

Lothian Pension Fund and Scottish Homes Pension Fund

2018/19 Annual Audit Report to Members and
the Controller of Audit

September 2019

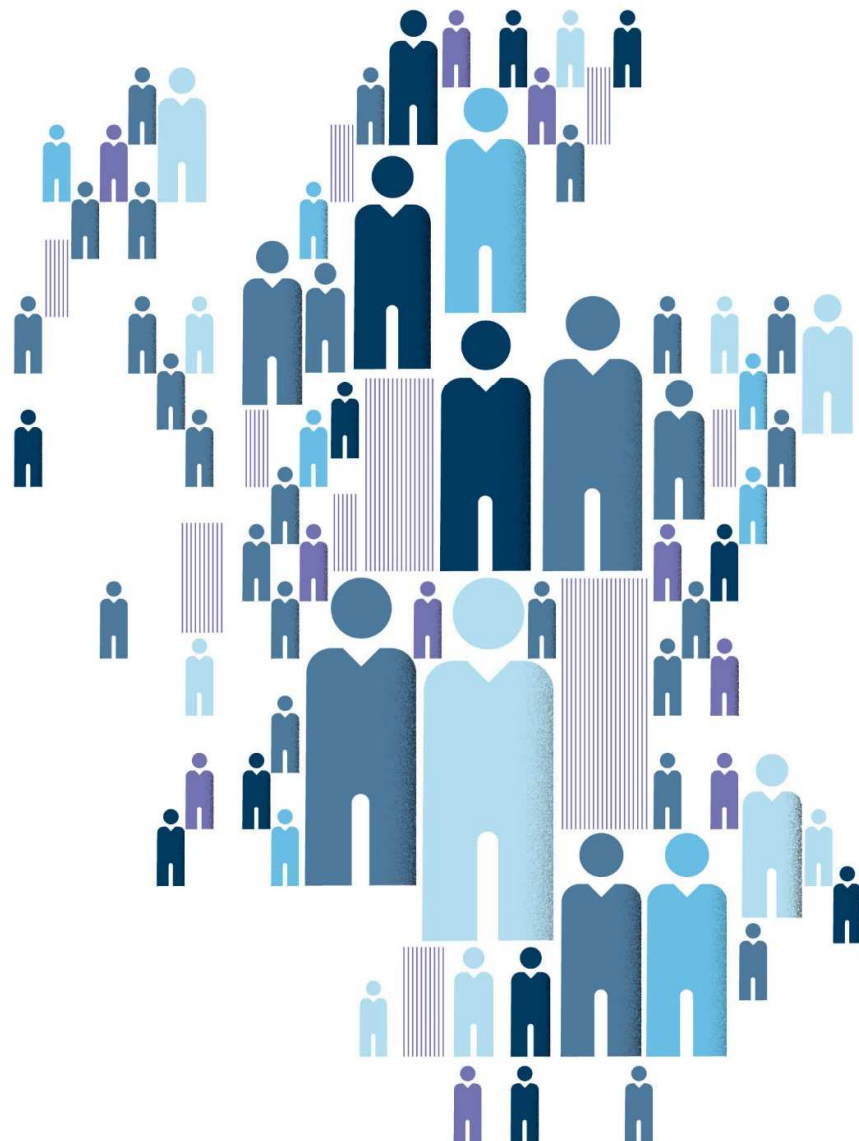




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1. Key messages





Annual accounts audit

Lothian Pension Funds approved the annual report and financial statements for 2018/19 on 25 September 2019. We report unqualified opinions on the financial statements and other prescribed matters for Lothian Pension Fund and Scottish Homes Pension Fund (collectively referred to as the “Funds”) within our independent auditor’s report. We also report that there were no matters which we were required to report by exception.

The annual report and financial statements and supporting schedules were of a high standard. Our thanks go to staff for their assistance with our work.

Wider scope audit

Financial sustainability

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

The focus of their investment strategy is to ensure a sufficient return over the long term to meet the funding objectives outlined by the Funding Strategy Statement. Performance over 5 years shows they are managing investment above benchmark.

There is an ongoing risk that the pension scheme is not affordable for admitted bodies and Lothian Pension Fund has reported an increase in the number of bodies leaving the Fund and an increase in the cessation liability following the 2017 triennial valuation.



Financial management

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

Lothian Pension Fund’s investment performance increased in 2018/19 and was above the short term benchmark and national average.

The net assets of Lothian Pension fund have risen in 2018/19 and Scottish Homes Pension Fund assets have not moved. The promised retirement benefits have increased across all three funds.



Governance and transparency

Governance arrangements at the Funds are deemed to be appropriate.

Our assessment has been informed by a review of the corporate governance arrangements in place, the information provided to the Board and Committees as well as the risk management arrangements in place.

We identified a significant risk regarding the transfer of assets from Lothian Buses Pension Fund to Lothian Pension Fund. We have confirmed appropriate governance processes were in place during 2018/19 to ensure the transfer was in line with relevant regulations.



Value for money

The Funds have appropriate arrangements in place to secure value for money through appropriate monitoring of performance of investments and the administration of the Funds.

The Funds’ investment performance is subject to regular review by the Pension Committee.



Conclusion

This report concludes our audit for 2018/19. Our work has been performed in accordance with the Audit Scotland Code of Audit Practice, International Standards on Auditing (UK) and Ethical Standards.

Scott-Moncrieff
September 2019



2. Introduction

This report is presented to those charged with governance and the Controller of Audit and concludes our audit of the Lothian Pension Funds for 2018/19.

We carried out our audit in accordance with Audit Scotland’s Code of Audit Practice (May 2016). This report also fulfils the requirements of International Standards on Auditing (UK) 260: Communication with those charged with governance.

We have designated the Pensions Committee as “those charged with governance” for the purposes of audit communication.



Introduction

1. This report summarises the findings from our 2018/19 audit of Lothian Pension Funds (the Funds).
2. We outlined the scope of our audit in our External Audit Plan, which we presented to the Pensions Committee at the outset of our audit. The core elements of our work include:
 - an audit of the 2018/19 annual report and accounts and related matters;
 - a review of the Funds' arrangements for governance and transparency, financial management, financial sustainability and value for money; and
 - any other work requested by Audit Scotland.

Exhibit 1: Audit dimensions within the Code of Audit Practice



3. The Funds are responsible for preparing an annual report and accounts which show a true and fair view and for implementing appropriate internal control systems. The weaknesses or risks identified 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 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.
4. The 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 on appropriate actions. We give each recommendation a grading to help the Funds assess their significance and prioritise the actions required.
5. We discussed and agreed the content of this report with the Chief Finance Officer. We would like to

thank all management and staff for their co-operation and assistance during our audit.

Confirmation of independence

6. International Standards on Auditing in the UK (ISAs (UK)) require us to communicate on a timely basis all facts and matters that may have a bearing on our independence.
7. We confirm that we have complied with the Financial Reporting Council's (FRC) Revised Ethical Standard (June 2016). In our professional judgement, the audit process is independent and our objectivity has not been compromised in any way.
8. We set out in Appendix 1 our assessment and confirmation of independence.



Adding value through the audit

9. All of our clients 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 standard of governance, better management and decision making and more effective use of resources.

Feedback

10. Any comments you may have on the service we provide, the quality of our work and our reports would be greatly appreciated at any time. Comments can be reported directly to the audit team or through our online survey: www.surveymonkey.co.uk/r/S2SPZBX
11. While this report is addressed to the Funds and the Controller of Audit, it will be published on Audit Scotland's website www.audit-scotland.gov.uk



3. Annual report and accounts

The Funds' annual report and accounts are the principal means of accounting for the stewardship of their resources and performance in the use of those resources.

In this section we summarise the findings from our audit of the 2018/19 annual report and accounts.

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Annual report and accounts

An unqualified audit opinion on the annual report and accounts

The annual report and accounts for the year ended 31 March 2019 were approved by the Pensions Committee on 25 September 2019. We report unqualified opinions within our independent auditor's report. We did not identify any significant adjustments to the unaudited annual report and accounts.

The Funds' had good administrative processes in place to prepare the annual report and financial statements and the required supporting working papers.

Overall conclusion

An unqualified audit opinion on the annual report and accounts

12. The annual report and accounts for the year ended 31 March 2019 were approved by the Pensions Committee on 25 September 2019. We report within our independent auditor's report:
 - an unqualified opinion on the financial statements; and
 - an unqualified opinion on other prescribed matters.
13. We are also satisfied that there are no matters which we are required to report by exception.

Good administrative processes were in place

14. We received unaudited annual report and accounts and supporting papers of a good standard, in line with our audit timetable. Our thanks go to staff at the Funds for their assistance with our work.

Our assessment of risks of material misstatement

15. The assessed risks of material misstatement described in Exhibit 2 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. Our audit procedures relating to these matters were designed 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. Our opinion on the annual report and accounts is not modified with respect to any of the risks described in Exhibit 2.



Exhibit 2 – Our assessment of risks of material misstatement and how the scope of our audit responded to those risks

1. Management override

In any organisation there exists a risk that management has 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 financial statements. This is treated as a presumed risk area in accordance with ISA (UK) 240 – *The auditor’s responsibilities relating to fraud in an audit of financial statements*.

Excerpt from the 2018/19 External Audit Plan

16. We have not identified any indication of management override in the year. We have reviewed the Funds’ accounting records and obtained evidence to ensure that transactions outside normal processes were valid and accounted for correctly. We have also reviewed management estimates and the journal entries processed in the period and around the year end. We did not identify any areas of bias in key judgements made by management and judgements were consistent with prior years.
17. While we have not identified any instances of management override from our testing we noted in 2017/18 that City of Edinburgh Council staff, with access to Oracle, have the ability to post journals to the Funds’ financial ledger. This is an ongoing issue in 2018/19, however, we did not identify any instances where journals were posted by inappropriate users.

