



# Lothian Pension Funds

2014/15 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](http://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](http://www.audit-scotland.gov.uk))

The Accounts Commission has appointed David McConnell as the external auditor of Lothian Pension Funds for the period 2011/12 to 2015/16.

This report has been prepared for the use of City of Edinburgh Council as Lothian Pension Funds 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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# Key messages

 <p>Audit of financial statements</p>	<ul style="list-style-type: none"> <li>• Unqualified auditor's report on the 2014/15 financial statements of the Lothian pension, Lothian Buses and Scottish Homes Funds.</li> <li>• No adjustments required to the Funds' financial statements.</li> </ul>
 <p>Financial management and sustainability</p>	<ul style="list-style-type: none"> <li>• Lothian Pension Fund net assets increased by 16.6% to £5,106 million at 31 March 2015. Lothian Buses and the Scottish Homes Pension Funds net assets increased by 14.5% and 13.5% to £386 million and £154 million, respectively, at 31 March 2015.</li> <li>• The Lothian Pension Fund 2014 triennial valuation reports that the fund's assets were sufficient to meet 91% of liabilities. Lothian Buses and Scottish Homes Funds 2014 triennial valuation reports that the fund's assets were sufficient to meet 106% and 92% of liabilities respectively.</li> <li>• Overall, satisfactory financial management arrangements in place.</li> </ul>
 <p>Governance and transparency</p>	<ul style="list-style-type: none"> <li>• The Funds have effective governance arrangements in place.</li> <li>• The Pensions Board established from April 2015.</li> <li>• System of internal control operated effectively.</li> <li>• Satisfactory arrangements in place for investigating and reporting data matches identified by the National Fraud Initiative.</li> </ul>
 <p>Best Value</p>	<ul style="list-style-type: none"> <li>• The Funds' return on investments for the 2014/15 financial year has met or exceeded benchmarks.</li> <li>• The Lothian Pension, Lothian Buses and Scottish Homes Funds have a ratio of management expenses to net assets (total expense ratio) of 0.56%, 0.37% and 0.16% respectively which compares well with other funds.</li> </ul>
 <p>Outlook</p>	<ul style="list-style-type: none"> <li>• From the start of 2015/16, the Lothian Pension Fund and Lothian Buses Pension Fund will provide benefits on a "career average" basis. This change will increase the complexity and workload of fund administration.</li> <li>• The global investment outlook is less certain due to political and economic challenges.</li> </ul>

# Introduction

1. This report is a summary of our findings arising from the 2014/15 audit of Lothian Pension Funds (the Funds). The report is divided into sections which reflect our public sector audit model.
2. The management of the Funds 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 the Funds, 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 the Funds understands its risks and has arrangements in place to manage these risks. The Pension Committee and senior management 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 co-operation and assistance we received from officers during the course of the audit.

# Audit of the 2014/15 financial statements

<b>Audit opinion</b>	<ul style="list-style-type: none"><li>• We have completed our audit and issued an unqualified independent auditor's report.</li></ul>
<b>Going concern</b>	<ul style="list-style-type: none"><li>• The financial statements of the Lothian pension, Lothian Buses and Scottish Homes funds' 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.</li></ul>
<b>Other information</b>	<ul style="list-style-type: none"><li>• 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.</li></ul>

## Submission of financial statements for audit

8. We received the unaudited financial statements on 16 June 2015, in accordance with the agreed timetable. The working papers were of a good standard and pension fund staff provided good support to the audit team which assisted in the delivery of the audit to deadline.

## 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 Pensions Audit Sub Committee on 25 March 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. The 2014/15 agreed fee for the audit which 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.
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.

- 12. **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.
- 13. 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

- 14. 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).
- 15. 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.
- 16. We summarised our approach to materiality in our Annual Audit Plan and set materiality at 0.5% of net assets and 1% of total contributions received for each separate Fund. We set a lower level, known as performance materiality, when defining our audit procedures.

- 17. Based on the unaudited financial statements, we revised our materiality for 2014/15 as illustrated at **Exhibit 1**.

### Exhibit 1: Materiality levels.

Financial statements	Materiality £000s	Performance Materiality £000s
<b>Lothian Pension Fund</b>		
Net assets	25,530	19,150
Fund account	1,910	1,435
Reporting threshold - £100k		
<b>Lothian Buses Pension Fund</b>		
Net assets	1,930	1,450
Fund account	95	70
Reporting threshold - £15k		
<b>Scottish Homes Pension Fund</b>		
Net assets	775	585
Fund account	8	6
Reporting threshold - £1k		

Source: Lothian Pension Funds audited financial statements 2014/15

## Evaluation of misstatements

18. There were no misstatements identified during the audit, which exceeded our misstatement threshold. Therefore, no amendments have been made to the financial statements which impact upon either the net returns on investments for the year or the net assets position at 31 March 2015.
19. 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

20. International Standard on Auditing 260 requires us to communicate to you significant findings from the audit, including:

- the auditor’s views about significant qualitative aspects of the entity’s accounting practices, including accounting policies, accounting estimates and financial statement disclosures
  - significant difficulties encountered during the audit
  - significant matters arising from the audit that were discussed, or subject to correspondence with management.
  - written representations requested by the auditor
  - other matters which in the auditor's professional judgment, are significant to the oversight of the financial reporting process.
21. The following table contains a summary of the significant findings that, in our view, require to be communicated to you in accordance with ISA 260.

