



Orkney Islands Council Pension Fund

Annual audit report to
Members and the
Controller of Audit

September 2015

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)

The Accounts Commission has appointed Stephen Boyle as the external auditor of Orkney Islands Council Pension Fund for the period 2012/13 to 2015/16.

This report has been prepared for the use of Orkney Islands Council as pension fund administrator and no responsibility to any member or officer in their individual capacity or any third party is accepted.

This report will be published on our website after it has been considered by the council. 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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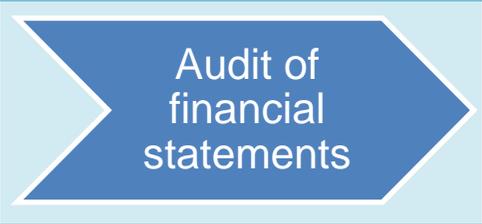
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Key messages

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|  <p>Audit of financial statements</p> | <ul style="list-style-type: none"> • The independent auditor's report on the 2014/15 financial statements of Orkney Islands Council Pension Fund is unqualified. • Net assets increased by 15.5% to £263.1m, due mainly to the performance of the investments. |
|  <p>Financial management and sustainability</p> | <ul style="list-style-type: none"> • The actuary completed the 2014 triennial valuation, and reported that the fund's assets were sufficient to meet 114% of liabilities. The scheme is in surplus. • Separation of council and pension fund money needs to be improved, building on the existing arrangements for the pension fund bank account. • The council's financial management arrangements are broadly satisfactory, but there is scope to strengthen financial monitoring. |
|  <p>Governance and transparency</p> | <ul style="list-style-type: none"> • A revised governance structure was introduced during the year, with the Investment Sub-committee becoming the Pension Fund Sub-committee for the purposes of pension fund business. • The Pensions Board has formed and includes elected member, trade union and admitted body representatives. • Systems of internal control operated effectively. • Orkney Islands Council participated in the National Fraud Initiative in 2014/15. A total of 1,214 matches were investigated. No frauds relating to the pension fund were identified. |
|  <p>Best Value</p> | <ul style="list-style-type: none"> • The fund's investments have performed well, resulting in the fund exceeding its one, three, five and ten year benchmarks. • The fund needs to improve the service it provides to members and employers. In 2014/15 it failed to meet a number of its pension administration targets. |



Outlook

- The fund is now providing benefits on a “career average” basis. This change has increased the complexity and workload of fund administration. This means it is particularly important that the fund prioritises the transfer of its member records into its new electronic system.
- The global investment outlook is less certain due to political and economic challenges.

Introduction

1. This report is a summary of our findings arising from the 2014/15 audit of Orkney Islands Council Pension Fund. The report is divided into sections which reflect our public sector audit model.
2. The management of Orkney Islands Council as administering body, 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 the Fund's affairs
 - ensuring that the financial position is soundly based.
3. Our responsibility, as the external auditor of Orkney Islands 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. **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 Orkney Islands Council as administering body understands its risks and has arrangements in place to manage these risks. The council and executive officers group should ensure that they are satisfied with proposed action and have a mechanism in place to assess progress and monitor outcomes.
6. We have included in this report only those matters that have come to our attention as a result of our normal audit procedures; consequently, our comments should not be regarded as a comprehensive record of all deficiencies that may exist or improvements that could be made.
7. We are grateful for the cooperation and assistance we received from officers during the course of the audit.

Audit of the 2014/15 financial statements

| | |
|---------------------------------|--|
| <p>Audit opinion</p> | <ul style="list-style-type: none"> • We have completed our audit and issued an unqualified independent auditor’s report. |
| <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>Other information</p> | <ul style="list-style-type: none"> • We review and report on other information published with the financial statements, including the management commentary, annual governance statement and governance compliance statement. We have nothing to report in respect of these statements. |

Submission of financial statements for audit

8. We received the unaudited financial statements on 25 June 2015, in accordance with the agreed timetable. We found the working papers to be of a good standard.

Overview of the scope of the audit of the financial statements

9. 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 Monitoring and Audit Committee on 19 February 2015.
10. 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. As such, the 2014/15 agreed fee for the audit which was set out in the Annual Audit Plan remains unchanged.
11. 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.

12. 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

13. 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).
14. 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.
15. We summarised our approach to materiality in our Annual Audit Plan. Based on our knowledge and understanding of Orkney Islands Council Pension Fund, we set our planning materiality at £2.3 million for investments (1% of investments)

and £95,000 for other areas of the accounts (1% of gross expenditure).

16. We report all misstatements greater than £5,000. Performance materiality was calculated at £1.2 million for investments, and £48,000 for other areas of the financial statements, to reduce to an acceptable level the probability of uncorrected and undetected audit differences exceeding our planning materiality level.
17. On receipt of the financial statements and following completion of audit testing we reviewed our materiality levels and concluded that our original calculation remained appropriate.

Evaluation of misstatements

18. We identified one unadjusted misstatement relating to transfers into the fund. The fund accounts for transfers in and out when cash is received or paid. However, the Code of Practice on Local Authority Accounting 2014/15 indicates that such transfers should be treated as assets or liabilities from the date they are agreed. This year, the amount of the unadjusted error was £27,000. This compares with the same error noted last year of £15,000. Transfers in and out are unpredictable and variable from year to year and we continue to apply the concept of materiality in determining whether an adjustment is required.

