Scott-Moncrieff
business advisers and accountants

Lothian Pension Funds

2016/17 Annual Audit Report to Members and the Controller of Audit

September 2017

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Key messages

Annual accounts

Lothian Pension Funds approved the annual accounts for 2016/17 on 27 September 2017. We reported unqualified opinions on the financial statements and other prescribed matters for Lothian Pension Fund, Lothian Buses Pension Fund and Scottish Homes Pension Fund within our independent auditor's report. We also reported that there were no matters which we were required to report by exception.

Wider Scope

Financial management

- The Funds have adequate and effective arrangements in place for managing their financial position and use of resources.
- We have evaluated the Funds' key financial systems and internal financial controls and determined these are adequate to prevent material misstatements in the annual accounts.

Financial sustainability

- We have concluded that the Funds have effective arrangements in place to ensure the ongoing sustainability of the pension funds.

Governance & transparency

- Our work on corporate governance focussed on reviewing the Funds' arrangements to ensure effective systems are in place regarding internal control, prevention and detection of fraud and irregularity and standards of conduct.
- Governance arrangements at the Funds were found to be satisfactory and appropriate.

Value for money

- The Funds have appropriate arrangements in place to monitor performance of investments and the administration of the Funds.

Key facts

- Net assets increased by 21% in 2016/17 to £6,595 million (2015/16: £5,433 million).
- Contributions received in year (£201.8 million) fell below the benefits paid out by the fund (£211.1 million) leaving a net withdrawal on the fund of £9.2 million.
- Return on investments in 2016/17 was 21.7% slightly behind the benchmark of 24.8%; however, the performance over the five year period to 31 March 2017 is exceeding the target of 11.4% by 1.5%.

Conclusion

This report concludes our audit for 2016/17. Our work has been performed in accordance with the Audit Scotland Code of Audit Practice, International Standards on Auditing (UK and Ireland) and Ethical Standards.

Scott-Moncrieff
September 2017

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Introduction

Introduction

1. This report summarises our findings from the 2016/17 audit of the Lothian Pension Fund, the Lothian Buses Pension Fund and the Scottish Homes Pension Fund (collectively referred to as the "Funds").

2. We outlined the scope of our audit in our external audit plan, which we presented to the Pensions Committee on 20 March 2017. The core elements of our audit work in 2016/17 have been:

   - an interim audit of the Funds' key financial systems and governance arrangements;
   - an audit of the Funds' 2016/17 annual report and accounts, including a review of the Annual Governance Statement;
   - a review of arrangements as they relate to the four dimensions of wider-scope public audit: financial management, financial sustainability, governance and transparency, and value for money; and
   - consideration of the local impact of the national performance report *The Role of Boards*.

3. The Funds are responsible for preparing annual accounts that show a true and fair view and for implementing appropriate internal control systems. The weaknesses and risks identified in this report are only those that have come to our attention during our normal audit work, and may not be all that exist. Communication in this report of matters arising from the audit of the financial statements or of risks or weaknesses does not absolve management from its responsibility to address the issues raised and to maintain an adequate system of control.

4. We discussed and agreed the content of this report with the Chief Finance Officer and Chief Executive. We would like to thank all management and staff for their co-operation and assistance during our audit.

5. This report contains an action plan with specific recommendations, responsible officers and dates for implementation. Senior management should assess these recommendations and consider their wider implications before deciding appropriate actions. We give each recommendation a grading to help the Funds assess their significance and prioritise the actions required.

Adding value through the audit

6. All of our clients quite rightly demand of us a positive contribution to meeting their ever-changing business needs. Our aim is to add value to the Funds through our external audit work by being constructive and forward looking, by identifying areas of improvement and by recommending and encouraging good practice. In this way, we aim to help the Funds promote improved standards of governance, better management and decision making and more effective use of resources.

7. We welcome any comments you may have on the quality of our work and this report via: *www.surveymonkey.co.uk/r/S2SPZBX*

8. This report is addressed to both Lothian Pension Funds and the Controller of Audit and will be published on Audit Scotland's website. *www.audit-scotland.gov.uk*.

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Annual accounts

Annual accounts

Introduction

9. The Funds' annual financial statements are the principal means of accounting for the stewardship of its resources and its performance in the use of those resources. The respective responsibilities of the Funds and the auditor in relation to the financial statements are outlined in appendix 2.

Overall conclusion

Unqualified audit opinions

10. The annual accounts for the year ended 31 March 2017 were approved by the Pensions Committee on 27 September 2017. We reported within our independent auditor's report:

- an unqualified opinion on the financial statements; and
- an unqualified opinion on other prescribed matters.

11. We are also satisfied that there are no matters which we are required to report to you by exception.

Good administrative processes were in place

12. We received draft financial statements and supporting papers of a good standard, in line with our agreed audit timetable. Our thanks go to management and staff for their assistance.

Our assessment of risks of material misstatement

13. The assessed risks of material misstatement described below are those that had the greatest effect on our audit strategy, the allocation of resources in the audit and directing the efforts of the audit team. We designed our audit procedures relating to these matters in the context of our audit of the annual report and accounts as a whole, and not to express an opinion on individual accounts or disclosures. We outline the significant risks below.

Audit Risk 1: Revenue Recognition

Under ISA 240 - The auditor's responsibilities relating to fraud in an audit of financial statements there is a presumed risk of fraud in relation to revenue recognition. The presumption is that the Funds could adopt accounting policies or recognise income and expenditure transactions in such a way as to lead to a material misstatement in the reported financial position.

14. While we did not suspect incidences of material fraud and error, we evaluated each type of revenue transaction and documented our conclusions. We have reviewed the controls in place over revenue accounting and found them to be sufficient. We have evaluated key revenue transactions and streams and carried out testing to confirm that the Funds' revenue recognition policies are appropriate and have been applied consistently.