2. Revenue recognition

Under ISA (UK) 240– *The auditors 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 revenue transactions in such a way as to lead to material misstatement in the reported financial position.

Excerpt from the 2018/19 External Audit Plan

18. 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.
19. We have evaluated key revenue transactions and streams to gain assurance over the completeness and occurrence of income. We are satisfied income is fairly stated in the financial statements. We also carried out testing to confirm that the Funds’ revenue recognition policies are appropriate and have been applied consistently throughout the year.



3. Risk of fraud in the recognition of expenditure

In 2016, the Public Audit Forum issued Practice Note 10 “*The Audit of Public Sector Financial Statements*” which applies to the audit of public sector financial statements for periods commencing after June 2016. This Practice Note recognises that most public sector bodies are net spending bodies and notes that there is an increased risk of material misstatement due to improper recognition of expenditure

Excerpt from the 2018/19 External Audit Plan

20. At the planning stage of our audit cycle, we reported that we did not believe the risk of fraud in expenditure recognition was material to the financial statements and we therefore rebutted this risk. This position has been reviewed throughout this audit and this conclusion has remained appropriate.
21. We conducted our testing based on our approach to low inherent risk areas and we evaluated each type of expenditure transaction and documented our conclusions. We gained reasonable assurance over the completeness and occurrence of expenditure and are satisfied that expenditure is fairly stated in the annual accounts. To inform our conclusion we carried out testing to confirm that the Funds’ policy for recognising expenditure is appropriate and has been applied consistently throughout the year.

4. Valuation of investments

The Funds held investments of £6.628 billion as at 31 March 2018, of which 33% (£2.184 billion) were classified as level 2 or level 3 financial instruments, meaning the valuation was not based on unadjusted quoted prices in active markets. Judgements are taken by the Investment Managers to value those investments whose prices are not publicly available. 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.

Excerpt from the 2018/19 External Audit Plan


22. In 2018/19, the value of level 2 and 3 investments rose by 13% to £2.639 billion (2017/18: £2.321 billion) increasing as a proportion of overall investments to 36% (34.7% in 2017/18). Fair values of investments of this nature are provided by fund managers and custodian using various bases selected by the investment manager or custodian. The base of investment values can include reference to similar companies or bid prices.
23. We have considered the valuation basis for a sample of investments and concluded that an appropriate base has been applied in each case. The custodian and investment managers are deemed to be management experts. In line with ISA (UK) 500 we have considered the competence, capability and objectivity of the experts used to inform the valuation. In addition we have reviewed auditor reports on the internal controls at the custodian and at each key investment manager. Our testing did not raise any issues regarding the qualifications of or work provided by the management experts employed by the Funds.
24. For a sample of hard to value investments we reviewed the assumptions and bases of the fair value. We challenged the Funds on the rationale for selecting the bases and assumptions and ensured we were satisfied they were appropriate.
25. The disclosures within the annual report and financial statements are consistent with the information provided by the custodian.



5. Lothian Buses Pension Fund Merger

In 2018/19 the assets and liabilities of Lothian Buses Pension Fund will be merged with Lothian Pension Fund. There is limited precedent for mergers of local government pension schemes and therefore, there is an increased risk of material misstatement due to the material and unusual nature of the transaction. There is a risk that the transfer of assets and liabilities from Lothian Buses Pension Fund is not accounted for in accordance with applicable accounting standards and/or statutory requirements.

Excerpt from the 2018/19 External Audit Plan

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26. Lothian Buses Pension Fund was set up by way of a minute of agreement between Lothian Regional Council and Lothian Region Transport PLC dated 31 March 1987 (the Admission agreement). This agreement outlines that the Authority (Council) wishes to establish a 'further fund' in terms of regulation 3 of the Local Government Superannuation (Funds) (Scotland) Regulations 1986 in addition to the existing fund (i.e. Lothian Pension Fund).
 27. Historically, Lothian Pension Fund has elected to present Lothian Pension Fund and Lothian Buses Pension Fund separately in the annual accounts. Following the decision to manage the Lothian Buses Pension Fund as part of the main Lothian Pension Fund in year, it was considered that the accounting policy of reporting the Funds separately in the accounts was no longer appropriate.
 28. The accounting policy of reporting Lothian Buses Pension Fund as a separate fund was therefore changed in 2018/19. From 2018/19 Lothian Buses Pension Fund was included in the Lothian Pension Fund accounts. As this is a change in accounting policy, there is a requirement to retrospectively restate the 2017/18 figures in line with accounting standards. Consequently, Lothian Pension Fund adjusted the prior year figures for comparative purposes.
 29. We have considered the basis for the change in accounting policy and concluded that the judgements made by the Funds' management were appropriate. In addition, we have reviewed the restated figures and confirmed that they are appropriate and accurately reflect the transactions which took place in 2017/18.



6. Governance statement

In 2017/18 Internal Audit provided a red¹ rated audit opinion meaning significant enhancements were required to the Funds' control environment.

The Funds' internal audit service is provided through the administering authority, City of Edinburgh Council. The 2018/19 internal audit plan was presented to the Pensions Committee and Pensions Audit Sub-Committee in March 2018. Within the plan, a total of 3 reviews were scheduled to take place during 2018/19 totalling 60 days.

All of the 2018/19 internal audit work is scheduled to take place between January and March 2019. Internal audit is a key source of assurance for the governance statement and there is pressure to ensure appropriate assurance is achieved prior to the year-end.

Excerpt from the 2018/19 External Audit Plan

30. The internal audit opinion was presented to the June Pensions Committee and provided an amber rating². This opinion was based on the findings from three reports in year and the follow up of prior year recommendations.
31. All internal audit reports issued within 2018/19 gave adequate assurance over the control environment. The amber rating related to overdue 'high risk' items from 2017/18 audit work.
32. The issues in 2017/18 related to IT Business Resilience and disaster recovery, pensions tax and third party suppliers. Internal audit confirmed that three of four high risk items had been appropriately addressed by June 2019. The outstanding item relates to the methodology used by Aquila Heywood in the calculation of pension tax. The Funds are currently engaged with Aquila Heywood to update the methodology.
33. The City of Edinburgh Council has considered the internal audit findings and its Chief Executive and Head of Finance are satisfied that reasonable assurance can be placed upon the adequacy and effectiveness of Funds' systems of internal control.
34. We noted that in the draft accounts the Governance Statement still refers to a red rating which is out of line with the findings of internal audit. We have requested this be updated in the revised accounts.

Our application of materiality

35. The assessment of what is material is a matter of professional judgement and involves considering both the amount and the nature of the misstatement. This means that different materiality levels will be applied to different elements of the financial statements.
36. Our initial assessment of materiality for the financial statements is set out in the table below. On receipt of the 2018/19 draft financial statements, we reassessed materiality as outlined in the table below. We consider that our updated assessment has remained appropriate throughout our audit.

¹ Significant enhancements to the control environment required

² Generally acceptable but with enhancements required



	Lothian Pension Fund ³ Group ⁴ materiality £million	Lothian Pension Fund ¹ Parent materiality £million	Scottish Homes materiality £million
Overall-planning	108	108	2.5
Overall-final	117	117	2.5
Dealings with members-planning	11.3	11.3	0.4
Dealings with members-final	12.0	11.9	0.4

37. Our assessment of materiality is set with reference to the Funds' net investment assets. We consider this to be one of the principal considerations for the users of the financial statements when assessing the financial performance.
38. As outlined in our External Audit Plan we considered transactions when dealing with members (i.e. contributions and expenditure incurred providing payments to pensioners) to also be of key interest to the users. This is reported in the first section of the Fund Account and contains information about the day to day operation of the Funds.
39. ISA 320 states that in certain circumstances it is appropriate to set a materiality amount for particular classes of transactions for which lesser amounts than the overall materiality could influence the decision of the users of the accounts. We have therefore set a separate materiality for transactions relating to dealings with members, based on the expenditure incurred for providing payments to pensioners.

Performance materiality

40. Performance materiality is the amount set by the auditor for each financial statement area, to reduce to an appropriately low level the probability that collectively any uncorrected and undetected

misstatements are less than materiality for the financial statements as a whole.

41. We set a performance (testing) materiality for each area of work which was based on a risk assessment for the area. We perform audit procedures on all transactions and balances that exceed our performance materiality. This means that we are performing a greater level of testing on the areas deemed to be of significant risk of material misstatement. Performance testing thresholds used are set out in the table below:

	Area risk assessment £million		
	High	Medium	Low
Lothian Pension Fund ¹ (Group ² and parent)- overall	58.50	70.20	87.75
Lothian Pension Fund ¹ (Group ² and parent)- dealings with members	5.95	7.14	8.93
Scottish Homes Pension Fund- overall	1.25	1.50	1.88
Scottish Homes Pension Fund- dealings with members	0.18	0.21	0.27

42. We agreed with the Pensions Committee that we would report on all material corrected misstatements, uncorrected misstatements with a value in excess of 5% of overall materiality, as well as other misstatements below that threshold which, in our view, warranted reporting on qualitative grounds.

Group accounts

43. The Funds' annual report includes accounts for Lothian Pension Fund and Scottish Homes Pension Fund.
44. Lothian Pension Fund accounts are prepared on a group basis following 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.
45. We reviewed the consolidation process in 2018/19 and concluded the subsidiary companies had been

³ From 2018/19 Lothian Pension Fund has merged with Lothian Buses Pension Fund and the materiality is based on the combined assets of the Funds.