19. A prior year adjustment was made as a consequence of a change to the accounting policy for dividend income. In previous years, dividend income was accounted for when it was received. From 2014/15, it is recognised on the date the shares are quoted ex-dividend, the date the holder becomes entitled to receive a dividend. A debtor of £792,000 has been recognised this year, with a corresponding amount of £712,000 last year. There was also additional income of £80,000 this year and a corresponding amount of £72,000 last year. The net assets figure brought forward at 1 April 2014 was increased by £640,000.
20. A number of presentational adjustments were identified within the financial statements during the course of our audit. These were discussed with relevant officers who agreed to amend the unaudited financial statements.

Significant findings from the audit

21. 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 judgement are significant to the oversight of the financial reporting process.
22. During the course of the audit we identified the following significant issue that, in our view, requires to be communicated to you.
23. The Fund's arrangements for separating pension fund and council monies do not meet the full requirement of the Local Government Pension Scheme (Management and Investment of Funds) (Scotland) Regulations 2010. This statutory instrument requires councils that administer local government pension funds to maintain a separate bank account for holding all monies received by it for the purpose of its pension fund. While the council has separate bank accounts for the pension fund, from September 2014 they were only used to hold money received from external admitted bodies.
24. Pension fund contributions for the council's own employees and admitted bodies on the council's payroll were retained in the council's bank account until after the end of the financial year. The offsetting pension payments to pensioners and transfer values paid and received from other pension funds which were also paid out of the council's bank account were less than the contributions retained. This led to a debt accumulating from the council to the pension fund, which at 31 March 2015 stood at £904,000.
25. There are two further implications of this:
- The balance is not included in the funds available to the investment managers which may affect the extent and timing of investment returns
 - The Pensions Regulator since 1 April 2015, under the Public Services Pensions Act 2013, has an oversight role over the local government pension scheme. It now requires to be informed of occasions when employers do not transfer money to pension funds in accordance with scheme rules. The fund has not advised the Pensions Regulator of this issue.
26. The council has agreed to reinstate a regular transfer of funds to the pension fund bank account to eliminate the outstanding balance.

Refer action plan point 1

Recent developments

Public Services Pensions Act 2013

27. The 2013 Act brings a number of significant changes to the Local Government Pension Scheme (LGPS) (Scotland) that apply from 1 April 2015. Some of the main changes are illustrated below:

Benefits from 1 April 2015 will build up on a career average basis at the rate of 1/49th of annual pensionable earnings

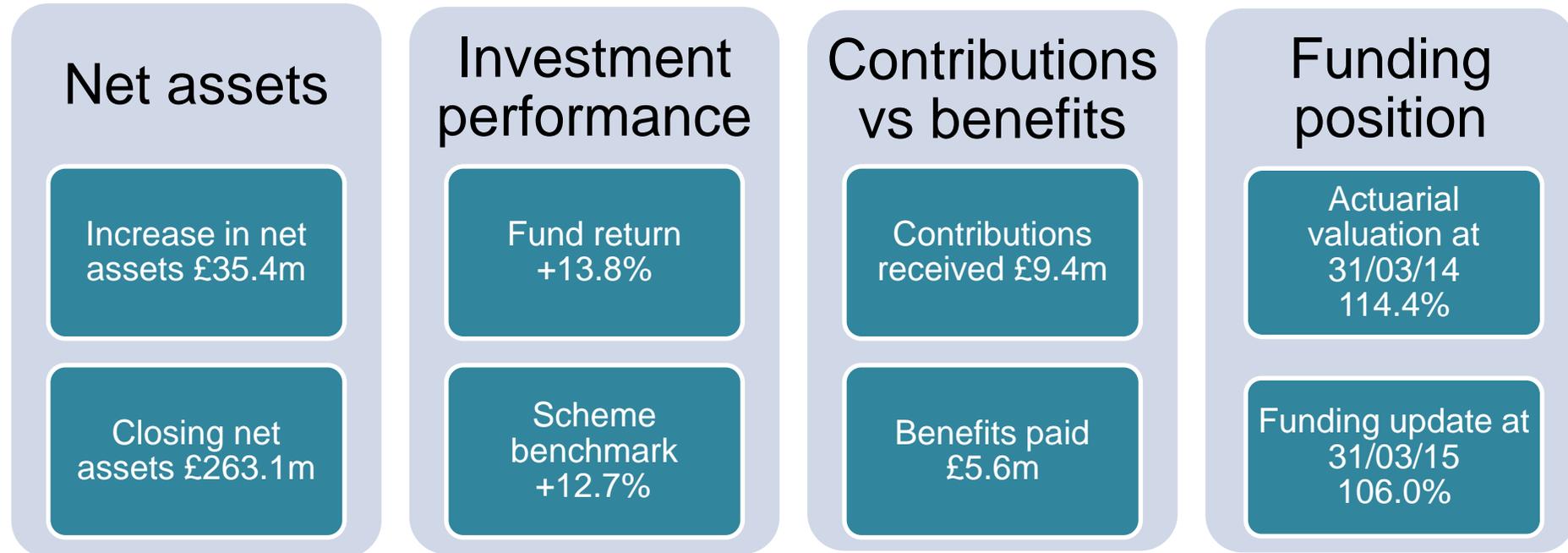
Normal Pension Age will be aligned with each member's own State Pension Age

The LGPS will have a national Advisory Board and local pension boards

Revised governance arrangements

28. The Local Government Pension Scheme (Governance) (Scotland) Regulations 2015 (SSI 2015-60) set out the new governance arrangements required from 1 April 2015.
29. At a national level the new arrangements include the establishment of a Scheme Advisory Board. Its role is to:
- provide advice to Scottish Ministers on proposed changes to the LGPS (Scotland)
 - provide advice to scheme managers or the scheme's pension boards on the effective and efficient administration of the scheme and any funds within the scheme.
30. The act also extends the powers of the Pensions Regulator to cover standards of governance and administration of the LGPS (Scotland).
31. At the local level, another key feature is the requirement for a Pension Board to be established from 1 April 2015 to assist the scheme manager (Orkney Islands Council) in securing compliance with the scheme rules and with the Pension Regulator's codes of practice. The council formed a Pension Board in February 2015 and it met for the first time in April.