## Significant findings from the audit

Issue	Resolution
<p><b>Management Commentary:</b> The new regulations have introduced the requirements for the annual report and accounts to include a management commentary in-line with Scottish Government guidance. Our review noted that the requirements were not fully disclosed in the management commentary, however, they were reported elsewhere in the annual report.</p>	<p>Officers have updated the management commentary in-line with Scottish Government guidance and no further adjustments are required to be made.</p>



Issue	Resolution
<p><b>Investment management fees:</b> The Funds’ officers have previously worked closely with CIPFA on the development of guidance on accounting for pension scheme management costs. As part of our audit we reviewed the reasonableness of the methodology applied and sample checked the calculations undertaken to determine the investment management costs. As part of our audit testing we noted one example where information in the calculation was extracted using inconsistent exchange rate period data compared to the previous year. This resulted in the estimate increasing by £0.578 million. Management have agreed that this was an error.</p>	<p>Except for the noted error, we accept that that the methodology is consistent with prior years and in-line with guidance. Management have confirmed that correct information will be used in future years to ensure a consistent approach is undertaken.</p> <p>The impact is not material and therefore no adjustment is required.</p>
<p><b>Group transfers:</b> Note 4 of the Lothian Pension Fund accounts disclose a group transfer-in of £0.703 million. The transfer related to 10 employees of “Gullane Fire College” who transferred to their new employer “Fire Scotland” in 2012. Unlike individual transfers, which are recognised in the fund accounts on a cash basis, group transfers should be accounted for on an accruals basis. However, no accrual was included in the accounts for 2012/13 or 2013/14 as the actuary had not agreed the transfer value. In the end, 3 employees transferred in to the fund and agreement on the actual transfer value of £0.703 million was reached during 2014/15, at which point the cash settlement was made and recognised in the financial statements.</p>	<p>No adjustment to the disclosure note will be required for 2014/15. Going forward, management have agreed that where there is a lack of clarity over the transfer value then group transfers in/out should be disclosed as a contingent asset/liability or a provision, where appropriate.</p>

Issue	Resolution
<p><b>Contributions received:</b> Officers compile an annual reconciliation of the employee contributions received from the seven largest employers of the Lothian Pension Fund, comparing the expected amount per the pension administration system to the actual amounts received. As at 6 August 2015, the reconciliation indicated that contributions received were £243,335 more than anticipated within the Pension administration system. This equates to 0.68% of the contributions receivable by the fund for the seven employers.</p>	<p>Officers have confirmed that these should represent valid contributions and the reconciliation differences arose due to delays in the notification of the entry of new members to the scheme. As at 4 September the contributions received were £156,647 more than anticipated within the Pension administration system. We have concluded that this is not material and no further action is required.</p>

## Recent developments

### Public Services Pensions Act 2013

22. 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

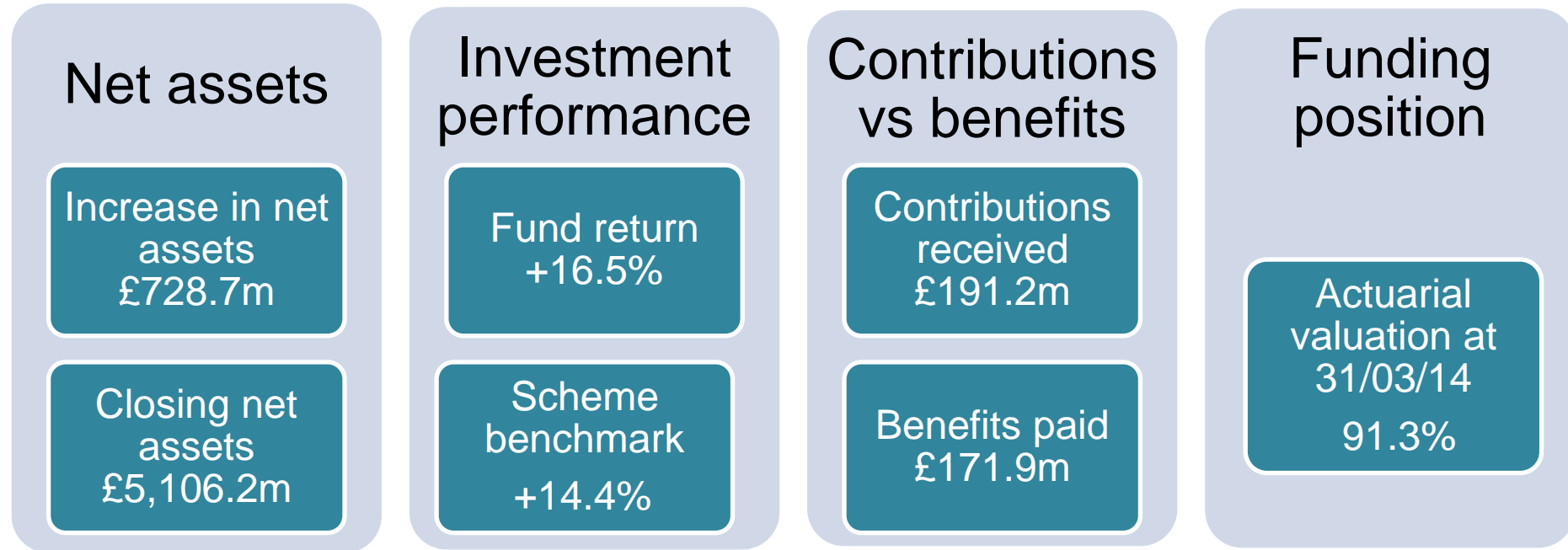
Normal Pension Age will be aligned with each member's own State Pension Age

