Lothian Pension Fund

2020/21 Annual Audit Report to the

Members of the Pensions Committee and the Controller of Audit

September 2021

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Key messages

This report concludes our audit of the Lothian Pension Fund and the Scottish Homes Pension Fund for 2020/21.

This section summarises the key findings and conclusions from our audit.

Financial statements audit

Audit opinion	Our draft independent auditor's report includes: • an unqualified opinion on the financial statements; • an unqualified opinion on other prescribed matters. Our audit work is substantially complete and there are currently no matters which would require modification of our audit report.
Key findings on audit risks and other matters	Our key findings are included in the financial statements audit section of this report. COVID-19 continues to present unprecedented challenges to the operation, financial management and governance of organisations, including public sector bodies. In response to the pandemic we identified potential areas of increased risk of material misstatement to the financial statements and our audit opinion. We are pleased to report those risks identified did not materialise. Lothian Pension Fund (LPF) had appropriate administrative processes in place to prepare the annual report and accounts and the required supporting working papers
Audit adjustments	We are required to communicate all potential adjustments, other than those considered to be clearly trivial. We are pleased to report that there were no material adjustments to the financial statements and no unadjusted differences identified. We identified some disclosure and presentational adjustments during our audit. These have been reflected in the final set of financial statements.
Accounting systems and internal controls	We have applied our risk based methodology to your audit. This approach requires us to document, evaluate and assess the Funds' processes and internal controls relating to the financial reporting process. Our audit is not designed to test all internal controls or identify all areas of control weakness. However, where, as part of our testing, we identify any control weaknesses, we have included these in this report. No material weaknesses or significant deficiencies were noted.

Wider scope audit

Financial Sustainability

Auditor judgement

LPF has adequate arrangements in place to ensure ongoing sustainability.

The focus of the Funds' investment strategy is to ensure a sufficient return over the long term to meet the funding objectives outlined by the Funding Strategy Statement.

The Triennial Valuation was carried out as at 31 March 2020 and estimates both Funds are fully funded at 106% for LPF and 118% for Scottish Homes Pension Fund. This represents an improvement on the previous triennial valuation where the funding levels were 98% and 105% respectively.

LPF has delivered strong absolute performance in 2020/21 of 15.5% annual return on investments. However, performance against benchmark has declined for one-year, five-year and ten-year annualised investment returns driven by the below benchmark returns on equities. We note that this is linked to the use of a 'defensive' strategy by the Fund. We recommend this should be formally included in the Fund's investing and funding strategy.

Financial Management

Auditor judgement

Lothian Pension Fund has effective arrangements for financial management and the use of resources.

The Funds reported a net increase in the Funds. LPF reported a net increased position in dealings with members of £58.03 million. Scottish Homes reported a net withdrawal position of £7.347 million.

Annual operating plan updates are provided to each Pension Committee meeting clearly explaining changes in group performance. However, improvements to reporting could be made by considering wider stakeholders such as the members and expanding reporting to provide further comparatives when reporting on each Fund.

Governance & Transparency

Auditor judgement

Governance arrangements at the Funds are 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.

The former Chief Executive left LPF in July 2021 and a new Chief Executive has been appointed. Suitable handover arrangements were in place to ensure that appropriate assurance could be provided over the internal control framework at Lothian Pension Fund.

Value for Money

Auditor judgement

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

Performance remains strong with nine out of the ten performance measures met. However, investment performance over the rolling five-year period is noted as being below benchmark.

Definition

Our wider scope audit involves consideration of the Board's arrangements as they relate to financial sustainability; financial management, governance and transparency and value for money. We have used the following grading to provide an overall assessment of the arrangements in place as they relate to the four dimensions.

There is a fundamental absence or failure of arrangements in place

There is no evidence to support improvement

Risks exist over the Pension Fund's ability achieve its desired outcomes

The Board's arrangements over the wider scope audit dimensions are inadequate or ineffective.

Pace and depth of improvement is slow

Risk exist over the Pension Fund's ability to achieve its desired outcomes

There are no major weaknesses in the Board's arrangements but there is scope for improvement.

Pace and depth of improvement is adequate

Risks exist over the Pension Fund's ability to achieve its desired outcomes

Effective and appropriate arrangements are in place

Pace and depth of improvement is effective

No risks exist over the Pension Fund's ability to achieve its desired outcomes

Introduction

We carried out our audit in accordance with Audit Scotland's Code of Audit Practice (2016) and maintained auditor independence

Scope

1. This report summarises the findings from our 2020/21 audit of the Lothian Pension Fund and Scottish Homes Pension Fund (LPF).

2. We outlined the scope of our audit in our External Audit Plan, which we presented to the Pension Committee at the outset of our audit. The core elements of our work include:

- an audit of the 2020/21 annual report and accounts and related matters;
- consideration of the wider dimensions of public audit work, as set out in Exhibit 1; and
- any other work requested by Audit Scotland.

Exhibit 1: Audit dimensions within the Code of Audit Practice (2016)

Responsibilities

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 in this report are only those that have come to our attention during our normal audit work and may not be all that exist. Communication in this report of matters arising from the audit or of risks or weaknesses does not absolve management from its responsibility to address the issues raised and to maintain an adequate system of control.

4. We do not accept any responsibility for any loss occasioned to any third party acting, or refraining from acting on the basis of the content of this report, as this report was not prepared for, nor intended for, any other purpose.

5. We would like to thank all management and staff for their co-operation and assistance during our audit.

Auditor 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 complied with the Financial Reporting Council's (FRC) Ethical Standard. In our professional judgement, we remained 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 LPF 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 LPF promote improved standards 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 any member of your audit team.

Openness and transparency

11. This report will be published on Audit Scotland's website www.audit-scotland.gov.uk.

Financial statements audit

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

Our independent auditor's report includes:

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

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

Overall conclusion

12. The annual report and accounts are due to be considered by the Pension Committee by October 2021. Our independent auditor's report is unqualified.

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

Our audit opinion

Opinion	Basis for opinion	Conclusions
Financial statements	We conduct our audit in accordance with applicable law and International Standards on Auditing as required by the Code of Audit Practice. Our findings / conclusion to inform our opinion are set out in this section of our annual report.	We have issued an unqualified audit opinion on the 2020/21 financial statements.
Going concern basis of accounting	In the public sector when assessing whether the going concern basis of accounting is appropriate, the anticipated provision of the services is more relevant to the assessment than the continued existence of a particular public body. We assess whether there are plans to discontinue or privatise the Funds' functions. Our wider scope audit work considers the financial sustainability of the Funds.	We reviewed the financial forecasts for 2021/22. 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. Our audit opinion is unqualified in this respect.
Matters prescribed by the	We read all the financial and non-financial information in the annual report and accounts to identify material inconsistencies with the	The annual report contains no material misstatements or

Opinion	Basis for opinion	Conclusions
Accounts Commission • Management Commentary • Annual Governance Statement • Governance Compliance Statement	audited financial statements and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by us in the course of performing the audit. We plan and perform audit procedures to gain assurance that the statutory other information has been prepared in accordance with relevant legislation and regulations.	inconsistencies with the financial statements. We have concluded that: • the information given in the Management Commentary is consistent with the financial statements and that report has been prepared in accordance with statutory guidance issued under the Local Government in Scotland Act 2003; • the information given in the Annual Governance is consistent with the financial statements and that report has been prepared in accordance with the Delivering Good Governance in Local Government: Framework (2016); and • the information given in the Governance Compliance Statement is consistent with the financial statements and that report has been prepared in accordance with The Local Government Pension Scheme (Scotland) Regulations 2018.
Matters reported by exception	We are required to report on whether: • adequate accounting records have not been kept; or • the financial statements are not in agreement with the accounting records; or	We have no matters to report.

Opinion	Basis for opinion	Conclusions
	• we have not received all the information and explanations we require for our audit.	

An overview of the scope of our audit

14. The scope of our audit was detailed in our External Audit Plan, which was presented to the Pension Committee in March 2021. 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 LPF. 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.

15. 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.

16. In our audit, we test and examine information using sampling and other audit techniques, to the extent we consider necessary to provide a reasonable basis for us to draw conclusions. We obtain evidence through performing a review of the significant accounting systems, substantive procedures and detailed analytical procedures.

Significant risk areas

17. Significant risks are defined by professional standards as risks that, in the judgement of the auditor, require special audit consideration. In identifying risks, we consider the nature of the risk, the potential magnitude of misstatement, and its likelihood. Significant risks are those risks that have a higher risk of material misstatement.

18. The significant risk areas described in the table below are those that had the greatest effect on our audit strategy, the allocation of resources in the audit and directing the efforts of the audit team. 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 below.