Financial management and sustainability



Financial management

32. In this section we comment on the fund's financial outcomes and assess its financial management arrangements.
33. Pension fund finances are independently assessed every three years by the fund's actuary. Employer contribution rates are determined by the actuary and used by the council as administering body to set an annual budget for the pension fund's expenditure and income. Regular monitoring of expenditure and income against agreed budgets is central to effective financial management.

Financial outcomes

34. The fund's net assets increased by £35.4 million (15.5%) in 2014/15. £27.3 million of this came from increases in investment valuations, both realised and unrealised, which was a significant increase on the year before (£14.7 million). This illustrates the volatility associated with investment returns. Income from dividends and interest was £5.6 million, also higher than last year's figure of £4.9 million.
35. Contribution income exceeded the cost of pensions and the net increase in the fund from dealings with members was £2.8 million, against £3.1 million last year. The slight decrease was due to variation in the value of transfers in and out, with less received from transfers in and a higher cost of members leaving the scheme.

Financial management arrangements

36. As auditors, we consider whether pension funds have established adequate financial management arrangements. We do this by considering a number of factors, including whether:
- the proper officer has sufficient status within the council to be able to deliver good financial management
 - financial regulations are comprehensive, current and promoted within the council
 - reports monitoring performance against budgets are accurate and provided regularly to budget holders
 - monitoring reports do not just contain financial data but are linked to information about performance
 - members provide a good level of challenge and question budget holders on significant variances.
37. We assessed the role and status of the proper officer against CIPFA's "Statement on the role of the Chief Financial Officer in Local Government". The council's arrangements do not fully comply with the governance requirements because the Head of Finance does not report directly to the Chief Executive. The council's arrangements largely achieve the intended outcomes of the CIPFA statement, however, and comply with it in all other material respects.
38. We reviewed the council's financial regulations, which are revised regularly, and concluded that they are comprehensive and current.

The council's financial regulations are available on the council's website.

39. Financial monitoring reports were provided to the Investments Sub-committee at meetings during the year using the amounts posted to the council's ledger and the council's usual presentation for management accounts. However, we understand from our audit work that investment transactions are posted to the ledger quarterly or annually, while income and expenditure from dealing with members is posted weekly or monthly. Timing issues therefore affect the figures reported to committee members, detracting from their value as a tool for monitoring performance against budget. Also, the presentation in the CIPFA format for councils is not well suited to the reporting needs of pension funds.
40. Budgetary arrangements should be able to forecast the expected surplus of contributions over pension payments each month and assist in the payment of the appropriate amount to the investment managers. It is our understanding that budget forecasts are not used in this way at present.

Refer action plan point 2

41. As noted at paragraph 23, there is a significant issue with the operation of the council's internal arrangements for separating pension fund assets from its own.

Conclusion on financial management

42. We have concluded that the fund's financial management arrangements are broadly satisfactory. This is because the council

takes appropriate steps to attribute income, expenditure, assets and liabilities correctly between the council and pension fund. However, there is scope to improve the existing arrangements, particularly with respect to the separation of fund and council money and in financial monitoring.

Financial sustainability

43. 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. There is a timing difference of many years between the receipt of contributions and the payment of pensions. Financial sustainability means that the fund maintains the capacity to meet the current and future needs of its members, despite changes in investment performance and life expectancy.
44. In assessing financial sustainability we are concerned with whether:
- The 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 fund's investments have a profile of risk that is consistent with expected cash flows.
45. Effective investment strategy, investment management and regular actuarial review are crucial to sustainability.

Funding position

46. The last two actuarial reviews showed the fund in a position of surplus, with assets exceeding liabilities (see exhibit 1 below). Based on advice from its actuaries, from next year, the contribution rate will come down from its present rate of 21.4% to 19.8% in 2016/17 and 19.2% in 2017/18.

Exhibit 1: Funding valuations 2011 to 2014

| Description | 31 March 2011 £ million | 31 March 2014 £ million |
|----------------------|----------------------------|----------------------------|
| Assets | 160 | 227 |
| Liabilities | (151) | (198) |
| Net surplus | 9 | 29 |
| Funding level | 106% | 114% |

