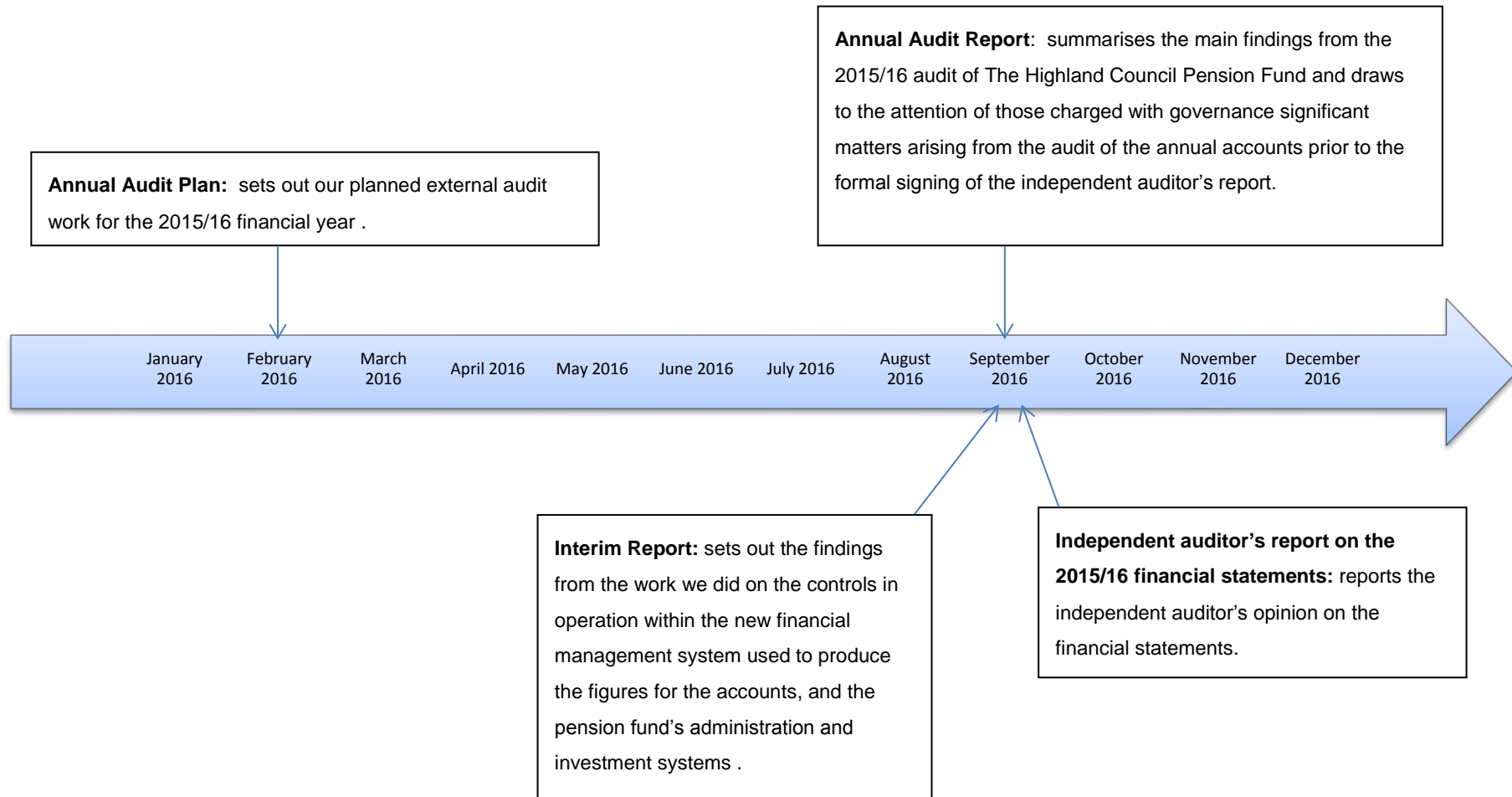
Audit Risk	Management assurance and audit procedures	Results and conclusions
<p>Local Government Pension Scheme 2015: the Public Service Pension Act 2013 and associated regulations replaced a final salary scheme with a career average revalued earnings (CARE) scheme from 1 April 2015. The calculation of benefits payable and contributions receivable under the CARE scheme are more complex increasing the risks of material misstatement in these key account areas.</p>	<p>Management assurance</p> <ul style="list-style-type: none"> • the software used to calculate benefits and contributions was tested and signed off prior to implementation • Internal Audit have included work on pension contributions in their audit plan. <p>Audit procedures</p> <ul style="list-style-type: none"> • audit testing of benefits awarded calculations • audit testing of employee and employer contributions calculations • reliance on Internal Audit’s work on contribution income. 	<p>Our testing of benefits payable confirmed pension benefits awarded were correctly calculated in accordance with the new scheme regulations. We were able to rely on Internal Audit’s work on contributions receivable to confirm employee and employer contributions were calculated as set out in the new scheme regulations.</p>

