Lothian Pension Fund

2022/23 Annual Audit Report to the Members of the Pensions Committee and the Controller of Audit

September 2023

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Key messages

This report concludes our audit of Lothian Pension Fund (LPF) and Scottish Homes Pension Fund ("the Funds") for the year ended 31 March 2023. This section summarises the key findings and conclusions from our audit.

Financial statements audit

Audit opinion	The annual accounts were considered and approved by the Pensions Committee on 27 September 2023. Our independent auditor's report is unqualified.
Key audit findings	The Funds had appropriate administrative processes in place to prepare the annual accounts and the supporting working papers. We have obtained adequate evidence in relation to the key audit risks identified in our audit plan. The accounting policies used to prepare the financial statements are considered appropriate. We are satisfied with the appropriateness of the accounting estimates and judgements used in the preparation of the financial statements. All material disclosures required by relevant legislation and applicable accounting standards have been made appropriately.
Audit adjustments	We have not identified any adjustments during the audit. We identified some disclosure and presentational adjustments during our audit, all of which have been reflected in the final set of financial statements.
Accounting systems and internal controls	We have applied a risk-based methodology to the 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 include these in this report. We consider the control environment within the Funds to be satisfactory, although there is scope for improvement.

Wider scope audit

Financial Management Financial management is concerned with financial capacity, sound budgetary processes and whether the control environment and internal controls are operating effectively.	**Auditor judgement** Effective and appropriate arrangements are in place Lothian Pension Fund has effective arrangements for financial management and the use of resources. The Funds reported a small net increase in the funds held. Lothian Pension Fund reported a net withdrawal position in dealings with members of £18.190 million. Scottish Homes reported a net withdrawal position of £7.013 million. Annual operating plan updates are provided to each Pensions Committee meeting clearly explaining changes in group performance.
Financial Sustainability Financial sustainability looks forward to the medium and longer term to consider whether the Funds are planning effectively to continue to deliver its services and the way in which they should be delivered.	**Auditor judgement** Risks exist to the achievement of operational objectives LPF has adequate arrangements in place to ensure ongoing financial 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. LPF has delivered low absolute performance in 2022/23 of 0.3% annual return on investments, which is higher than the benchmark returns of -14.6% while maintaining lower risk. The five-year and ten-year annualised investment returns for the first time in years outperformed the benchmark, due to consistent returns on equities and real assets relative to the benchmark. We would encourage Lothian Pension Fund to consider the medium and longer term implications of the expected triennial valuation results.

	Auditor judgement No major weaknesses in arrangements but scope for improvement exists
Vision, Leadership and Governance Vision, Leadership and Governance is concerned with the effectiveness of scrutiny and governance arrangements, leadership and decision making, and transparent reporting of financial and performance information.	Project Forth, a proposed merger between Lothian and Falkirk Pension Funds was approved by Lothian Pension Fund's Pensions Committee in September 2021, subject to the approval of City of Edinburgh Council and Falkirk Council as administering authorities. However, we noted further delays in progressing with the project and in September 2023 the Pensions Committee decided to pause it. The cost of the Project Forth to date, and excluding officers time, amounts to £0.619 million. We recommend that after three years of pursuing the project, the Fund makes a clear decision regarding its strategic direction and builds this into future business plans and strategy documents. Governance arrangements at the Funds in relation to corporate governance and the information provided to the Board and Committees as well as the risk management are appropriate. We would recommend all members of the Board and Pensions Committee attend the minimum number of hours as required by the Funds' training policy.
Use of Resources to Improve Outcomes Audited bodies need to make best use of their resources to meet stated outcomes and improvement objectives, through effective planning and working with strategic partners and communities. This includes demonstrating economy, efficiency, and effectiveness through the use of financial and other resources and reporting performance against outcomes.	**Auditor judgement** Effective and appropriate arrangements are in place 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 all ten performance measures met.

Definition

We use the following gradings to provide an overall assessment of the arrangements in place as they relate to the wider scope areas. The text provides a guide to the key criteria we use in the assessment, although not all of the criteria may exist in every case.

There is a fundamental absence or failure of arrangements

There is no evidence to support necessary improvement

Substantial unmitigated risks affect achievement of corporate objectives.

Arrangements are inadequate or ineffective

Pace and depth of improvement is slow

Significant unmitigated risks affect achievement of corporate objectives

No major weaknesses in arrangements but scope for improvement exists

Pace and depth of improvement are adequate

Risks exist to achievement of operational objectives

Effective and appropriate arrangements are in place

Pace and depth of improvement are effective

Risks to achievement of objectives are managed

Introduction

The annual audit comprises the audit of the financial statements and the wider-scope audit responsibilities set out in the Code of Audit Practice.

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. We have not made any significant subsequent changes to the risks outlined in that plan.

Responsibilities

The Funds are responsible for preparing its annual accounts, including financial statements 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.

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.

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

Auditor independence

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.

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.

We set out in Appendix 1 our assessment and confirmation of independence.

Adding value

All of our clients quite rightly demand of us a positive contribution to meeting their ever-changing business needs. We add value by being constructive and forward looking, by identifying areas of improvement and by recommending and encouraging good practice. In this way we aim to promote improved standards of governance, better management and decision making and more effective use of public money.

Any comments you may have on the service we provide would be greatly appreciated. Comments can be reported directly to any member of your audit team.

Openness and transparency

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

Annual report and accounts 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 audit opinion

Opinion	Basis for opinion	Conclusions
Financial statements	We conduct our audit in accordance with applicable law and International Standards on Auditing. Our findings / conclusions to inform our opinion are set out in this section of our annual report.	The draft financial statements. management commentary, annual governance statement, governance compliance statement and remuneration report were considered by the Pensions Committee and approved on 21 June 2023. They were reconsidered and approved post audit on 27 September 2023. We have issued unqualified audit opinions. We have not identified any material misstatements during the audit. We received the draft annual accounts and supporting papers in line with our audit timetable. The accounts and working papers were prepared to a high standard. Further information and revisions were provided promptly where required.

