



Orkney Islands Council Pension Fund

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

September 2016

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The Accounts Commission is a statutory body which appoints external auditors to Scottish local government bodies (www.audit-scotland.gov.uk/about/ac/). 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 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.

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 2015/16 financial statements

- An unqualified auditor's report has been issued on the 2015/16 financial statements.
- The draft annual report and accounts were submitted for audit in line with the agreed timetable. The draft annual report and accounts contained a number of inconsistencies and presentational errors that required adjusting during the audit process.

Financial management and sustainability

- The fund's net assets increased by £2.8 million (one per cent) to £265.9 million in 2015/16. Estimated pension liabilities have reduced by 15 per cent from £296 million at 31 March 2015 to £281 million due to an increase in the discount rate from 3.2 per cent to 3.5 per cent used to estimate their current value.
- Investment performance in 2015/16 was not as good as previous years. At March 2016, the pension fund returned a loss of 0.6 per cent, 0.1 per cent below the local authority benchmark based on average performance.

Governance, transparency and best value

- The fund has coped well with the introduction of new governance arrangements which arise from LGPS 2015 with the creation of a new Pensions Sub-Committee and Pension Board.
- No material weaknesses in the accounting and internal control systems were identified. However, improvements could be made to increase the transparency of information, such as creating its own dedicated webpages.
- Although one-year investment performance fell, the fund exceeded its three, five and ten-year investment performance benchmarks due to its stock selection activities. Administrative performance remains in need of improvement and declined in three-out-of-five standards in 2015/16.



Outlook

- Overall, allowing for the fall back of investment performance in the year, we believe the fund has a sound 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 our findings arising from the 2015/16 audit of Orkney Islands Council Pension Fund.

Our annual audit report

2. Our report is divided into the following sections to reflect our public sector audit model. These are:
 - Audit of the 2015/16 financial statements
 - Financial management and sustainability
 - Governance and transparency
 - Best value
3. [Appendix I](#) highlights significant audit risks that we identified in the annual audit plan we issued in February 2016. [Appendix II](#) is an action plan setting out our recommendations to address the high-level risks we identified during the course of the audit.
4. 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 its affairs
 - ensuring that the financial position is soundly based.

5. 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 Pension Fund, understands its risks and has arrangements in place to manage these risks. The Pension Fund Sub-Committee 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.

Our appointment as external auditors

7. 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.
8. 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.

9. The cooperation and assistance afforded to the audit team during the course of the audit is gratefully acknowledged. From 2016/17, Audit Scotland will continue as external auditors of Orkney Islands Council Pension Fund, although the appointed auditor and audit team will change. 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 Orkney Islands 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. Orkney Islands Council as the administering authority, increased their staffing capacity during 2015/16 to manage their workload. The fund's membership is growing and this will increase requests for information and services, which will likely add to existing workloads.

13. Management costs and investment performance will come under increasing scrutiny given the financial pressures faced by employers and employees alike. Orkney Islands Council Pension Fund should increase transparency around administrative and investment decisions to help support members and the public in their understanding of the challenges ahead. We comment further at paragraph 68.

14. Financial austerity within the public sector is 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 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 a 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 the remuneration report. We have nothing to report as a result of our review.

Submission of financial statements for audit

15. We received the unaudited financial statements on 10 June 2016, in accordance with the agreed timetable. The working papers were of a reasonable standard although there are areas where improvement is required (see paragraph 28). Council staff provided good support to the audit team which assisted the delivery of the audit to the deadline.

Overview of the scope of the audit of the financial statements

16. 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 Sub-Committee in February 2016.
17. 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 any 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.
18. 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.

19. 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

20. 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).
21. 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.
22. 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 one per cent of gross expenditure for pensions administration and one per cent of net assets for investments. For 2015/16, for most areas

of the accounts, planning materiality was £97,000. For investments, planning materiality was £2.45 million.

23. We report all misstatements greater than £5,000. Performance materiality was calculated at £1.23 million for investments and £49,000 for other areas of the accounts, to reduce to an acceptable level the probability of uncorrected and undetected audit differences exceeding our planning materiality level.
24. On receipt of the financial statements and following completion of audit testing we reviewed our materiality levels and raised the thresholds for materiality and performance materiality for most areas of the accounts to £111,000 and £55,000. For investments, materiality was increased to £2.65 million and performance materiality to £1.32 million.

Evaluation of misstatements

25. All misstatements identified during the audit, which exceeded our misstatement threshold, have been amended in the financial statements.
26. 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. The effect of these adjustments is to reduce the loss on investments by £43,000 representing capitalised dealing costs which were reallocated to management costs, in accordance with recent CIPFA guidance.