Significant risk areas

1. Management override	
Significant risk description	In any organisation, there exists a risk that management have the ability to process transactions or make adjustments to the financial records outside the normal financial control processes. Such issues could lead to a material misstatement in the 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.* **Risk assessment**: **High**
How the scope of our audit responded to the significant risk	**Key judgement** There is the potential for management to use their judgement to influence the financial statements as well as the potential to override the Funds' controls for specific transactions. **Audit procedures** • Review of the Funds' accounting records and audit testing on transactions. • Adoption of data analytics techniques in testing carried out. • Review of judgements and assumptions made in determining accounting estimates as set out in the financial statements to determine whether they are indicative of potential bias. This included a retrospective review of the prior year estimates against the current year estimates.
Key observations	We have not identified any indication of management override in the year. We did not identify any areas of bias in key judgements made by management and judgements were consistent with prior years.

2. Revenue recognition	
Significant risk description	Under *ISA (UK) 240 - The auditor's responsibilities relating to fraud in an audit of financial statements* there is a presumed risk of fraud in relation to revenue recognition. The presumption is that LPF could adopt accounting policies or recognise income and expenditure transactions in such a way as to lead to a material misstatement in the reported financial position. **Risk assessment: Low**
How the scope of our audit responded to the significant risk	**Key judgements** Given the financial pressures facing the public sector as a whole, there is an inherent fraud risk associated with the recording of income around the year end. However, we do not deem this risk to be present for contributions received from member bodies due to a lack of incentive and opportunity to manipulate transactions. **Audit procedures** • Evaluate the significant revenue streams and review the controls in place over accounting for revenue. • Consider the Funds' key areas of revenue and obtain evidence that revenue is recorded in line with appropriate accounting policies and that the policies have been applied consistently across the year.
Key observations	We have gained reasonable assurance on the completeness and occurrence of income and we are satisfied that it is fairly stated in the financial statements.

3. Expenditure recognition	
Significant risk description	As most public sector bodies are net expenditure bodies, the risk of fraud is more likely to occur in expenditure. There is a risk that expenditure may be misstated resulting in a material misstatement in the financial statements. **Risk assessment: Low**
How the scope of our audit responded to the significant risk	**Key judgements** Given the financial pressures facing the public sector as a whole, there is an inherent fraud risk associated with the recording of accruals around the year end. However, we do not deem this risk to be material in pension's dealing with members due to the lack of incentive or opportunity to manipulate transactions. **Audit procedures** • Evaluate the significant non-pay expenditure streams and review the controls in place over accounting for expenditure. (Pensions paid is subject to separate tailored testing). • Consider LPF's key areas of expenditure and obtain evidence that expenditure is recorded in line with appropriate accounting policies and the policies have been applied consistently across the year. • Review accruals around the year end to consider if there is any indication of understatement of balances held. Consider accounting estimates.
Key observations	We gained reasonable assurance over the completeness and occurrence of expenditure and are satisfied that expenditure is fairly stated in the financial statements.

4. Valuation of Investments

Significant risk description	The Funds held investments of £7.445 billion as at 31 March 2020, of which 37% (£2.455 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. **Risk assessment: High**
How the scope of our audit responded to the significant risk	**Key judgements** There is the potential for management to use their judgement to influence the financial statements. **Audit procedures** • Evaluate the Funds' investment strategy and review the controls in place over accounting for investments. • Consider LPF's material investments and obtain evidence that investments have been appropriately valued at 31 March 2021 including challenging fair value classification. • Review investment transactions and obtain evidence that investment transactions are recorded in line with appropriate accounting policies and the policies have been applied consistently across the year. • Review management experts including the custodian and external investment managers. This includes reviewing auditor reports on the internal controls at the custodian and at each key investment manager. • Review the disclosures within the annual report and financial statements to ensure they are consistent with the information provided by the custodian
Key observations	As at 31 March 2021, LPF investments assets increased to £8.686 billion, of which 30% (£2.645 billion) were classified as level 2 or level 3 financial instruments. We gained reasonable assurance over the valuation of investments at year end and are satisfied that investments and investment transactions are fairly stated in the financial statements.

5. Accounting for Investment Properties	
Significant risk description	LPF hold a portfolio of investment properties which as at the 31 March 2020 was valued at £367 million. The management of the properties is undertaken by JLL, along with the Fund accounting for the portfolio. In 2019/20 the valuation of this investment property, undertaken by CBRE, was qualified with a material valuation uncertainty given the unknown future impact that COVID-19 might have on the real estate market. Our audit opinion included an emphasis of matter drawing this matter to the attention of the reader. **Risk assessment: High**
How the scope of our audit responded to the significant risk	**Key judgements** There is the potential for management to use their judgement to influence the financial statements. **Audit procedures** • Evaluate the Funds' investment strategy and review the controls in place over accounting for investment properties. • Review management experts including the valuer and external investment manager. • Consider the disclosures within the annual report and financial statements to ensure they are consistent with the information provided by the valuer. • Challenge the assumptions, judgements and sources of data used in the valuation to ensure that management have appropriate assurance over the valuation of properties.
Key observations	LPF's investment properties were valued at £366 million as at 31 March 2021. The valuation undertaken by CBRE did not include a qualification for material valuation uncertainty. CBRE considers that sufficient market evidence exists upon which to base opinions of value. Based on our audit procedures and evaluation of expert's work we concur with this judgement. We gained reasonable assurance over the valuation of investment properties at the year end and are satisfied that investment properties are fairly stated in the financial statements.

Other risk factors

Impact of COVID-19 on the annual accounts

19. COVID-19 continues to present unprecedented challenges to the operation, financial management and governance of organisations, including public sector bodies. In response to the pandemic we identified potential areas of increased risk of material misstatement to the financial statements and/or our audit opinion. Our conclusions are set out in the table below.

Area considered	Description	Conclusion
Valuation of investment assets	In 2019/20 the valuation of this investment property, undertaken by CBRE, was qualified with a material valuation uncertainty given the unknown future impact that COVID-19 might have on the real estate market. Our audit opinion in 2019/20 included an emphasis of matter drawing this matter to the attention of the reader.	We have confirmed that the 2020/21 valuation of investment properties does not include a qualification. We have not qualified our audit opinion in respect to valuation of investments in 2020/21.
Access to audit evidence	For the second year in a row our audit has been carried out remotely. As a consequence, we identified a risk that access to and provision of sufficient, appropriate audit evidence in support of our audit opinion may be impacted by the inherent nature of carrying out our audit remotely.	We have employed a greater use of technology to examine evidence, but only where we have assessed both the sufficiency and appropriateness of the audit evidence produced. We stayed in close contact with the Funds' finance team right up until the point of accounts signing, to ensure all relevant issues were satisfactorily addressed.

Area considered	Description	Conclusion
Group Considerations	COVID-19 has given rise to additional uncertainty in relation to the going concern of many companies. The group includes two limited companies, LPFE & LPFI who hold revenue contracts with parties outwith the group. A risk has been identified in the audit plans of the companies.	We have considered the going concern assumption for all group entities, taking a risk based approach. We have not identified any conditions or events which would indicate that the going concern assumption should not be applied.

Estimates and judgements

20. We are satisfied with the appropriateness of the accounting estimates and judgements used in the preparation of the financial statements.

21. As part of the planning and fieldwork stages of the audit we identified all accounting estimates made by management and determined which of those were key to the overall financial statements. Consideration was given to asset valuations, impairment, depreciation and amortisation rates, provisions for legal obligations, and accruals. We identified three accounting estimates listed below.

22. Our audit work consisted of reviewing these keys areas for any indication of bias and assessing whether the judgements used by management are reasonable. We have summarised our assessment of this below, categorised between Prudent, Balanced and Optimistic.

Estimates and judgements	
Present value of retirement obligations	Balanced

Management consider the present value of retirement obligations on an annual basis. The valuation is carried out by the actuarial firm Hymans Robertson. We considered key assumptions against other sources of evidence and did not identify any indication that the valuation was materially misstated as at 31 March 2021.

The assumptions of the actuary, Hyman Robertson, were within our expected range. The assumptions were predominantly in the middle our expected range with the exception of the discount rate which, while within our expected range, is considered to be on the prudent end of the scale.

Estimates and judgements	
Investment Asset valuation	Balanced
Monthly valuation exercises of the investment portfolio exercises are carried out to confirm that the valuation provided by the Custodian, Northern Trust, is appropriate and in line with management's expectation. As at 31 March 2021, the Funds' internal valuation exercise resulted in a valuation of £8.584 billion, a valuation £13.6 million (0.16%) lower than the Custodian's valuation which is included in the accounts. The difference relates to timing of when information was received and the availability of information on certain foreign holdings. The Funds confirm that the valuation included in the accounts is materially in line with the internal exercise and that the Custodian's valuation better reflects information known at 31 March 2021. We considered investment valuations against other sources of evidence and did not identify any indication that the valuation was materially misstated as at 31 March 2021.	
Investment Property Valuation	Balanced
Management consider the valuation of investment property on an annual basis. The valuation is carried out by the chartered valuation firm CBRE. We considered key assumptions against other sources of evidence and did not identify any indication that the valuation was materially misstated as at 31 March 2021.	