Audit Risk 2: Management override of controls

In any organisation, there exists a risk that management have the ability to process transactions or make adjustments to the financial records outside the normal financial control processes. Such issues could lead to a material misstatement in the annual accounts. This is treated as a presumed risk area in accordance with ISA 240 - *The auditor's responsibilities relating to fraud in an audit of financial statements*.

15. While we did not suspect any incidences of management override leading to financial reporting issues, we reviewed the accounting records for significant transactions outside the normal course of business and obtained evidence to ensure that these were valid and accounted for

correctly. Based on our audit work to detect potential material misstatement we have not identified any indications of such management override during the year.

Audit Risk 3: Valuation of Investments

The Lothian Pension Fund held investments of £5.399 billion as at 31 March 2016, of which 30% (£1.663 billion) were classified as level 2 or level 3 financial instruments, meaning the valuation was not based on unadjusted quoted prices in active markets. Investments of this nature are complex, difficult to value and include a significant degree of judgement from the investment manager. The material nature of this balance means that any error in judgement could result in a material valuation error.

16. In 2016/17 the value of level 2 and level 3 investments rose in year to £2.069 billion increasing as a proportion of overall investments to 31%. Fair values of investments of this nature are provided by the fund managers and custodian using different bases as deemed appropriate, including reference to similar companies and bid prices. The valuation basis for each class of investment is disclosed within the accounting policies of the Funds.

17. We have considered the competence, capability and objectivity and control environment of the key fund managers and the custodian. Our testing did not raise any issues regarding the qualifications of or work provided by management's experts.

18. The disclosures in the financial statements are consistent with the information provided by the custodian.

Audit Risk 4: Pension liability assumptions

An actuarial estimate of the pension fund liability is calculated on an annual basis under IAS 19 and on a triennial funding basis by independent firm of actuaries with specialist knowledge and experience. The estimates are based on the most up to date membership data held by the pension fund and have regard to local factors such as mortality rates and expected pay rises with other assumptions around inflation when calculating the liabilities. There is a risk that the assumptions used are not appropriate.

19. Our review of the control environment around membership data did not identify any weaknesses in its design which would be likely to lead to a material misstatement.

20. The assumptions used by the actuary were compared to benchmarks across the sector and deemed to be reasonable.

Our application of materiality

21. Materiality is an expression of the relative significance of a matter in the context of the financial statements as a whole. A matter is material if its omission or misstatement would reasonably influence the decisions of an addressee of the auditor's report. The assessment of what is material is a matter of professional judgement over both the amount and the nature of the misstatement.

22. On receipt of the draft 2016/17 accounts, we reassessed materiality which resulted in a change to the level of materiality applied. Our revised assessment of materiality along with our planning materiality for each Fund is set out in the table below. The Funds hold significant investment assets, which form the largest part of the net asset statements for each pension fund. We consider that the net asset statements are of primary interest to the reader of the annual accounts and therefore consider that these should be used in the calculation of overall materiality.

23. ISA 320 states that in certain circumstances it is appropriate to set a materiality amount for particular classes of transactions for which the lesser amounts than the overall materiality could influence the decision of the users of the accounts. We considered the transactions in the Fund Accounts to be of key interest to the users as it contains information around the day to day performance of the Funds. We have therefore set a materiality for this class of transactions based on return on investments and the expenditure incurred for providing payments to pensioners.

	Overall Planning materiality £million	Fund account planning materiality £million	Overall Final materiality £million	Fund account final materiality £million
Lothian Pension Fund (group)[1]	81.5	8.8	98.9	19.9
Lothian Pension Fund (single entity)	81.5	8.8	98.9	19.9
Lothian Buses Pension Fund	5.9	0.4	7.3	1.5
Scottish Homes Pension Fund	2.3	0.2	2.5	0.5

24. We set a performance materiality for each area of work which is based on a risk assessment for that area. We have performed audit procedures on all transactions, or groups of transactions, and balances that exceed our performance materiality. This means that we performed a greater level of testing on the areas deemed to be of significant risk of material misstatement

	Area risk assessment £million		
	High (45%)	Medium (55%)	Low (70%)
Lothian Pension Fund (group and parent)	44.5	54.4	69.2
Lothian Buses Pension Fund	3.2	4.0	5.1
Scottish Homes Pension Fund	1.1	1.4	1.7

25. We agreed to report any misstatements identified through our audit that fall into one of the following categories:

- All material corrected misstatements;
- Uncorrected misstatements over £250,000, less than 1% of the overall materiality figure;
- Misstatements below the £250,000 threshold we believe warrant reporting on qualitative grounds.

Other matters

26. We identified one medium risk matter relating to the authorisation of journal entries. We have reported on this fully within appendix 1 to this report.

Audit adjustments identified

27. We identified some disclosure and presentational adjustments during our audit, which have been reflected in the final set of annual accounts.

[1] Lothian Pension Fund group comprises Lothian Pension Fund, LPFE Ltd and LPFI Ltd

Board representations

28. We have requested that the Pensions Committee present a signed representation letter, covering a number of issues, to us at the date of signing the financial statements.

29. In June 2017 a voluntary disclosure of under-declared Output Tax was made to HMRC by the City of Edinburgh Council on behalf of the Funds. The under declaration arose from two properties managed by Standard Life which did not have VAT applied correctly. A review of all properties has been undertaken and the total under declaration was £0.51 million. The total under declaration covers a number of tax periods and does not breach the penalty threshold in any financial year. The proposed adjustment is outlined at appendix 2.

30. We do not consider the difference to be material to the financial statements, either individually or in aggregate. Through discussion with the Chief Finance Officer, the decision was taken not to adjust the financial statements. The difference is reported through the representation letter.

An overview of the scope of our audit

31. We detailed the scope of our audit in our external audit plan. We presented the plan to the Pensions Committee on 20 March 2017.

32. Our plan explained that we follow a risk-based approach to audit planning that reflects our overall assessment of the relevant risks that apply to the Pensions Committee. This ensures that our audit focuses on the areas of highest risk. Planning is a continuous process and our audit plan is subject to review during the course of the audit to take account of developments that arise.