Significant findings from the audit

27. 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.
28. 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 in accordance with ISA260

Preparation of annual report and accounts

The draft annual report and accounts were submitted for audit in line with the agreed timetable. Although the working papers closely followed the format of previous years, changes were required to ensure the annual report and accounts met the requirements of the Code of practice on local authority accounting in the UK, CIPFA guidance and the Local Authority Accounts (Scotland) Regulations 2014 and other relevant guidance. In particular, the need to provide more analysis of investments and management costs revealed deficiencies in the current method of accounts preparation. Reconciliation of the draft annual report and accounts to the ledger and investment schedules was difficult in places.

Resolution: Council officers made improvements to working papers and subsequent drafts of the annual report and accounts and have agreed to take the necessary action required to improve the quality of the annual report and accounts for 2016/17 to ensure they are compliant with applicable legislation, guidance and good practice.

Appendix IV – Action Plan No. 1

Internal audit

In 2015/16, for the fourth consecutive year, internal audit did not carry out specific work relevant to Orkney Islands Council Pension Fund and therefore there were no areas where we could place formal reliance. With limited internal audit coverage, it is difficult to fulfil assurance requirements over systems of internal control. The 2015/16 internal audit plan anticipated undertaking work on the pension system migration – the transfer of manual records to Heywood’s Pensions Administration system, Altair. This was transferred to 2016/17 as the migration was incomplete.

Resolution: Internal audit have agreed with council officers that an audit of the pensions administration system will be undertaken during 2016/17.

Appendix IV – Action Plan No. 2

Future accounting and auditing developments

Code of Audit Practice

29. A new Code of Audit Practice will apply to all audits from financial year 2016/17. There will be a focus on four areas:

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

30. In addition, as well as the annual audit report, other significant outputs, such as the annual audit plan, will be published on Audit Scotland's website.

Code of Practice on Local Authority Accounting

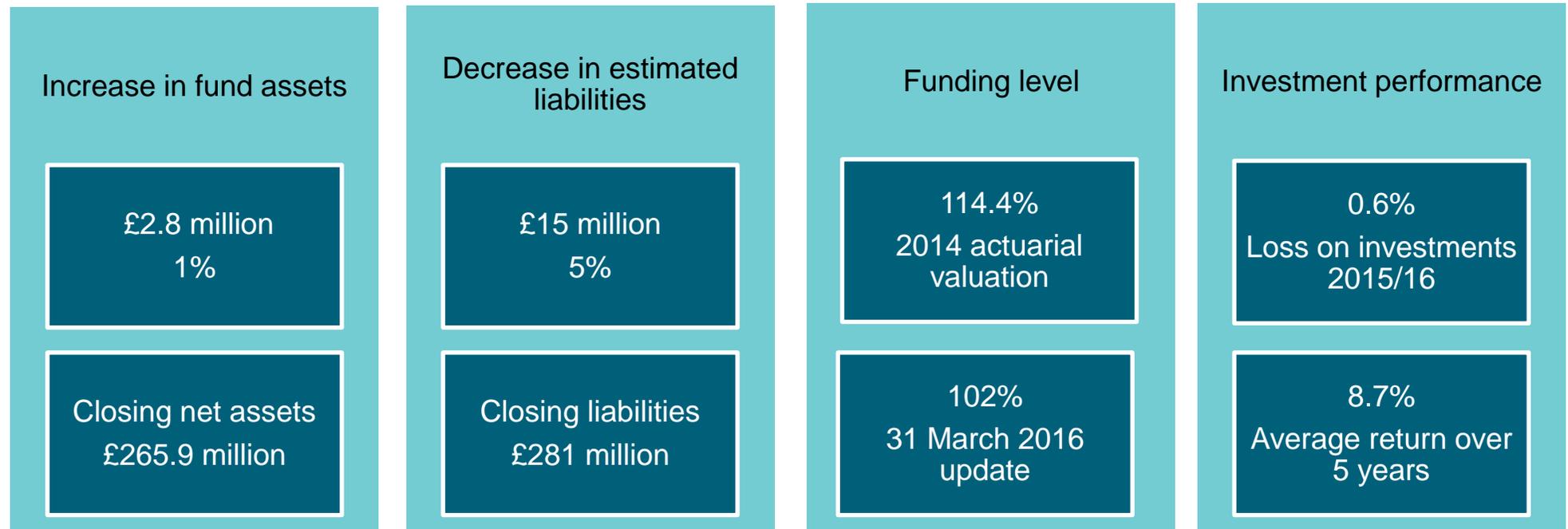
31. The financial statements of pension funds are prepared in accordance with the Code of Practice on Local Authority Accounting in the UK (the Code) which interprets and adapts International Financial Reporting Standards (IFRS) to the local authority context.