Opinion	Basis for opinion	Conclusions
		Our thanks go to the Finance team for their assistance with our work.
Going concern basis of accounting	In the public sector, when assessing whether the going concern basis of accounting is appropriate, the anticipated provision of 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.	Last year we concluded that a proposed LPF and Falkirk Pension Fund merger, Project Forth, would represent a transfer of services under combinations of public sector bodies, and hence does not negate the presumption of going concern. However, in September 2023 on the advice of the administering authority the Pensions Committee took a decision to re-consider the merger decision and pause further work on Project Forth, and therefore there is no further consideration in relation to going concern necessary until a decision on future strategy is made. Our audit opinion is unqualified in this respect.
Opinions prescribed by the Accounts Commission: • Management Commentary • Annual Governance Statement • Governance Compliance Statement	We read all the financial and non-financial information in the annual report and accounts to identify material inconsistencies with the 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.	The annual report contains no material misstatements or inconsistencies with the financial statements. We have concluded that: • the information given in the Management Commentary is consistent with the financial statements and has been prepared in accordance with relevant statutory guidance; • the information given in the Annual Governance Statement is consistent with

Opinion	Basis for opinion	Conclusions
	We plan and perform audit procedures to gain assurance that the statutory other information has been prepared in accordance with relevant legislation and regulations.	the financial statements and has been prepared in accordance with the Delivering Good Governance in Local Government: Framework; • 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 and the audited part of the remuneration report are not in agreement with the accounting records; or • we have not received all the information and explanations we require for our audit.	We have no matters to report.

An overview of the scope of our audit

The scope of our audit was detailed in our External Audit Plan, which was presented to the Pensions Committee in March 2023. 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 (the significant risk areas). 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.

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.

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 and key audit matters

Significant risks are defined by auditing 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. Audit procedures were designed to mitigate these risks.

As required by the Code of Audit Practice and the planning guidance issued by Audit Scotland, we consider the significant risks for the audit that had the greatest effect on our audit strategy, the allocation of resources in the audit and directing the efforts of the audit team (the ‘Key Audit Matters’), as detailed in the tables below.

Our audit procedures relating to these matters were designed in the context of our audit of the annual accounts as a whole, and not to express an opinion on individual accounts or disclosures.

Our opinion on the annual accounts is not modified with respect to any of the risks described below.

Significant risks at the financial statement level

These risks are considered to have a pervasive impact on the financial statements as a whole and potentially affect many assertions for classes of transaction, account balances and disclosures.

Risk area	Management override of controls
Significant risk description	Management of any entity is in a unique position to perpetrate fraud because of their ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. Although the level of risk will vary from entity to entity, this risk is nevertheless present in all entities. Due to the unpredictable way in which such override could occur, it is a risk of material misstatement due to fraud and thus a significant risk on all audits. This was considered to be a significant risk and Key Audit Matter for the audit.
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 controls for specific transactions. **Audit procedures** • Documenting our understanding of the journals posting process and evaluating the design effectiveness of management controls over journals. • Analysing the journals listing and determining criteria for selecting high risk and / or unusual journals. • Testing high risk and / or unusual journals posted during the year and after the unaudited annual accounts stage back to supporting documentation for appropriateness, corroboration and appropriate processing in line with the Funds' journals policy. • Gaining an understanding of the accounting estimates and critical judgements made by management. We challenged key assumptions and considered the reasonableness and indicators of management bias which could result in material misstatement due to fraud. • Evaluating the rationale for any changes in accounting policies, estimates or significant unusual transactions.

Risk area	Management override of controls
Key observations	Our work in this area is complete. We did not identify any indication of management override of controls from our audit work. We did not identify any areas of bias in key judgements made by management. Key judgements were consistent with prior years.

Significant risks at the assertion level for classes of transaction, account balances and disclosures

Key risk area	Fraud in revenue recognition
Significant risk description	Material misstatement due to fraudulent financial reporting relating to revenue recognition is a presumed inherent risk on every audit unless it can be rebutted. The presumption is that the Funds could adopt accounting policies or recognise income in such a way as to lead to a material misstatement in the reported financial position. 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, in respect of contributions received from member bodies we do not consider the revenue recognition risk to be significant due to a lack of incentive and opportunity to manipulate revenue of this nature. The risk of fraud in relation to revenue recognition is present in all other income streams. This was considered to be a significant risk and Key Audit Matter for the audit.
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. **Audit procedures** • Evaluating the significant income streams and reviewing the controls in place over accounting for revenue. • Considering key areas of income and obtaining evidence that income is recorded in line with appropriate

Key risk area	Fraud in revenue recognition
	accounting policies and the policies have been consistently applied during the year. • Performing substantive test on all material revenue streams.
Key observations	We have performed additional audit procedures as confirmations from some auditors of the employer members of the LPF were not provided on time. Based on audit work done, we gained reasonable assurance on the completeness and occurrence of all other material income streams and we are satisfied that income is fairly stated in the financial statements.

Key risk area	Fraud in non-pay expenditure
Significant risk description	As most public sector bodies are net expenditure bodies, the risk of fraud is also present in relation to expenditure. There is a risk that expenditure may be materially misstated in the financial statements.
How the scope of our audit responded to the significant risk	Based on our fieldwork assessment, we do not deem this risk to be present for expenditure due to the materially low levels of expenditure incurred. This was not considered to be a significant risk during our fieldwork.
Key observations	Based on audit work performed, we gained reasonable assurance on the completeness and occurrence of expenditure and we are satisfied that expenditure is fairly stated in the financial statements.

Key risk area	**Investment valuations (significant accounting estimate)**
Significant risk description	The Funds held investments of £9.650 billion as at 31 March 2023, of which 33% (£3.175 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.
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 values within the financial statements. **Audit procedures** • Evaluate the Funds' investment strategy and review the controls in place over accounting for investments. • Consider the Funds' material investments and obtain evidence that investments have been appropriately valued at 31 March 2023 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.
Key observations	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.

Key risk area	**Investment property valuations (significant accounting estimate)**
Significant risk description	LPF hold a portfolio of investment properties. The management of the properties is undertaken by JLL, along with the Fund accounting for the portfolio. Investment properties are valued annually at fair value, in line with the Code. There is a significant degree of subjectivity in the measurement and valuation of investment properties. This subjectivity and the material nature of the Funds' investment property portfolio represents an increased risk of misstatement in the annual accounts.
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 investment property values within the financial statements. **Audit procedures** • Ensuring that investment properties are recorded in the annual accounts in accordance with the Code and the Funds' accounting policies, and have been accounted for appropriately. We will review investment property valuations. • Considering the competence, capability and objectiveness of the valuer in line with ISA (UK) 500 Audit Evidence. We will review the valuation report and consider the assumptions used by the valuer against external sources of evidence. • Considering the scope of the valuer's work and the information provided to the valuer for completeness.
Key observations	LPF's investment properties were valued at £365.7 million as at 31 March 2023. The valuation undertaken by CBRE did not include any qualification. 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

Key risk area	**Investment property valuations (significant accounting estimate)**
	investment properties are fairly stated in the financial statements.