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

### Revised governance arrangements

23. The Local Government Pension Scheme (Governance) (Scotland) Regulations 2015 (SSI 2015-60) set out the new governance arrangements required from 1 April 2015.
24. 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.
25. The act also extends the powers of the Pensions Regulator to cover standards of governance and administration of the LGPS (Scotland).
26. At the local level, another key feature is the requirement for a Pension Board to be established from 1 April 2015 to assist the Funds in securing compliance with the scheme rules and with the Pension Regulator's codes of practice. The Funds formed a Pensions Board in March 2015 and it met for the first time in April.

# Financial management and sustainability – Lothian Pension Fund



Source: Lothian Pension Funds' Financial Statements – Lothian Pension Fund data

## Financial management

27. In this section we comment on the fund's financial outcomes and assess its financial management arrangements.
28. 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 Funds to set an annual budget for expenditure and income. Regular monitoring of expenditure and income against agreed budgets is central to effective financial management.

### Financial outcomes

29. The Lothian Pension Fund reported an increase in net assets of £728.7 million (16.6%). This relates mainly to investment valuations, both realised and unrealised, which showed a significant increase on the year before (£4,377.5 million) and illustrates the volatility associated with investment returns. There was also a surplus of £6.4 million contribution income over pensions expenditure.
30. Lothian Buses and Scottish Homes Pension Funds reported an increase in net assets of £48.7 million and £18.4 million respectively. Lothian Buses and Scottish Homes reported an increase in net withdrawals from dealing with members of £1.4 million and £0.129 million respectively.

## Financial management arrangements

31. As auditors, we need to consider whether the 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.
32. 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" and concluded that the Funds' comply with the statement's five principles.
33. Our review noted that the proper officer (the Pensions and Accounting Manager) has sufficient status to deliver good financial management of the Funds.

34. The Funds do not have their own financial regulations, however they comply with City of Edinburgh Council's (administering authority) financial regulations. Our review of the Council's financial regulations concluded that they are comprehensive and current. The financial regulations are available on the council's website.
35. Regular reporting on budget monitoring and investment performance updates is provided to the Pensions committee members on a regular basis throughout the year.

## Conclusion on financial management

36. We have concluded that the Funds' financial management arrangements are satisfactory.

## Financial sustainability

37. The Funds give their 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 of investment performance and life expectancy.
38. In assessing financial sustainability we are concerned with whether:
  - the Funds liabilities are greater or smaller than the Funds assets (the actuarial position)

- contribution rates strike an appropriate balance between the needs of the schemes and the needs of employers
  - where there is a deficit, long term recovery measures are in place
  - the Funds' investments have a profile of risk that is consistent with expected cash flows.
39. Effective investment strategy, investment management and regular actuarial review are crucial to sustainability.

## Funding position

40. The last two actuarial reviews showed the Lothian Pension Fund in a position of deficit, with liabilities exceeding assets (See Exhibit 2 below).
41. Based on advice from its actuaries, from next year, the employers contribution rates will increase for scheduled and admitted bodies. For example, the administering authority's (City of Edinburgh) contribution rate will increase from its present rate of 17.2 to 20.1 in 2016/17 and 2017/18.
42. The funding levels calculated at the last triennial revaluations in 2014 for the Lothian Buses Pension Fund and Scottish Homes Pension Fund were 117% and 89% respectively.

**Exhibit 2: Movement in Lothian Pension Fund valuations 2011 to 2014**

Description	31 March 2011 £ million	31 March 2014 £ million
Assets	3,477	4,379
Liabilities	(3,619)	(4,796)
Net surplus	(142)	(417)
<b>Funding level</b>	<b>96.1%</b>	<b>91.3%</b>

Source: Actuary's valuations from 2011 and 2014

43. The actuarial values of promised retirement benefits for each fund are calculated annually by the actuary for the purposes of international accounting standards. These annual values represent a snapshot and are not relevant for calculating funding levels or setting employer contribution levels.

The Lothian Pension Fund actuarial annual statement at 31 March 2015 estimated a value of promised retirement benefits as £6,663 million (2013/14: £5,483 million). Net assets of £5,106 million at 31 March 2015 were sufficient to meet 77% of this value. This increase in the net liability is mainly due to a fall in market yields. The liability is not a full actuarial valuation, but an estimate of the present value of the future liabilities of the fund, based on the future discount rate as required by international accounting standards, longevity of members and rate of inflation.

44. Based on the 31 March 2015 actuarial annual statement for the Lothian Buses Pension Fund, the net assets of £386 million represent 96.5% of existing promised benefits of £400 million. This fund stopped admitting new members in 2008, consequently the long term trend will be for the number of active members to decrease.
45. The Scottish Homes Pension Fund has no active members contributing to the fund. Based on the 2013/14 actuarial statement, net assets of £155 million at 31 March 2014 represent 91% of estimated promised retirement benefits of £141million. As guarantor of the fund, the Scottish Government is liable to meet any shortfall in funding.