Audit Risk	Management assurance and audit procedures	Results and conclusions
<p>Workforce planning: the council is currently seeking to significantly reduce its workforce in order to help balance its 2016/17 budget. This approach can be an effective way of reducing costs, but it may not ensure that the right people are retained in the right place. There is a risk that the council will not retain sufficiently qualified and experienced staff to ensure that the pension fund is adequately administered and that the financial statements are prepared to the required quality and by the agreed timescales. Workforce reductions will also impact on the membership profile within the pension fund resulting in changes to the numbers of active, deferred and pensioner members.</p>	<p>Management assurance</p> <ul style="list-style-type: none"> • the Director of Finance, along with the Chief Executive have delegated authority to review staffing structures and ensure that sufficient resources are in place to deliver the outputs from the Service. <p>Audit procedures</p> <ul style="list-style-type: none"> • review of revised staffing structures • early financial statements planning meeting • review disclosures within the financial statements. 	<p>There were no changes to the accounting team that prepared the 2015/16 financial statements. As noted above, the unaudited accounts submitted for audit were of a good standard.</p>

Audit Risk	Management assurance and audit procedures	Results and conclusions
Wider dimension issues and risks		
<p>Pension Board: the Local Government Pension Scheme (Governance) Scotland Regulations 2015 required the pension fund to establish a Pension Board to assist it in complying with the scheme regulations and requirements of the Pensions' Regulator. It will take time for these new arrangements to be in and become effective, and training and support will be necessary for board members to enable them to adequately fulfil their role.</p>	<p>Management assurance</p> <ul style="list-style-type: none"> the Scottish Government and Governance Group will be organising training for members twice yearly members have access to the Pension Regulator's Trustees Toolkit for comprehensive self-serve online training a training needs assessment will be undertaken with members of the Pensions Board to identify future training requirements. <p>Audit procedures</p> <ul style="list-style-type: none"> continue to monitor the pension fund's governance arrangements through attendance at Pension Board meetings review of the training and support provided to Pension Board members. 	<p>Training and support has been provided to Pension Board members to assist them fulfil their roles. A training needs assessment for Pension Board members has not been undertaken.</p>

Audit Risk	Management assurance and audit procedures	Results and conclusions
<p>Pension liberation: from 6 April 2015 members of defined contribution pension schemes have more freedom over how they can access their pension savings. Although not applying directly to LGPS members, a member can transfer the value of their LGPS benefits to a defined contribution scheme and then exercise these new freedoms. If the value of the defined benefits to be transferred exceeds £30,000 the member is required by law to take independent financial advice. The pension fund also has a legal duty to ensure that this advice has been obtained before transfer is made.</p>	<p>Management assurance</p> <ul style="list-style-type: none"> the requirement to obtain independent financial advice for transfers exceeding £30,000 is publicised on the pension fund's website a standard letter is sent in response to all enquiries received advising of the legal requirements and best practice payment will only be made once officers are satisfied that independent financial advice has been obtained. <p>Audit procedures</p> <ul style="list-style-type: none"> review of any transfers made to defined contributions schemes to ensure evidence of independent financial advice was obtained prior to payments in excess of £30,000 being made. 	<p>Our review of transfers made to defined contribution schemes confirmed that independent financial advice had been taken by the pension scheme member for transfer payments out of the fund exceeding £30,000.</p>

Appendix II: Summary of local audit reports 2015/16



Appendix III: Action plan

No.	Paragraph ref.	Issue/risk/Recommendation	Management action/response	Responsible officer / Target date
1.	29	<p>Issue</p> <p>The intercompany accounts reconciliation was not kept up to date during 2015/16 and identified differences were not fully investigated until after the accounts had been submitted for audit. The nature of the transactions making up the unexplained difference reinforces the importance of keeping these reconciliations up to date and promptly investigating all unexplained differences.</p> <p>Risk</p> <p>Transactions between the pension fund and the council are not correctly disclosed in their respective financial statements or bank accounts.</p> <p>Recommendation</p> <p>The intercompany accounts should be reconciled on a monthly basis. Differences should be promptly investigated and appropriate correcting entries processed.</p>	<p>The process for intercompany transactions has been reviewed and in the future intercompany accounts will be reconciled a monthly basis.</p>	<p>Finance Manager – Corporate Budgeting, Treasury and Taxation 30/09/2016</p>