Key risk area	**Valuation of defined benefit pension obligations (significant accounting estimate)**
Significant risk description	An actuarial estimate of the pension fund asset/liability is calculated on an annual basis under IAS 26 and on a triennial funding basis by an independent firm of actuaries with specialist knowledge and experience. The estimates are based on the most up to date membership data held by the Funds and have regard to local factors such as mortality rates and expected pay rises with other assumptions around inflation when calculating the liabilities. There is a risk that the assumptions used are not appropriate.
How the scope of our audit responded to the significant risk	**Key judgements** A significant level of estimation is required in order to determine the valuation of pension assets/liabilities. Small changes in the key assumptions (including discount rates, inflation and mortality rates) can have a material impact on the pension asset/liability. **Audit procedures** • Evaluating management processes and assumptions for the calculation of the estimates, the instructions issued to their actuarial experts and the scope of their work. • Evaluating the competence, capabilities and objectivity of management's actuarial expert. • Considering the basis on which the valuation was carried out and challenging the key assumptions applied. • Evaluating the information provided to the actuary for the purposes of their calculation of the IAS 26 estimate to ensure it was complete and consistent with our understanding.

Key risk area	Valuation of defined benefit pension obligations (significant accounting estimate)
Key observations	We reviewed the reasonableness of those assumptions used in the calculation against other local government pension fund actuaries and other observable data, with no issues identified. In addition, we reviewed the information in the actuarial report for completeness. We have considered the competence, capability and objectivity of the actuary in line with the requirements of ISA (UK) 500 Audit Evidence. From this review we did not identify any items which gave us cause for concern over the suitability of the actuary.

Estimates and judgements

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

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 pension assumptions, investments valuation, investment properties valuation, provisions for legal obligations, doubtful debts and expected credit losses, investment fees and accruals. Other than investments valuation, investment property valuation and pension assumptions, we have not determined the accounting estimates to be significant. We revisited our assessment during the fieldwork and completion stages of our audit and concluded that our assessment remained appropriate.

Our audit work consisted of reviewing these key 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

Investments valuation	Auditor judgement: 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 2023, the Funds' internal valuation exercise resulted in a valuation of £9.646 billion, a valuation £5.3 million (0.06%) higher 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 2023.

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 2023.

Asset valuations at the Funds are based on third party information, where available, including publicly available market information, fund managers and custodian valuations. We evaluated the competence, objectivity and capability of management's expert in line with the requirements of ISA (UK) 500 and concluded that use of the experts was appropriate. We considered key assumptions against other sources of evidence.

Our findings and conclusions are included in the significant risk table above.

Investment property valuation	Auditor judgement: 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 2023.

Pensions Assumptions	Auditor judgement: Balanced

We reviewed the reasonableness of those assumptions used in the calculation against other local government pension fund actuaries and other observable data, with no issues identified. In addition, we reviewed the information in the actuarial report for completeness.

Estimates and judgements

We have considered the competence, capability and objectivity of the actuary in line with the requirements of ISA (UK) 500 Audit Evidence. From this review we did not identify any items which gave us cause for concern over the suitability of the actuary.

Materiality

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 the Funds and the needs of users. We review our assessment of materiality throughout the audit.

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.

Group and the Funds materiality

Our initial assessment of materiality for LPF Group was £143 million. On receipt of the 2022/23 unaudited annual accounts, we reassessed materiality and updated it to £145 million, but kept the single entity materiality unchanged. We consider that our updated assessment has remained appropriate throughout our audit.

Our initial assessment of materiality for Scottish Homes Pension Fund was £2.3 million. On receipt of the 2022/23 unaudited annual accounts, we reassessed materiality and updated it to £1.9 million. We consider that our updated assessment has remained appropriate throughout our audit.

	Group (£m)	Lothian Pension Fund (£m)	Scottish Homes Pension Fund (£m)
Overall materiality for the financial statements	145	143	1.9
Performance materiality	108.7	107.3	1.4
Trivial threshold	0.250	0.250	0.095

Materiality	Our assessment is based on approximately 1.5% of the group and Funds' net investment assets as disclosed in the unaudited annual accounts. We consider this to be the principal consideration for the users of the annual accounts when assessing the financial performance of the Funds' and the group. In performing our audit we apply a lower level of materiality to the audit of the Remuneration 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	Trivial misstatements are matters that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any quantitative or qualitative criteria.

Special materiality for dealings with members

Our initial assessment of materiality for dealing with members for LPF was £13.1 million. On receipt of the 2022/23 unaudited annual accounts, we reassessed materiality and updated it to £14.2 million. The group materiality has been updated to £14.3 million accordingly. We consider that our updated assessment has remained appropriate throughout our audit.

	Group	**Lothian Pension Fund**	**Scottish Homes Pension Fund**
	(£m)	**(£m)**	**(£m)**
Dealings with members materiality	14.3	14.2	0.34
Performance materiality	10.7	10.6	0.25
Trivial threshold	0.250	0.250	0.017

Materiality	We apply lower materiality for dealings with members, based on the fact these transactions are significant to the Funds' activities and it would not be appropriate to use the assets based materiality to them. Our assessment is based on approximately 5% of the group and Funds' 2022/23 gross expenditure as disclosed in the unaudited annual accounts. We consider this to be the principal consideration for the users of the annual accounts when assessing financial performance of the Funds' and its group.
Performance materiality	Using our professional judgement, we have calculated performance materiality at approximately 75% of overall materiality.

Group audit

Lothian Pension Fund prepares its financial statements on a group basis. The group consists of Lothian Pension Fund and two special purpose vehicles, LPFE Ltd and LPFI Ltd. As group auditors under ISA (UK) 600 we are required to obtain sufficient appropriate audit evidence regarding the financial information of the components and regarding the consolidation process to express an opinion on whether the group financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. The following table sets out the components within the group.