### Financial planning

46. The financial plans of pension funds have a horizon 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, officers of the Funds' updates the Funding Strategy Statement.
47. Fund membership increased during the financial year by 1,789 to 72,635 and is likely to increase further as other employers progress through the auto-enrolment process. This is an area for management to monitor closely to ensure the fund remains sustainable.
48. The Funds' investment strategies 2012-17, as agreed by the Pensions Committee in October 2012, have continued to be

implemented during 2014/15. The key objective of the Funds' investment strategies is to maximise return within reasonable and considered risk parameters. For the Lothian Pension Fund, this has been progressed in 2014/15 through reduction within equity and alternative portfolios to equities with less volatility, along with an increased exposure to index-linked assets.

- 49. For Lothian Buses, this has been progressed through a reduction within their equity portfolio and an increase in their exposure to alternatives.
- 50. For the Scottish Homes Pension Fund, the strategy has been to reduce the allocation to equities and increased in the allocation to bonds.

## Conclusion on financial sustainability

- 51. We conclude that the funds are in a good position with regard to financial sustainability through aligning the investment allocations and implementation of the investment strategy 2012-17.

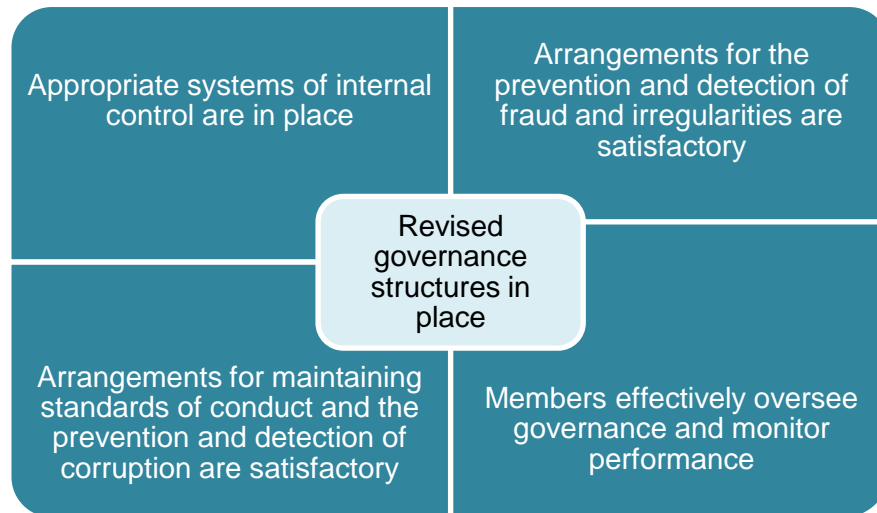
## Outlook

- 52. 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 pressures on the fund from increased administration workloads and reductions in member contribution levels.

- 53. 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.
- 54. 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 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.
- 55. 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



56. Members of the Pensions Committee is responsible for establishing arrangements for ensuring the proper conduct of the affairs of the Funds and for monitoring the adequacy and effectiveness of these arrangements. We concluded that the council has effective overarching and supporting governance arrangements which provide an appropriate framework for organisational decision making.

57. Members of the Funds should be able to hold the Funds to account for the services these provide. Transparency means that fund members should 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 although there are some areas where practices could be improved

## Corporate governance

58. The corporate governance framework for the Funds is centred on the Pensions Committee which is supported by a Pensions Audit Sub-Committee. City of Edinburgh Council's Director of Corporate Governance has delegated authority for the implementation of the Funds' investment strategy. An Investment Strategy Panel provides advice on these matters.

59. Based on our observations and audit work our overall conclusion is that the governance arrangements within the Funds are operating effectively and that the Funds are open and transparent.

## Governance processes and committees

60. City of Edinburgh Council acts as the administering authority for the Funds. It is responsible for managing and administering the scheme for scheduled and admitted bodies.

61. The Council has delegated the administration, management and investment of the Funds to the Pensions committee. The committee comprises councillors from City of Edinburgh Council and representatives from employers and members of the schemes.
62. A Consultative Panel to enhance participation in the development and scrutiny of matters relating to the Pension Funds was disbanded in order to meet new regulations on 31 March 2015.
63. The Consultative Panel has been replaced by a Pensions Board from 1 April 2015, in compliance with the Public Service Pensions Act 2013. The Board's role is to assist the Funds Manager in ensuring compliance with the rules relating to schemes governance and administration. The Pension Board meets quarterly on the same cycle as the committee.
64. As the Council is the administering authority for the Lothian Pension Funds the day to day administration of the Funds is carried out by the Investment and Pensions Division. The Pensions and Accounting Manager has been delegated section 95 responsibility for the Funds.
65. The Pensions Committee and subsequently City of Edinburgh Council, agreed in October 2014 to the creation of two special purpose vehicle wholly owned and controlled by the council to be established for the purpose of seeking Financial Conduct Authority (FCA) authorisation for the activities of this team and directly employing certain key staff associated with Lothian Pension Fund's investment function to minimise the risk of not retaining staff.
66. The two special purpose vehicles were not set up until April 2015 and do not have an impact on the 2014/15 financial statements. Therefore, the impact of these changes will require to be discussed in detail with Funds' officers during 2015/16 in relation to accounting for these special purpose vehicles e.g. group accounting and potential changes to accounts presentation.
67. As the Council is the administering authority for the Lothian Pension Funds the day to day administration of the Funds is carried out by the Investment and Pensions Division. The Pensions and Accounting Manager has been delegated section 95 responsibility for the Funds.