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

32. 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 the administering authority, to set an annual budget for the pension fund's expenditure and income.
33. 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 funding position, 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

34. The fund's net assets increased by £2.8 million (one per cent) in 2015/16. This is largely attributable to contributions received exceeding those payable by £4.5 million and investment net income of £6.1 million during the year. These were offset by management expenses (£1.1 million) and a fall in the market value of investments (£6.3 million). Estimated pension liabilities have reduced by 15 per cent to £281 million mainly due to an increase in the discount rate from 3.2 per cent to 3.5 per cent used to estimate their current value.
35. Investment performance has a significant influence on movements in net assets. In terms of investment performance, 2015/16 was not

as strong as previous years. Investment performance depends not only on market conditions but also asset allocation, fund manager approach and ultimately risk. For the year to March 2016, the pension fund's investments returned a loss of 0.6 per cent, 0.1 per cent below the local authority benchmark based on average performance.

Financial management arrangements

36. 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.
37. The Head of Finance, as section 95 officer, is part of the corporate management team and reports directly to the Chief Executive. The Pension Fund manager reports directly to the Pensions Sub-Committee. These arrangements ensure that pension fund issues receive due management attention.

38. The financial regulations of the administering authority apply to the pension fund. We reviewed these regulations and consider them to be sufficiently comprehensive and current. The regulations are available on the council's website.
39. Investment and administration performance reports are submitted to the pension sub-committee on a quarterly basis. Reports are comprehensive and we have observed a good level of review and scrutiny by councillors and board members at the meetings we attended.
40. We have concluded that the council's financial management arrangements are sound. However, there are some areas where improvements could be made to enhance existing arrangements, particularly in strengthening controls and checks on calculations as well as the presentation of information available for audit. These are outlined in more detail in [appendix II](#).
- ## Financial sustainability
41. The fund gives its members a guarantee that in exchange for contributions during their employment, it will pay pension benefits in the future to members, or their spouses and dependents depending on personal circumstances. 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.
42. 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.
43. Effective investment strategy, investment management and regular actuarial review are crucial to sustainability.
44. Orkney Islands Council Pension Fund is a multi-employer fund with members from eight admission bodies in addition to members employed by Orkney Islands Council. Active membership at 31 March 2016 was 1,888, of which, 158 members (eight per cent) were from admission bodies. Orkney Ferries Limited and Pickaquoy Centre Trust members made up 85 per cent of active admission bodies' members. Given the size and nature of these employers the funding risk associated with default is seen as relatively low.
45. The new 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.

46. Every three years an actuarial review is undertaken. The most recent review was carried out in 2014 and showed the fund in a surplus position (Exhibit 1). Based on advice from the actuaries, the contribution rates for the next two years will reduce from a current level of 21.4 per cent to 19.8 per cent in 2016/17 and 19.2 per cent in 2017/18.

Exhibit 1: Actuarial funding valuations at 31 March 2014

Description	£ million
Assets	227
Liabilities	(198)
Net surplus	29
Funding level	114%

Note: The funding update at 31 March 2016 shows a funding level of 102%.

Source: Orkney Islands Council

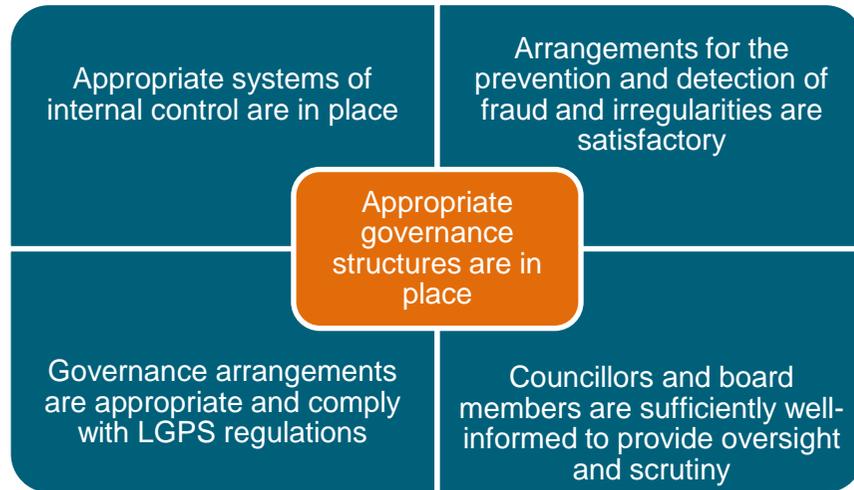
47. The financial plans of pension funds are determined by the expected longevity of their members, and by assumptions about investment returns and the benefits payable in the future. Every three years, following the review, the scheme actuary updates the Funding Strategy Statement. The next actuarial review is due in March 2017.