33. At the planning stage we identified the significant risks that had the greatest effect on our audit. We then designed audit procedures to mitigate these risks. We base our standard audit approach on performing a review of the key accounting systems in place, substantive tests and detailed analytical review.

34. Tailored audit procedures, including those designed to address significant risks, were completed by the audit fieldwork team and the results were reviewed by the audit manager and audit partner. In performing our work, we have applied the concept of materiality, which is explained earlier in this report.

Accounting and Internal Control systems

35. The Funds have adequate systems in place to record, process, summarise and report financial and other relevant data. We have not identified any material weaknesses or governance issues in the Funds' accounting and internal control systems during our final audit.

Other matters identified during our audit

36. During the course of our audit we noted the following:

The Local Authority Accounts (Scotland) Regulations 2014

37. As part of our audit we reviewed the Council's compliance with the Local Authority Accounts (Scotland) Regulations 2014, in particular with respect to regulations 8 to 10[2] as they relate to the annual accounts. Overall we concluded that appropriate arrangements are in place to comply with these Regulations.

Management commentary

38. The Local Authority Accounts (Scotland) Regulations 2014 require pension funds to include a management commentary within the annual accounts. The management commentary is intended to assist readers in understanding the annual accounts and the organisation that has prepared them. As auditors we are required to read the management commentary and express an opinion as to whether it is consistent with the annual accounts. We have concluded that the management commentary is consistent with the annual accounts.

39. As part of our audit we also reviewed the Council's management commentary against the non-statutory guidance issued by the Scottish

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[2] Regulations 8 to 10 relates to the preparation and publication of unaudited accounts, notice of public right to inspect and object to the accounts and consideration and signing of the audited accounts.

Government (Local Government Finance Circular 5/2015). We considered the extent to which the Funds' management commentary included relevant information in respect of:

- The context of the annual accounts;
- Insight into the priorities of the Funds' and strategies adopted to achieve these priorities and objectives;
- Information on future plans;
- KPIs which measure the investment performance of the Funds'; and
- Information on the principal risks and uncertainties facing the authority.

Annual governance statement and Governance Compliance Statement

40. The Chief Executive and Acting Executive Director of Resources of the City of Edinburgh Council along with the Chief Executive Officer of Lothian Pension Fund have confirmed that in their opinion, reasonable assurance can be placed upon the adequacy and effectiveness of Lothian Pension Funds' systems of governance. The Annual Governance Statement identifies a range of actions that have been, or will be, taken by the Council to continue to progress improvements in the Council's governance arrangements.

41. We have reviewed the Funds' Annual Governance Statement and have found that it complies with the relevant guidance: *Delivering Good Governance in Local Government*. However, it is a requirement that the Annual Governance Statement outlines an action plan outlining the actions that the Funds' will take to continue to progress improvements in the Funds' governance processes. This was not present in the draft accounts.

Action Plan point 2

42. We found that the processes used to prepare the statements are reasonable and appropriate.

43. The Local Government Pension Scheme (Scotland) Regulations 2014 require all pension funds to prepare a Governance Compliance Statement. The purpose of this statement is to compare the Funds' governance arrangements with those standards set out in guidance from the Scottish Ministers.

44. We have reviewed the Governance Compliance Statement and we are satisfied the disclosures comply with guidance issued by Scottish Ministers and are not inconsistent with our knowledge of the arrangements in place at the Funds.

Group accounts

45. The Pensions Committee for the Funds approved the creation of two special purpose vehicles, LPFE Ltd and LPFI Ltd in October 2014. The companies are wholly owned and controlled by the City of Edinburgh Council. Group accounts were prepared for the Funds for the first time in 2015/16 incorporating LPFE Ltd. LPFI Ltd became operational in 2016/17 after the funds received Financial Conduct Authority authorisation.

46. We reviewed the consolidation process in 2016/17 and concluded the subsidiary companies had been correctly included in the group accounts of Lothian Pension Fund.

Legality

47. We have planned and performed our audit recognising that non-compliance with statute or regulations may materially impact on the annual accounts. Our audit procedures included the following:

- Reviewing minutes of relevant meetings;
- Enquiring of senior management and the Funds' solicitors the position in relation to litigation, claims and assessments; and
- Performing detailed testing of transactions and balances.

48. We are pleased to report that we did not identify any instances of concern with regard to the legality of transactions or events.

Qualitative aspects of accounting practices and financial reporting

49. We have considered the qualitative aspects of the financial reporting process, including items that have a significant impact on the relevance, reliability, comparability, understandability and materiality of the information provided by the financial statements. Our findings are summarised below:

Qualitative aspect considered	Audit conclusion
The appropriateness of the accounting policies used.	We have reviewed the significant accounting policies which are disclosed in the annual accounts of the Funds. We consider the policies to be appropriate to the Funds, however, we have noted that the Funds have departed from CIPFA Guidance in relation to investment management expenses. During 2015/16 CIPFA issued guidance stating that pension funds should only report the direct costs of using investment managers. The impact of this is that investment management costs associated with fund of funds transactions would not be reported. The Funds feel this would detract from the transparency of the accounts and have reported indirect costs of £4.16 million for Lothian Pension Fund and £0.33 million for Lothian Buses (there were no indirect costs for Scottish Homes). The impact of this accounting treatment is to increase the investment management expense which is offset by an increase in the change in market value of investments. The net impact on the fund account is therefore zero.
The timing of the transactions and the period in which they are recorded.	We did not identify any concerns over the timing of transactions or the period in which they were recognised.
The appropriateness of the accounting estimates and judgements used.	The Funds have significant levels of accounting estimates and judgements used by management in preparing the financial statements. The principal areas of estimation concern the valuation of unquoted private equity and infrastructure investments and the actuarial valuation of promised retirement benefits. We are satisfied with the appropriateness of the accounting estimates and judgements used in the preparation of the annual accounts. We have considered the disclosures around the estimates, including sensitivity analysis and concluded that they are appropriate.
The potential effect on the financial statements of any uncertainties, including significant risks and related disclosures that are required.	We have not identified any uncertainties, including any significant risk or required disclosures, which should be included in the financial statements (beyond the existing disclosures made).