### *Investment Operations*

65. A review of investment governance arrangements of the Funds was undertaken during 2013/14 by external consultants and concluded that the existing systems and controls were generally sufficient for the Funds' current investment activities. However, a number of key risks were identified including those around the investment staff remuneration and retention policies.

### **Annual Governance Statement and Governance Compliance Statement**

68. The Code of Practice on local authority accounting in the United Kingdom 2014/15 has been amended to require the Funds Annual Report and Accounts to include both an annual governance statement and an annual compliance statement.

69. Our review of the 2014/15 Annual Governance Statement noted that it has been based primarily on the content of the council's Annual Governance Statement. Whilst some of the content within the council's statement is pertinent to the Funds, there are aspects which are of less relevance.

#### Recommendation 1

70. The governance compliance statement is developed to measure the Funds' governance arrangements against the standards set out in the guidance issued by the Scottish Ministers. We reviewed the governance compliance statement we are satisfied that it complies with the guidance issued by the Scottish Ministers.

71. The governance structures have been seen to be working well with no issues with regard to openness, reporting or scrutiny. The information reported in the governance compliance statement is consistent with our knowledge and understanding of the Funds' governance arrangements, based on our audit knowledge, attendance at meetings, and review of papers and minutes.

### Internal control

72. The Funds' financial systems are run alongside those of the City of Edinburgh Council and some of the council's systems are used by the Investments and Pensions Division. We obtained confirmation from the external auditors of the council that there were no significant weaknesses in the internal controls for those systems utilised by the Investments and Pensions Division for 2014/15.

73. As part of our work we also took assurance from key controls within the Funds' financial systems. From our work on these systems, we noted that the Funds' policy is for Committee members to have at least 3 days training per year. A register of training for committee members is maintained by the Funds' detailing a range of training opportunities and time spent training. However, our review noted that only two out of seven Pensions Committee members received 3 days training during 2014/15.

#### Recommendation 2

### Internal audit

74. Internal audit is an important element of the Funds governance structure. Internal audit provides the Pensions Sub-Audit committee, Pension committee members and management of the Funds 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

75. The internal audit service is provided by City of Edinburgh Council via a co-source arrangement with PricewaterhouseCoopers. 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.

76. The Public Sector Internal Audit Standards require internal audit to deliver an annual internal audit opinion and report that can be used by the organisation to inform its governance statement.
77. The annual internal audit opinion should conclude on the overall adequacy and effectiveness of the organisation's framework of governance, risk management and control. It should also contain certain information, including a summary of the work that supports the opinion; a statement on conformance with the Public Sector Internal Audit Standards and the results of the quality assurance and improvement programme.
78. Internal Audit conducted two pension fund reviews during 2014/15 on scheme of delegation and pension administration. This work was considered in our assessment of the internal controls put in place by the Funds.
79. Internal Audit has not identified any fundamental weaknesses in the framework of governance, risk management and control. Therefore, Internal audit provided an opinion in compliance with the above requirements, and it was presented to the Pensions Audit Sub Committee on 23 June 2015 along with other key assurance statements, as part of the consideration of the unaudited financial statements.

## Arrangements for the prevention and detection of fraud

80. The Funds comply with the relevant fraud and irregularity policies of City of Edinburgh 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

81. 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.
82. As part of our local audit work we monitor City of Edinburgh Council's approach to participation in NFI both in terms of the submission of the required datasets and their approach to and progress investigating the subsequent data matches. A total of 898 pension matches were identified from the most recently completed exercise. Of these, 306 were 'recommended matches'.
83. During 2014/15, the Pension and Investment Division officers were engaged in investigating matches and resolving outcomes. The

exercise is still ongoing and an update on outcomes will be provided to the Pension Committee by the end of the year.

84. Overall, we concluded that the Pension and Investment Division 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

85. The arrangements for the prevention and detection of corruption in the fund are satisfactory and we are not aware of any specific issues that we need to record.

## Transparency

86. 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.
87. Financial monitoring reports are provided to attendees at the Pension Funds Sub-Audit committee and Pension Board going forward. Information about the pension fund is published on the Funds' website.

88. Overall we concluded that the Funds administration is open and transparent although there are some areas where practices could be improved.

## Outlook

89. The introduction of career average pensions and impact of these changes may result in system or performance issues due to the complexity of pension calculations. The Funds will therefore require to consider procedural changes and staff resourcing during 2015/16.
90. Confirmation may also require to be sought from system providers that all upgrades have been fully tested and no control weaknesses have been identified. In addition, as the two special purpose vehicles were set up in April 2015, the impact of these changes will require to be discussed in detail with Funds' officers during 2015/16 in relation to accounting for these special purpose vehicles in such areas as group accounting and any potential changes to accounts presentation.