Source: Orkney Islands Council Pension Fund 2014/15 financial statements

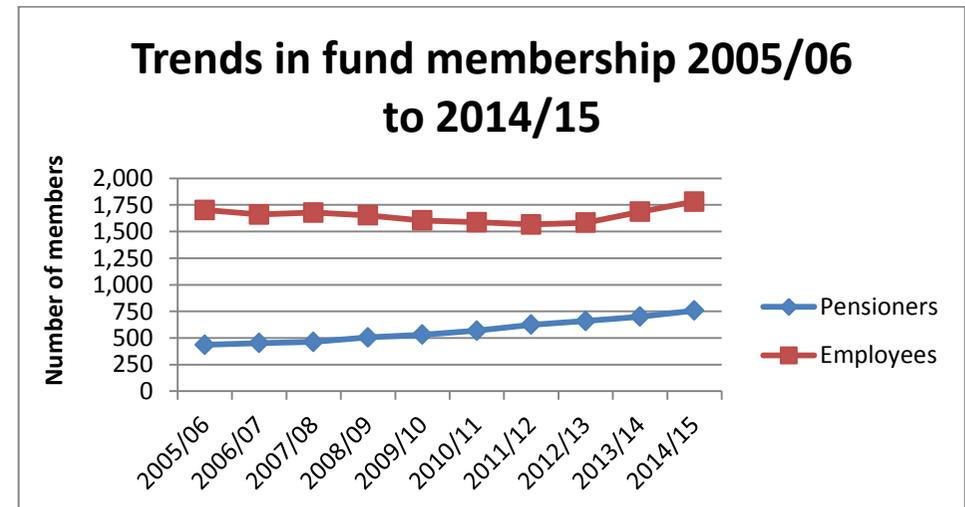
Financial planning

47. The financial plans of pension funds are determined by the expected longevity of their members, and by assumptions about investment returns and the benefits payable in the future. Every three years, following the triennial review, the scheme actuary updates the Funding Strategy Statement.
48. We note that the fund achieves a surplus each year from its dealings with members of around 1% of net assets. This money,

together with accumulated income from investments, helps to reduce the volatility of investment returns.

49. As the graph of trends in fund membership shows (see exhibit 2), the decline in membership that started in 2008/09 has reversed and, due in part to auto-enrolment, the fund now has the largest number of active members it has had for some time. As such, its current positive cash flow position is likely to be sustained.

Exhibit 2: Trends in fund membership 2005/06 – 2014/15



Source: Orkney Islands Council Pension Fund financial statements

50. New members are often younger than the scheme average and the favourable trend should help to extend the duration of the scheme's liabilities further into the future. If this trend continues the fund is

unlikely to need to draw down funds to pay pensions until well into the future.

51. The fund's actuary has reviewed the fund's investment strategy and is due to present its findings shortly.

Conclusion on financial sustainability

52. We think that the fund is in a sound funding position to meet the current and future needs of its members.

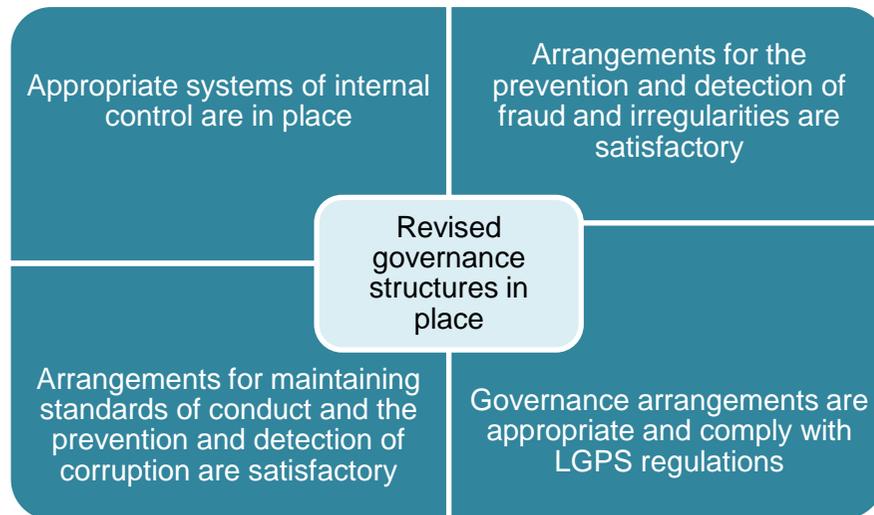
Outlook

53. While the fund is currently in a good position, it is clear that the outlook for public spending remains very challenging and the need for spending constraints and budget reductions will continue. Any further staff reduction schemes introduced by employers will place pressure on the fund, arising from lower member contribution levels and increased administration workloads.
54. The Public Service Pensions Act 2013 is designed to ensure the continued sustainability of the LGPS. In particular, the introduction of the 'employer cost cap' which will shift some of the risk of future rises in scheme costs onto members.
55. The Scottish LGPS Advisory Board is being formed with effect from 1 April 2015 under section 7 of the Public Service Pensions Act 2013. It is expected to operate at a national level and will have members drawn from employers, trade unions, professional

advisors and bodies such as the Pensions Regulator and the National Association of Pension Funds.

56. It may publish guidance for funds, for example on the operation of their local Pension Boards, and provide a forum for discussion on the future structure of the LGPS.

Governance and transparency



57. Pension Fund Sub-committee members and management of the fund are responsible for establishing arrangements to ensure that its business is conducted in accordance with the law and proper standards, that public money is safeguarded and for monitoring the adequacy and effectiveness of these arrangements. We concluded that the council, as administering authority for the fund, has effective governance arrangements which provide an appropriate framework for decision making.
58. Members of the pension fund should be able to hold the fund to account for the services it provides. Transparency means that fund

members have access to understandable, relevant and timely information about how the fund is taking decisions and how it is using its resources. Overall we concluded that the council is open and transparent.

Corporate governance

59. The main governance structures in place during 2014/15 are summarised below:
- Until February 2015, the Investments Sub-committee (ISC) considered pension fund business under delegation from the Policy and Resources Committee.
 - In February, the Policy and Resources Committee agreed that a Pension Fund Sub-committee would be formed with the same membership as the ISC and meeting at the same time. The remit of the sub-committee gives it delegated authority over all pension fund business.
 - At the same time, a Pension Board was set up, with separate membership, consisting of employer members and trade union representatives. This meets at the same time and place as the Pension Fund, with the chair of the Pension Fund Sub-committee chairing the concurrent meeting.
60. These new governance arrangements came into force on 1 April 2015, see paragraph 28. These were discussed and agreed by the Policy and Resources Committee on 17 February and approved by Orkney Islands Council in the same month.