The extent to which the financial statements have been affected by unusual transactions during the period and the extent that these transactions are separately disclosed.	From the testing performed, we identified no significant unusual transactions in the period.
Apparent misstatements in the Management Commentary or material inconsistencies with the financial statements.	The annual report and accounts contain no material misstatements or inconsistencies with the annual accounts in the Management Commentary.
Any significant financial statements disclosures to bring to your attention.	There are no significant financial statements disclosures that we consider should be brought to your attention. All the disclosures required by relevant legislation and applicable accounting standards have been made appropriately.
Disagreement over any accounting treatment or financial statements disclosure.	While some disclosure and presentational adjustments were made through the audit process, there was no material disagreement during the course of the audit over any significant accounting treatment or disclosure.
Difficulties encountered in the audit.	There were no significant difficulties encountered during the audit.

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Financial management

Financial management

Overall conclusion

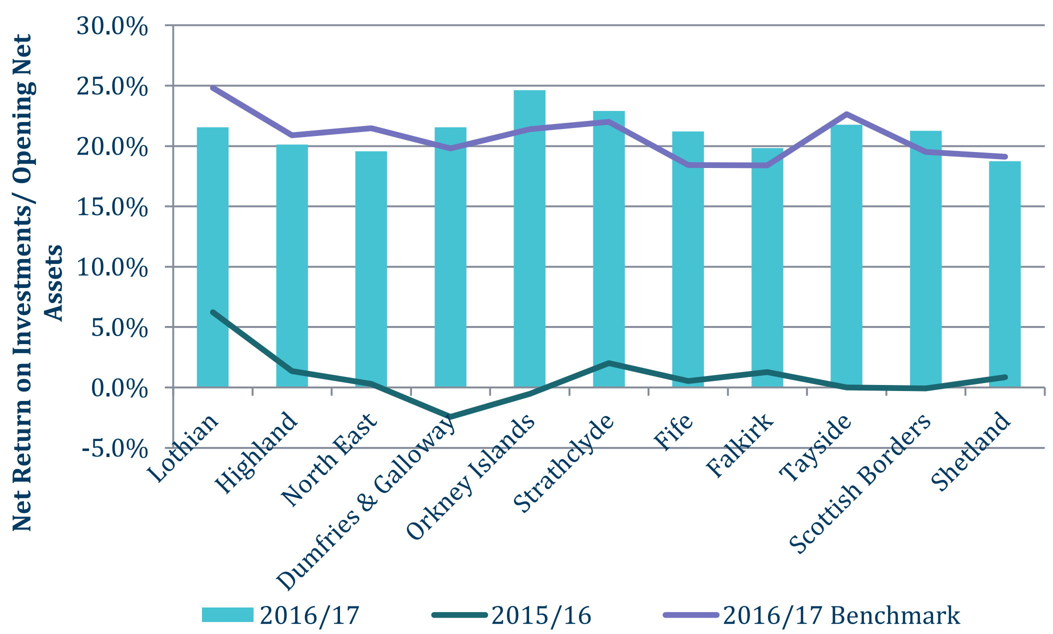
The Funds have effective arrangements in place for financial management and the use of resources

50. Overall, the Funds have effective arrangements in place for financial management and the use of resources. Our conclusion is based on a review of the Funds' financial performance against their investment strategy and our review of the system of internal control

The Funds' financial performance in 2016/17

The Funds were slightly behind the 1 year benchmark but achieved their longer term targets

51. The key financial indicator for the across pension funds in Scotland is the return on investments. Following a relatively poor performance across all investment funds in 2015/16 the investment performance has improved across all Scottish Finds in 2016/17.



52. The average return on investments in 2016/17 was 21.19% a significant increase compared to 0.86% in 2015/16.

53. The Lothian Pension Funds have consistently performed above the average figure.

54. The graph above focuses on the short term performance of the Scottish Pension Funds but the Funds investment programme recognises that long term performance is key to ensure the sustainability of the Funds. Consequently the Funds review performance against benchmark over one, five and ten years.

55. The Funds were slightly behind the one year benchmark on Lothian Pension Fund and Lothian Buses Pension Fund. The performance over the longer term is consistently meeting or exceeding benchmark which indicates the investment portfolio is being managed appropriately.

	1 year		5 years		10 Years	
	Return	Benchmark	Return	Benchmark	Return	Benchmark
Lothian Pension Fund	21.7%	24.8%	12.9%	11.4%	8.2%	6.6%
Lothian Buses	23.7%	24.2%	13.2%	11.5%	9.6%	8.0%
Scottish Homes	18.9%	18.7%	10.8%	10.7%	9.1%	9.1%

Financial Position

56. The net assets of the Fund continued to increase in 2016/17, reflecting the level of returns achieved in year and the relatively strong position of the market in year.

	2016/17 £m	2015/16 £m	% Movement
Lothian Pension Fund	6,594	5,434	21.3%
Lothian Buses	488	394	19%
Scottish Homes	171	150	14%

57. Although the net assets position is increasing the Funds' actuary, Hymans Robertson estimated that the present value of the promised retirement benefits had risen across Lothian Pension Fund and Lothian Buses Pension Fund by approximately 31%. Scottish Homes had a smaller increase of only 12%.

58. The actuarial calculations are based on the 2014 Actuarial Valuation rolled forward. It was noted by the Actuary in their report that the performance of real bond yields has declined in recent years meaning the funding levels set in 2014 are likely to be worse than predicted and the liability increased.

59. The liability figures do not appear in the primary financial statements and appear only in the notes to the accounts. This is in line with the options in the CIPFA Code of Practice on Local Authority Accounting.

60. This recognises that the liabilities are recognised on the employing bodies' balance sheets. However, the financial environment continues to be challenging and following the 2017 Actuarial Valuation it may become increasingly difficult for employers to meet the contribution demands of the Funds.