# Best Value

91. The Funds have a duty to ensure Best Value in the provision of services and to report performance publicly so that Funds' members, employers and other stakeholders know the quality of service being delivered and what they can expect in the future.
92. The Funds have not been subject to a Best Value review, however, it is covered by the overall Best Value arrangements of the administering authority, City of Edinburgh Council.

## Performance

### *Investment Performance*

93. Investments are managed both by external fund managers and the Funds' internal investment management team. Through the use of mandates, responsibility for the management of the Funds' investments has been divided up. **Exhibit 3** shows the allocation of investments to fund managers for the Lothian Pension Fund as at 31 March 2015.
94. Approximately 45% of the Lothian Buses Pension Fund is managed by in-house investment managers, with the remainder allocated between 2 separate external investment managers, Baillie Gifford (46%) and Standard Life (9%).

95. Approximately 36% of the Scottish Homes Pension Fund investments are managed by in-house investment managers, with the remainder allocated between 2 separate external investment managers State Street (69%) and Schroders (5%).

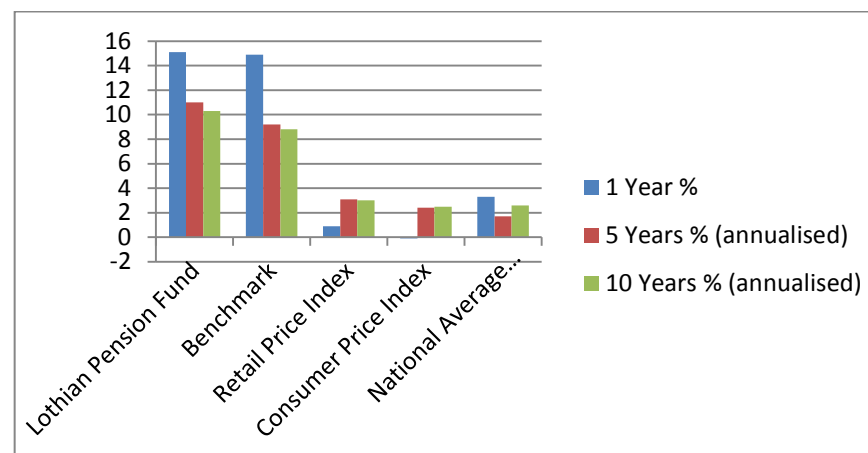
### Exhibit 3: Fund managers' allocation 2014-15 (Lothian Pension Fund)

Fund Manager	Market Value £'000	% of Total Fund Value
<b>Cantillon</b>	265,575	5.2
<b>Harris</b>	205,125	4.0
<b>In-house Investment Managers</b>	3,789,521	74.8
<b>Mondrian</b>	104,048	2.1
<b>Nordea</b>	203,667	4.0
<b>Standard Life</b>	382,694	7.5
<b>UBS</b>	121,954	2.4
<b>Total</b>	5,072,584	100

Source: Lothian Pension Fund audited financial statements 2014/15

96. The main mechanism for measuring investment performance is through an analysis of the returns achieved by each of the Funds' fund managers. Each active Investment Manager has a defined performance benchmark and objective, against which performance will be measured. Their performance, in terms of achieving benchmarks, is subject to independent verification by an external specialist provider and is regularly reported to the pensions committee and investment strategy panel.
97. Investment returns of the Lothian Pension Fund have outperformed benchmark targets over the short, medium and longer term, as illustrated in **Exhibit 4**. The table also shows that over a period of one, five and ten years the pension fund has outperformed measures of inflation i.e. the consumer price index, the retail price index and national average earnings.
98. Lothian Buses Pension Fund investment returns exceeded the required performance benchmark levels for 2014/15. The portfolio as a whole made returns of 15.1% against the benchmark target of 14.9%.
99. Scottish Homes Pension Fund investment returns exceeded the required performance benchmark levels for 2014/15. The portfolio as a whole made returns of 19.7% against the benchmark target of 19.4%.

#### Exhibit 4: Investment Performance – Lothian Pension Fund



Source: Lothian Pension Fund audited financial statements 2014/15

### Administration performance

100. The Funds' Administration Strategy was approved by the Pensions Committee in September 2013. It contains the standards which are required of the participating employers to ensure that the Funds meet their statutory obligations and are able to deliver services efficiently. The strategy contains a variety of performance measures against which the Funds and the participating employers are assessed.
101. In accordance with Local Government Regulations, the Funds' annual report discloses performance against the measures detailed in the Pension Administration Strategy. In relation to 2014/15 the Funds' performance was broadly in line with the annual targets set.

## Investment strategies

- 102.** The Funds' investment strategies 2012-17, as agreed by the Pensions Committee in October 2012, have continued to be implemented during 2014/15. The key objective of the Funds' investment strategies is to maximise the investment return within reasonable and considered risk parameters, as illustrated in **Exhibit 5**.
- 103.** The Lothian Pension Fund had a higher position in equities and cash, and was lower in index-linked assets and alternatives compared to the interim strategy at 31 March 2015.
- 104.** The Lothian Buses Pension Fund had a higher position in equities and cash, and was lower in index-linked assets and in alternatives compared to the interim strategy at 31 March 2015.
- 105.** For the Scottish Homes Pension Fund, the strategy has been to reduce the allocation to equities and property and increase the allocation to bonds.