48. We note that the fund achieves a surplus each year from its dealings with members of around one per cent of net assets. This

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

49. Overall, despite the recent dip in investment performance, we believe the fund has a sound financial position that will allow it to meet both the current and future needs of its members. However, it is clear that the outlook for public spending remains very challenging and the need for spending constraints and budget reductions will continue. Any staff reduction schemes introduced by employers will place pressure on the fund, arising from lower member contribution levels and increased administration workloads.

Governance and transparency



50. Pension Fund Sub-Committee members and management of the fund, supported by the pension board, are responsible for establishing arrangements to ensure the proper conduct of the affairs of the Orkney Islands Council Pension Fund in accordance with the law and proper standards and for monitoring the adequacy and effectiveness of these arrangements.

51. As part of our audit we reviewed various aspects of governance that apply to the 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 open and transparent arrangements in place.

Governance structure

52. 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. In February 2015, the Pension Fund Sub-Committee was formed with a remit which gives it delegated authority over all pension fund business. The remit includes the administration of the pension fund and investments, as well as the responsibility for preparing, publishing and maintaining the Funding Strategy Statement and the Statement of Investment Policies.
53. At the same time, a Pension Board was set up with separate membership, consisting of four employer members and four trade union representatives. The remit of the Pension Board is to support the Pension Sub-Committee in compliance with regulations and with requirements imposed by the Pension Regulator. The Pension Board and Pension Sub-Committee met concurrently throughout 2015/16.

Internal control

54. The Accounts Regulations 2014 require the Pension Sub-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.

55. 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 council's financial statements.
56. 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.
57. Each year, the council receives internal control reports on their investment managers, Baillie Gifford, and on Bank of New York Mellon for asset services. These are high-level reviews developed under International Standard on Assurance Engagements (ISAE3402), to provide assurance to user organisations and their auditors on the controls at a service organisation that are likely to impact or be a part of the user organisation's system of internal control over financial reporting.
58. We found that the council has no system that documents management review or any observations from these reports. To strengthen arrangements, we recommend that the internal controls reports produced by the auditors of the investment managers are reviewed by management to consider any relevant issues.
Appendix IV – Action Plan No. 3.
59. During the year, the new pensions system, Altair, was increasingly used to record member entitlements and to perform calculations. With the new system and more staff now working on pensions there is an opportunity to revise and refresh internal controls to reduce the risks of errors and provide the opportunity for independent checks by more staff.
60. The pace of migration to the Altair system is slow, with only around half the membership now transferred. Priority is given to members with status changes where calculations are made. The council plans to upload the remaining members over the coming year in batches. The council needs to increase the pace of migration as this represents a reduction in the efficiency of service to the fund's members. **Appendix IV – Action Plan No. 4.**
61. In our 2014/15 Annual Audit Report we highlighted the council had difficulties in issuing benefits statements to its pension fund members. The council confirmed that annual benefits statements for all active and deferred members were issued for 2015/16 by the August 2016 deadline.

Internal audit

62. 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 for the pension fund. Auditing standards require internal and external auditors to work closely together to make best use of available audit resources. Internal audit services are provided by the Internal Audit section of the council.
63. 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. In 2015/16, for the fourth consecutive year, internal audit did not carry out specific work relevant to Orkney Islands Council Pension Fund and therefore there were no areas where we could place formal reliance.

64. The 2015/16 internal audit plan anticipated undertaking work on the pension system migration – the transfer of manual records to Heywood’s Pensions Administration system, Altair. At its meeting in November 2015, the council’s Monitoring and Audit Committee agreed to transfer this internal audit to 2016/17 as the migration was incomplete. **Appendix IV – Action no.2**

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

65. The pension fund complies with the relevant fraud and irregularity policies of Orkney Islands Council, including whistleblowing. These were reviewed as part of our audit of the council. No issues were identified for inclusion in this report.