⁴ Lothian Pension Fund group comprises Lothian Pension Fund (incorporating Lothian Buses Pension Fund transactions and balances), LPFE Ltd and LPFI Ltd



correctly included in the group accounts of Lothian Pension Fund.

Audit differences

46. We are pleased to report that our audit identified no material adjustments. In addition, we can confirm there were no unadjusted errors relating to the 2018/19 financial statements.
47. We identified some disclosure and presentational adjustments during our audit, which have been reflected in the final set of annual report and financial statements.
48. The most significant disclosure change related to the present value of promised retirement benefits.
49. In 2018/19 there were 2 significant legal cases in relation to pension scheme's which we considered to have a potential financial impact on the Funds' present value of promised retirement benefits:

- **McCloud Judgement:** This case related to an employment tribunal ruling that transitional provisions impacting on a public sector final salary scheme were unlawfully age discriminatory. This was upheld in the Courts in December 2018 although the Government at that stage sought leave to appeal this judgement. The ruling has implications for all public service schemes including the LGPS funds. In June 2019, the Supreme Court has rejected the Government's request for a further appeal.
- **Guaranteed minimum pension (GMP)** was accrued by members of the Local Government Pension Scheme (LGPS) between 6 April 1978 and 5 April 1997. The value of GMP is inherently unequal between males and females for a number of reasons, including a higher retirement age for men and GMP accruing at a faster rate for women. However overall equality of benefits was achieved for public service schemes through the interaction between scheme pensions and the Second State Pension. The introduction of the new Single State Pension in April 2016 disrupted this arrangement and brought uncertainty over the ongoing indexation of GMPs, which could lead to inequalities between men's and women's benefits. As an interim solution to avoid this problem, GMP rules were changed so that the responsibility for ensuring GMPs kept pace with inflation passed in full to pension schemes themselves for members reaching state pension age between 6 April 2016 and 5 April 2021. This new responsibility leads to increased costs for schemes (including the LGPS) and hence scheme employers.

50. We requested the Funds' consider the likely implications for their financial statements and consult with their actuary on whether a revised estimate was required. The advice from the actuary was that the GMP impact was likely to be immaterial and that McCloud may have more significant consequences. This was in line with our understanding of the sector and therefore revised figures were only requested to show the impact of the McCloud judgement. The disclosures in note 23 in the accounts have been updated to show a present value of promised retirement benefits of £9,435 million, an increase of £102 million against the amount disclosed in the draft accounts.
51. Lothian Pension Fund group accounts disclose the actuarial valuation of the pension liability for LPFE Ltd. The actuary provided revised figures taking into consideration the McCloud judgement. The impact on the liability is £0.282 million. Management has considered the movement and elected not to adjust the accounts on the basis of materiality and to reflect that the figures used are from LPFE's audited accounts. Full details of the adjustment are included in appendix 3.

An overview of the scope of our audit

52. The scope of our audit was detailed in our External Audit Plan, which was presented to the Pensions Committee in March 2019. The 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 Funds. 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.
53. At the planning stage we identified the significant risks that had the greatest effect on our audit. Audit procedures were then designed to mitigate these risks.
54. Our standard audit approach is based on performing a review of the key financial systems in place, substantive tests and detailed analytical procedures. 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.

Other matters identified during our audit

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



Other information in the annual report and accounts

56. “Other information” in the annual report and accounts comprises any information other than the financial statements and our independent auditor’s report. We do not express any form of assurance conclusion on the “other information” except as specifically stated below.

Management Commentary

57. The management commentary is a requirement of the Local Authority Accounts (Scotland) Regulations 2014 and is intended to assist readers in understanding the financial statements and provide an overview of the organisation and its performance.
58. Guidance issued by the Scottish Government (Local Government Finance Circular 5/2015) also provides a guide as to the minimum required disclosures in the management commentary including:
- The context of the annual report and financial statements;
 - 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.
59. We have concluded that the management commentary has been prepared in line with the regulations and Scottish Government guidance and is consistent with the financial statements.

Annual governance statement

60. We have reviewed the Funds’ annual governance statement against the relevant guidance: Delivering Good Governance in Local Government.
61. We consider the coverage of the annual governance statement to be broadly in line with expectations.
62. We highlighted a minor disclosure issue within the governance statement at paragraph 34 in relation to the internal audit opinion. This will be updated in the revised accounts.
63. Subject to this adjustment we have concluded that the annual governance statement is in line with the required guidance and is consistent with the accounts and assurances provided in year.

Governance compliance statement

64. 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.
65. 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.

Remuneration and staff report

66. In February 2018 staff previously employed by the City of Edinburgh Council with responsibility for the Funds’ were transferred to LPFE Ltd. From this point all new staff employed for roles with the Funds were employed by LPFE Ltd.
67. The Local Authority Accounts (Scotland) Regulations 2014 (the 2014 Regulations) require that where a local government body has a subsidiary the details of the Chief Executive’s salary and any employee with remuneration over £0.150 million is included in a remuneration report.
68. The Funds’ therefore produced a remuneration report for the first time in 2018/19. The Funds’ met all statutory reporting requirements, however, the Funds’ expressed concern that the revised disclosure has decreased the transparency of reporting with regards to senior manager pay costs. This is an area we will revisit in 2019/20 to establish if clarity and transparency can be improved while meeting the statutory disclosure requirements.
69. We have concluded that the audited part of the remuneration and staff report has been prepared in accordance with directions from Scottish Ministers and is consistent with the financial statements.

Legality

70. We have planned and performed our audit recognising that non-compliance with statute or regulations may materially impact on the annual report and accounts.

The Local Authority Accounts (Scotland) Regulations

71. As part of our audit we reviewed the Funds’ compliance with the 2014 Regulations, in particular



with respect to regulations 8 to 105 as they relate to the annual report and financial statements.

72. In 2018/19 we received an objection to the notice of the public right to inspect. Upon review there was found to be a delay in displaying the hard copy of the public inspection notice which is required to be published prior to 17 June as outlined by the 2014 Regulations. The notice was published in the local newspaper and on the City of Edinburgh Council website by 17 June 2019, however, was not available at Council offices until 26 June 2019.
73. We highlighted issues with regards to the public inspection in 2017/18 and we would recommend the Funds make arrangements to ensure full compliance in 2019/20. We have noted that prior period issues in this area are ongoing in appendix 2.
74. Other than the above issue we concluded that appropriate arrangements are in place to comply with these Regulations.

Banking arrangements

75. It was highlighted during the course of our audit that the Pension Fund had not been operating its bank account in line with the Local Government Pension Scheme (Management and Investment of Funds) (Scotland) Regulations 2010. There is a requirement for administering authorities to hold a separate bank account for funds and this should be used to hold pension fund money.
76. The Funds use the Council bank account to ensure that no unfunded payments are taken from a pension fund bank account.
77. In 2018/19 the Funds have requested that “unfunded discretionary payments” be transferred to the Scottish Public Pensions Agency which would mitigate the requirement for the Funds’ to use the Council’s bank account. However, this had not been agreed by the year end.
78. If the transfer of unfunded discretionary payments is not possible the resolution of this issue would depend on the procurement of a new ledger system which did not progress in 2018/19.

Qualitative aspects of accounting practices and financial reporting

79. During the course of our audit, we consider 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 annual accounts. The following observations have been made:

⁵ 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.



Qualitative aspect considered	Audit conclusion
<p>The appropriateness of the accounting policies used.</p>	<p>We have reviewed the significant accounting policies which are disclosed in the annual report and financial statements 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.</p> <p>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 £5.062 million for Lothian Pension Fund (2017/18: £5.912 million). There were no indirect costs for Scottish Homes in either 2017/18 or 2018/19.</p> <p>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.</p>
<p>The timing of the transactions and the period in which they are recorded.</p>	<p>We did not identify any concerns over the timing of transactions or the period in which they were recognised.</p>
<p>The appropriateness of the accounting estimates and judgements used.</p>	<p>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. These estimates have been informed by advice from qualified, independent experts. We evaluated the competence, objectivity and capability of management experts in line with the requirements of ISA (UK) 500 and concluded that use of the expert is appropriate.</p> <p>We are satisfied with the appropriateness of the accounting estimates and judgements used in the preparation of the annual report and financial statements. We have considered the disclosures around the estimates, including sensitivity analysis and concluded that they are appropriate.</p>
<p>The appropriateness of the going concern assumption</p>	<p>We have reviewed the detailed financial forecasts for 2019/20. Our understanding of the legislative framework and activities undertaken provides us with sufficient assurance that the Funds will continue to operate for at least 12 months from the signing date.</p>
<p>The potential effect on the annual accounts of any uncertainties, including significant risks and related disclosures that are required.</p>	<p>We have not identified any uncertainties, including any significant risk or required disclosures, which should be included in the annual accounts beyond those already made.</p>
<p>The extent to which the annual accounts have been affected by unusual transactions during the period and the extent that these transactions are separately disclosed.</p>	<p>From the testing performed, we identified no significant unusual transactions in the period.</p>



Qualitative aspect considered	Audit conclusion
Apparent misstatements in the annual report or material inconsistencies with the financial statements.	The annual report contains no material misstatements or inconsistencies with the financial statements.
Any significant annual accounts disclosures to bring to your attention.	There are no significant annual accounts 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 annual accounts disclosure.	While disclosure and presentational adjustments were made during the audit, there was no material disagreement during the course of the audit over any accounting treatment or disclosure.
Difficulties encountered in the audit.	There were no significant difficulties encountered during the audit.



4. Financial sustainability

Financial sustainability looks forward to the medium and longer term to consider whether the Funds' planning processes support the future delivery of services.