**Exhibit 5: Allocation of Investments to Investment strategy**

Funds	Allocation 31 March 2015 %	Strategy 31 March 2015 %
<b>Lothian Pension Fund</b>		
Equities	69.1	68.0
Index-Linked Assets	6.1	7.0
Alternatives	21.0	24.0
Cash	3.8	1.0
<b>Lothian Buses Fund</b>		
Equities	62.0	60.5
Index-Linked Assets	11.0	12
Alternatives	23.0	27.5
Cash	4	0
<b>Scottish Homes Fund</b>		
Equities	28.0	27.5
Bonds	66.8	67.5
Property	5.2	5.0

Source: Pension Committee June 2015 - Annual Investment updates

## Management expenses

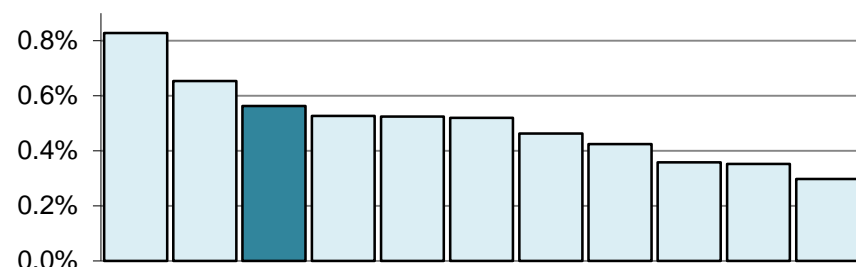
- 106.** There are three main categories of management expense, with the largest being investment management costs. Other expenses are the cost of the administration services provided by the council and the governance fees for actuarial and audit services.



107. In 2014/15 the investment management costs of the Lothian Pension Fund rose from £24.022 million to £25.479 million.

108. **Exhibit 6** shows provisional figures for total management costs as a percentage of net assets, with the Lothian Pension Fund highlighted separately.

### Exhibit 6: Management costs as percentage of net assets of Scottish LGPS funds



Source: Draft financial statements published for 2014/15

109. At 0.56%, the Lothian Pension Fund's management costs are comparatively low, which contributes to long term asset growth.

110. It is noted at this stage that there is inconsistency in the level of cost transparency between funds and that management costs will be heavily influenced by the asset allocation of a Fund.

## National performance reports

111. 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.

112. 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).

113. These and other Audit Scotland reports are available on Audit Scotland's website ([www.audit-scotland.gov.uk](http://www.audit-scotland.gov.uk)).

## Outlook

114. 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. 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.

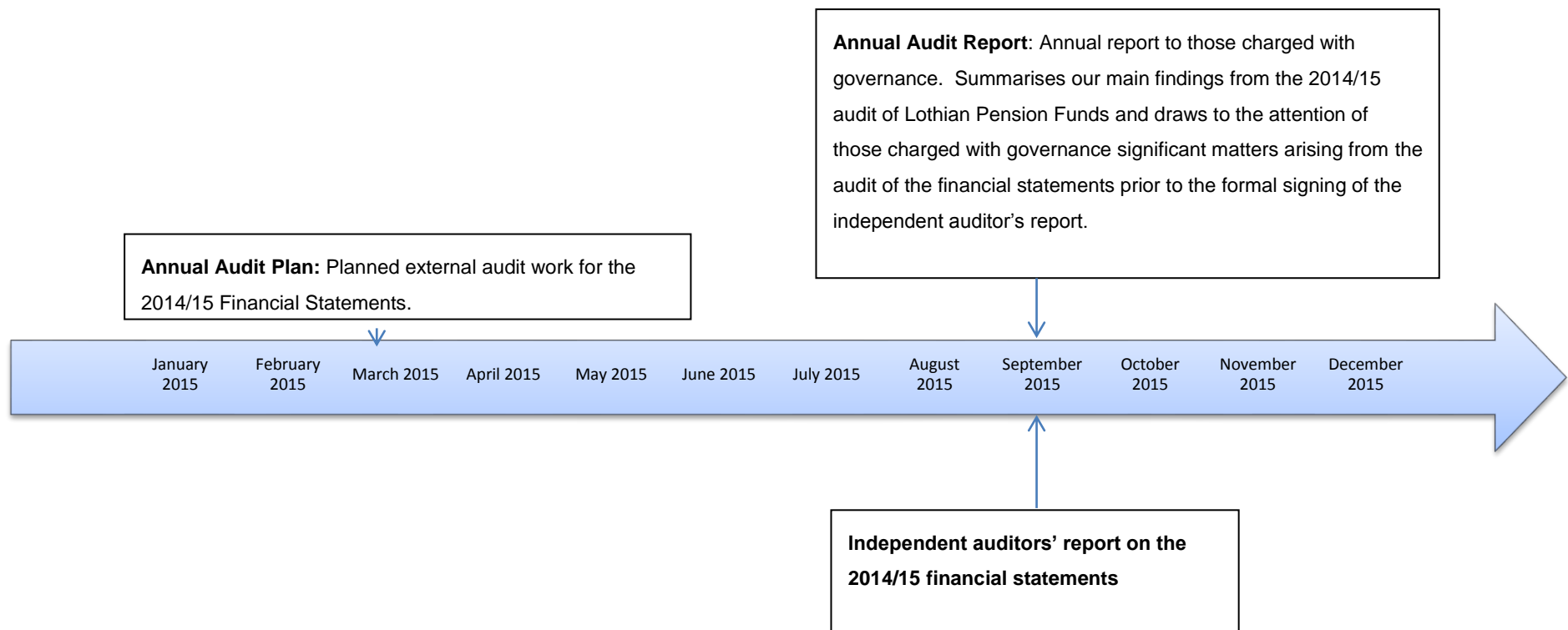
Audit Risk	Assurance procedure	Results and conclusions
<b>Risk of material misstatement</b>		
<p><b>Management override of controls</b></p> <p>ISA 240 requires that audit work is planned to consider the risk of fraud, which is presumed to be a significant risk in any audit. This includes consideration of the risk of management override of controls in order to change the position disclosed in the financial statements</p>	<ul style="list-style-type: none"> <li>• Detailed testing of journal entries</li> <li>• Review of accounting estimates for bias</li> <li>• Evaluating significant transactions that are outside the normal course of business</li> </ul>	<p>We undertook detailed testing of journal entries, accruals and prepayments. We also reviewed accounting estimates and transactions for appropriateness.</p> <p>We did not identify any incidents of management override of controls</p>