61. In addition to this there are a number of employers within the Lothian Pension Fund with fewer than 5 employees who may be in a position where the debt crystallises on the cessation of active members. Due to the low market yields it is anticipated that cessation valuations would show sizable deficits.

62. This has increased the risk of employers defaulting on the exit payments required to cover the liability attributable to their employees.

63. The Funds have recognised this as a significant risk and are taking steps to mitigate this risk. Lothian Pension Fund is working with the at risk employers to ensure they can continue to meet the contribution demands of the fund or can meet the cessation liability.

64. Lothian Pension Fund currently has a contingent asset of £0.33 million relating to unsecured assets due from ceased employers.

65. As this is deemed to be a significant risk to Lothian Pension Fund we recommend that increased disclosure around the nature of the risk, the level of at risk employers within the Fund and the potential impact on the funding level is included in the financial statements.

Action Plan Point 3

The Funds have effective budget setting and monitoring arrangements

66. We have considered the Funds' system of budgetary control and financial management and did not identify any significant deficiencies.

67. The Funds align their financial regulations and policies with the City of Edinburgh Council. The financial regulations were last subject to review in 2017 and were approved by the Council in June 2017.

68. The Pensions Committee consider the investments control environment and performance over the annual committee cycle in line with a formal long term agenda plan. Over the course of the financial year the Pensions Committee has taken reports on the investment strategy panel, investment principles and the performance of the Funds.

69. The Pensions Committee also receive a report on the financial performance of the Funds in year, encompassing the contributions received and pensions paid along with the administration costs. Where there are variances adequate narrative is provided to ensure the Pensions Committee have an understanding of the reason for the movement and the action being taken by the Funds.

Prevention and detection of fraud and irregularity

70. Our audit was planned to provide a reasonable expectation of detecting material misstatements in the financial statements resulting from fraud and irregularity. We found the Funds' arrangements for the prevention and detection of fraud and other irregularities to be adequate.

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Financial sustainability

Financial Sustainability

Overall Conclusion

The Funds have effective arrangements in place to ensure the ongoing sustainability of the pension funds.

71. The Funds have a responsibility to pay pensions to members until the end of their life. The payments required are based on the contributions made by members over the course of their employment.

72. Overall we have concluded that the Funds have effective arrangements in place to ensure the ongoing sustainability of the pension funds. When assessing financial sustainability we have considered the contribution rates set, the Funding Strategy Statement and the Investment Strategies in place for the Funds.

Triennial Valuation

73. The Funds' undertook an actuarial valuation in 2014 in line with the requirements of the Local Government Pension Scheme Regulations 2014. The 2014 Actuarial Valuation was a triennial valuation with the purpose of setting rates for the three year period commencing 1 April 2015.

74. The 2014 Actuarial Valuation was undertaken by Hymans Robertson in accordance with Regulation 32 of the Local Government Pension Scheme (Administration) (Scotland) Regulations 2008 as amended.

75. At the 2014 Actuarial Valuation the funding level reduced for Lothian Pension Fund but increased across Lothian Buses Pension Fund and Scottish Homes Pension Fund. The Lothian Buses Pension Fund was the only fund achieving its target funding level.

Funding level

	Actual 2014 (%)	Target (%)
Lothian Pension Fund	91.3%	100%
Lothian Buses	117%	100%
Scottish Homes	88.8%	91.5%

76. In light of the funding levels the 2016/17 financial statements show that the Lothian Pension Fund has now moved to a position where payments exceed contributions received.

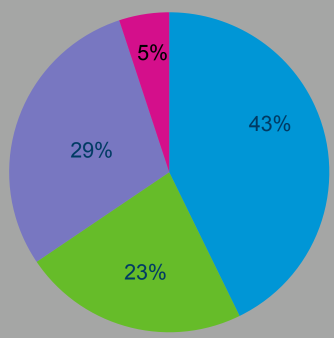
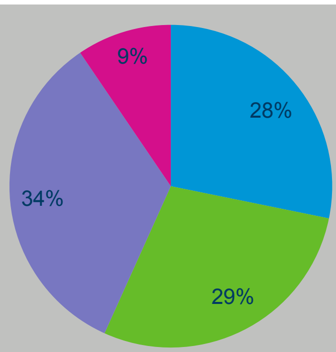
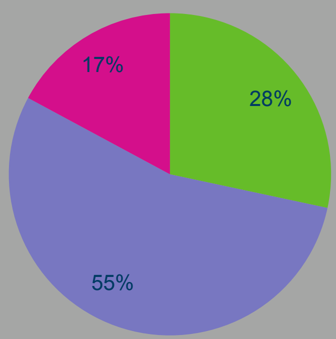
	Lothian Pension	Lothian Buses	Scottish Homes
Contributions and transfers	201,849	9,801	675
Payments (including admin)	(211,085)	(12,522)	(7,540)
Net position	**(9,236)**	**(2,721)**	**(6,865)**

77. Lothian Buses and Scottish Homes have operated at a net withdrawals position for a number of years. This is due to the fact both schemes are now closed to members, with Scottish Homes having no active members. The Funds are managing their investment strategy to ensure there is adequate investment income to cover payments.

78. The next detailed actuarial valuation for the Funds will be carried out as at 31 March 2017 and at this stage the contribution rates required to support the Lothian Pension Fund back to fully funded status will be considered.

Funding Strategy Statement

79. The longer term sustainability of the Funds' is considered in the Funding Strategy Statement which was prepared in 2015 concurrently with the triennial actuarial valuation and creates a different strategy for each of the funds.