Component	Significant	Level of response required
Lothian Pension Fund	Yes	Comprehensive
LFPI Ltd	No	Analytical
LPFE Ltd	No	Analytical

Comprehensive – the component is of such significance to the group as a whole that an audit of the component's financial statements is required for group reporting purposes.

Analytical - the component is not significant to the group and audit risks can be addressed sufficiently by applying analytical procedures at the group level.

LPFE Ltd and LPFI Ltd are fully consolidated. We did not consider either to be of individual financial significance to the group or, due to the specific nature or circumstances, include a significant risk of material misstatement to the group financial statements.

We have completed our review of the consolidation entries made within the group accounts, to confirm those entries back to the financial statements of the group bodies. We have not identified any material misstatements as a result of that work.

Azets is also the appointed auditor to LPFI Ltd and LPFE Ltd. During our audit we liaised with the audit teams to confirm that their programme of work is adequate for our purposes.

We revisited our assessment, following receipt of the unaudited accounts and our assessment remained the same.

We have nothing to report in respect of the following matters:

- no significant deficiencies in the system of internal control or instances of fraud were identified by the component auditor; and
- there were no limitations on the group audit.

Audit differences

We are pleased to report that there were no material adjustments to the financial statements. We have identified one unadjusted error of £4.9 million arising as a result of a change to technical guidance on calculation of a pension asset ceiling in LPFE Ltd accounts, and then not adjusted for in the group accounts.

We also identified minor disclosure and presentational adjustments during our audit which have been reflected in the final set of financial statements.

Internal controls

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 Pensions Committee. These matters are limited to those which we have concluded are of sufficient importance to merit being reported.

We did not identify any significant control weaknesses during our audit.

Follow up of prior year recommendations

We followed up on progress in implementing actions raised by the audit in the prior year. Full details of our findings are included in Appendix 3.

Other communications

Accounting policies, presentation and disclosures

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.

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

Fraud and suspected fraud

We have previously discussed the risk of fraud with management and the Pensions Committee. 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.

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

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.

Written representations

Written representations from management were approved at the same time as the financial statements were approved by the Pensions Committee, signed by the responsible officer and returned to us.

Related parties

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

Confirmations from third parties

All requested third party confirmations have been received including fund manager investment valuation reports.

Wider Scope

Financial management

Financial performance

The Funds have developed an annual Operating Plan which sets out the strategic aims of the Funds. A two-year budget to 2023/24 supports the delivery of the Plan which considers the Group as a whole.

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.

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.

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.

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.

Lothian Pension Fund reported a net withdrawals position in dealings with members in line with forecast.

In line with forecast, Scottish Homes Pension Fund reported a net withdrawals position in dealings with members.

The small return on the Lothian Pension Fund and decrease in value of investments in the Scottish Homes Pension Fund were reflected in the net assets position for both. Consequently, LPF Fund's net assets have increased slightly while SHPF's decreased by 18% due to gilt market decreases.

The present value of the retirement benefit obligations are presented as a note to the accounts. A significant increase in the discount rate and minimum return on assets in the year have resulted in a lower obligation. This is despite a significant increase in pensions in April 2023 of 10.1% also taken into account by the actuary. This movement in the net asset position and present value of retirement obligations is shown in Exhibit 1.

Exhibit 1 – The Funds' Financial Position

	Net Assets	Present Value of Retirement Benefits
Lothian Pension Fund		
2022/23 (£million)	9,695	6,971
2021/22 (£million)	9,607	10,049
Movement (%)	1%	-31%
Scottish Homes Pension Fund		
2022/23 (£million)	126	95
2021/22 (£million)	154	116
Movement (%)	-18%	-18%

Source: Lothian Pension Funds Annual Report and Accounts

Withdrawal rates compare Funds income (contributions, transfers in) to its payments (pension related and transfers out). LPF recorded a higher withdrawal rates when compared to the forecast and to previous year. The higher 2022/23 withdrawal position resulted from a combination of lower income, higher pension payments and higher transfers out from the scheme. Scottish Homes Pension Funds withdrawal rate was below expected forecast. SHPF is a closed scheme therefore there is no income from contributions expected.

Exhibit 2 – Forecast versus Actual Net Withdrawals from the Funds

	2022/23 Forecast (£'000)	2022/23 Actual (£'000)	2021/22 Actual (£'000)
Lothian Pension Fund	(16,330)	(18,190)	(5,771)
Scottish Homes Pension Fund	(7,350)	(7,013)	(6,387)

Source: Lothian Pension Funds Annual Report and Accounts

Systems of internal control

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.

As a part of this year's audit, and in accordance with the revised requirements of the International Standard on Auditing 315, we have assessed the control environment of General IT controls in relation to the pension payments, ledger and payroll systems and the overall environment.

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

Prevention and detection of fraud and irregularity

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 but has done so voluntarily. The Fund has completed work to provide data to the scheme.

The most recent NFI exercise commenced in 2022. LPF uploaded the data, investigated the matches and returned the results to its administering authority, The City of Edinburgh Council. There are no significant findings to note so far.

Overall, the LPF arrangements with respect to NFI are satisfactory.

Standards of Conduct

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

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

Internal audit

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.

Internal Audit presented a 'reasonable assurance', amber opinion to the Pensions Committee for the year to 31 March 2023. An amber opinion was given as Internal Audit reflected that LPF has generally sounds system of governance, risk management and control in place, with some issues of non-compliance and scope for improvement identified. The opinion is different from a 'Limited assurance' opinion from the previous year, but Internal Audit highlighted that direct comparison between the years might not be appropriate due to the different type of work being performed and different risk profiles in a year.

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 and the Head of Finance at the City of Edinburgh Council.

In 2022/23 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.

Financial sustainability

Significant audit risk

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

Extract from External Audit Plan - Financial sustainability
The Funds held investments of £9.528 billion as at 31 March 2022. 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 June 2021. 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 as to withstand market volatility in the long term, we have noted that COVID-19, inflation levels and other worldwide political events had a significant impact on the market in the recent years. While the last two years saw a return to improved performance, a significant risk remains particularly in relation to impact of increased inflation, expected government monetary policies and uncertainties in relation to geopolitical situation. There is a risk that the value of investments is significantly impacted by events within the wider environment.

Our detailed findings on the Funds financial sustainability arrangements are set out below.