Audit Risk	Assurance procedure	Results and conclusions
<p><b>Investment management – special purpose vehicles</b></p> <p>Investment and other senior staff will be transferred to a new company created to provide the Funds more flexibility in the terms and conditions on which staff are recruited.</p> <p>There is a risk that transactions between the Funds and the newly established company may not be recorded and disclosed in accordance with the accounting requirements of 'The Code'.</p>	<ul style="list-style-type: none"> <li>• Detailed testing of transaction between the Funds and the newly established company.</li> <li>• Review of the disclosures made in the Funds' 2014/15 financial statements concerning the relationship between the Funds and the company against the requirements of 'The Code' and sector specific guidance.</li> </ul>	<p>Discussion with management confirmed that the two special purpose vehicles were not set up until April 2015 and do not have an impact on the 2014/15 financial statements.</p> <p>We plan to continue to discuss the impact of these changes with management during 2015/16 in relation to accounting for these special purpose vehicles e.g. group accounting and potential changes to accounts presentation.</p>

Audit Risk	Assurance procedure	Results and conclusions
<p><b>Investment management expenses</b></p> <p>CIPFA guidance applicable for 2014/15 requires all management expenses, including those deducted from the capital value of investments, to be fully disclosed in a note to the financial statements. Lothian Pension Fund applied a revised methodology in 2013/14, in advance of the CIPFA guidance, with a view to enhancing the transparency of existing disclosures.</p> <p>There is a risk that the methodology applied does not fully reflect the requirements set out in the CIPFA guidance, or provide a level of comparability with other pension fund disclosures.</p>	<ul style="list-style-type: none"> <li>Review of the Funds' approach to estimating management expenses against the CIPFA guidance.</li> </ul>	<p>We undertook a review of investment management expenses disclosed in the financial statements and no significant issues identified. The methodology is consistent with prior years and in-line with guidance.</p>
<p><b>Requirements of new accounting regulations</b></p> <p>The Local Authority Accounts (Scotland) Regulations 2014 introduce some changes to the contents of the financial statements and the approval processes for the annual accounts.</p> <p>There is a risk that the pension fund annual accounts do not comply with the new regulations and are not approved in accordance with the new requirements.</p>	<ul style="list-style-type: none"> <li>Review of compliance as part of the detailed financial statements review for 2014/15</li> </ul>	<p>We discussed and agreed with officers, all amendments to the presentation of the Annual Report and Accounts to ensure requirements of the new regulations were complied with.</p>

# Appendix II

## Summary of Lothian Pension Funds local audit reports 2014/15



# Appendix III

## Action plan

No. Page/para	Issue/risk/Recommendation	Management action/response	Responsible officer	Target date
1 19/69	<p><b>Issue</b></p> <p>The Funds have included an Annual Governance Statement in their annual report as part of the new regulations. This statement has been based primarily on the content of the council's Annual Governance Statement. Whilst some of the content within the council's statement is pertinent to the Funds, there are aspects which are of less relevance.</p> <p><b>Risk</b></p> <p><i>There is a risk that the disclosures in the Annual Governance Statement are not focused on the governance arrangements of the Pension Funds.</i></p> <p><b>Recommendation</b></p> <p>The Funds should consider the current format and content of the Annual Governance Statement.</p>	With the evolution and ongoing enhancement of the governance and control procedures of the City of Edinburgh Council this point is recognised and acknowledged.	Claire Scott Investment and Pensions Service Manager	31 March 2016

No. Page/para	Issue/risk/Recommendation	Management action/response	Responsible officer	Target date
2 19/73	<p><b>Issue</b></p> <p>Not all members received the minimum training requirements as per the Funds policy during 2014/15.</p> <p><b>Risk</b></p> <p>Members, especially new members of the Pension Board, are not kept updated with changes in pension regulations and standards in public life.</p> <p><b>Recommendation</b></p> <p>The Funds should ensure that all members receive the minimum of three days training (as per the Funds policy).</p>	With the introduction of the new Pension Board, training will be a priority over the coming year.	Clare Scott Investment and Pensions Service Manager	31 March 2016