	Pension Fund Membership	Funding Strategy
Lothian Pension Fund		Lothian Pension Fund is open to new members with active members still being the highest proportion of members. Lothian Pension Fund has adopted a long term investment strategy split into 2 strategies. Strategy 1 applies to 99% of the employee liability and aims to maximise the investment return within reasonable and considered risk parameters. The second strategy invests in a portfolio of UK index linked gilts to reduce funding level and contribution rate risk to a level appropriate to their circumstances.
Lothian Buses Pension Fund		Lothian Buses Pension Fund is closed to new members and the liabilities are expected to mature. A revised strategy was approved in March 2016 to be implemented over the period from 2016 to 2021. The revised strategy reduces the Fund's allocation to equities and increases the allocation to index gilts and fixed income assets. The revised strategy is designed to reduce risk in order to take account of the maturing employee liability.
Scottish Homes Pension Fund		Scottish Homes Pension Fund currently has a funding arrangement in place with the Scottish Government, where the government is acting as guarantor for the scheme and provides funding on an annual basis to help fund the employee liability. A bespoke Investment strategy is in place to reduce the level of funding in equities and increase the level of funds invested in bonds. In line with this strategy the investments in equities reduced from 30% to 17.5% in 2016/17.

■ Active ■ Deferred ■ Pensioners ■ Dependants

80. As part of the triennial valuation process the Funds' Funding Strategy Statement is being reviewed and revised. In line with the Scheme Regulations the Funds' are making arrangements for consultation with scheme employers. The draft Funding Strategy Statement will be issued for consultation in late 2017.

Investment Strategy Panel

81. The Pensions Committee has delegated responsibility for investment strategy to an Investment Strategy Panel made up of:
- Head of Finance, City of Edinburgh Council;
- Chief Executive, LPFE Ltd;
- Chief Investment Officer, LPFE Ltd;
- Chief Finance Officer, LPFE Ltd; and
- three external investment consultants.

82. In 2016/17 Lothian Pension Fund set up a joint working arrangement with Falkirk Pension Fund which includes a joint Investment Strategy Panel. The role of this panel will be to advise the Finance Directors of each administering authority on the implementation of investment strategy. There has been collaborative investment in 2016/17 with 7 investments being made alongside Falkirk Pension Fund.

83. The Funds' are committed to reducing costs thereby improving longer term sustainability through increasing collaboration with other Scottish Local Authorities.

5

Governance & transparency

Governance & transparency

84. Governance and transparency is concerned with the adequacy of governance, leadership and decision making, and transparent reporting of financial and performance information. The Funds are responsible for ensuring the proper conduct of their affairs including compliance with relevant guidance, the legality of activities and transactions and for monitoring the adequacy and effectiveness of these arrangements.

Overall conclusion

85. The Funds have appropriate governance arrangements in place. Our audit work has included reviewing corporate governance arrangements as they relate to the corporate governance framework in place, the information provided to the Pension Committee and Audit Sub-Committee and the risk management arrangements in place.

Governance Structure

86. The Pensions Committee, supported by an Audit Sub-Committee, has been delegated responsibility for governance by the City of Edinburgh Council, the administering authority.

87. As outlined by the City of Edinburgh Council Scheme of Delegation the Pensions Committee has responsibility for the administration, management and investment strategy for the Funds.

88. From 1 April 2015 all pension funds were required to introduce local pension boards in line with the Public Service Pension Act 2013. This is the second year of operation of the Pension Board.

89. The Pension Board meet quarterly on a concurrent basis with the Pension Committee.

90. The remit of the Pension Board is to support the Pension Committee in compliance with regulations and the requirements of the Pension Regulator. In line with legislation if more than half of the members of the Pension Board disagree with a decision of the Pension Committee then they can request in writing that the Pension Committee review that decision. There have been no requests to review decisions in 2016/17.

Risk Management

91. A developed and integrated approach to risk management is a key feature of a robust system of internal control. The Pension Funds maintain a risk register in line with the City of Edinburgh Council Risk Management Policy and Procedures.

92. Risk management arrangements are firmly embedded in the governance process. The Pensions Committee receive a risk management update on a quarterly basis which provides information of the movement in risks and the actions being taken on the most notable risks.

93. The Pensions Audit Sub-Committee reviews the risk management process on an annual basis to ensure it is appropriate.

94. From our review of the risk management arrangements in place we have concluded that there are adequate arrangements in place at the Funds.

Internal Audit

95. An effective internal audit service is an important element of the Funds' governance arrangements. The Funds' internal audit service is provided by the City of Edinburgh Council via a co-source arrangement with PricewaterhouseCoopers (PwC).

96. Internal audit completed three reviews in year as follows:

- internally managed investments;
- a vulnerability assessment for online modules accessible to employers and members of the Funds; and
- governance of the Lothian Pension Fund Group.

97. The Internal Audit Plan was subject to scrutiny at the Pensions Audit Sub-Committee in December 2016. The Committee were satisfied that the level of review would provide them with adequate assurance in 2016/17.

98. During our audit we considered the work of internal audit wherever possible to avoid duplication of effort and make the most efficient use of the Funds' audit resource.

Standards of conduct

99. In our opinion the Funds' arrangements in relation to standards of conduct and the prevention and detection of bribery and corruption are adequate.

100. Our conclusion has been informed by a review of the arrangements for adopting and reviewing standing orders, financial regulations and schemes of delegation and for complying with national and local codes of conduct.

The Role of Boards

101. In September 2010 the Auditor General for Scotland published a report aiming to assess the role and work of boards across 67 public bodies and 39 colleges. The report made a number of recommendations as follows:

All non-executives should receive a formal induction	Boards should review the skills and expertise required on the Board and attract people to plug the gaps	Performance of non-executives should be assessed on a regular basis	Scrutiny efforts should be focused on organisational performance, financial and risk management
Performance information provided to the Board could be improved	Boards should aim to maximise openness and accessibility of papers	Declarations of interest should be considered at every meeting	Boards should review the use of Committees and ensure delegation levels are appropriate

102. As part of our audit work in 2016/17 we followed up on the Funds' response to the issues highlighted by Audit Scotland. Our aim was to identify any causes for concern or areas of good practice. Our detailed findings were submitted to Audit Scotland and are summarised below.