Materiality

23. Materiality is an expression of the relative significance of a matter in the context of the financial statements as a whole. A matter is material if its omission or misstatement would reasonably influence the decisions of an addressee of the auditor's report. The assessment of what is material is a matter of professional judgement and is affected by our assessment of the risk profile of the organisation and the needs of users. We review our assessment of materiality throughout the audit.

24. Whilst our audit procedures are designed to identify misstatements which are material to our audit opinion, we also report to the Funds and management any uncorrected misstatements of lower value errors to the extent that our audit identifies these.

25. We based our initial assessments of materiality levels on the information available at the time ie. prior years audited accounts. For The Funds' financial statements the initial materiality was set at £112 million. On receipt of 2020/21 unaudited annual accounts, we reassessed materiality and updated it to £128 million. We consider that our updated assessment has remained appropriate throughout our audit.

26. Our initial assessment of materiality for Scottish Home's financial statements was £2.5 million. On receipt of the unaudited 2020/21 annual accounts, we reassessed materiality and updated it to £2.3

million. We consider that our updated assessment has remained appropriate throughout our audit.

27. ISA (UK) 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 decisions of users of the accounts. As set out in our Annual Audit Plan, we consider transactions when dealing with members (i.e. contributions and expenditure incurred providing payments to pensioners) to be of key interest to the users.

28. Our initial assessment of materiality for dealing with members was £14 million. On receipt of the 2020/21 unaudited annual accounts, we reassessed materiality and updated it to £12.5 million. We consider that our updated assessment has remained appropriate throughout our audit.

29. Our initial assessment of materiality for dealing members for Scottish Homes financial statements was £0.36 million. On receipt of the 2020/21 unaudited annual accounts, we reassessed materiality and updated it to £0.37 million. We consider that our updated assessment has remained appropriate throughout our audit.

Materiality – Lothian Pension Fund

Overall materiality

£128,000,000

£128,000,000	100%	Accounts materially misstated where total errors exceed this value

Performance materiality

£96,000,000	75%	Work performed to capture individual errors at this level

Trivial threshold

£250,000	Audit Scotland threshold	All errors greater than this level are reported

Materiality – Lothian Pension Fund (Dealings with Members)

Overall materiality

£12,500,000

100%

Accounts materially misstated where total errors exceed this value

Performance materiality

£9,375,000

75%

Work performed to capture individual errors at this level

Trivial threshold

£250,000

Audit Scotland threshold

All errors greater than this level are reported

Materiality – Scottish Homes

Overall materiality

£2,300,000

100%

Accounts materially misstated where total errors exceed this value

Performance materiality

£1,725,000

75%

Work performed to capture individual errors at this level

Trivial threshold

£115,000

5%

All errors greater than this level are reported

Materiality – Scottish Homes (Dealings with Members)

Overall materiality

£370,000

100%

Accounts materially misstated where total errors exceed this value

Performance materiality

£278,000

75%

Work performed to capture individual errors at this level

Trivial threshold

£18,500

5%

All errors greater than this level are reported

Materiality	Our assessment is made with reference to Lothian Pension Fund and Scottish Home Pension Fund net investment assets. The Funds hold significant investment assets, which form the largest part of the net asset statements for each pension fund. The primary business of the Funds is to hold sufficient assets to generate returns to meet future pension obligations. Our assessment of materiality equates to approximately 1.5% of the Pension Funds net investment assets as disclosed in the 2020/21 unaudited annual accounts. Our assessment of materiality in relation to dealings with members equates to approximately 5% of the Pension Funds gross expenditure as disclosed in the 2020/21 unaudited annual accounts. The above approach and percentages are consistent with prior year's. In performing our audit we do apply a lower level of materiality to the audit of the Remuneration and Staff Report. Our materiality is set at £5,000.

Performance materiality	Performance materiality is the working level of materiality used throughout the audit. We use performance materiality to determine the nature, timing and extent of audit procedures carried out. We perform audit procedures on all transactions, or groups of transactions, and balances that exceed our performance materiality. This means that we perform a greater level of testing on the areas deemed to be at significant risk of material misstatement. Performance materiality is set at a value less than overall materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of the uncorrected and undetected misstatements exceed overall materiality.
Trivial misstatements	Clearly trivial are matters that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any quantitative or qualitative criteria.

Audit differences

30. We are pleased to report that there were no material adjustments to the financial statements or unadjusted audit differences.

31. We identified some disclosure and presentational adjustments during our audit which have been detailed in Appendix 2.

Internal controls

32. As part of our work we considered internal controls relevant to the preparation of the financial statements such that we were able to design appropriate audit procedures. Our audit is not designed to test all internal controls or identify all areas of control weakness. However, where, as part of our testing, we identify any control weaknesses, we report these to The Funds. These matters are limited to those which we have concluded are of sufficient importance to merit being reported.

Action plan and follow up of prior year recommendations

33. An action plan and our recommendations are included in Appendix 3. Action points to follow-up outstanding from prior years are presented in Appendix 4.

Area	Assessment	Comment
Control and process environment	**Satisfactory**	We consider the control environment within the entity to be satisfactory.
Quality of supporting schedules	**Satisfactory**	The supporting schedules received during the course of the fieldwork were sufficient for our audit purposes.
Responses to audit queries	**Satisfactory**	Management's responses to our audit queries were appropriate and received on a timely basis.

Other communications

Accounting policies, presentation and disclosures

34. Our work included a review of the adequacy of disclosures in the financial statements and consideration of the appropriateness of the accounting policies adopted by The Funds.

35. The accounting policies, which are disclosed in the annual accounts, are in line with the Code, and are considered appropriate.

36. There are no significant financial statements disclosures that we consider should be brought to your

attention. All the disclosures required by relevant legislation and applicable accounting standards have been made appropriately.

37. Overall, we found the disclosed accounting policies, and the overall disclosures and presentation to be appropriate.

Fraud and suspected fraud

38. We have previously discussed the risk of fraud with management. We have not been made aware of any incidents in the period nor have any incidents come to our attention as a result of our audit testing.

39. Our work as auditor is not intended to identify any instances of fraud of a non-material nature and should not be relied upon for this purpose.

Non-compliance with laws and regulations

40. As part of our standard audit testing, we have reviewed the laws and regulations impacting The Funds. There are no indications from this work of any significant incidences of non-compliance or material breaches of laws and regulations that would necessitate a provision or contingent liability.

Written representations

41. We will present the final letter of representation to the Pensions Committee to sign at the same time as the financial statements are approved.

Related parties

42. We are not aware of any related party transactions which have not been disclosed.

Confirmations from third parties

43. All requested third party confirmations in respect of legal confirmations have been received.

Financial sustainability

Financial sustainability looks forward to the medium and longer term to consider whether The Funds is planning effectively to continue to deliver its services and the way in which they should be delivered.

Financial sustainability

Auditor judgement	

LPF has effective arrangements in place to ensure ongoing sustainability.

The focus of the Funds' investment strategy is to ensure a sufficient return over the long term to meet the funding objectives outlined by the Funding Strategy Statement.

The Triennial Valuation was carried out as at 31 March 2020 and estimates both Funds are fully funded at 106% for LPF and 118% for Scottish Homes Pension Fund. This represents an improvement on the previous triennial valuation where the funding levels were 98% and 105% respectively.

LPF has delivered strong absolute performance in 2020/21 of 15.5% annual return on investments. However, performance against benchmark has declined for one-year, five-year and ten-year annualised investment returns driven by below benchmark returns on equities. We note that it is linked to the use of a 'defensive' strategy by the Fund. We recommend this should be formally included in the Funds' investing and funding strategy.

Financial sustainability

Financial sustainability looks forward to the medium and longer term to consider whether The Funds is planning effectively to continue to deliver its services or the way in which they should be delivered.

Significant audit risk

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

Financial sustainability
The Funds held investments of £7.443 billion as at 31 March 2020. 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 updated and approved by the Pensions Committee in December 2019. The primary objective of the Funds is to ensure that there are sufficient funds available to meet all pension and lump sum liabilities as they fall due for payment. The funding objectives for each Fund are documented in the Committee's Funding Strategy Statement, which is reviewed at least triennially. The funding objectives, together with the rates of return being targeted and levels of risk to be tolerated, are central to each Fund's investment strategy and govern the allocation across various asset classes. The investment objectives of the Funds are to achieve a return on Fund assets which is sufficient over the long term to meet the funding objectives as outlined in the Funding Strategy Statement. Investment returns are generated by a combination of income (from dividends, interest and rents) and gains or losses on capital. 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 COVID-19 and other worldwide political events had a significant impact on the market in 2019 and 2020, with this volatility expected to continue in 2021. There is a risk that the value of investments is significantly impacted by events within the wider environment.