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

The focus of their investment strategy is to ensure a sufficient return over the long term to meet the funding objectives outlined by the Funding Strategy Statement. Performance over 5 years shows they are managing investment above benchmark.

There is an ongoing risk that the pension scheme is not affordable for admitted bodies and Lothian Pension Fund has reported an increase in the number of bodies leaving the Fund and an increase in the cessation liability following the 2017 triennial valuation.

There is an ongoing review of the structure of Local Government Pension Schemes in Scotland. This could have a significant impact on the Funds and will be monitored in 2019/20.



Significant audit risk

Our audit plan identified a significant risk in relation to financial sustainability under our wider scope responsibilities.

Financial sustainability: Market volatility

The Funds held investments of £6.628 billion as at 31 March 2018. Investment strategies are in place for each of the funds which outline the Funds approach to ensure that all members and their dependents receive their benefits when they become payable. The investment strategy was recently updated and approved by the Pensions Committee in December 2018.

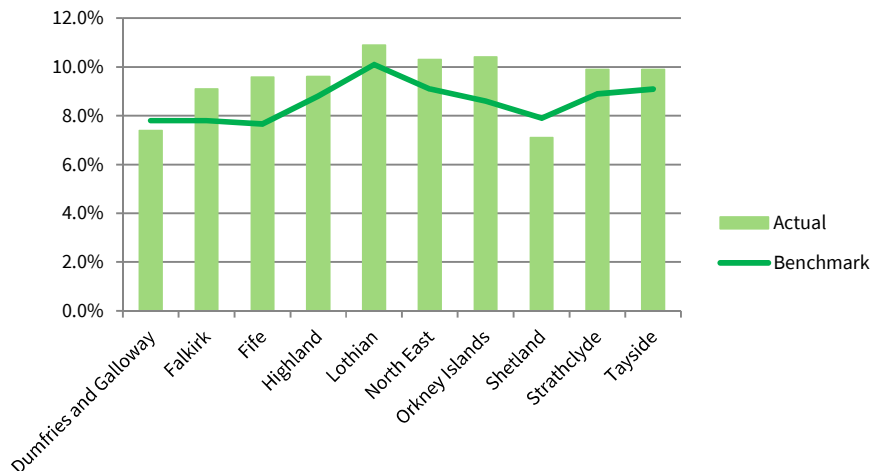
The objective of the Funds is that over the short term the fund should perform better than its strategic allocation if markets fall significantly. The Investment Strategy Panel and the internal investment team monitor investment risks on a regular basis.

While it is noted that the Funds investment strategy is designed in such a way to withstand market volatility in the long term, we have noted that worldwide political events had a significant impact on the market in 2018 and volatility is expected to continue in 2019. There is a risk that the value of investments is significantly impacted by events within the wider political environment.

Excerpt from the 2018/19 External Audit Plan

- 80. Financial sustainability of the Funds relates to the performance over the longer term. The investment objective of the Funds is to achieve a return on the fund assets which is sufficient over the long term to meet the funding objectives outlined in the funding statement strategy.
- 81. When considering the risk over market volatility we have considered the performance over the longer term.

Exhibit 3: Annualised 5 year returns across LGPS Scotland Funds against benchmark



Source: Unaudited Pension Fund Annual Report and Accounts⁶

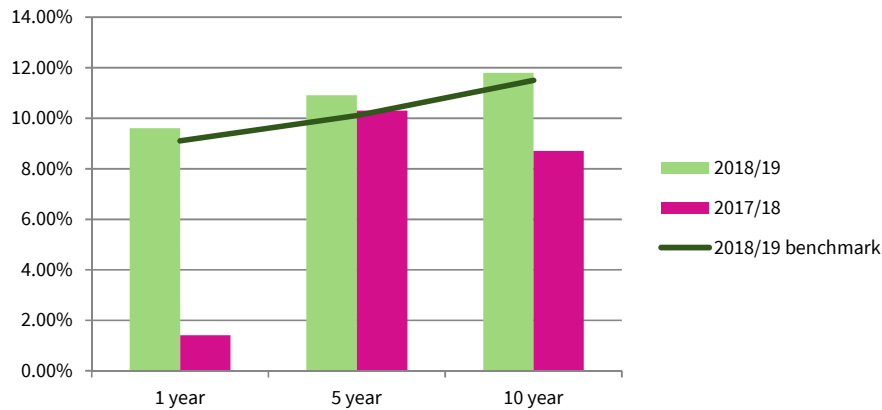
- 82. Lothian Pension Fund is reporting the highest annualised 5 year return and is one of eight funds reporting returns above the longer term benchmark.

⁶ Scottish Borders Pension Fund do not publish their 5 year annualised return



83. Lothian Pension Fund performance in 2018/19 was consistently above benchmark across short, medium and long term and has improved since 2017/18. No benchmark was set for Scottish Homes Pension Fund as investments are mandated by the Scottish Government to be held in gilts.

Exhibit 4: Performance against benchmark and compared to prior year



Source: Unaudited Lothian Pension Fund Annual Report and Accounts

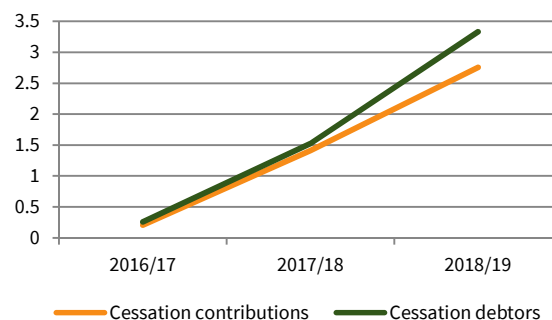
84. We have concluded that the Funds have an appropriate approach to managing investments; however, within the current political climate market volatility will continue to be a risk.
85. The Funds' have this as a risk on the risk register and it is currently rated green due to the predicted low impact on service delivery and likelihood of occurrence.

Employers within the scheme

86. A full actuarial valuation in 2017 highlighted that Lothian Pension Fund was behind the target level for funding (98% against a target of 100%). Both Lothian Buses Pension Fund and Scottish Homes Pension Fund were ahead of target.
87. Contribution rates across employers within Lothian Pension Fund generally increased leading to affordability issues.
88. In recognition of this Lothian Pension Fund updated their Funding Strategy Statement with a requirement for employing bodies to confirm their commitment to meet the minimum contributions.
89. In 2018/19 three employers elected to leave the Fund and a further admitted body was wound up and left the Fund.
90. At the end of 2018/19 there were 13 ceased employees which have set up or are setting up funding agreements with Lothian Pension Fund.
91. The level of cessation contributions has increased by 1225% since 2016/17, with the long term debtors

relating to ceased employers rising by a similar level.

Exhibit 5: Cessation contributions and debtors (£m)



Source: Lothian Pension Fund annual accounts

92. There is therefore an ongoing risk that an employer fails to pay contributions leading to increased contributions and pressure on other scheduled and admitted bodies.



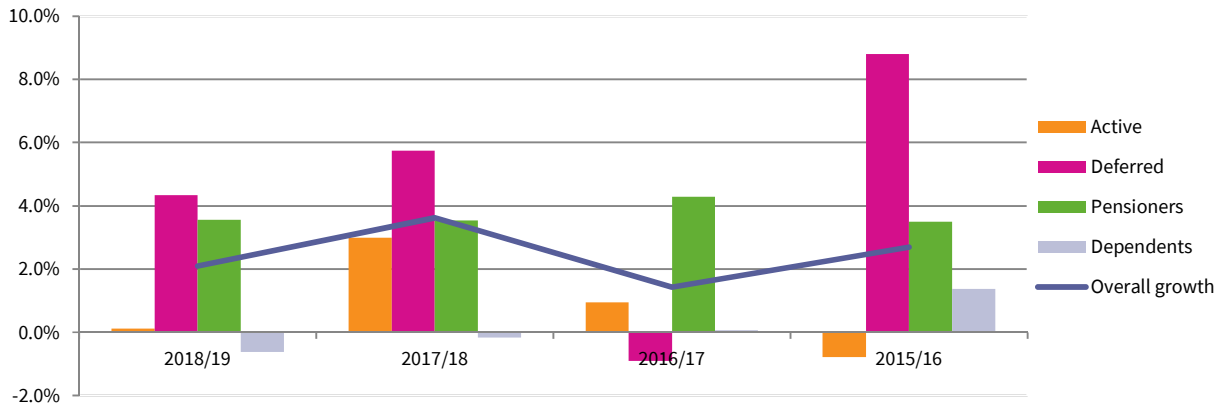
Membership

93. Lothian Pension Fund is a multi-employer fund with 15 scheduled bodies, including 4 Councils, and 68 admitted bodies. The scheme has a significant membership profile with active members being the majority. This differs from Scottish Homes Pension Funds which is a single employer scheme and have

a majority of inactive members (deferred, pensioners and dependents).

94. Analysis shows that although there is an overall increase in membership at Lothian Pension Fund, active members have been growing at a slower rate than deferred members and pensioners.

Exhibit 6: % year on year growth in members across categories



Source: Lothian Pension Funds Annual Report and Accounts

95. The fund relies on active members to meet the payments to pensioners and there is a risk that if growth in pensioners, increases at a faster rate than active members additional affordability pressures will be faced by Lothian Pension Fund.

- Merge the 11 funds into one or more new funds.

96. It is, however, noted that active members have only decreased by 1.3% as a proportion of total members moving from 42.3% of members in 2015/16 to 41% of members in 2018/19. Pensioners have increased by 1.2% as a proportion of the total members and in 2018/19 make up 30% of the membership of Lothian Pension Fund. The movement is therefore slow and this is likely to be a low risk area with regards to financial sustainability.