Funding Strategy

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.

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.

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

The previous year's market volatility created by recovery from COVID, inflation and the war in Ukraine continue into this year. The key factors impacting the markets were high inflation rates and the impact on government gilt prices. Central banks reacted to inflation with tighter monetary policies and interest rates increases.

When compared to the previous year, 2022/23 overall returns were lower. The UK Equities reported a -1.4% (2022: +14.5%) return for the 12 months, however this is in sterling, and when US dollar is used the decline of returns in equities was equal to -7.4%. Government bond prices fell during the year because of higher inflation and increasing interest rates. Returns on investments properties also weakened due to the impact of the increasing cost of borrowing.

Actuarial funding levels

The funding of Lothian Pension Fund was 106% at the last triennial valuation at the March 2020. The assets levels increased during the 2023/24 financial year, while liabilities decreased due to increasing discount rates. The results of the next triennial valuation at 31 March 2023 will be available in 2024. The draft results indicate a significantly increased level of funding, and well above 100%. This could mean potential changes to the employers' membership levels in the scheme, if for example, admitted employers elect to leave the Fund to take advantage of high funding levels.

We would encourage Lothian Pension Fund to consider the medium and longer term implications of the expected triennial valuation results, including potential exits from the Fund by smaller bodies, and the impact this might have on the Funds liability and net withdrawals.

Recommendation 1

The funding level of Scottish Homes Pension Fund at the 2020 Triennial Valuation was 117.7% (2017: 104.7%), reaching full funding faster than anticipated. The Scottish Government, as Guarantor, was consulted on future funding options. The decision reached was to maintain the current approach, which minimises investment risk.

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 Strategy

Lothian Pension Fund has described their investment position as 'defensive'. The approach is generally expected to deliver outperformance when equity market returns are poor.

Lothian Pension Fund revised the investment strategy in June 2021. The improved position reported at the triennial valuation provided scope to reduce investment risk while generating sufficient returns to remain fully funded. The Fund's allocation of assets held in equities has decreased to 58.5% (2020: 60%).

Following its last triennial valuation the Fund set out a revised investment strategy in June 2021. The investment strategy has a significant impact on the investment performance, ultimately impacting the funding level and contribution rates. Hymans Robertson, as scheme actuary, undertook asset liability modelling to assess the impact of different investment strategies.

The modelling highlights the sensitivity of the funding level on gilt yields. While the investment risk is largely driven by equities, modelling illustrates that the Fund must invest in assets with returns above those of UK gilts to achieve its objectives. A revised strategy was therefore proposed which reduces the funds exposure to equities from a strategic allocation of 65% of assets to 60% (actual: 58.5%), with corresponding increases in real assets and gilts.

Investment Performance

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.

Annual performance to March 2023 was weaker than in previous year, with overall annual returns of 0.3% (2022: 10.8%). However, the performance was above the benchmark of -14.6% while maintaining investment in lower risk equities. Lothian Pension Fund's performance against benchmark and prior year is given at Exhibit 3.

Exhibit 3: Performance of Lothian Pension Fund against benchmark and prior year

Source: Unaudited Annual Report and Accounts

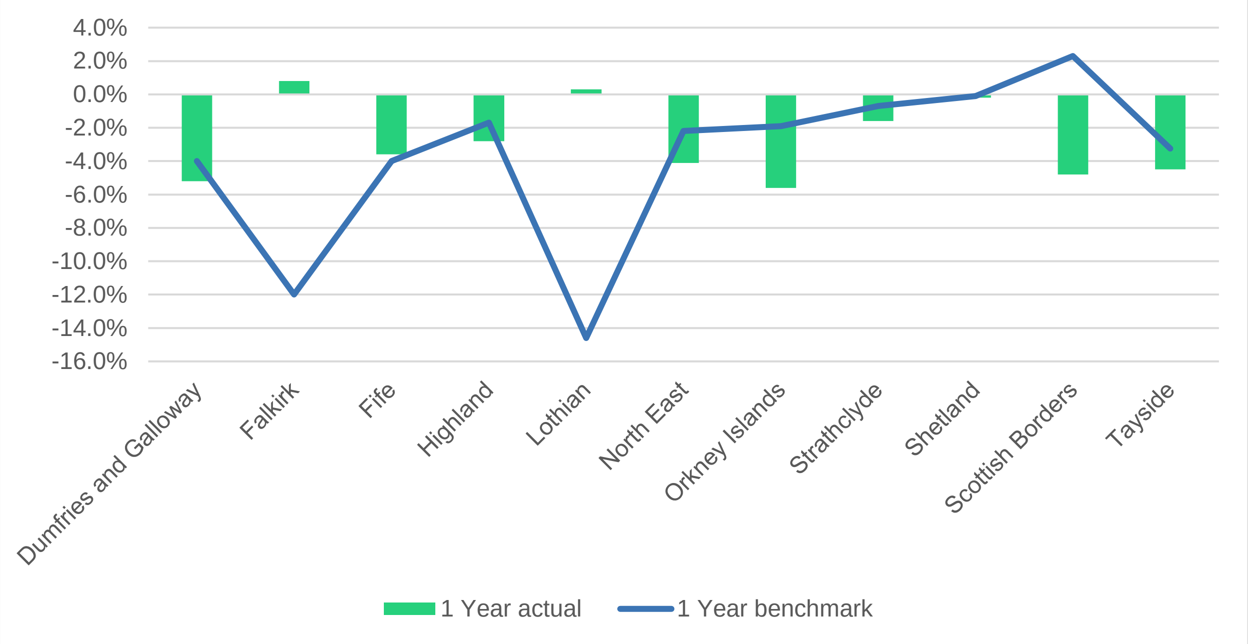
The impact of uncertain market conditions can be seen on the returns. Despite absolute performance being significantly lower than in 2021/22, the Fund's defensive market positioning helped the Fund outperform the annual benchmark.

There have been no changes to the overall Fund strategy during 2022/23. The main movements included the real assets allocation increase for new investments, a small decrease to non-gilt debt and the overall net reduction in cash, with no significant changes to the equities allocation.

Annual returns comparison

The Fund reported the second highest (2022: third highest) annual return and was one of only three LGPS to exceed annual benchmark returns. See Exhibit 4 for Lothian Pension Fund's annual performance against other Scottish LGPS Schemes.