103. In our opinion arrangements for scrutiny and decision making are appropriate.

104. The Pensions Committee and Board members receive an induction which includes specific training on the activity of pension funds and investment management. Following the local elections in May 2017 there were 2 new Councillors elected to the Pensions Committee. Appropriate training for new members is scheduled for September 2017.

105. Due to the specialised nature of the Funds, it is vital that members have the appropriate knowledge and understanding to provide appropriate challenge and operate effectively. Training is therefore seen as a fundamental requirement for all Committee and Board members. Our review found that all Pension Committee and Board members met the requirement to have a minimum of 21 hours training during 2016/17.

106. The Pensions Committee and Pensions Audit Sub-Committee meetings are held in public, papers are available in advance and minutes of the meetings are published on the City of Edinburgh Council's website. Information about the Funds is published on the Funds' website including key strategic documents. Overall we have concluded there is a good level of transparency around the pension fund business.

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Value for Money

Value for money

Introduction

107. Value for money is concerned with the appropriate use of resources and ensuring continuous improvement of services delivered.

Overall conclusions

108. The Funds have appropriate arrangements in place to monitor performance of investments and the administration of the Funds. Our review was informed by the information provided to the Pensions Committee and the operations in place at the Pension Fund.

Investment operations

109. In October 2014 the Pensions Committee and City of Edinburgh Council agreed to the creation of two special purpose vehicles: LPFE Ltd and LPFI Ltd. Both companies were wholly owned and controlled by the Council.

110. In 2016/17 LPFI Ltd obtained Financial Conduct Authority authorisation (LPFE Ltd obtained this in 2015/16). The special purpose vehicles were established to support the investment programme of the in-house investment team by providing operational efficiencies.

111. Investments at the Funds are managed through a combination of external fund managers and the Funds' investment management team. The proportion of funds managed internally has increased over recent years.

Lothian Pension Fund proportion of internally managed Funds

112. The Funds' have used the internal investment team to drive efficiencies in year including a reduction of investment managers expenses as a proportion of net investment assets from 0.5% to 0.4% for Lothian Pension Fund.

113. Lothian Buses Pension Fund and Scottish Homes Pension Fund have followed the same pattern with a decrease in the level of externally managed investments as a proportion of net assets to 0.3% (2015/16: 0.4%) and 0.06% (2015/16: 0.07%) respectively.

Monitoring investment performance

114. There is an annual review of investment performance in June. Due to the elections in 2017 the Pension Committee was cancelled, however, a briefing meeting was held for the newly formed Committee. From our attendance at this briefing and the Pensions Committee in year we concluded that Pension Committee and Board Members are engaged in monitoring the performance of investments.

115. In addition to monitoring at a Committee level the Funds' performance is reviewed by an external provider on a monthly basis. The external provider compiles information covering monthly, quarterly, yearly and 3 yearly performance measures. This information is presented to the Investment Strategy Panel to allow for scrutiny investment performance of the Funds.

Administrative Performance

116. The Funds' have developed a Service Plan covering the period 2016- 2018 which focuses on four key objectives:

- We put our customers first and aim to provide the very best service
- Our people are at the very heart of our business and we work together to deliver our service
- We strive to improve our services by thinking ahead and developing new solutions
- We are committed to supporting a culture of honesty and transparency.

117. The Pensions Committee receive updates on the service plan at each meeting. The annual results for 2016/17 are presented in the Funds' Management Commentary. The Performance Report highlights that the Fund are meeting the majority of their targets (81%) with only 2 areas where performance was not in line with target levels:

- Overall staff satisfaction decreased in year from 73% to 70% which was below the target level of 75%.
- The target for the proportion of active members receiving their annual benefit statement by 31 August 2016 was 100% but the Funds' achieved a level of 99.6%. The issue of annual benefits statements by 31 August is a requirement of the Local Government Pension Scheme (Scotland) 2014. The statements not issued related to members employed on a casual basis prior to March but who did not contribute to the scheme up to the end of the year. The members should consider whether they deem this an issue which should be self-referred to the Pension Regulator.

Action Plan point 4

Tendering for Services

118. The Funds make use of a range of service providers including investment managers, an actuary and a custodian. In order to ensure the Funds are achieving value for money it is good practice to tender for services at set intervals.

119. The Funds follow the City of Edinburgh Council procurement procedures and maintain a contract register.

120. It was noted that two contracts were currently in their extension period and were due to go out to tender in 2017/18. We consider the adequacy of this process as part of our 2017/18 audit procedures.

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Appendices

Appendix 1: Management action plan

Our action plan details the control weaknesses and opportunities for improvement that we have identified during our audit.

It should be noted that the weaknesses identified in this report are only those that have come to our attention during the course of our normal audit work. The audit cannot be expected to detect all errors, weaknesses or opportunities for improvements in management arrangements that may exist. The weaknesses or risks identified are only those which have come to our attention during our normal audit work, and may not be all that exist.

Communication of the matters arising from the audit of the annual report and accounts or of risks or weaknesses does not absolve management from its responsibility to address the issues raised and to maintain an adequate system of control.

Action plan grading structure

To assist the Funds in assessing the significance of the issues raised and prioritising the action required to address them, the recommendations have been rated. The rating structure is summarised as follows:

Grade 5	Very high risk exposure – major concerns requiring Board attention
Grade 4	High risk exposure – material observations requiring senior management attention
Grade 3	Moderate risk exposure – significant observations requiring management attention
Grade 2	Limited risk exposure – minor observations requiring management attention
Grade 1	Efficiency / housekeeping point