National Fraud Initiative

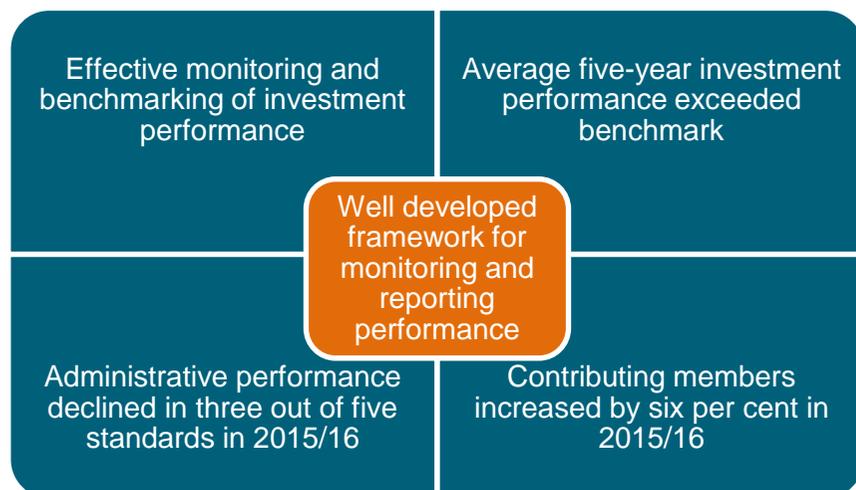
66. The National Fraud Initiative (NFI) is a counter-fraud exercise that is coordinated by Audit Scotland every two years. It uses electronic data analysis techniques to compare information held on individuals by different public sector bodies and different financial systems, to identify data matches that might indicate the existence of fraud or error.

67. In June 2016, we published our findings from the latest [NFI exercise](#). Our work found a total of almost £17 million worth of fraud and error across services in Scotland in the two years since the exercise was last conducted. No frauds relating to the pension fund were identified and we concluded that the council has satisfactory arrangements in place for investigating and reporting data matches identified by the NFI.

Transparency

68. Orkney Islands Council’s website hosts information relating to the Pension Fund Sub-Committee. This is mostly restricted to meeting agendas and papers therefore key documents are spread across different web-pages and only accessible via the relevant papers. The council should create its own dedicated pension fund webpage, so comprehensive information about the fund, its performance and the challenges faced, is easily accessible to both members and the public. **Appendix IV – Action Plan No. 5.**
69. The annual report and accounts are comprehensive and provide members with detailed information about the fund’s investment performance. Performance monitoring reports are also presented to the Pension Fund Sub-Committee during the year.

Best Value



70. 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.
71. Best value requires clear strategic goals and priorities and these are well developed and articulated for the pension fund.

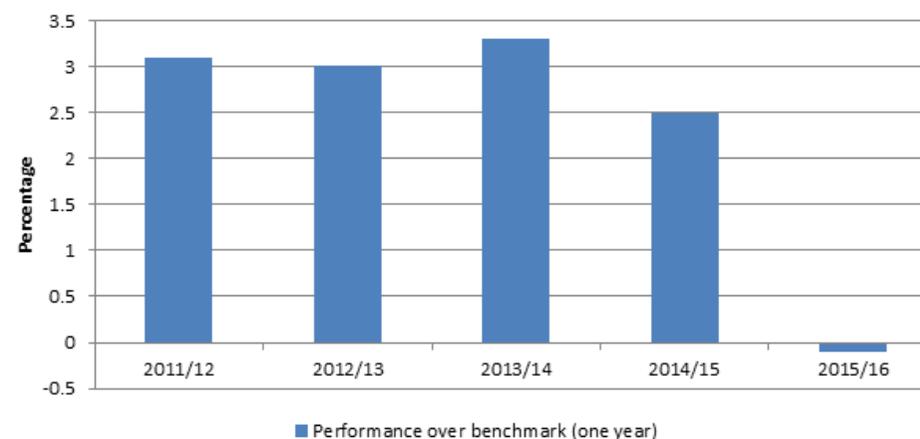
Investment performance

72. 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. These reports are considered by the Pension Fund Sub-Committee.

73. As highlighted at paragraph 35 above, the pension fund investments returned a loss of 0.6 per cent, 0.1 per cent below the local authority benchmark based on average performance. (Exhibit 2). The fund's investment manager, Baillie Gifford, has a target of outperforming WM's local authority benchmark by one per cent over rolling five-year periods. Average performance over the last five years is 8.7 per cent. This is ahead of the performance target of eight per cent and benchmark of seven per cent.

Exhibit 2: One-year investment performance



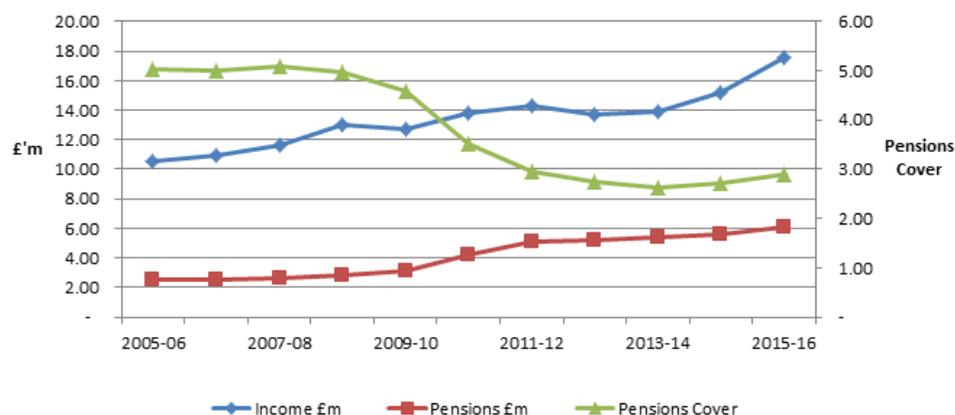
Source: Orkney Islands Council

74. The fund also exceeded its three, five and ten-year performance benchmarks largely due to stock selection by the investment manager. The economies of scale and investment opportunities that