61. The main change is the formation of the new Pension Board, in compliance with the Public Service Pensions Act 2013. The Board's role is to assist the Scheme Manager, Orkney Islands Council, in ensuring compliance with the rules relating to scheme governance and administration.

Internal control

62. The fund's main financial systems run alongside those of the administering authority, Orkney Islands Council, and the fund uses the council's financial ledger and payroll system to process transactions. The fund also has specific systems in place for pension administration and investments.
63. As part of our audit we reviewed the high level controls in a number of systems fundamental to the preparation of the financial statements. Our objective was to obtain evidence to support our opinion on the fund's financial statements.
64. We reported our findings to the council's Monitoring and Audit Committee in June 2015. No material weaknesses in the accounting and internal control systems were identified which could adversely affect the ability to record, process, summarise and report financial and other relevant data so as to result in a material misstatement in the financial statements.

Internal audit

65. Internal audit provides Pension Fund Sub-committee members and management of the fund 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.

66. The internal audit service is provided by Orkney Islands Council. Our review of internal audit concluded that it complies with the main requirements of the Public Sector Internal Audit Standards and has sound documentation standards and reporting procedures in place.
67. Internal audit did not carry out any specific work on the fund this year, although work on data migration to the new computerised system was planned. The work programme included work on council systems used by the fund. In future, the fund should consider requesting internal audit coverage of pension fund systems.

Refer action plan point 3

Arrangements for the prevention and detection of fraud

68. The pension fund complies with the relevant fraud and irregularity policies of Orkney Islands Council and these have been reviewed as part of our audit of the council. No issues have been identified for inclusion in this report.

National Fraud Initiative in Scotland

69. The National Fraud Initiative (NFI) in Scotland brings together data from councils and other agencies to help identify and prevent a wide range of frauds against the public sector. Matching data obtained from the systems of participating bodies allows the identification of potentially fraudulent claims on the public purse including occupational pension fraud and payroll fraud. If fraud or overpayments are not identified in a body, and the NFI exercise has been undertaken properly, assurances may be taken about internal arrangements for preventing and detecting fraud.
70. The council participated in the NFI in 2014/15. A total of 1,214 matches were identified and investigated. No frauds relating to the pension fund were identified. Overall, we concluded that the council has satisfactory arrangements in place for investigating and reporting data matches identified by the NFI.

Arrangements for maintaining standards of conduct and the prevention and detection of corruption

71. The arrangements for the prevention and detection of corruption in Orkney Islands Council Pension Fund are satisfactory and we are not aware of any specific issues.

Transparency

72. This is the first year that the financial statements have included a management commentary. This includes management's

assessment of the financial performance of the fund, and the risks that are managed. It also includes indicators of administrative performance.

73. Financial monitoring reports are provided to attendees at the Pension Fund Sub-committee and Pension Board. However, as noted at paragraph 39, these could be improved to make them more relevant.
74. Information about the pension fund is published on the council's website. However, documents are currently dispersed across several pages. It would improve transparency to group them in one area within the council website. It would also help to include the names and register of interests of the members of the Pension Board and Pension Fund Sub-committee in the same place, for ease of reference.

Computerisation of member records

75. The fund began inputting the records of new members in the electronic administration system in April 2013. During audit work in June 2015, we estimated by sampling that around 10% of records of active members are electronic.
76. The complexity of providing benefits calculations has increased as a result of the move to the career average scheme from 1 April 2015. The scheme has not provided all of its members with annual benefit statements for four years, due in part to workload issues.

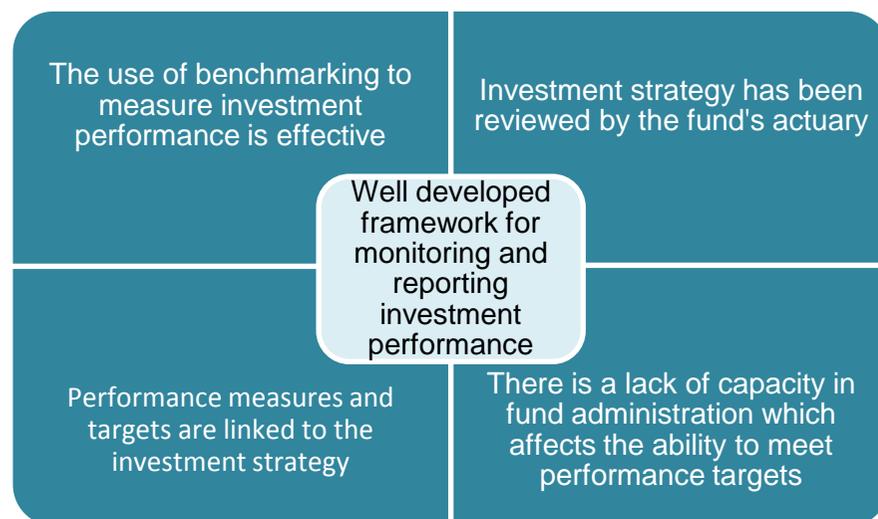
77. It is essential to the achievement of the Fund's objectives for administration that the migration is completed as soon as possible and annual benefit statements are prepared.

Refer action plan point 4

Outlook

78. The introduction of career average pensions will not only increase administrative workloads initially but could generate more enquiries from fund members seeking clarification of their benefits on an ongoing basis. It will also increase the complexity of pension calculations significantly. It is important that the fund prioritises the transfer of its member records into its new electronic system.

Best Value



80. The fund has a duty to ensure Best Value in the provision of services and to report performance publicly so that fund members, employers and other stakeholders know the quality of service being delivered and what they can expect in the future.