Noted in the 2020/21 External Audit Plan

45. Our detailed findings on the LPF's financial framework for achieving long term financial sustainability are set out below.

Funding Strategy

46. The Funds' objectives, as set out in the Funding Strategy Statement, are to generate sufficient long term returns to pay promised pensions. This must be balanced with making the scheme affordable to employers now and in the future.

47. Liabilities will be met by asset returns, resulting from the Investment Strategy, and contributions, resulting from the Funding Strategy. A core funding objective is to maximise asset returns, within reasonable and considered risk parameters, in order to minimise the cost to employers.

48. Funding levels can be volatile, due to intrinsic uncertainties over asset returns particularly when considered only in the short term. Minimising short term changes in contribution rates is an objective of the Funds'. Funding and investment strategies must be set with appropriate tolerances to adapt to market volatility.

Market Volatility

49. The effects of COVID-19 and other worldwide political events caused significant market volatility over the last two years. Strong growth in returns have been seen in 2020/21, with UK equities reaching 12 month returns to 31 March of 26.7% (2020: -18.5%). While growth is projected to continue into 2021, significant risks remain particularly in relation to the tapering off of government support and uncertain impact of the new COVID variants.

50. Lothian Pension Fund has described their investment position as 'defensive'. The approach is generally expected to deliver outperformance when equity market returns are poor. In rising equity markets, such as has been seen in 2020/21, good, but lower than benchmark returns are expected.

51. Lothian Pension Fund noted the opportunity to invest in equities after the decline in value in March 2020. The Fund rebalanced the portfolio in March 2021 to re-invest the strong equity returns generated into other portfolios. The Fund's allocation of asset held in equities has increased to 60% (2020: 58.3%).

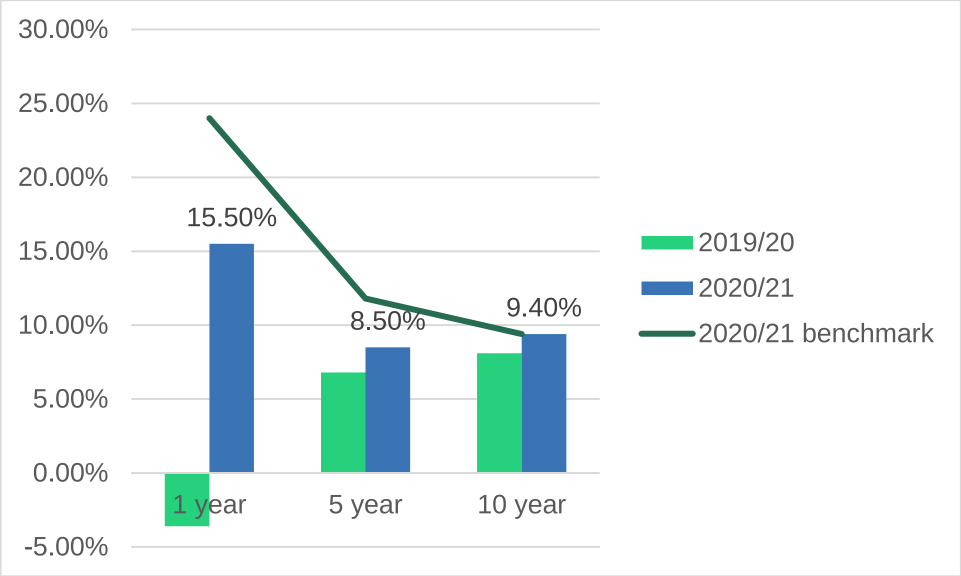
52. While Scottish Homes Pension Fund holds mainly UK Gilts in line with the Fund's funding strategy, both Fund's hold significant cash reserves. For Scottish Homes Pension Fund, this was equivalent to two years' pension payments. This provides an important buffer against short term market volatility affecting meeting pension liabilities as they fall due.

Investment Performance

53. Lothian Pension Fund aims to achieve a return in line with its strategic benchmark allocation, over the long term, with a lower-than-benchmark level of risk.

54. Annual performance was strong to March 2021 with overall annual returns of 15.5% (2020: -3.6%). However, performance was below the benchmark of 24% due to the defensive positioning and investment in lower risk equities. Lothian Pension Fund's performance against benchmark and prior year is given at Exhibit 2.

Exhibit 2: Performance of Lothian Pension Fund against benchmark and prior year



Source: Unaudited Lothian Pension Fund Annual Report and Accounts

55. The Fund's equity strategy has had a significant impact on the five-year returns which, at 8.5%, is 3.3 percentage points below the benchmark. Comparison of Lothian Pension Fund's performance against other Scottish LGPS Schemes is given in Exhibit 3.

56. Lothian Pension Fund is reporting the second lowest five-year annualised return (2020: second highest). The Fund also was the only Fund to report an annual return lower than benchmark for the year to 31 March 2021. See Exhibit 4 for Lothian Pension Fund's annual performance against other Scottish LGPS Schemes.

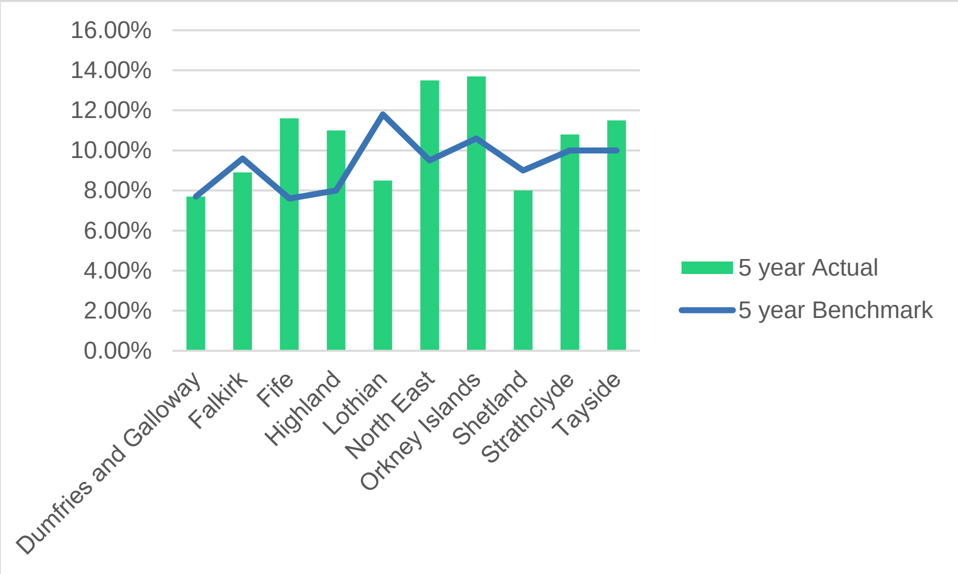
57. Lothian Pension Fund notes that it is absolute returns which allow the Fund to meet pension liabilities as they fall due. However, maximising asset returns within the risk tolerances reduces the cost to the members in the long term. Should equity markets continue to perform well, Lothian Pension Fund may continue to underperform against benchmark due to the defensive positioning. While we understand this position has been discussed and scrutinised by the Pension Committee, it has not been clearly documented in investment or funding strategies.

Action Point 1

Scottish Homes Pension Fund

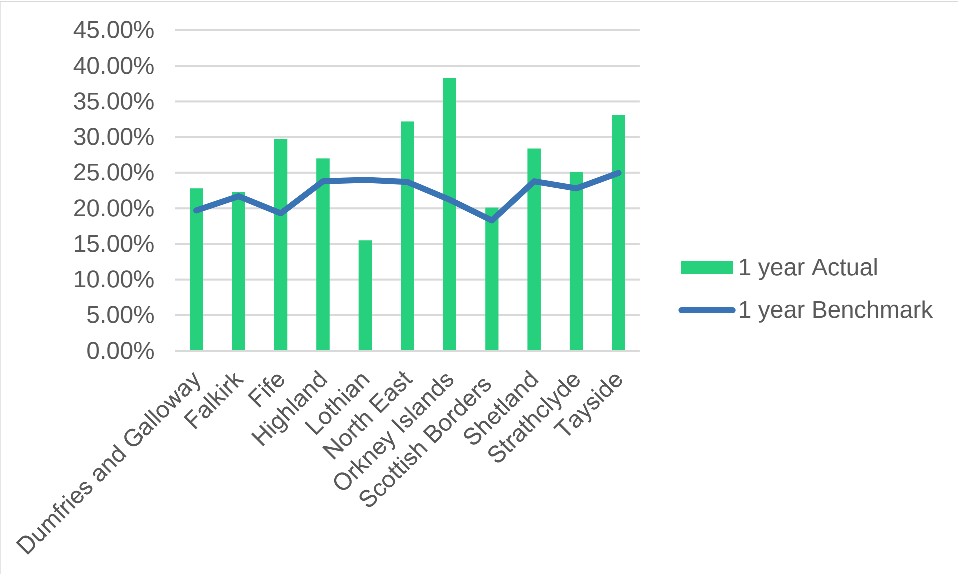
58. Scottish Homes Pension Fund is fully funded and closed to new members. No benchmarks are set for the Fund as investments are mandated by the Scottish Government to be held in gilts. The Fund seeks to match cash flows from gilt income to expected liabilities from pension payments. In 2020/21, gilt redemptions of £7.2 million helped fund £6.6 million in pension payments.