99. The consultation period opened in June 2018 and closed in December 2018. Responses were received from 56 bodies ranging from pension funds to professional bodies to individuals.

100. The results of the review to date are that there is general support for some change to the structure with the majority considering some form of co-operation as the best option

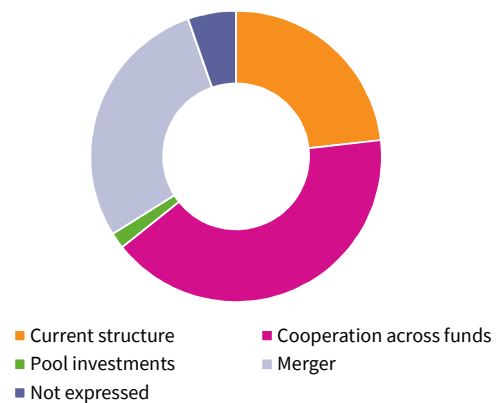
LGPS Consultation

97. A review of the structure of the Scottish Local Government Pension Schemes was agreed with stakeholders and Scottish Government in 2015 when changes to the scheme and Scheme Advisory Board ('SAB') were introduced.

98. In February 2017, SAB produced a review report which highlighted 4 options for the future structure of the local government pension scheme in Scotland:

- Retain the current structure with 11 funds;
- Promote cooperation in investing and administration between the 11 funds;
- Pool investments between the 11 funds; and

Exhibit 7: Responses to LGPS Scotland consultation



Source: Scheme Advisory Board

101. Lothian Pension Fund responded in favour of reform, specifically the creation of conditions in which like-minded schemes could seek to merge.



102. The draft report went to the Scheme Advisory Board on 24 April 2019 and further work on how to proceed is scheduled. We will continue to monitor the position in 2019/20.



5. Financial management

Financial management is concerned with financial capacity, sound budgetary processes and whether the control environment and internal controls are operating effectively.



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

Lothian Pension Fund's investment performance increased in 2018/19 and was above the short term benchmark and national average.

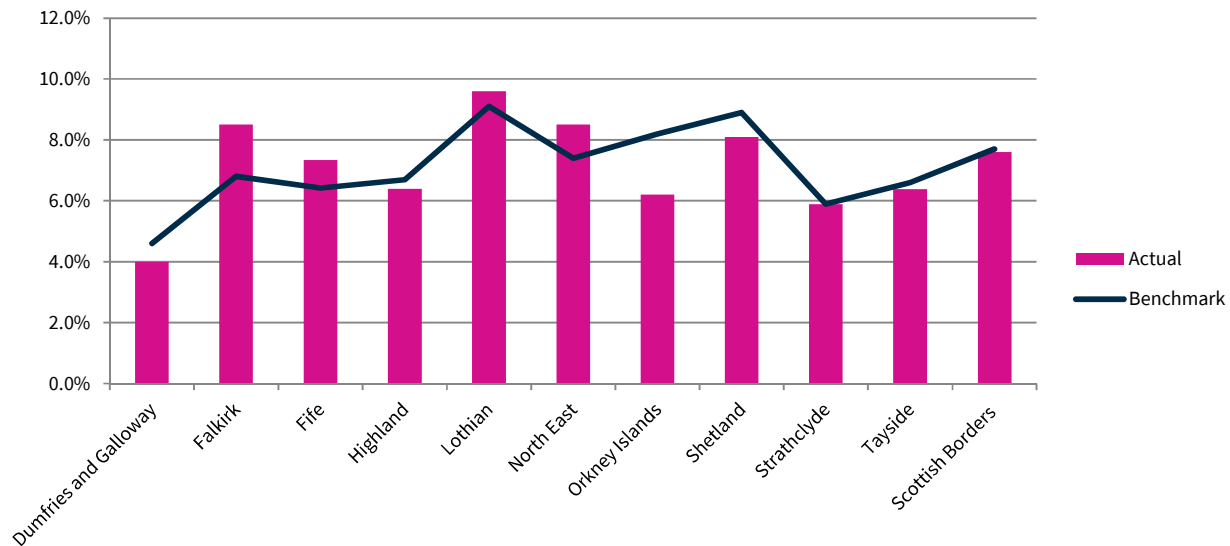
The net assets of Lothian Pension fund have risen in 2018/19 and Scottish Homes Pension Fund assets have not moved. The promised retirement benefits have increased across all three funds.



Investment performance

103. The Funds report their performance with regards to returns on investments as part of the annual report and financial statements. As shown in Exhibit 8 below Lothian Pension Fund, reported performance above the 1 year benchmark. This is an improvement from 2017/18 where performance was significantly behind benchmark.
104. Investment performance across LGPS in Scotland was generally stronger in 2018/19 than in 2017/18. The average return on investments in 2018/19 was 7.1% a small increase from 6.12% in 2017/18.

Exhibit 8: One year investment performance across LGPS Funds



Source: Unaudited LGPS Scotland Annual Report and Accounts

105. In contrast to 2017/18 Lothian Pension fund was above the national average in 2018/19 and was one of only four funds to outperform the benchmark.
106. We have highlighted in the past that the focus of the funds is long term stability and we have noted in the Financial Sustainability section that the longer term performance is also above benchmark.
107. The short and long term results indicate that the investment portfolio is being managed appropriately.
- Financial position**
108. The movement in net assets of the funds varied across each fund as shown in Exhibit 9. Both funds have reported a net withdrawal position from dealings with members, which is consistent with prior year. In 2018/19 the net return on investments at Lothian Pension Fund exceeded the withdrawals position leading to an overall increase in net assets. Scottish Homes Pension Fund return on investments met the net withdrawal meaning the level of net assets was maintained from 2017/18.

Exhibit 9: Lothian Pension Funds' Financial Position

	Net assets			Present value of retirement benefits		
	2018/19	2017/18	% Movement	2018/19	2017/18	% Movement
Lothian Pension Fund	7,819	7,174	8.99%	9,333	8,254	13.07%
Scottish Homes	164	164	0.00%	135	134	0.75%

Source: Lothian Pension Funds Annual Report and Accounts

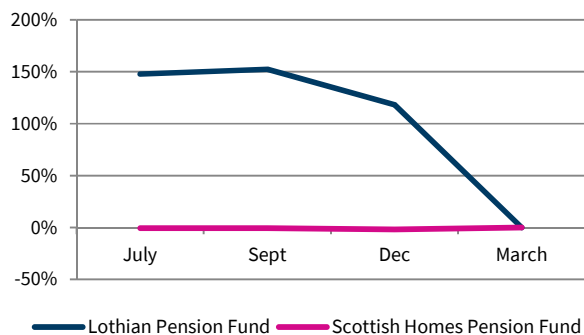


109. Hymans Robertson provided an estimate of the present value of the promised retirement benefits. The discount rate applied increased to 2.7% from 2.4% in the previous year. This has a negative effect on the scheme obligation, resulting in an increase in the obligation. The net pension obligation also includes the impact of the McCloud judgement as explained at paragraphs 50 and 51.

Financial Performance

110. As part of our audit we considered the Funds' systems of budgetary control and financial management and did not identify any significant deficiencies.
111. Service update reports are provided to each meeting of the Pensions Committee. The reports include forecasts to the year-end and explanations for any movements.
112. In year update reports highlighted that a net withdrawals position was expected, however, the forecasts were significantly above the year-end position.

Exhibit 10: Reported movement against the year-end position



Source: Pensions Committee Service Updates

113. The Lothian Pension Fund predicted position in December 2018 was 118.3% higher than the actual year-end position. This was due to employee and employer contributions being £10 million higher than anticipated and lump sums being £5 million lower than forecast. While the actual position is better than forecast, we would recommend the Funds investigate how forecasting information can be improved.

Action plan point 1

Systems of internal control

114. We have evaluated the Funds' key financial systems and internal financial controls to determine whether they are adequate to prevent material misstatements in the annual accounts. Our approach has included documenting the key internal financial controls and performing walkthroughs to confirm that they are operating as intended.
115. We identified three areas where there was an opportunity to improve the control environment:
- registers of interest compliance monitoring;
 - review of bank reconciliations by a senior member of the finance team; and
 - verification of all key details on transfers of individuals from the scheme.
116. Full details of the controls weaknesses and our recommendations are outlined in appendix 2.

Action plan points 2 to 4

117. We identified a number of areas for improvement in 2017/18 which were followed up at the year-end. We have reported progress against outstanding actions in appendix 2.

Prevention and detection of fraud and irregularity

118. Our audit was planned to provide a reasonable expectation of detecting material misstatements in the financial statements resulting from fraud and irregularity. Lothian Pension Fund was not required to participate in the National Fraud Initiative in 2018/19 but did so voluntarily.
119. We found the Funds' arrangements for the prevention and detection of fraud and other irregularities to be adequate and appropriate.

Standards of conduct

120. In our opinion the Funds' arrangements in relation to standards of conduct and the prevention and detection of bribery and corruption are adequate.
121. Our conclusion has been informed by a review of the arrangements for adopting and reviewing standing orders, financial instructions and scheme of delegation and for complying with national and local codes of conduct.



Internal audit

122. An effective internal audit service is an important element of the Funds' governance arrangements. The City of Edinburgh Council provide the Funds' internal audit service. 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
123. In 2018/19 it was noted that the service did not fully comply with Public Sector Internal Audit Standards in relation to quality assurance reviews. The Pensions Committee were advised that the instances of non-conformance have had no direct impact on the quality of internal audit reviews completed for the Funds in 2018/19.
124. Internal audit has advised that quality assurance reviews will be reinstated with effect from 1 April 2019.
125. In 2018/19 we did not place formal reliance on the work of internal audit, however, we have considered their findings in respect of our wider scope responsibilities and we are grateful to the internal audit team for their assistance during the course of our work.