Exhibit 4: Annual return across LGPS Scotland Funds against benchmark



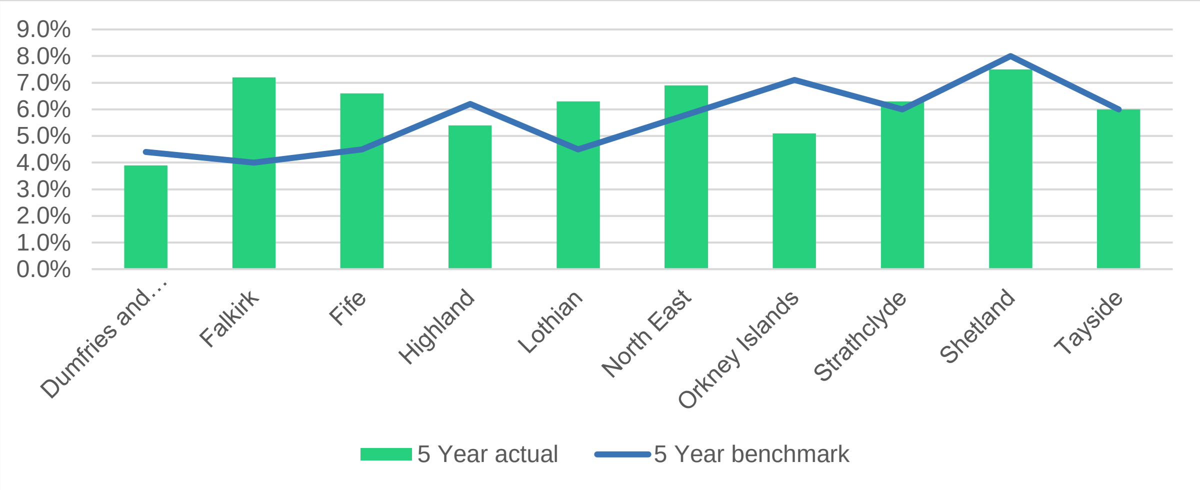
Source: Unaudited Annual Report and Accounts

5 year returns comparison

We have observed across our appointment that the gap between the return and 5 year benchmark continues to narrow and in 2022/23 LPF outperformed the benchmark. We do note that previous year's LPF return performance was positioned in the middle of the Scottish LGPS', while the benchmark was 2nd highest when compared to other pension funds. However, we understand that the benchmarks are based on many factors individual to investment types, pension fund and fund managers.

Comparison of Lothian Pension Fund's performance against other Scottish LGPS Schemes is given in Exhibit 5.

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



Source: Unaudited Annual Report and Accounts

Other factors

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.

High levels of the UK inflation and continuing war in Ukraine have had impact on the investment returns. Pension benefits were also increased in April 2023 by 10.1% to reflect inflation impact, but the adverse impact of that increase on the funding level is not expected to be significant enough to outweigh increases in interest rates which in turn decrease the Funds' liabilities value.

The Fund divested any Russian directly linked investments in the previous years, leaving only trivial holdings in such investments. However, we noted that nearly £17 million is included in an investment kept in another fund, Macquarie Infrastructure and Real Assets (Europe) Limited, which invests in a company (EPIF) owning almost half of Eustream which in turn gets the majority of its revenues from payments from Gazprom. According to LPF:

- This investment is part of an Infrastructure portfolio, which is relatively illiquid and invested in 2016. According to LPF their interactions with the manager confirm that the company LPF invested in (and owning 49% of Eustream) has committed to achieve net zero emissions by 2050, in line with the Paris Accord, and more broadly, that the manager will play an important role in the energy transition.
- Neither EPIF nor Eustream have seen any of their clients become subject to any relevant sanctions and ultimately gas transit via the Eustream system and related services have been carved out from international sanctions. Both EPIF and Eustream continue to monitor international sanctions to ensure full compliance.

Vision, leadership and governance

Our detailed findings on the Funds' arrangements are set out below.

Vision

Lothian Pension Fund's Strategy document defines its vision 'to deliver outstanding pension and investment services for the benefit of members and employers'. The strategy document contains further information on purpose of the Fund and its core values. LPF is striving to be the best LGPS in Scotland, if not the UK, in terms of meeting the needs of members and employers, in using their influence as a leading responsible investor, and offering a superior employment proposition to their employees. The strategy goes into detail on the key goals of the Fund and of its more detailed objectives. These are accompanied by financial metrics, headcount, and the other essential components of a comprehensive business plan.

Project Forth

In September 2021, Lothian Pension Fund agreed in principle to merge Lothian Pension Fund with Falkirk Pension Fund, subject to further work including approvals by the City of Edinburgh Council and Falkirk Funds, as administering authorities. The intention to merge was publicly announced on 24th May 2022.

The aim and business case behind Project Forth is that a merger will result in substantial cost savings, achieve economies of scale and provide a future proofed best in class governance model fit for the increasing legal and regulatory landscape of the LGPS.

The proposed structure agreed by the Pensions Committee was a joint venture between the City of Edinburgh Council and Falkirk Funds, as administering authorities. This would be a company limited by guarantee holding nominal membership pro-rated to contributing assets.

Under the original timeline, the administering authorities were due to consider the proposal in February 2022 and then in December 2022, due to further due diligence checks required. The two Funds intended to align the timing of when the proposal is considered for approval. We noted further delays on progressing with the project and in September 2023 the Pensions Committee decided to re-consider the merger proposal and paused the project.

In the last three years the Funds have been focusing its strategic direction towards Project Forth and merger with the Falkirk Pension Fund. As this has now been subject to further considerations, we recommend that after three years of pursuing the project the Fund makes a clear decision as to its strategic direction. We would also expect this to be formally reflected in the Fund strategy and operational plans where appropriate.

Recommendation 2

Governance structure

The Pensions 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.

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 setting the investment strategy.

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

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 Pensions Committee.

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

In line with legislation, if more than half of the members of the Pension Board disagree with a decision of the Pensions Committee then they can request in writing that the Committee review that decision. There have been no requests to review decisions in 2022/23.

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

Our review found that all, but one, current Pensions Committee and Board members met the requirement to have a minimum of 21 hours training. While the LPF Code of Conduct states that these requirements have to be met 'from time to time' we would encourage all the members to fulfil this obligation to allow an effective oversight of the Funds activities.