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



Source: Unaudited Annual Report and Accounts[1]

Exhibit 4: Annual return across LGPS Scotland Funds against benchmark



Source: Unaudited Annual Report and Accounts

[1] Scottish Borders do not publish their five-year annualised returns

Triennial Valuation

59. The triennial valuation was carried out as at 31 March 2020. The valuation considers the funding level, the ratio of a pension scheme's assets to liabilities. The contribution rates are also set for the three years to 31 March 2024.

60. For Lothian Pension Fund, the funding level significantly increased to 106% (target: 100%) from the 98% reported at the 31 March 2017 valuation. Scottish Homes Pension Funds increased to 118% from 105% recorded in 2017.

61. Key changes from the Actuarial Valuation for Lothian Pension Fund include:

- higher than expected leavers from the scheme prior to retirement has reduced the liability;
- changes to longevity assumptions has reduced the liability;
- a decrease in the assumed rate of future CPI inflation has reduced the liability; and
- a decrease in assumed rate of future investment returns has increased the liability.

62. The investment return on assets between March 2017 and March 2020 was 7.1% which increased the Fund's assets in that period by £442 million. Additionally, net cashflows into the Fund, including the transfer in of Lothian Buses Pension Fund, have also increased the Fund's assets by £429 million.

63. The Actuarial Report notes that the funding level's use as a statistic to indicate the health of a fund is limited as it based on a single set of assumptions. A post valuation event is included in the Actuarial Valuation which notes that the funding level as at October 2020 is likely higher than reported as at March 2020 due to improvements in investment returns. Per the Actuarial Valuation, this is not of material concern due to the long-term approach taken when setting contribution rates.

Employer Contribution Rates

64. Contribution rates have been generally increasing leading to affordability issues.

65. In recognition of this, the Fund has developed a Contribution Stability Mechanism which offers some employers stabilised employer contribution rates. The largest member bodies of the Fund are covered by this policy. Contribution rates for these employers will remain frozen for four years then move by no more than 0.5% of their payroll. The Actuarial Valuation 2020 has set contribution levels for the next three years in consideration of this policy.

66. Contribution rates are based on market conditions and expectations as at 30 June 2020. This decision was made to prevent undue influence on the rates by the extreme short-term market conditions in force at 31 March 2020.

67. Under the Funding Strategy Statement, member bodies are required to confirm their commitment to meet minimum contributions. The Fund is comfortable that it does not have to issue a notification of termination to any employer. Further cessations are expected to follow on a voluntary basis.

Membership

68. Lothian Pension Fund is a multi-employer fund with 14 scheduled bodies, including 4 Councils, and 58 admitted bodies. The scheme has a significant membership profile with active members being the majority. This is shown in Exhibit 5.

69. This differs from Scottish Homes Pension Fund which is a single employer scheme and has a majority of inactive members (deferred, pensioners and dependents).

70. 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. This is shown in Exhibit 6.

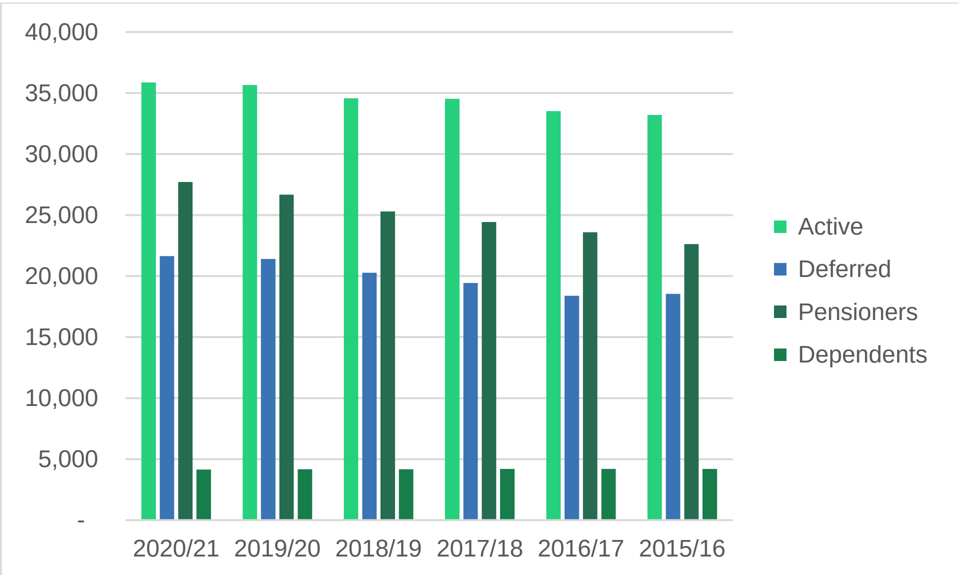
71. The fund relies on active members to meet the payments to pensioners and there is a risk that if growth in pensioners, increases at a faster rate than active members additional affordability pressures will be faced by Lothian Pension Fund.

72. The change in composition is however slow and does not pose a significant Financial Sustainability risk to LPF at present. As noted in paragraph 60, the Fund is over 100% funded per the 2020 Actuarial Valuation.

73. In 2020/21, three employers left the scheme. The level of cessation contributions has increased by 645% since 2016/17, with the long-term debtors relating to ceased employers rising by 2,409%. This is shown at Exhibit 7.

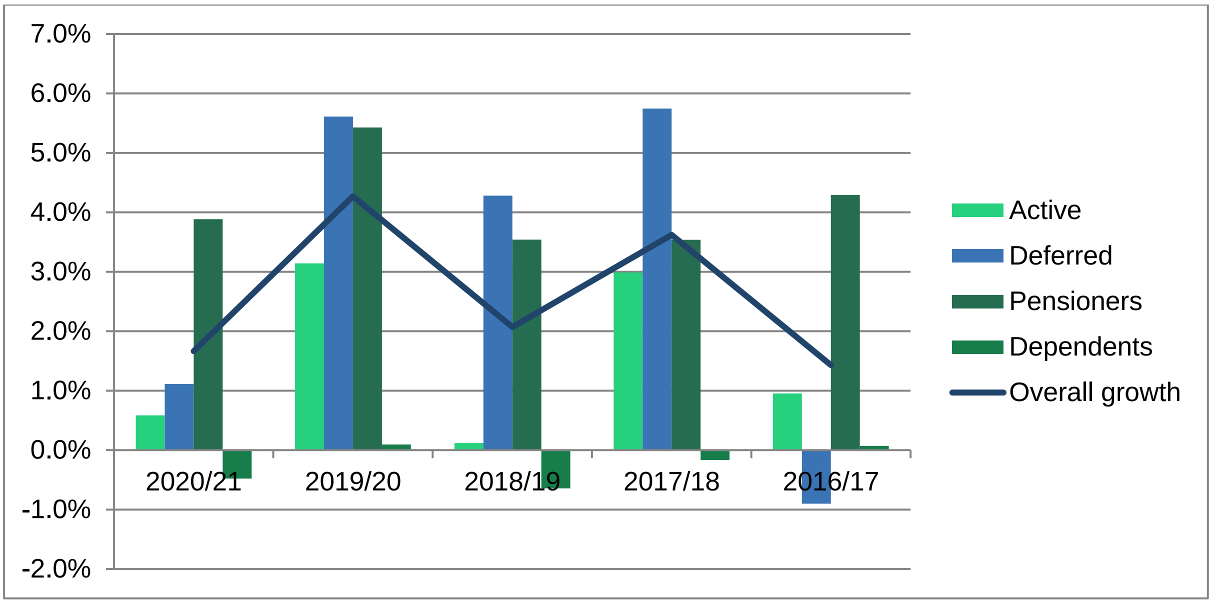
74. LPF continues to implement new initiatives around affordability, including confirmation from employers over contributions as noted in paragraph 67. Employer covenants are in place to ensure recoverability and no significant Financial Sustainability risk is noted at present.