6. Governance and transparency

Governance and transparency is concerned with the effectiveness of scrutiny and governance arrangements, leadership and decision making and transparent reporting of financial and performance information.



Governance arrangements at the Funds are deemed to be appropriate.

Our assessment has been informed by a review of the corporate governance arrangements in place, the information provided to the Board and Committees as well as the risk management arrangements in place.

We identified a significant risk regarding the transfer of assets from Lothian Buses Pension Fund to Lothian Pension Fund. We have confirmed appropriate governance processes were in place during 2018/19 to ensure the transfer was in line with relevant regulations.



Significant audit risk

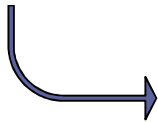
126. Our audit plan identified a significant risk in relation to financial sustainability under our wider scope responsibilities.

Governance and transparency: Lothian Buses Pension Fund merger

As noted in our financial statement section above, the Pensions Committee approved the transfer of the assets and liabilities of the Lothian Buses Pension Fund into the Lothian Pension Fund in March 2018, subject to the satisfactory completion of a revised admission agreement and shareholder guarantee. The transfer took place on 31 January 2019.

Mergers of local government pension schemes are highly unusual and therefore, there is significant risk around the governance, consultation and communication of the transfer.

Excerpt from the 2018/19 External Audit Plan



127. An investment strategy review in 2016 highlighted that Lothian Buses Pension Fund was defined in regulations as a sub-fund of Lothian Pension Fund. It was determined at this stage that there was an option for the Fund to be subsumed into Lothian Pension Fund. It was agreed at the meeting to begin exploring options to proceed with the merger.
128. As noted in the annual report and accounts section of the report, Lothian Buses Pension Fund was established under the Local Government Superannuation (Funds) (Scotland) Regulations 1986 (the 1986 Regulations). Regulation 8 of the 1986 Regulations outlines the process for dissolution of further funds. The administering authority may if they think fit dissolve a further fund and transfer the assets thereof, to the administering fund. Any entitlement to participate in the benefits of the further fund shall become an entitlement to participate in the benefits of the fund and the fund shall become the appropriate superannuation fund for those participants.
129. The administering authority may not dissolve a further fund unless they have given notice of not less than 28 days to the bodies whose employees are entitled to participate in that fund of their intention to dissolve the fund.
130. A transfer agreement ('the Deed of Transfer') was put in place between Lothian Buses and the City of Edinburgh Council in January 2019. This outlines terms and conditions for the transfer of the Fund to within the Main Fund.
131. Subsequent to this Lothian Buses and the City of Edinburgh Council entered into a revised admission agreement which states "The Authority and the Admission Body (together the "Parties") have agreed that the Authority shall transfer all of the assets and liabilities of the Lothian Buses Fund to the Main Fund, so that all benefits payable or prospectively payable under the Lothian Buses Fund will instead be payable under the Main Fund, with future contributions in respect of the Admission Body's participation in the Local Government Pension Scheme being paid into the Main Fund."
132. Following a review by the Funds actuary and legal advisers, it was determined that a guarantee would be required from the shareholders of Lothian Buses (City of Edinburgh Council; West Lothian Council; East Lothian Council and Midlothian Council).
133. We have concluded that Lothian Pension Fund has correctly assessed Lothian Buses Pension Fund as a 'further fund' as defined by the 1986 regulations and that appropriate confirmations from Lothian Buses and the City of Edinburgh Council were in place to allow the transfer to take place. In addition we have confirmed that revised admission agreements and guarantees have been put in place in line with legal advice provided to the Funds.



Governance structure

134. The Pensions Committee, supported by an Audit Sub-Committee, has been delegated responsibility for governance by the City of Edinburgh Council, the administering authority.
135. 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.
136. In line with the requirements of the Public Service Pension Act 2013 the Pensions Committee is supported by a Pensions Board.
137. The Pensions Board is responsible for establishing arrangements that ensure proper conduct of the affairs of the Board and meet quarterly on a concurrent basis with the Pension Committee.
138. The Funds complied with best practice and appointed an independent professional observer to the Board and Committee. The appointed independent observer resigned in February 2018 and a replacement was appointed in May 2018.
139. 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 2018/19.
140. 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.
141. Our review found that all current Pension Committee and Board members met the requirement to have a minimum of 21 hours training.
142. The Pensions Committee has delegated responsibility for investment strategy to the Executive Director of Resource who takes advice from a Joint Investment Strategy Panel made up of:
- Chief Executive, LPFI Ltd (until December 2018);
 - Chief Investment Officer LPFI Ltd;
 - Regulated investment advisor, LPFI Ltd (from December 2018); and
- two external independent investment consultants.
143. The joint Investment Strategy Panel covers joint working arrangement with Falkirk Pension Fund and Fife Pension Fund.
144. The Joint Investment Strategy Panel meets quarterly and considers the appropriate investment management structure required to implement the Funds' investment strategy. In addition it is responsible for:
- making recommendations about investment strategy; and
 - directing and monitoring strategy implementation and risk.
145. The primary focus of the panel during 2018/19 has been the implementation of existing strategies for Lothian Pension Fund, Lothian Buses Pension Fund (until merger with Lothian Pension Fund in February 2019) and Scottish Homes Pension Fund.
146. In addition to this following the merger of Lothian Buses Pension Fund with Lothian Pension Fund the Panel considered the Investment Strategy for the revised structure.
147. From December 2018, Lothian Pension Fund operated four investment strategies recognising the differing requirements of the various scheduled and admitted employers.

Training and development

Joint Investment Strategy Panel

142. The Pensions Committee has delegated responsibility for investment strategy to the Executive Director of Resource who takes advice from a Joint Investment Strategy Panel made up of:
- Chief Executive, LPFI Ltd (until December 2018);
 - Chief Investment Officer LPFI Ltd;
 - Regulated investment advisor, LPFI Ltd (from December 2018); and



Exhibit 11: Lothian Pension Fund investment strategies



Source: Joint Investment Strategy Panel annual report

148. Scottish Homes Pension fund achieved full funding at the 2017 actuarial valuation and therefore the strategy is low risk and designed to protect from short term market changes. This is similar to Strategy 2 which focuses on investments in UK gilts and cash.

Openness & Transparency

149. Audit Scotland also cited a risk in relation to public sector organisations keeping pace with public expectations on openness and transparency.
150. In our opinion, the Funds demonstrates good practice with respect to openness and transparency in the following ways:
- Committee agendas and papers are published on the Funds' website in advance of meetings being held;
 - Committee minutes and updates are available to the public;
 - Key publications (including operational plan, results of annual review, annual accounts) are available on the Funds' website; and
 - the quality of reports presented to the Pensions Committee is such that it supports the transparency of decision making.

In September 2018 the Pensions Committee considered a report as to whether their proceedings should be included as part of the council web-casting facility. It was agreed that the benefits arising from the existing format outweighed those that would arise from web-casting.

Impact of EU withdrawal

151. Audit Scotland has highlighted EU withdrawal as a significant risk facing public bodies across Scotland. Three streams of potential impact were identified:
- Workforce;
 - Funding; and
 - Regulation.
152. The Funds have considered the impact across all three areas, and have identified that this is an area of low risk for the pension fund. From an initial assessment of the workforce and funding streams no significant implications have been identified. This is in line with our understanding of the nature of the Funds'.
153. Regulations may have a more significant impact, however, the Funds consider that as a UK based pension Fund collaborating with other UK based funds the impact is expected to be limited
154. The primary consideration was the impact of the EU withdrawal on movement in investments and as outlined in the financial sustainability and value for money sections the Funds have tailored their objective and approach to focus on long term safeguarding of returns.

Key supplier dependency

155. Following the collapse of Carillion, it became apparent that public sector bodies face significant risks where suppliers are experiencing difficult trading conditions.
156. We have evaluated the Funds' key suppliers and considered the contract management arrangements as part of our work on expenditure and value for money
157. There are a number of areas where the Funds use one key supplier e.g. custodian, pensions administration and investment managers. However, we are aware appropriate contract management is in place and that there is a range of potential suppliers should a change be necessary. We therefore consider this to be low risk.
158. The Funds ICT environment is through the City of Edinburgh Council and their supplier. In 2018/19 the Funds have encountered delays and service disruptions across a number of ICT areas.
159. The ongoing issues are on the risk register and graded high risk and the Funds attend quarterly meetings with City of Edinburgh Council ICT officers and the supplier.



160. We consider the actions of the Funds with regard to key suppliers to be appropriate and proportionate to the level of risk.



7. Value for money

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



The Funds' investment performance is subject to regular review by the Pension Committee.

The Funds have appropriate arrangements in place to secure value for money through appropriate monitoring of performance of investments and the administration of the Funds.