Performance management

81. The fund has service standards for administration and recently started to report its performance. The fund has difficulty meeting its targets, which is likely to be a consequence of the small size of the administration team. The fund had particular difficulty meeting its standards for processing requests for retirement estimates and

transfers. 52% of these requests were processed outwith the timescales set by the council.

Investment performance

82. The fund benchmarks its investment performance against other LGPS funds using the services of State Street's WM company. WM provide regular reports to the fund showing the performance of the fund's investment manager, Baillie Gifford, in relation to asset allocation and stock selection. These are considered periodically by the Pension Fund Sub-committee.
83. Baillie Gifford has the target of out-performing WM's local authority benchmark by 1% over rolling five year periods. Average performance over the last five years is 11.4% which is ahead of the performance target of 9.7% and benchmark of 8.7%.
84. The fund also exceeded its one, three and ten year benchmarks. The fund's investment's grew by 13.4% in 2014/15, exceeding the benchmark of 12.7%.

National performance audit reports

85. Audit Scotland carries out a national performance audit programme on behalf of the Accounts Commission and the Auditor General for Scotland. During 2014/15, no reports were issued which directly related to pension funds.

86. A number of local government reports were issued during the year and some of the topics covered may be of interest to members. These include:
- Scotland's public finances – a follow up: Progress in meeting the challenges (June 2014)
 - Update on developing financial reporting (March 2015)
 - An overview of local government in Scotland (March 2015).
87. These and other Audit Scotland reports are available on Audit Scotland's website (www.audit-scotland.gov.uk).

Outlook

88. Low interest rates and relaxed monetary policy have resulted in high equity valuations and low yields on fixed interest securities. Against this background, investment managers may find it difficult to achieve positive returns in 2015/16.
89. Continued global turmoil and persistent weaknesses in the Eurozone economies has created uncertainty in the financial markets. The UK government's commitment to hold a referendum on continued membership of the European Union is adding to this uncertainty. There is a risk that these factors could have a negative impact on asset valuations.

Appendix I – Significant audit risks

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

| Audit Risk | Assurance procedure | Results and conclusions |
|---|---|--|
| Risk of material misstatement | | |
| <p>Cessation events at admitted bodies</p> <p>Under the Local Authority Accounts (Scotland) Regulations 2014, the administering authority is required to obtain an actuarial valuation and adjustments certificate for employers without active members that are exiting the scheme. In previous years, these valuations have not been obtained. An admitted body leaving the scheme may be required to pay additional contributions or make an exit payment. Actuarial valuations of these cessation liabilities are required to ensure they are disclosed appropriately in the financial statements.</p> | <p>Completing an ISA500 assessment on the work carried out by the actuary.</p> <p>Review of correspondence between management and the actuary and reports by the actuary.</p> <p>Review of minutes and evidence to support the existence or absence of cessation valuations.</p> <p>Review of orphaned liabilities and any required accounting disclosures.</p> | <p>Cessation valuations for three bodies as at 1 April 2011 showed that, taken together, they had a net surplus and that the council as the largest employer was not disadvantaged.</p> <p>The fund has obtained cessation valuations for three bodies which ceased to have active members from 1 April 2015. The net funding position for these three bodies is a £23k deficit.</p> |

| Audit Risk | Assurance procedure | Results and conclusions |
|---|---|--|
| <p>Actuarial valuation</p> <p>The triennial actuarial valuation is taking place at a time when the fund’s member records are moving from paper to a computerised system. There is a risk that the valuation is not based on accurate information, during this period of transition.</p> | <p>Work by an external expert to evaluate the actuary and the actuarial assumptions.</p> <p>Audit sampling to test completeness of the actuarial data return and accuracy of contributions.</p> <p>Confirmation of checks carried out by the actuary.</p> | <p>Our external expert confirmed the validity of the actuarial assumptions.</p> <p>Audit sampling included satisfactory verification of the contributions of 30 members.</p> <p>The actuary confirmed that the data provided by the council met their quality requirement.</p> |
| <p>Loans fund balances</p> <p>At 31 March 2014, the pension fund owed the council £541,000 in recharges. This is equivalent to two years of administration recharges. There is a risk that the council is not being reimbursed for the services it provides to the pension fund.</p> | <p>Review of bank and inter-organisation transactions.</p> | <p>During the year, the council recovered the money owed to it by withholding transfers to the pension fund; by the end of the financial year the position had reversed with the council owing the pension fund £904,000.</p> |
| <p>Management override of controls</p> <p>As noted in ISA240, the unique position of management gives rise to a risk of fraud, as they are able to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively.</p> | <p>Detailed testing of journal entries.</p> <p>Review of accounting estimates for bias.</p> <p>Evaluating significant transactions that are outside the normal course of business.</p> | <p>Our testing showed that the accounting records can be substantiated to third party sources and are covered by an effective system of internal control.</p> |