Action plan point	Issue & Recommendation	Management Comments
1. Authorisation of journals **Rating** **Grade 3** **Paragraph ref** **25**	**Observation** Our review of the journals environment found that there was a lack of segregation of duties over the posting of journals. Journals are currently posted by individuals without an authorisation process. Journals can be used to override controls and create fraudulent errors therefore it is crucial there are strong controls in place. **Recommendation** Whilst we were able to obtain alternative audit evidence to provide assurance that there were no material issues with regards to the posting of journals, we recommend that a review process for all journals is put in place.	Agreed the fund will undertake a review of the journals processes. All parties that use the Council's financial systems are affected by this finding. The Fund awaits the Council's response to the issue. The Fund is satisfied that there are sufficient controls in place to prevent an actual cash payment leaving the Fund without full authorisation and that the ability to post journals is limited to staff authorised to do so. The system also records the username of the person posting the journal. **Action owner:** John Burns **Due Date:** 31 January 2018

Action plan point	Issue & Recommendation	Management Comments
2. Annual Governance Statement **Rating** **Grade 3** **Paragraph ref** **40**	**Observation** We have reviewed the Funds' Annual Governance Statement and identified that improvements could be made. To be fully compliant with the Delivering Good Governance in Local Government guidance an action plan outlining the actions the Funds' will take to progress improvements in the Funds' governance process should be disclosed. **Recommendation** We recommend the Funds' consider the disclosures in the Annual Governance Statement to ensure they are meeting applicable guidance.	Agreed to review for next year's accounts **Action owner:** Struan Fairbairn **Due Date:** 31 March 2018

Action plan point	Issue & Recommendation	Management Comments
3. Employer cessation liabilities **Rating** **Grade 3** **Paragraph ref** **63**	**Observation** Lothian Pension Fund has identified that there are significant pressures facing the employing body members of the Fund. This has increased the risk of employers defaulting on payments required to cover the liability attributable to their employees. **Recommendation** We recommend that increased disclosure around the nature of the risk, the level of at risk employers within the Fund and the potential impact on the funding level is included in the financial statements.	Agreed to review disclosures in management commentary for next year's accounts after the completion of the 2017 triennial actuarial valuation. Contingent assets in respect of Funding Agreements for employers which have terminated membership of the Fund are disclosed to the extent that such default protection is provided to any aligned body (as defined in the Funding Strategy Statement) or other employers in the Fund. Such contingent assets do not have a material impact on net liabilities. **Action owner:** John Burns **Due Date:** 31 March 2018

Action plan point	Issue & Recommendation	Management Comments
4. Annual benefits statements **Rating** **Grade 2** **Paragraph ref** **116**	**Observation** The issue of all annual benefit statements by 31 August 2016 is a requirement of the Local Government Pension Scheme (Scotland) Regulations 2014. In 2016/17 the Funds' achieved 99.6% of the annual benefits statements by the deadline. **Recommendation** The Pension Committee members should consider whether they deem this to be an issue which should be self-referred to the Pension Regulator.	The Funds have considered this in line with the Pensions Regulator guidance and do not feel this would be of material significance and therefore have deemed it unnecessary to declare the breach to the Pensions Regulator.

Appendix 2: Unadjusted differences

Board representations

We have requested that the signed representation letter, covering a number of issues, be presented to us at the date of signing the financial statements. We identified one unadjusted difference during our audit work. These differences are not considered to be material to the financial statements individually or in aggregate. The unadjusted items are included within the representation letter and shown below:

Unadjusted differences	Fund Account		Net Asset Statement	
	DR £'000	CR £'000	DR £'000	CR £'000
Investment Management Expenses	509			
Creditors				509
Being the under declaration of output tax dating back to 2011.				

Appendix 3: Respective responsibilities of the Pensions Committee and the Auditor

Responsibility for the preparation of the annual report and accounts

It is the responsibility of the Pensions Committee and the Chief Finance Officer, as Accountable Officer, to prepare financial statements in accordance with the Local Government (Scotland) Act 1973 and directions made thereunder.

In preparing the annual report and accounts, the Pensions Committee and the Chief Finance Officer, as Accountable Officer are required to:

- apply on a consistent basis the accounting policies and standards;
- make judgements and estimates on a reasonable basis;
- state whether applicable accounting standards as set out in the Code of Practice on Local Authority Accounting (the Code) have not been followed where the effect of the departure is material;
- prepare the accounts on a going concern basis unless it is inappropriate to presume that the Lothian Pension Fund will continue to operate.

The Chief Finance Officer is also responsible for

- keeping proper accounting records which are up to date; and
- taking reasonable steps for the prevention and detection of fraud and other irregularities.

Auditor responsibilities

We audit the annual report and accounts and give an opinion on whether:

- give a true and fair view, in accordance with applicable law and the Code, of the state of the affairs of the Funds as at 31 March 2016 and of the income and expenditure of the Council and its group for the year then ended;
- have been properly prepared in accordance with IFRSs as adopted by the European Union, as interpreted and adapted by the Code;
- they have been prepared in accordance with the requirements of the Local Government (Scotland) Act 1973, the Local Authority Accounts (Scotland) Regulations 2014 and the Local Government in Scotland Act 2003;
- the information given in the Management Commentary is consistent with the annual accounts.

We are also required to report by exception if, in our opinion

- adequate accounting records have not been kept;
- we have not received all the information and explanations we require for our audit;
- there has been a failure to achieve a prescribed financial objective.

Wider scope of audit

The special accountabilities that attach to the conduct of public business, and the use of public money, mean that public sector audits must be planned and undertaken from a wider perspective than in the private sector. This means providing assurance, not only on the annual accounts, but providing audit judgements and conclusions on the appropriateness, effectiveness and impact of corporate governance and performance management arrangements and financial sustainability.

The Code frames a significant part of our wider scope responsibilities in terms of four audit dimensions. As part of our annual audit we will consider and report against these four dimensions: financial management; financial sustainability; governance and transparency; and value for money.

Independence

We are required by International Standards on Auditing to communicate on a timely basis all facts and matters that may have a bearing on our independence. We can confirm that we have complied with the Financial Reporting Council's Ethical Standard. In our professional judgement the audit process has been independent and our objectivity has not been compromised. In particular, there have been no relationships between Scott-Moncrieff and the Pensions Committee or senior management that may reasonably be thought to bear on our objectivity and independence.

Scott-Moncrieff
business advisers and accountants