Exhibit 5: Members of Lothian Pension Fund across categories



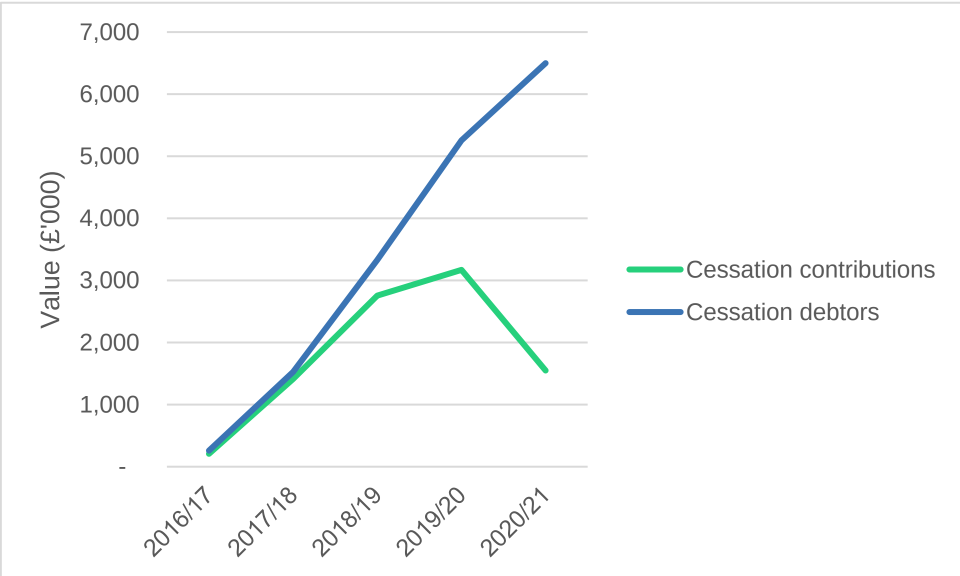
Source: Lothian Pension Fund Annual Report and Accounts

Exhibit 6: % annual growth in members of Lothian Pension Fund across categories



Source: Lothian Pension Fund Annual Report and Accounts

Exhibit 7: Value of Cessation Contributions and Debtors at 31 March 2021



Source: Lothian Pension Fund Annual Report and Accounts

Financial management

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

Financial management

Auditor judgement	

Lothian Pension Fund has effective arrangements for financial management and the use of resources.

The Funds reported a net increase in the funds held. Lothian Pension Fund reported a net addition position in dealings with members of £58.03 million. Scottish Homes reported a net withdrawal position of £7.347 million.

Annual operating plan updates are provided to each Pension Committee meeting clearly explaining changes in group performance. Improvements to reporting could be made by further considering wider stakeholders and expanding reporting to provide relevant comparatives when reporting on each Fund.

Financial Performance

75. The Funds have developed an annual Operating Plan which sets out the strategic aims of the Funds. A two-year budget to 2022/23 supports the delivery of the Plan which considers the Group as a whole.

76. Operating Plan updates are provided to each Pensions Committee meeting. The updates note progress of the Funds against the budget along with performance indicators and cashflow monitoring.

77. While the budget splits out the group into constituent components, budget reporting considers the Group as a whole. Due to the structure of the group, movements in year can affect performance of all group entities. The changes in financial performance for the group are supported by clear explanations.

78. Performance of the individual Funds can be scrutinised by the cashflow monitoring update provided in each Operating Plan update. This details the Funds' dealing with members for the year to date and the projected year end position on a cash basis.

79. While the information is presented such that it can be compared with the annual accounts, no information is provided on how performance to date compares with expectation, or prior year. Additionally, information is not provided on liquidity of the fund and ability to meet upcoming liabilities as they fall due.

Action Point 2

Financial Position

80. Lothian Pension Fund reported a net addition position in dealings with members. This reflects a significant departure from forecast. This favourable movement resulted from a one-off transfer in of £58 million for the consolidation of VisitScotland's pension scheme into Lothian Pension Fund.

81. In line with forecast, Scottish Homes Pension Fund reported a net withdrawal position dealings with members. This is shown in Exhibit 8.

82. The increase in the market value of investments meant both Funds have reported an overall net increase in the Fund. Consequently, an increase in net assets position was reported. The movement in the net asset position is shown in Exhibit 9.

Systems of Internal Control

83. 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.

84. No significant issues were identified from our audit work. We consider the system of control in place at the Funds' to be satisfactory.

Exhibit 8 – Forecast versus Actual Net Withdrawals from the Funds

	2020/21 Forecast (£'000)	2020/21 Actual (£'000)	Difference (%)
Lothian Pension Fund	-10,900	58,030	-119%
Scottish Pension Fund	-7,570	-7,347	3%

Source: Lothian Pension Funds Annual Report and Accounts

Exhibit 9 – The Funds' Financial Position

	Net Assets			Present Value of Retirement benefits		
	2020/21 (£'million)	2019/20 (£'million)	Movement (%)	2020/21 (£'million)	2019/20 (£'million)	Movement (%)
Lothian Pension Fund	8,698	7,480	16%	10,374	8,774	18%
Scottish Pension Fund	166	166	0%	125	122	2%

Source: Lothian Pension Funds Annual Report and Accounts

Prevention and detection of fraud and irregularity

85. Our audit was planned to provide a reasonable expectation of detecting material misstatements in the financial statements resulting from fraud and irregularity.

86. Lothian Pension Fund was not required to participate in the National Fraud Initiative in 2020/21 but has done so voluntarily. The Fund has completed work to provide data to the scheme.

87. Lack of notification of the deaths of members is a significant fraud risk area for the Funds. NFI provides one opportunity for the Funds to identify fraudulently paid out pensions. However, the Funds operate other controls to support the identification of pension fraud. Participation in the UK Government's 'Tell Us Once' service allows the Funds to access up-to-date information provided by the next of kin to the registrar.

88. Work is ongoing to investigate and action the results provided by the NFI scheme. No significant frauds have been identified to date.

89. Since the start of the pandemic, there has been the potential for the risk of fraud and error to increase as the control environment and internal controls have changed.

90. We found LPF's arrangements for the prevention and detection of fraud and other irregularities to be adequate. We reviewed Audit Scotland's report on COVID-19 Emerging Fraud Risks and satisfied ourselves that where there have been changes in the control environment, appropriate mitigating controls have been implemented.

Standards of Conduct

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

92. 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

93. 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.

94. Internal Audit presented a limited, amber opinion to the Pension Committee for the year to 31 March 2021. A limited opinion was given as Internal Audit do not consider LPF's subsidiaries and hence do not cover all systems. The opinion has improved from 2019/20.

95. LPF has considered the assurances provided by Internal Audit as part of the Annual Governance Statement. The opinion is considered within the context of the wider assurance framework including assurances provided by the Section 95 Officer for the LPF Group, John Burns, and the Head of Finance at the City of Edinburgh Council, Hugh Dunn.

96. In 2020/21 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

Governance and transparency

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

Governance and Transparency

Auditor judgement

Governance arrangements at the Funds are 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.

The former Chief Executive of Lothian Pension Fund, left in July 2021 and a new Chief Executive has been appointed. Suitable handover arrangements are in place to ensure that appropriate assurance can be provided over the internal control framework at Lothian Pension Fund.

Governance Structure

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

98. The Pensions Committee's responsibilities, as set out in the City of Edinburgh Council's Scheme of Delegation, include the administration and management of the Funds including set the investment strategy.

99. In line with the requirements of the Public Service Pension Act 2013 the Pensions Committee is supported by a Pensions Board.

100. 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.

101. The Funds complied with best practice and appointed an independent professional observer to the Board and Committee.

102. 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 2020/21.

Appointment of the Chief Executive

103. In February 2021, Lothian Pension Fund Chief Executive Doug Heron announced his departure from the Funds. David Vallery has been appointed to assume the role, effective from 21st June 2021. A period of overlap has been arranged to ensure that suitable oversight is in place for the full period of the transition.

104. Suitable arrangements are in place to provide the new Chief Executive assurance over the operation of internal controls up to the date of signing the accounts. A regulated handover will be provided to the incoming Chief Executive signed by the outgoing Chief Executive.

Training and development

105. Due to the specialised nature of the Funds, it is vital that members have the appropriate knowledge and understanding to provide appropriate challenge and operate effectively. Training is therefore seen as a fundamental requirement for all Committee and Board members.

106. Our review found that all current Pension Committee and Board members met the requirement to have a minimum of 21 hours training.

Joint Investment Strategy Panel

107. 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 Investment Officer, LPFI Ltd;
- a second senior investment officer of LPFI Ltd; and

- two external independent investment advisers.

108. The Joint Investment Strategy Panel covers joint working arrangement with Falkirk Pension Fund and Fife Pension Fund.

109. 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.

110. The primary focus of the panel during 2020/21 has been the implementation of existing strategies for Lothian Pension Fund and Scottish Homes Pension Fund, as well as the implementation of the strategies of the collaborative partner funds.

111. Special areas considered by the panel in 2020/21 include:

- consideration of the 2020 Actuarial Valuation;

- review of the Funding Strategy Statement and Investment Strategy; and

- development of the Statement of Investment Principals.