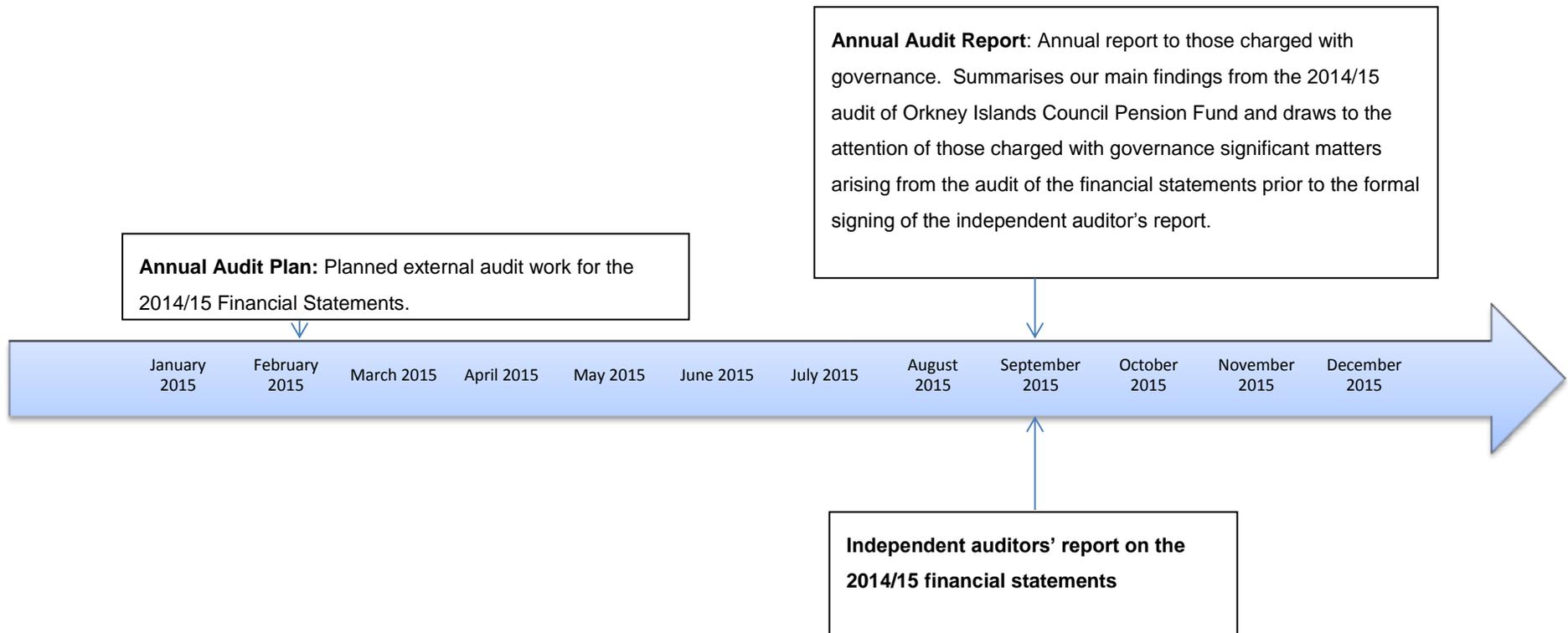
| Audit Risk | Assurance procedure | Results and conclusions |
|---|--|---|
| <p>Income</p> <p>The pension fund receives a significant amount of income as contributions from members and employers. The fund depends upon employers to make the correct contributions from pensionable salary, which may vary from month to month for some employment contracts.</p> <p>The difficulty of proving income means there is an inherent risk of fraud as described in ISA240.</p> | <p>We will evaluate the effectiveness of systems of internal control over contributions, including the analytical review of income streams and testing of reconciliations and annual certificates.</p> | <p>As part of our testing of figures used for the actuarial review, we tested a number of payroll pension contributions and found that in all cases the deductions and contributions were correctly made and accounted for.</p> <p>We were also content with the annual reconciliations and certificates.</p> |
| <p>Requirements of new accounting regulations</p> <p>The Local Authority Accounts (Scotland) Regulations 2014 introduce changes to the content and approval process of the financial statements. There is a risk that the accounts do not comply with the new regulations.</p> | <p>Our audit of the 2014/15 financial statements will review in detail compliance with the new accounting regulations.</p> <p>Ongoing planning with officers to ensure audit work can be completed in sufficient time to allow approval of the audited accounts by 30 September.</p> | <p>Key changes were identified by officers and reflected in the draft accounts, which were provided in line with the agreed timetable.</p> <p>The accounts comply with the new regulations.</p> |
| <p>Risks identified from the auditor's wider responsibility under the Code of Audit Practice</p> | | |

| Audit Risk | Assurance procedure | Results and conclusions |
|--|--|--|
| <p>Governance and scheme of delegation</p> <p>The remit of the Policy and Resources Committee was revised in 2013/14 and the formation of the Local Government Pension Scheme (LGPS) Pension Fund Forum was announced. There is a risk that the new arrangements do not address concerns over committee oversight and responsibility we have raised in previous years.</p> | <p>Review of committee minutes and papers. Observation of Investments Sub-Committee and Pensions Board meetings.</p> | <p>The newly formed Pension Fund Sub-committee and Pension Board have memberships and remits which comply with the requirements of legislation and have met for the first time under the new arrangements.</p> |
| <p>Risk management</p> <p>As noted in last year’s audit, the pension fund does not have a risk register and therefore it is not clear if members have a full view of the issues facing the fund and the action management is taking in response.</p> | <p>Review of minutes, committee papers and fund governance documents.</p> | <p>A risk register was prepared in the year and presented to the April 2015 meeting of the Pension Fund Sub-committee and Pension Board.</p> |
| <p>Computerisation</p> <p>As noted in last year’s audit, the fund is in the process of transferring its member records and the administration of these into an electronic system. The introduction of the new LGPS career average pension scheme in April 2015 will increase the complexity of pension calculations significantly. There is a risk that the fund cannot provide accurate pension calculations for its members if data is not transferred timeously to the new system.</p> | <p>Discussion with management. Monitoring of progress in transferring member records to the new system.</p> | <p>Progress with the migration remains slower than expected. The risk remains that the fund is not in a position to provide accurate pension calculations for its members this year.</p> |