larger funds benefit from are not available to Orkney Islands Council Pension Fund but net investment performance compared favourably with other LGPS funds in Scotland.

75. Compared with previous years, the fund overall continues to demonstrate a stable position. Despite rising pension costs, there is a positive cash flow position, with increasing income levels, largely attributable to the increase in the fund’s active membership. (Exhibit 3).

Exhibit 3: Changes in fund ‘health’ 2005/06 to 2015/16



Source: Orkney Islands Council

76. On 23 June 2016, the UK voted to start negotiations to leave the European Union. The timing and detail of the UK’s exit remains unclear, therefore any potential impact on the fund and its investment is unknown. Following an initial adverse reaction within the financial markets, while the value of fund’s investments has

since increased by 13 per cent to 31 August 2016, it is notable that the overall impact on the funding position has been a slight deterioration from 102 per cent to 96 per cent due to a fall in government bond yields together with lower expected future investment returns. 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.

Administrative performance

77. Orkney Islands Council Pension Fund has its own standards for its administration performance. In 2015/16, the fund reported a mixed performance against these standards, with performance improving in only two of its five key service standards. (Exhibit 4).

Exhibit 4: Administrative performance

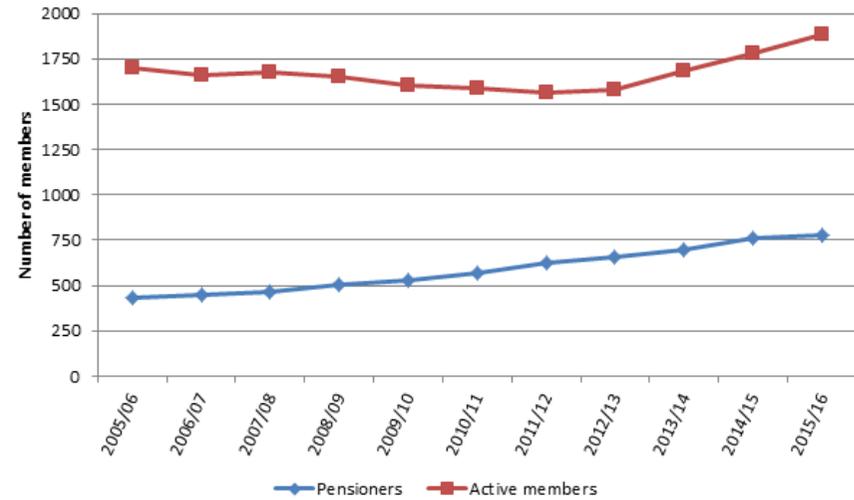
Category	Performance standard (days)	% processed within standard (14/15)	% processed within standard (15/16)
Pension estimates	10	51.9	35.4 ↓
Retirement	3	91.9	96 ↑
Trans in	10	52	80 ↑
Trans out	10	84.6	55.6 ↓

Refunds	3	89.3	88.9 ↓
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Source: Orkney Islands Council

78. The Orkney Islands Council in-house pensions team is responsible for the membership and benefits administration of the fund. In 2015/16, approval was granted to increase the team from 1.5 to 3 (full-time equivalent) staff members, in recognition of increased workloads arising from the transfer of records to the new pensions system, Altair, and the changes in pension regulations. This provides an excellent opportunity for the council to improve its administration performance across all areas during 2016/17.
79. Improving performance in each area will become more challenging as the number of members increases. In 2015/16, membership grew in each category, with total membership increasing by four per cent from 3,396 in 2014/15 to 3,547 in 2015/16. This included an increase of six per cent in contributing members, rising from 1,781 to 1,888. (Exhibit 5).