112. Lothian Pension Fund continues to operate four investment strategies recognising the different membership profiles and requirements of the admitted and scheduled employers.

113. 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.

Impact of COVID-19

114. As a result of the COVID-19 pandemic, meetings of the Pensions Committee and the pensions audit sub-committee have been held remotely.

115. The Pensions Committee and audit sub-committee are required to meet four times a year. In 2020/21, the Pension Committee met five times. However, the audit sub-committee met only three times.

116. We consider that business has been covered appropriately and in a timely manner.

Value for money

Value for money is concerned with using resources effectively and continually improving services. In this section we report on our audit work as it relates to the Council's reporting of its performance.

Value for Money

Auditor judgement	

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 the performance of investments and the administration of the Funds.

Performance remains strong with nine out of the ten performance measures met. However, investment performance over the rolling five-year period is noted as being below benchmark.

Investment Manager Operations

117. Lothian Pension Fund operates two special purpose vehicles: LPFE Ltd and LPFI Ltd. Both companies are wholly owned and controlled by the Council.

118. 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.

119. In 2020/21, the proportion of funds managed internally remained 92% in line with 2019/20 when the transfer of the property portfolio management to an in-house team was undertaken. External investment managers are primarily used in the management of overseas equities and corporate bonds.

Management Expenses

120. Lothian Pension Fund reported management expenses of £41.358 million in 2020/21, an increase of 18% on prior year. The increase primarily relates to performance-related fees for pooled investments.

121. Management expenses are split into three main categories: administrative costs; investment manager expenses and oversight and governance costs. Investment management expenses account for 87% of total management expenses.

122. In year Lothian Pension Fund's investment manager expenses (excluding indirect expenses) increased marginally as a proportion of net assets. This is broadly in line with trends across the Local Government Pension Funds as shown in Exhibit 9.

123. Investment manager expenses can vary due to a number of factors including actual returns on investments and the nature of the investment assets held.

124. The Funds include detailed analysis over investment expenses in the 2020/21 Annual Report. Disclosures on investment management expenses exceed the requirements of CIPFA guidance on cost transparency as LPF consider that the CIPFA methodology would result in under-reporting indirect management expenses.

125. The Funds undertake annual benchmarking exercises using externally provided data, covering 37 LGPS funds and a wider global universe of 325 funds. Analysis of investment costs is carried out by an independent provider, CEM Benchmarking Inc.

126. The benchmarking exercise reported in March 2021 covers investment performance in 2019/20. For this year, Lothian Pension Fund reported an actual investment cost of 0.36% of net assets which was below the benchmark of 0.51%.

127. The Funds credit the strong performance against benchmark to two factors. The first is the high percentage of assets managed internally which allows the Funds to control costs effectively. Additionally, the Funds have accessed private market investments at a lower fee than the benchmark group.

128. In relation to pension administration benchmarking exercises undertaken by CEM, the Funds were categorised as 'low cost; high service standard'. The Funds' cost per member was £24.90 compared with a benchmark of £35.28. This was supported an improved service score of 71 out of 100 driven by the Funds' noted speed at paying lump sums and strong social media presence.

Monitoring investment performance

129. 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 Pensions Committee and Board Members are engaged in monitoring the performance of investments.

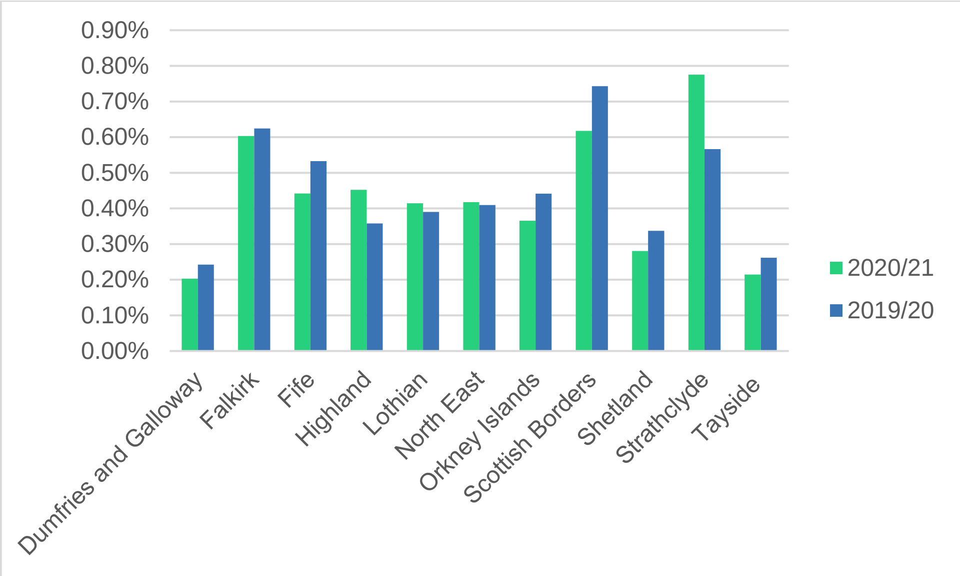
130. In addition to monitoring at a Committee level the Funds' performance is calculated by an external provider on a monthly basis. The external provider compiles information covering monthly, quarterly, yearly, 3, 5, 10 since inception yearly performance measures. This information is presented to the Joint Investment Strategy Panel to allow for scrutiny of the investment performance of the Funds.

Administration Performance

131. The Funds have developed an annual Operating Plan which sets out the strategic aims of the Funds. The aims are supported by performance indicators which are reported on to each Pension Committee meeting as part of the Operating Plan Update.

132. The annual results for 2020/21 are presented in the Funds' Management Commentary. Performance remains strong with nine out of the ten performance measures met. Investment performance and risk over a rolling five year period is noted as being below benchmark. This has been further discussed under Financial Sustainability section.

Exhibit 9 – Management expenses as a proportion of net assets



Source: Unaudited Annual Report and Accounts

Appendices

Appendix 1: Respective responsibilities of the Funds and the Auditor

The Code of Audit Practice (2016) sets out the responsibilities of both the Funds and the auditor and are detailed below.

The Funds' responsibilities

The Funds have primary responsibility for ensuring the proper financial stewardship of public funds, complying with relevant legislation and establishing effective arrangements for governance, propriety and regularity that enable them to successfully deliver their objectives.

Area	The Funds' responsibilities
Corporate governance	The Pensions Committee and Chief Financial Officer (as accountable officer) is responsible for establishing arrangements to ensure the proper conduct of its affairs including the legality of activities and transactions, and for monitoring the adequacy and effectiveness of these arrangements. Those charged with governance should be involved in monitoring these arrangements.
Financial statements.	The Pensions Committee and the Chief Financial Officer have responsibility for: • preparing financial statements which give a true and fair view of its financial position and their expenditure and income, in accordance with the applicable financial reporting framework and relevant legislation; • maintaining accounting records and working papers that have been prepared to an acceptable professional standard and that support its financial statements and related reports disclosures; • ensuring the regularity of transactions, by putting in place systems of internal control to ensure that they are in accordance with the appropriate authority; • maintaining proper accounting records; and • preparing and publishing, along with the financial statements, an annual governance statement, management commentary (or equivalent) and a remuneration report that is consistent with the disclosures made in the financial statements. Management commentary should be fair, balanced and understandable and also address the longer term financial sustainability of the Funds.

Area	The Funds' responsibilities
	Management is responsible, with the oversight of those charged with governance, for communicating relevant information to users about the entity and its financial performance, including providing adequate disclosures in accordance with the applicable financial reporting framework. The relevant information should be communicated clearly and concisely. The Pensions Committee and the Chief Financial Officer are responsible for developing and implementing effective systems of internal control as well as financial, operational and compliance controls. These systems should support the achievement of its objectives and safeguard and secure value for money from the public funds at its disposal. They are also responsible for establishing effective and appropriate internal audit and risk-management functions.
Standards of conduct for prevention and detection of fraud and error	The Funds are responsible for establishing arrangements to prevent and detect fraud, error and irregularities, bribery and corruption and also to ensure that its affairs are managed in accordance with proper standards of conduct.
Financial position	The Pensions Committee and Chief Financial Officer are responsible for putting in place proper arrangements to ensure the financial position is soundly based having regard to: • Such financial monitoring and reporting arrangements as may be specified; • Compliance with statutory financial requirements and achievement of financial targets; • Balances and reserves, including strategies about levels and their future use; • Plans to deal with uncertainty in the medium and long term; and • The impact of planned future policies and foreseeable developments on the financial position.
Best value	Accountable officers have a specific responsibility to ensure that arrangements have been made to secure best value.