Recommendation 3

Joint Investment Strategy Panel

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:

- the Chief Investment Officer, LPFI Ltd;

- a second senior investment officer of LPFI Ltd; and
- two external independent investment advisers.

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

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.

The primary focus of the panel during 2022/23 has been the implementation and monitoring 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.

Special areas considered by the panel in 2022/23 include:

- annual review of investment strategy;
- responsible investment principles; and
- the implications of a merger of the Lothian and Falkirk funds
- consideration of wider economic and political issues.

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

Scottish Homes Pension Fund achieved full funding at the 2017 and 2020 actuarial valuations and therefore the strategy is low risk and designed to protect from short term market changes.

Cybersecurity

There continues to be a significant risk of cyber-attacks to public bodies, and it is important that they have appropriate cyber security arrangements in place. A number of recent incidents have demonstrated the significant impact that a cyber-attack can have on both the finances and operation of an organisation. We have considered risks related to cyber security at the Fund as part of our integrated audit as part of our understanding of the Fund's use of IT.

The revised ISA (UK) 315 includes enhanced requirements for auditors to understand a body's use of IT in its business, the related risks and the system of internal control addressing such risks. Our specialist IT auditors team have made an initial assessment of the IT environment and its key systems impacting preparation of the financial statements. Some of these systems are provided by the administering authority, which means reliance on a third party controls in place. We have however identified that these other IT systems possess ISO 27001 certification giving further assurance over information security arrangements. Conformity with this ISO means that Funds have put in place a system to manage risks related to the security of data owned or handled by the Funds, and that this system respects all the best practices and principles of the standard.

The client side IT management team are currently in the process of developing a suite of IT policies to support the Funds going forward.

We have noted that the Funds have not been subject to a successful cyberattack and we have noted that the key IT systems used and impacting on the financial statements possess relevant ISO certificates and appropriate arrangements are in place.

Use of resources to improve outcomes

Our detailed findings on the Funds arrangements are set out below.

Investment Manager Operations

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

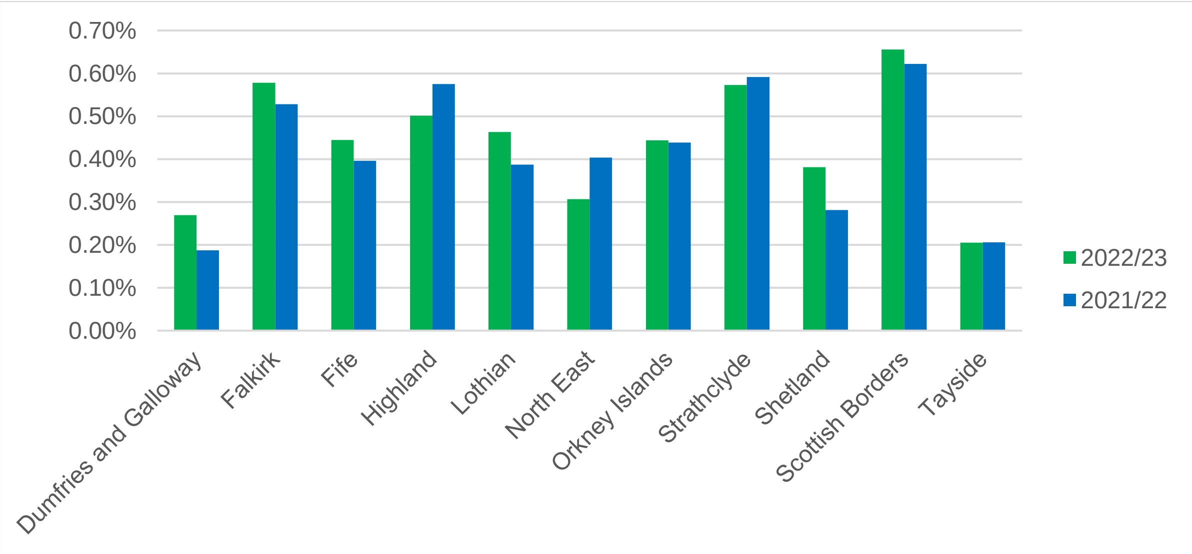
The special purpose vehicles were established to support the investment programme of the in-house investment team by providing organisational arrangements consistent with the capability, systems and controls of authorised investment companies.

In 2022/23, the proportion of funds managed internally remained at c.93%, with the last significant movement in 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.

Lothian Pension Fund reported management expenses of £48.1 million in 2022/23, an increase of 20% on the prior year. Management expenses are split into three main categories: administrative costs; investment manager expenses and oversight and governance costs. Investment management expenses account for 86% of total management expenses.

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 6.

Exhibit 6 – Management expenses as a proportion of net assets



Source: Unaudited Annual Report and Accounts

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

The Funds include detailed analysis over investment expenses in the 2022/23 Annual Report. Disclosures on investment management expenses exceed the requirements of the CIPFA guidance on cost transparency as LPF consider that the CIPFA methodology would result in under-reporting of indirect management expenses.

The Funds undertake annual benchmarking exercises using externally provided data, covering 30 LGPS funds and a wider global universe of 299 funds. Analysis of investment costs is carried out by an independent provider, CEM Benchmarking Inc.

The benchmarking exercise reported in March 2023 covers investment performance in 2021/22. For this year, Lothian Pension Fund reported an actual investment cost of 0.29% of average assets which was below the benchmark of 0.50%.

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.

In relation to the pension administration benchmarking exercise undertaken by CEM, the Funds were categorised as 'low cost; high service standard'. The Funds' cost per member was £26.30 compared with a benchmark of £39.94. This was supported by an improved service score of 74 out of 100 driven by the Funds' noted speed at paying lump sums and strong social media presence.

Monitoring investment performance

There is an annual review of investment performance published 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 the Pensions Committee and Board Members are engaged in monitoring the performance of investments.

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, and 1, 3, 5, 10 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

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 to each Pensions Committee meeting as part of the Operating Plan Update.

The annual results for 2022/23 are presented in the Funds' Management Commentary. Performance remains strong in all ten performance measures met.

Climate change

Principal 11 of the Statement of Investment Principles notes the Funds' commitment to responsible investment, while stating that divestment is inconsistent with the Funds' fiduciary duties to members and employers. This covers the Funds' approach to climate change, amongst other significant areas.