Investment manager operations

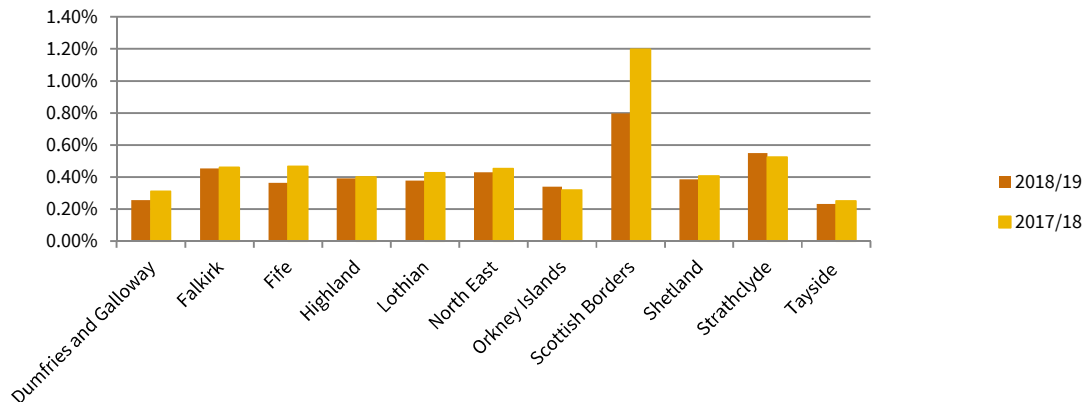
161. Lothian Pension Fund operates two special purpose vehicles: LPFE Ltd and LPFI Ltd. Both companies are wholly owned and controlled by the Council.
162. The special purpose vehicles were established to support the investment programme of the in-house investment team by providing organisational arrangements consistent with the capability, systems and controls of authorised investment companies.
163. Effective leadership is key to the success of the Funds achievement of objectives. In 2018/19 there was a significant change to the leadership team at LPFI Ltd.
164. In June 2018 the Chief Executive announced her intention to leave the Funds with a planned leaving date of December 2018. A new Chief Executive was appointed and commenced his position in January 2019.
165. There has been no significant change to the operation of the Funds to date and the proportion of funds managed internally has remained steady at approximately 85% of investments since 2015/16.

Management expenses

166. Lothian Pension Fund reported management expenses of £38.634 million in 2018/19, an increase of 1.8% from the prior year.
167. Management expenses are split into three main categories: administrative costs; investment manager expenses and oversight and governance costs. Investment management expenses account for 90% of total management expenses.
168. In year Lothian Pension Fund's investment manager expenses (excluding indirect expenses) fell marginally as a proportion of net assets. This is broadly in line with trends across the Local Government Pension Funds.



Exhibit 12: Lothian Pension Funds' Financial Position



Source: LGPS Scotland Unaudited Annual Report and Accounts

169. The analysis above does not include indirect investment management costs as CIPFA guidance states that only direct investment management costs i.e. those that the fund can control should be reported. Lothian Pension Fund reported £5.062 million of indirect manager expenses in 2017/18. It is not possible to benchmark the impact of indirect management costs across Scottish Local Government Pension Funds.
170. Investment manager expenses can vary due to a number of factors including actual returns on investments and the nature of the investments assets held.
171. The Funds undertake annual benchmarking exercises using externally provided data, covering 41 LGPS funds and a wider global universe of 346 funds.
172. Analysis of investment costs is carried out by an independent provider, CEM benchmarking Limited. In 2018/19 Lothian Pension Fund reported an actual investment cost of 0.43% of net assets which was below the benchmark of 0.55%.
173. The Funds credit the improved performance against benchmark to the high percentage of assets managed internally.
174. Analysis of pension administration costs was undertaken by the Chartered Institute of Public Finance Accountants. Pension cost per member was in 2018/19 £23.38, which is higher than the average cost of local authority funds of £21.74. The cost per member is broadly deemed to be in line with other local authority funds who operate within the range of costs of £11 to £61 per member.

175. The Funds have noted that there are restrictions over the comparability of the data and that the membership composition can have a significant impact on the cost. It is noted that there is a high degree of variation across the membership across LGPS Funds.

Monitoring investment performance

176. There is an annual review of investment performance in June for each of the Funds. The report provides a detailed analysis of each of the Fund's investment performance against its investment strategy. We concluded that Pension Committee and Board Members are engaged in monitoring the performance of investments.
177. In addition to monitoring at a Committee level the Funds' performance is calculated by an external provider on a monthly basis. The external provider compiles information covering monthly, quarterly, yearly, 3, 5, 10 since inception yearly performance measures. This information is presented to the Joint Investment Strategy Panel to allow for scrutiny investment performance of the Funds.

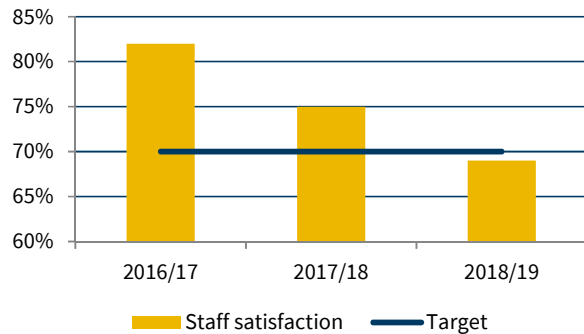
Administrative Performance

178. The Funds' have a Service Plan in place covering the period 2018- 2020. The Pensions Committee receive updates on the service plan at each meeting. The annual results for 2018/19 are presented in the Funds' Management Commentary.
179. The Performance Report highlights that the Funds are meeting the majority of their targets (90%) with only 1 area where performance was not in line with target levels:
180. The target for the staff engagement index was 70% but the Funds achieved a level of 69%. The funds recognise the importance of the workforce in



achieving objectives and conduct an annual staff survey to monitor engagement.

Exhibit 13: Lothian Pension Funds' Financial Position



Source: Lothian Pension Funds unaudited annual report and accounts

181. The Funds have reported a decline over recent years and in 2018/19 they are below target.

Tendering for Services

182. 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.
183. The Funds follow the City of Edinburgh Council procurement procedures and maintain a contract register.
184. A paper went to the Pensions Committee in December 2018 providing an update on the tender of custodian services.
185. We have concluded that contract arrangements in place at the Funds are appropriate.



8. Appendices





Appendix 1: Respective responsibilities of the Funds 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 2018 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 report and financial statements.

We are also required to report, if in our opinion:

- adequate accounting records have not been kept; or
- the annual accounts and the part of the Remuneration and Staff Report to be audited are not in agreement with accounting records; or
- we have not received all the information and explanations we require for our audit; or
- 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 financial statements, but providing audit judgements and conclusions on the appropriateness, effectiveness and impact of corporate governance and performance management arrangements and financial sustainability.

The Code of Audit Practice frames a significant part of our wider scope responsibilities in terms of four audit dimensions: financial sustainability; financial management; governance and transparency; and value for money.



Independence

International Standard on Auditing (UK) 260 "Communication with those charged with governance" requires us to communicate on a timely basis all facts and matters that may have a bearing on our independence.

Non-audit services

In addition to our work on the Funds we are also responsible for the audit of the financial statements of LPFE Ltd and LPFI Ltd, the subsidiaries of Lothian Pension Fund. In addition to the audit of the subsidiaries, Scott-Moncrieff provides accounts preparation, corporation tax services and ad hoc VAT advice to both LPFE Ltd and LPFI Ltd.

All tax services are provided by an independent tax partner and staff who have no involvement in the audit of the financial statements.

The accounts are prepared from trial balances provided by LPFE Ltd and LPFI Ltd and no significant policies, disclosures, adjustments or estimates are decided by Scott-Moncrieff.

In 2018/19 Scott-Moncrieff undertook a review of pay arrangements at the request of LPFE Ltd. This review was undertaken by a team independent of the external audit team and who have no involvement in the audit of the financial statements.

Confirmation of independence

We confirm that we have complied with the FRC's Revised Ethical Standard (June 2016).

In our professional judgement, the audit process is independent and our objectivity has not been compromised in any way. In particular there are and have been no relationships between Scott-Moncrieff and the Funds, its Board members and senior management that may reasonably be thought to bear on our objectivity and independence.



Appendix 2: Action plan

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

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	Explanation
Grade 5	Very high risk exposure - Major concerns requiring immediate attention.
Grade 4	High risk exposure - Material observations requiring 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.



Current year action plan

Action plan point	Issue & recommendation	Management comments
<p>1. Accuracy of forecasting information</p> <p>Rating</p> <p>Grade 3</p> <p>Paragraph Ref</p> <p>110</p>	<p>Issue In year service update reports highlighted that a net withdrawals position was expected, however, the forecasts were significantly above the year-end position with December being 118% higher than the actual position.</p> <p>Risk There is a risk that the year-end position is significantly different to the forecast position with an adverse variance.</p> <p>Recommendation We recommend the Funds takes action to improve the quality of forecasting information presented to the Pensions Committee.</p>	<p>It should be noted that the cashflow forecasts reported to Pensions Committee as part of the regular "Service Plan update" are prepared on a strict cash basis. This differs from the year end reporting which reflects accrual of both expenditure and income.</p> <p>This clarification is highlighted in the narrative of the regular reporting to Pensions Committee.</p> <p>Relevant extract from the meeting of 26 September 2018 is -</p> <p>Membership and Cashflow monitoring</p> <p>a. The tables below detail the cashflows as at the end of July 2018 and projections for the financial year. These have been prepared on a cashflow basis (compared to the accruals basis of the year-end financial statements and budget projections).</p> <p>In future the financial statements will disclose reconciliation to the cash accounting basis together with explanatory narrative for any significant variances.</p> <p>Responsible officer: Chief Finance Officer, Lothian Pension Fund</p> <p>Implementation date: 31 May 2020</p>