Exhibit 5: Trend in membership



Source: Orkney Islands Council

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>Operation of the pension fund control account</p> <p>Last year, the way in which the control account between the pension fund and the council was operated led to a temporary situation in which the council owed the pension fund several months of contributions.</p> <p>Risk: Failure of an employer to pay contributions to a scheme within a statutory timescale is a breach of the Pensions Act 1995.</p>	<ul style="list-style-type: none"> • Review of the monthly arrangements to reconcile pension fund balances • Confirmation of bank payments from council to pension fund. • Review of the year-end reconciliation and confirmation of the entries to totals paid and received in the year. 	<p>The council's balance with the pension fund is now settled monthly and a reconciliation is prepared between the ledger and the pension fund's bank account.</p> <p>Conclusion:</p> <p>The pension fund control account is operated in accordance with regulations.</p>
<p>Cessation liabilities</p> <p>At the start of 2015/16, two admitted bodies ceased to have active members and in accordance with the scheme rules, the fund obtained valuations to determine the amounts</p>	<ul style="list-style-type: none"> • Observation at Pensions Sub-Committee and Pensions Board and review of minutes • Review of management reports to the Pensions Sub-Committee and Pensions Board 	<p>With the exception of the financial statements, there are no formal reports to the Pensions Sub-Committee and Pensions Board that cover cessations.</p> <p>The financial statements disclose cessation</p>

Audit Risk	Assurance procedure	Results and conclusions
<p>still due in contributions.</p> <p>Risk: The fund lacks formal procedures to determine how decisions are made about the recoverability of cessation liabilities.</p>		<p>events, though the values are not presented. Triennial valuations suggest a figure of the order of £15,000.</p> <p>The number of members of the ceased admission bodies is fewer than five and the scheme is in a positive funding position, backed by strong investment performance.</p> <p>Conclusion:</p> <p>Although there may be some recoverable cessation liabilities, we agree with management that the values are unlikely to be material to the financial statements.</p>
<p>Fraud risk - Management override of controls</p> <p>As stated in ISA 240, there is a risk that management is in a unique position to perpetrate fraud because of management's ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively</p>	<ul style="list-style-type: none"> • Detailed testing of journal entries • Review of accounting estimates for bias • Evaluating significant transactions that are outside the normal course of business. 	<p>We tested transactions arising from the normal course of business as well as a sample of book-keeping adjustments processed at the year-end. All the reviewed transactions and adjustments were supported by appropriate evidence, including third party and arms length information. The significant accounting estimates are provided by third parties, and are not susceptible to management influence.</p> <p>Conclusion:</p> <p>There is no evidence of management override</p>

Audit Risk	Assurance procedure	Results and conclusions
of controls.		
Wider dimension issues and risks		
<p>Local Government Pension Scheme (Scotland) Regulations 2014</p> <p>The powers of the Pensions Regulator now cover standards of governance and administration within the LGPS. These standards consider the training and register of interests for new pension board members. The Pension Regulator also requires that all pension funds assess compliance with the Pension Regulator’s Code of Practice and develop a formal policy on reporting significant failures of pension fund administration / breaches of the law.</p> <p>Risk: The fund and those involved in its governance may fail to understand and comply with the law and the requirements of the Pensions Regulator.</p>	<ul style="list-style-type: none"> • Observation at Pensions Sub-Committee and Pensions Board and review of minutes • Review of management reports to the Pensions Sub-Committee and Pensions Board • Progress with completion of the Fund Administration Strategy and associated governance documents • Updates to the risk register to reflect specific threats to the scheme and its performance 	<p>We attended one meeting and reviewed the papers of three meetings held in the year.</p> <p>We felt members had a good understanding of regulatory, governance and investment issues and exercised their responsibility appropriately.</p> <p>The increase in the resources available to the pensions section has helped to address backlog issues, though there is yet to be an improvement in reported performance.</p> <p>Conclusion:</p> <p>The fund has made good progress in implementing the requirements of the LGPS Regulations 2014.</p>
<p>New pension scheme requirements</p> <p>The new regulations bring about a change in the way in which the fund calculates members’ retirement benefits from April 2015. Additional</p>	<ul style="list-style-type: none"> • Sampling of retirement calculations in the year • Review of fund administrative performance against key measures 	<p>We reviewed a sample of calculations and confirmed that the fund is applying the new factors for benefits accrued after 1 April 2015.</p> <p>This year, a number of new administrative</p>

Audit Risk	Assurance procedure	Results and conclusions
<p>complexity and the possibility of more enquiries from members put pressure on scheme administration.</p> <p>Risk: Failure to complete the implementation of the computer system increases the risk that statutory deadlines for scheme administration are not met, resulting in reportable breaches of the Pensions Acts.</p>	<ul style="list-style-type: none"> Attendance and observation at meetings of the Pensions Sub-committee and Pensions Board 	<p>measures were reported for the first time. Although reported performance was disappointing, the measures provide a useful benchmark for future improvement.</p> <p>Conclusion:</p> <p>The council is managing the risks associated with slow migration to the new computer system.</p>