| Audit Risk | Assurance procedure | Results and conclusions |
|--|---|--|
| <p>Administrative resources and workload</p> <p>The pensions section consists of only two trained staff and this year with the actuarial valuation, system migration and preparations for the new LGPS scheme, the workload is higher than usual. There is a risk that this results in delays to administrative processes such as the implementation of the new scheme, processing of transfers and issue of annual valuation statements.</p> | <p>Testing of internal control systems.</p> <p>Monitoring of committee proceedings.</p> | <p>The performance figures reported in the management commentary indicate that some key administrative processes are affected by backlogs of cases. These backlogs affect the capacity of the pensions section to deal with additional work, such as the requirements of the new scheme, the migration and the issue of annual valuation statements.</p> |
| <p>Scrutiny and reporting of administration performance</p> <p>In comparison with other LGPS funds, the degree of scrutiny by councillors of pension administrative performance is limited. An absence of comprehensive management reporting affects the ability of councillors to adequately scrutinise the standard of service provided to members of the pension fund.</p> | <p>Monitoring of committee proceedings.</p> <p>Monitoring of progress in preparing administration strategy.</p> | <p>With the recent introduction of formal reporting measures, we have yet to observe the extent of scrutiny. However, the presentation of actual performance against the fund's targets is likely to facilitate scrutiny and debate.</p> |

Appendix II

Summary of Orkney Islands Council Pension Fund local audit reports 2014/15



Appendix III

Action plan

| No. Page/ para | Issue/risk/Recommendation | Management action/response | Responsible officer | Target date |
|----------------------|---|---|---------------------|-----------------|
| 1 10/26 | <p>Operation of bank account</p> <p>In 2014/15 the council did not operate the pension fund bank account in accordance with regulations and in future will need to consider the position of the Pensions Regulator.</p> <p>Risk:</p> <p>Failure to comply with regulations is a serious shortcoming which could result in action against the council as administering authority.</p> <p>Also, money which should be available for investment may attract a very low rate of interest in the council's bank accounts.</p> <p>Recommendation:</p> <p>The council should review its arrangements for ensuring the separation of council and pension fund money, and remitting an appropriate amount each month to the investment manager.</p> | <p>The council had been deducting employer and employee pension contributions into and paying the pensioners payroll out of the council bank account. Any death grants or transfer values to or from other pension funds were also paid from the council's bank account. A regular monthly transfer to the pension fund was also in place; all of which resulted in a balance of £541,000 owed by the pension fund to the council at 31 March 2014. The council recovered this money by stopping regular transfers to the pension fund from September 2014 and by the end of the financial year the position had reversed with the council owing the pension fund £904,000. Interest has also been credited to the pension fund at the loans fund deposit rate.</p> <p>The council will review its arrangements for ensuring the separation of council and pension fund money and compliance with The Local Government Pension Scheme (Management and Investment of Funds) (Scotland) Regulations 2010.</p> | Head of Finance | 31 October 2015 |

| No. Page/ para | Issue/risk/Recommendation | Management action/response | Responsible officer | Target date |
|----------------------|---|---|---------------------|------------------|
| 2 14/40 | <p>Financial monitoring</p> <p>The pension fund uses reports from the council's financial ledger to prepare its budget monitoring reports. These exclude investment transactions and present the information in a way that is not well suited to understanding pension fund finances.</p> <p>Risk:</p> <p>Management and members may find it hard to understand financial reports and identify trends which need to be addressed.</p> <p>Recommendation:</p> <p>Consideration should be given to improving financial reporting, including the way that budgets are used to forecast cash flow.</p> | <p>A review of financial monitoring reports prepared for other pension fund committees will be conducted to identify improvements that can be incorporated into the financial monitoring reports for the Orkney Islands Council Pension Fund.</p> | Head of Finance | 31 December 2015 |

| No. Page/ para | Issue/risk/Recommendation | Management action/response | Responsible officer | Target date |
|----------------------|---|---|---------------------|------------------------|
| 3 18/67 | <p>Internal audit</p> <p>Internal audit did not carry out any specific work on the fund this year.</p> <p>Risk:</p> <p>With limited coverage, it is difficult to fulfil assurance requirements over systems of internal control.</p> <p>Recommendation:</p> <p>In future, the fund should consider requesting internal audit coverage of pension fund systems.</p> | <p>Although no internal audit work on pension fund matters was scheduled for 2014/15, internal audit work on systems and controls has been undertaken in previous years and can still be used to provide some assurance.</p> <p>The changing pensions landscape in terms of governance, systems and scheme changes makes it appropriate that pension fund activity is more heavily scrutinised. This will be highlighted to the Chief Internal Auditor with a proposal that internal audit work on pensions be reflected in the internal audit work plan for 2016/17.</p> | Head of Finance | 31 December 2015 |

| No. Page/ para | Issue/risk/Recommendation | Management action/response | Responsible officer | Target date |
|----------------------|---|---|---------------------|------------------|
| 4 20/77 | <p>Computerisation</p> <p>The migration from manual to computerised members records has a significant way to go.</p> <p>Risk:</p> <p>It will be difficult for the scheme to provide members benefit statements to reflect the first year of the career average scheme in 2015/16.</p> <p>Recommendation:</p> <p>Assistance should be provided to complete the migration and clear administrative backlogs.</p> | <p>Approval has recently been given to the Payroll Manager to secure additional temporary staff resources to overcome the backlog of record migration to the Altair system.</p> <p>A service pressure growth bid for additional staffing resource has also been prepared for the budget setting process for financial year 2016/17.</p> | Pensions Manager | 31 December 2015 |