Action plan point	Issue & recommendation	Management comments
2. Registers of interest	<p>Issue</p> <p>A compliance email has not been issued to the Pensions Board/Non-Elected Committee Members during 2018/19. This email should be sent on a quarterly basis, however, the last email was sent in March 2017.</p>	<p>Pension Board and non-elected members are required to sign a Code of Conduct, as well as making declarations to the Funds dual interest and hospitality register. The last item on the dual interest register was declared in September 2018.</p>
Rating	<p>Risk</p> <p>There is a that the Funds do not hold an up to date register of interests for all the Pensions Board/Non-Elected Committee Members, and is therefore unable to identify any potential related party transactions.</p>	<p>At Pension Board meetings, declaration of interest is a standing agenda item. Should there be no declarations of interest, this is recorded in the minutes.</p>
Grade 3	<p>Recommendation</p> <p>We recommend that compliance e-mails are issued in line with the stated policy.</p>	<p>The Fund has been undertaking a governance review over the last few months which includes a review of the code of conduct for Pension Board and Non-elected Committee members. If the Committee approves the new Code of Conduct in September 2019, all Committee members and Board members will be required to sign the new Code of Conduct (this includes Councillors). Thereafter, an annual refresh will be required.</p>
Paragraph Ref		<p>Although the Fund does consider the risk to be low, it does acknowledge that compliance emails have not been sent to Pensions Board and Committee members (non-Councillors) during the financial year. To strengthen policies and procedures as well as raise the profile of compliance further, quarterly e-updates to Pension Board and Pension Committee members from September onwards will now include a compliance reminder section.</p>
117		<p>Responsible officer: Chief Risk Officer, Lothian Pension Fund</p> <p>Implementation date: 31 October 2019</p>



Action plan point	Issue & recommendation	Management comments
3. Review of bank reconciliations	<p>Issue As part of our testing of bank reconciliations we sample checked the controls in place across the year. We noted that for one sampled month the bank reconciliation had been completed but had not been reviewed by a senior member of the finance team.</p> <p>Risk There is a risk that there is an error in the bank reconciliation which is not detected.</p> <p>Recommendation We recommend that all bank reconciliations are subject to review by an appropriate individual.</p>	<p>Change in bank account reconciliation process took place during the year to become paperless. Month -end reconciliations are completed by the Finance team and then e-mailed to Finance management to review. Reconciliations have been reviewed. The recording (sign-off) of this validation, however, has not taken place. Procedure will be reviewed to better capture and record electronic approvals.</p> <p>Responsible officer: Chief Finance Officer, Lothian Pension Fund</p> <p>Implementation date: 31 October 2019</p>
Rating		
Grade 3		
Paragraph Ref		
117		

Action plan point	Issue & recommendation	Management comments
4. Verification of pensioner details	<p>Issue As part of our verification of controls we walked through a transfer out of a member. The sampled record did not have their date of birth confirmed or checked to supporting documentation.</p> <p>Risk This is a key control in confirming pension eligibility and could lead to an error in payments made.</p> <p>Recommendation We recommend that verification of key details are conducted in line with the stated procedures.</p>	<p>This case is an interfund transfer rather than a transfer to another pension scheme. An interfund transfer means that the member is transferring to the same scheme (LGPS) and the transfer value payment is simply a way of transferring the liability from one Fund to another.</p> <p>There is an agreement between the Scottish Funds that dates of birth do not need to be verified if already verified by one scheme. In this case, however, this did not happen in either fund.</p> <p>The existing documented LPF administration procedure already reflected requisite date of birth verification. In this case, the procedure had not been correctly followed (human error). The importance of the check has been re-iterated to the pensions administration team, both orally and by e-mail communication.</p> <p>Responsible officer: Chief Finance Officer, Lothian Pension Fund</p> <p>Implementation date: 30 September 2019</p>
Rating		
Grade 3		
Paragraph Ref		
117		



Follow up of prior year recommendations

Of the four recommendations raised within our 2016/17 and 2017/18 interim audit reports and 2016/17 and 2017/18 annual audit reports, we note that one has been closed and three are ongoing. Details are given below.

1. Publication of the financial statements

Initial rating	Issue & recommendation	Management comments
Grade 2	<p>Observation</p> <p>In 2017/18 Lothian Pension Fund received objections to the accounts relating to the public right to inspect the accounts. The objections related to the wording in the public inspection notice and the availability of the annual report and financial statements on the Lothian Pension Fund website.</p> <p>Recommendation</p> <p>We recommend that the annual report and financial statements are posted on the Lothian Pension Fund website, following approval from the Pensions Committee and in line with the public inspection notice.</p>	<p>Recommendation is accepted. Following consideration of the Annual Report 2019 (and Financial Statements) Unaudited by Pensions Committee, this will be posted on the Lothian Pension Fund website, supplementing the prior disclosure of all the reports to that Committee on the Council's website.</p> <p>Responsible officer: Chief Executive Officer, Lothian Pension Fund</p> <p>Implementation date: June 2019</p>
Current status	Audit update	Management response
Ongoing	<p>In 2018/19 we received an objection to the notice of the public right to inspect. Upon review there was found to be a delay in publishing the public inspection notice which is required to be published prior to 17 June as outlined by the 2014 Regulations. The notice was published in the local newspaper and on the City of Edinburgh Council website by 17 June 2019, however, was not available at Council offices until 26 June 2019.</p> <p>We recommend procedures are put in place to ensure all the regulations are complied with in 2019/20.</p>	<p>While detailed procedure notes are already in place, these will be reviewed to introduce an element of independent review, thereby ensuring all key steps are undertaken by the required dates.</p>



2. Bank accounts

Initial rating	Issue & recommendation	Management comments
Grade 3	<p>Observation</p> <p>The Local Government Pension Scheme (Management and Investment of Funds) (Scotland) Regulations 2010. require administering authorities to hold a separate bank account for funds and to be used to hold pension fund money.</p> <p>There is an ongoing issue that although the Funds' held their own bank accounts, monies were transferred to the City of Edinburgh Council holding account and the money was managed through this account. Actions were taken in 2017/18 to progress the issue of compliance, however, significant delays mean that during the year the Funds were not in fully compliant with the regulations.</p> <p>Recommendation</p> <p>We recommend the Funds put arrangements in place to ensure compliance with the regulations.</p>	<p>Quotation for a stand-alone ledger for the Funds was also sought from CGI, the Council's ICT provider, but this did not offer a cost-effective solution. Whilst LPF now fully anticipates a successful project delivery by the Council and CGI, with integration of the LPF requirement in the ledger specification, the option of complete separation, i.e. LPF to procure an alternative to the Council solution, is retained as "last resort".</p> <p>Responsible officer: Chief Finance Officer, Lothian Pension Fund</p> <p>Implementation date: As soon as possible, subject to the implementation of a revised financial ledger system by the Council to incorporate this functionality, or alternatively a separate procurement by LPF.</p>
Current status	Audit update	Management response
Ongoing	<p>The resolution of this issue is linked to the procurement of a new ledger system which has not progressed in 2018/19.</p>	<p>LPF has requested that responsibility for "unfunded (discretionary) payments" be transferred to Scottish Public Pensions Agency (SPPA). Should this be accepted by SPPA, then there would be no requirement for LPF to utilise the Council's bank account.</p> <p>The procurement of a new ledger is also linked to LPF's consideration of its broader ICT service requirements.</p>



3. User access controls

Initial rating	Issue & recommendation	Management comments
Grade 3	<p>Observation</p> <p>Our review of the journals environment identified that all City of Edinburgh Council staff with access to Oracle, the financial ledger system, have the ability to post to the Funds' financial ledgers.</p> <p>Recommendation</p> <p>While our audit review in respect of the 2017/18 financial year did not identify any indications of user access being manipulated, we recommend that the Funds' officers in conjunction with City of Edinburgh Council review user access controls for the financial ledger.</p>	<p>Recommendation is accepted.</p> <p>Responsible officer: Chief Finance Officer, Lothian Pension Fund</p> <p>Implementation date: March 2019</p>
Current status	Audit update	Management response
Ongoing	<p>This is an ongoing issue in 2018/19, however, we did not identify any instances where journals were posted by inappropriate users.</p>	<p>There remains no existing system-based means of preventing staff from posting journal entries affecting other organisations. Indications received suggest that the cost of introducing such controls would be prohibitive relative to the resulting benefits. The posting of journal entries exists, however, within a wider framework of financial analysis, peer review and reporting. Any cost-effective means of effecting further improvements in this area will be considered as part of the Council's Oracle system refresh due for implementation in mid-2020.</p>



4. Cyber essentials

Initial rating	Issue & recommendation	Management comments
Grade 3	<p>Observation</p> <p>In 2017/18 In May 2017, a number of health boards across NHS Scotland were affected by the Wannacry global ransomware attack. In response to this the Scottish Government launched 'A Cyber Resilience Strategy for Scotland: Public Sector Action Plan, 2017/18'.</p> <p>The action plan outlines a number of requirements that public bodies should be taking forward. This includes an action for public bodies to achieve a Cyber Essentials Plus certification by the end of October 2018. The Funds are aware of the work but do not have a formal plan to achieve certification.</p> <p>Recommendation</p> <p>We recommend that the Funds make arrangements to ensure Cyber Essentials certification is achieved by 31 October 2018.</p>	<p>Recommendation is accepted. LPF is liaising with the Council's Chief Information Officer to secure requisite certification.</p> <p>Responsible officer: Chief Executive Officer, Lothian Pension Fund</p> <p>Implementation date: October 2018</p>
Current status	Audit update	Management response
Completed	<p>Our audit testing in 2018/19 confirmed that Cyber Essentials accreditation was not achieved by the October deadline and however, the Cyber Essentials Certification was achieved in 2018/19 by City of Edinburgh Council and the Funds.</p>	Not applicable



Appendix 3: Unadjusted audit differences

We identified the following adjustment to the financial statements during our audit. We have discussed this with management and have agreed that it will not be reflected in the financial statements on the grounds of materiality.

Adjusted difference	SoCNE		Balance Sheet	
	DR £m	CR £m	DR £m	CR £m
Past Service Cost		0.252		
Net interest cost		0.003		
Return on assets (excluding net interest)		0.027		
Pension liability				0.282
<i>Being updated pension liability after the impact of the McCloud judgment</i>				
Net impact on income / expenditure	£0.282			