Appendix II: Action plan

No.	Para ref.	Issue/risk/Recommendation	Management action/response	Responsible officer / Target date
1.	28	<p>Preparation of annual report and accounts</p> <p>Changes were required to ensure the annual report and accounts met the requirements of the Code of practice on local authority accounting in the UK, CIPFA guidance and the Local Authority Accounts (Scotland) Regulations 2014 and other relevant guidance. In particular, the need to provide more analysis of investments and management costs revealed deficiencies in the current method of accounts preparation.</p> <p>Risk: Inadequate audit trail between workings and accounts increases the risk of misstatement in the financial statements. It also adds to the time required to prepare and audit accounts which leads to additional cost.</p> <p>Recommendation: Council officers should take the necessary action required to improve the quality of the annual report and accounts for 2016/17 submitted for audit. This should include the preparation of an extended trial balance to assist in the reconciliation of ledger balances and investment analysis.</p>	<p>Agreed. For the 2016/17 draft accounts we will prepare an extended trial balance to allow for a clear reconciliation between the ledger balances and investment analysis. We will also ensure that relevant guidance and regulations are reviewed to ensure the 2016/17 annual report and accounts meet their requirements.</p>	<p>Head of Finance / 31 March 2017.</p>

No.	Para ref.	Issue/risk/Recommendation	Management action/response	Responsible officer / Target date
2.	28, 62-64	<p>Internal audit</p> <p>In 2015/16, for the fourth consecutive year, internal audit did not carry out specific work relevant to Orkney Islands Council Pension Fund and therefore there were no areas where we could place formal reliance.</p> <p>Risk: With no internal audit assurance, it is difficult to fulfil assurance requirements over systems of internal control.</p> <p>Recommendation: Council officers should ensure that an appropriate level of internal audit assurance work is carried out in 2016/17.</p>	<p>Agreed. We will discuss internal audit plans for the pension fund with Internal Audit to ensure that specific work is carried out on the fund during 2016/17.</p>	<p>Chief Internal Auditor / 31 March 2017</p>

No.	Para ref.	Issue/risk/Recommendation	Management action/response	Responsible officer / Target date
3.	58	<p>Management review of internal controls reports</p> <p>Each year the council receives internal control reports on their investment managers, Baillie Gifford, and on Bank of New York Mellon for asset services. These are high-level reviews, however, there is no system that documents management review or any observations.</p> <p>Risk: There is a risk that internal control reports highlight an issue of importance to Orkney Islands Council's Pension Fund that may go unnoticed without appropriate action.</p> <p>Recommendation: To strengthen arrangements, we recommend that the internal controls reports produced by the auditors of the investment managers are reviewed by management to consider any relevant issues.</p>	<p>Agreed. We will introduce a documented review process for all internal control reports that includes a process for reporting any significant issues to members of the Pension Board and Sub-Committee.</p>	<p>Head of Finance / 30 November 2016.</p>

No.	Para ref.	Issue/risk/Recommendation	Management action/response	Responsible officer / Target date
4.	60	<p>Altair ICT system</p> <p>During the year, the Altair ICT system was increasingly used to record member entitlements and to perform calculations. With the new system and more staff now working on pensions there is an opportunity to revise and refresh internal controls to reduce the risks of errors and provide the opportunity for independent checks by more staff.</p> <p>In addition, the pace of migrating information to the new system is slow, reducing the efficiency of service provided to members.</p> <p>Risk: 1. Changes to staff and a new pensions system may increase the risk of errors occurring. 2. Slow migration to the new system increases the inefficiency of service provided to members.</p> <p>Recommendation: The council should increase the pace of migration to the new system so that all members' records are included as soon as possible. The council should also revise and update its internal controls using the new system.</p>	<p>Agreed. We will seek to increase the pace of migration to ensure all members are transferred to the new system with a target for completion by 31 March 2017. We will also revise and update our internal controls to reflect the new system.</p>	<p>Pensions Manager / 31 March 2017</p>

No.	Para ref.	Issue/risk/Recommendation	Management action/response	Responsible officer / Target date
5.	68	<p>Transparency of information</p> <p>Orkney Islands Council's website hosts information relating to the Pension Fund Sub-Committee. This is mostly restricted to meeting agendas and papers therefore key documents are spread across different webpages and only accessible via the relevant papers.</p> <p>Risk: There is a risk that the transparency of information is reduced when documents are difficult to locate or not held within the same area.</p> <p>Recommendation: The council should consider creating its own dedicated pension fund webpage, so comprehensive information about the fund and its performance is easily accessible to both members and the public.</p>	<p>Agreed. We will create our own webpages to provide members with accessible and comprehensive information about the fund, its performance, and the challenges ahead.</p>	<p>Pensions Manager / 31 March 2017</p>