Auditor responsibilities

Auditor responsibilities are derived from statute, the Code of Audit Practice, International Standards on Auditing (UK), professional requirements and best practice. These are to:

- undertake statutory duties, and comply with professional engagement and ethical standards;
- provide an opinion on the financial statements and the regularity of transactions;
- review and report on, as appropriate, other information such as annual governance statements, management commentaries and remuneration reports;
- notify the Auditor General when circumstances indicate that a statutory report may be required; and
- demonstrate compliance with the wider scope of public audit.

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

In accordance with our profession's ethical guidance and further to our External Audit Annual Plan issued confirming audit arrangements there are no further matters to bring to your attention in relation to our integrity, objectivity and independence.

We confirm that Azets Audit Services and the engagement team complied with the FRC's Ethical Standard. We confirm that all threats to our independence have been properly addressed through appropriate safeguards and that we are independent and able to express an objective opinion on the financial statements.

Audit and non-audit services

The total fees (VAT inclusive) charged to LPF for the provision of services in 2020/21 (with prior year comparators) are as follows:

	Current year £	Prior year £
Audit of Lothian Pension Fund (Auditor remuneration)	41,388	40,458
Pooled costs	3,690	3,680
Audit support costs	2,310	2,280
Total audit	**47,388**	**46,418**
Non-audit services	25,622	6,156
Total fees	**73,010**	**52,574**

FRC's Ethical Standard stipulates that where an auditor undertakes non audit work, appropriate safeguards must be applied to reduce or eliminate any threats to independence. We have outlined the safeguards to our independence in our Annual Audit Plan. We confirm that we complied with the Financial Reporting Council's (FRC) Ethical Standard. In our professional judgement, we remained independent and our objectivity has not been compromised in any way.

Audit quality

The Auditor General and the Accounts Commission require assurance on the quality of public audit in Scotland through comprehensive audit quality arrangements that apply to all audit work and providers. The audit quality arrangements recognise the importance of audit quality to the Auditor General and the Accounts Commission and provide regular reporting on audit quality and performance.

Audit Scotland maintains and delivers an Audit Quality Framework.

The most recent audit quality report which covers our work at LPF since appointment can be found at https://www.audit-scotland.gov.uk/report/quality-of-public-audit-in-scotland-annual-report-202021

Appendix 2: Adjusted and unadjusted errors identified during the audit

Corrected and uncorrected misstatements

We did not identify any corrected or uncorrected misstatements during our audit of the Funds' annual report and accounts.

Disclosure amendments

No	Detail
1	Remuneration Report – update to the disclosure of the prior year comparison of a member of the Remuneration Report.

Appendix 3: Action Plan

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

The recommendations are categorised into three risk ratings:

Key:

Significant deficiency

Other deficiency

Other observation

Investment Performance		
Issue	Lothian Pension Fund has not met its investment objective to deliver benchmark returns at below benchmark risk. The Fund attributes this to the defensive positioning of the Fund which delivers good but below benchmark returns in strong equities markets. The positioning of the Fund is a significant driver of performance which has been discussed by the Pension Committee. However, the positioning is not documented in the Funding Strategy Statement or Statement of Investment Principles.	
Risk	Implications of the defensive positioning on investment objectives may not be communicated to wider stakeholders such as member bodies due to the lack of inclusion in investment strategies.	
Recommendation	The Investment Strategy should document the Fund's approach to the overall positioning of the Fund and the implications on achieving investment objectives.	
Rating	**Other deficiency**	**Implementation date: June 2022 (which is the date of the annual update).**

Investment Performance	
Management comments:	Principle 13 of the Statement of Investment Principles (SIP) highlights that "The Funds are long term in nature and the success of a given investment strategy is likely to ebb and flow with changing investment environments in an unpredictable way. Investment monitoring is challenging and should be viewed through a long-term lens." Following a period of strong performance relative to the benchmark, the Lothian Pension Fund's returns have fallen below benchmark, but these have been generated with lower than benchmark risk. The Pensions Committee receives a detailed report annually on investment performance and positioning as well as training sessions to describe positioning of the fund. The annual reporting in June highlighted that the benchmark, which is heavily weighted to the US equity market, has appreciated at a significantly above trend growth rate, exactly the environment when the fund is likely to lag the benchmark, yet still generate strongly positive, absolute returns. To address the risk highlighted by Azets, we propose to make an amendment to the SIP highlighting the expected outcomes of positioning within policy groups. This seems appropriate as the document is updated and approved by the Committee at least annually, so communication of fund positioning will be refreshed at least annually.
Responsible Officer:	Bruce Miller, Chief Investment Officer

Fund Performance Reporting	
Issue	The Funds report regularly on progress against the Group budget to the Pension Committee. The information is aggregated at a group level and focused on the management of the Group as a whole. Performance of the Lothian Pension Fund and Scottish Pension Fund's cash flows when dealing with members is provided separately alongside a forecast year end position. Comparatives such as prior year performance are not provided for cash flow monitoring. While information was provided on significant movements such as the Visit Scotland transfer, the forecast position in March 2021 was materially different to that reported in the Annual Accounts due to the timing of the transfer. Provision of further

Fund Performance Reporting		
	comparatives against which to measure performance and explanation of movement against these would help communicate performance to a wider group of stakeholders.	
Risk	Lack of appropriate comparatives included in reporting the Funds dealing with members hampers communication of performance to the wider stakeholders such as member bodies and pensioners.	
Recommendation	The Funds should consider the inclusion of further comparatives and explanation of movement against forecast in reporting on dealings with members.	
Rating	**Other deficiency**	**Implementation date: Completed**
Management comments:	The Fund provides quarterly updates to the Pension Committee on its year to date and forecasted financial year cashflow movements from dealing with members, as well as commenting on the expected long-term trends. To meet the concerns raised by Azets the Fund will include prior year comparative figure for cashflows as well as a brief narrative on any material movements between the prior and current year for future committee updates.	
Responsible Officer:	Jason Koumides, Senior Finance Manager	

Appendix 4: Follow up of prior year recommendations

We have followed up on progress in implementing the outstanding action raised in the prior years. This action remains in progress.

The recommendations are categorised into three risk ratings:

Key:

Significant deficiency

Other deficiency

Other observation

Bank Accounts – action raised in 2017/18	
Recommendation	The Local Government Pension Scheme (Management and Investment of Funds) (Scotland) Regulations 2010 require that after 1st April 2011 all pension fund monies are held in a separate bank account to the administering body and that all future monies received are directly to a pension fund bank account. There are a limited number of occasions where LPF needs to issue sales invoices to recover charges made to employers and members. The amounts involved are insignificant in comparison to the value of pension contributions. As the CEC finance system, as currently configured, does not allow LPF to raise sales invoices in its own name, the invoices go out under the name of CEC and payments are collected in a CEC bank account. However, the amounts involved are clearly identified and are held for the benefit of LPF. As regards purchase ledger payments, the CEC finance system, as currently configured, does not allow LPF to pay suppliers directly from an LPF bank account. However, the amounts involved are clearly identified and netted off against the sales ledger receipts mentioned above. Purchase ledger payments exceed sales ledger receipts by a considerable margin and LPF makes regular monthly payments to CEC. In LPF's opinion, the Regulations do not require payments to LPF suppliers to be made directly from an LPF bank account. As is typical within the Local Government Pension Schemes (LGPS), arrangements exist whereby unfunded benefits are paid to teachers and other people on behalf of employers as part of the LPF pension payroll. Based on LPF's current understanding, there is a danger

Bank Accounts – action raised in 2017/18			
	that if the unfunded benefits were paid directly from an LPF bank account, HMRC could regard such payments as unauthorised. For that reason, all benefit payments are made from a CEC bank account with LPF paying the value of the funded benefits into that bank account and CEC covering the value of the unfunded benefits (the cost being recovered by CEC via sales invoices to employers). In LPF's opinion, the Regulations do not require payments to LPF pensioners to be made directly from an LPF bank account. We recommend the Funds put arrangements in place to ensure compliance with the regulations.		
Rating	**Other deficiency**	**Implementation date**	Initial target date: As soon as possible
Ongoing	Unfunded benefit payments: • LPF has requested that SPPA should assume responsibility for the calculation and payment of unfunded benefits for both the LGPS and Teachers' Scheme. This request remains under consideration by SPPA and a definitive response is awaited. • LPF has sought external seeking legal advice as to the basis of HMRC regarding such unfunded pension payments as unauthorised (should payment be made directly from the Fund bank account). As regards, LPF sales ledger receipts and purchase ledger payments, an option appraisal for a new financial ledger system has been initiated. The specification for such would achieve purchase and sales ledger separation from City of Edinburgh Council. Quotation for discrete "book of account" utilising the scheduled upgrade to the Council's Oracle system has been received and this will be externally market tested to determine the best value option.		

User access controls– action raised in 2017/18			
Recommendation	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.		
Rating	**Other deficiency**	**Implementation date**	Initial target date: March 2019
Ongoing	This is an ongoing issue in 2020/21; however, we did not identify any instances where journals were posted by inappropriate users.		