The Investment Strategy review provided an opportunity for the impact of climate change on the Funds to be assessed. Uncertainty is high in climate modelling, but the modelling suggested that, on balance, there is a risk of deterioration of the financial position due to climate change. Reduction in exposures to equities was suggested as a prudent measure to mitigate the most pessimistic climate scenarios, which is being implemented.

Tackling climate change is one of the greatest global challenges. The Scottish Parliament has set a legally binding target of becoming net zero by 2045 and has interim targets including a 75 percent reduction in greenhouse gas emissions by 2030.

There are specific legal responsibilities placed on public bodies to contribute to reducing greenhouse gas emissions, to adapt to climate change, to act sustainably and to report on progress. All public bodies need to reduce their direct and indirect emissions and should have plans to do so. Many public bodies also have a role in reducing emissions in wider society, and in supporting activity to adapt to the current and potential future impact of climate change.

The key actions the Funds have taken to reduce climate change are set out in the table below:

What targets has the body set for reducing emissions in its own organisation or in its local area?	LPF supports the reduction in corporate emissions and the achievement of net zero targets.
Does the body have a climate change strategy or action plan which sets out how the body intends to achieve its targets?	LPF has a strategy on how it manages climate change risks within the investment portfolio. This is included within the Statement of Responsible Investment Principles available online.
How does the body monitor and report progress towards	There is regular reporting to the Pensions Committee. Whilst LPF does not set emissions targets the Fund will disclose the Weighted Average Carbon Intensity of

meeting its emission targets internally and publicly?	their investment portfolio (where data is available) and trend results over time.
Has the body considered the impact of climate change on its financial statements?	Yes, the Fund has engaged a consultant to undertake climate scenario analysis to aid understanding of the scale of the risks.
What are the areas of the financial statements where climate change has, or is expected to have, a material impact?	The value of the Funds investment portfolio and their liabilities might be materially impacted by the climate change.
Does the body include climate change in its narrative reporting which accompanies the financial statements and is it consistent with those financial statements?	Yes, the annual report and accounts have a separate section on climate change within the responsible investment part of the report. This is consistent with other parts of the accounts.

Appendices

Appendix 1: Responsibilities of the Funds and the Auditor

Responsibilities of the Funds

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 Funds are 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 and related reports	The Funds have responsibility for: • preparing financial statements which give a true and fair view of the financial position of the Funds and its group 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 support the balances and transactions in its financial statements and related disclosures; • preparing and publishing, along with the financial statements, an annual governance statement, governance compliance statement, management commentary (or equivalent) and a remuneration report that is consistent with the disclosures made in the financial statements and prepared in accordance with prescribed requirements. The management commentary should be fair, balanced and understandable and also address the longer-term financial sustainability of the Funds. Management is responsible, with the oversight of those charged with governance, for communicating relevant information to users about the Funds and its financial performance, including providing adequate disclosures in accordance with the applicable financial

Area	The Funds' responsibilities
	reporting framework. The relevant information should be communicated clearly and concisely. The Funds 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. The Funds 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 Funds are responsible for putting in place proper arrangements to ensure its 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.

Auditor responsibilities

Code of Audit Practice

The Code of Audit Practice (the Code) describes the high-level, principles-based purpose and scope of public audit in Scotland. The 2021 Code came into effect from 2022/23.

The Code of Audit Practice outlines the responsibilities of external auditors appointed by the Auditor General and it is a condition of our appointment that we follow it.

Our responsibilities

Auditor responsibilities are derived from the Code, statute, International Standards on Auditing (UK) and the Ethical Standard for auditors, other professional requirements and best practice, and guidance from Audit Scotland.

We are responsible for the audit of the accounts and the wider-scope responsibilities explained below. We act independently in carrying out our role and in exercising professional judgement. We report to the Funds and others, including Audit Scotland, on the results of our audit work.

Weaknesses or risks, including fraud and other irregularities, identified by auditors, are only those which come to our attention during our normal audit work in accordance with the Code and may not be all that exist.

Wider scope audit work

Reflecting the fact that public money is involved, public audit is planned and undertaken from a wider perspective than in the private sector.

The wider scope audit specified by the Code broadens the audit of the accounts to include additional aspects or risks in areas of financial management; financial sustainability; vision, leadership and governance; and use of resources to improve outcomes.

Financial management

Financial management means having sound budgetary processes. Audited bodies require to understand the financial environment and whether their internal controls are operating effectively.

Auditor considerations

Auditors consider whether the body has effective arrangements to secure sound financial management. This includes the strength of the financial management culture, accountability, and arrangements to prevent and detect fraud, error and other irregularities.

Financial sustainability

Financial sustainability means being able to meet the needs of the present without compromising the ability of future generations to meet their own needs.

Auditor considerations

Auditors consider the extent to which audited bodies show regard to financial sustainability. They look ahead to the medium term (two to five years) and longer term (over five years) to consider whether the body is planning effectively so it can continue to deliver services.

Vision, leadership and governance

Audited bodies must have a clear vision and strategy and set priorities for improvement within this vision and strategy. They work together with partners and communities to improve outcomes and foster a culture of innovation.

Auditor considerations

Auditors consider the clarity of plans to implement the vision, strategy and priorities adopted by the leaders of the audited body. Auditors also consider the effectiveness of governance arrangements for delivery, including openness and transparency of decision-making; robustness of scrutiny and shared working arrangements; and reporting of decisions and outcomes, and financial and performance information.

Use of resources to improve outcomes

Audited bodies need to make best use of their resources to meet stated outcomes and improvement objectives, through effective planning and working with strategic partners and communities. This includes demonstrating economy, efficiency and effectiveness through the use of financial and other resources, and reporting performance against outcomes.

Auditor considerations

Auditors consider the clarity of arrangements in place to ensure that resources are deployed to improve strategic outcomes, meet the needs of service users taking account of inequalities, and deliver continuous improvement in priority services.

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. These 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 can be found at https://www.audit-scotland.gov.uk/publications/quality-of-public-audit-in-scotland-annual-report-202223

Independence

The Ethical Standards and ISA (UK) 260 require us to give the Funds full and fair disclosure of matters relating to our independence. In accordance with our profession's ethical guidance and further to our External Audit Annual Plan issued confirming audit arrangements we do not have any matters to not in that regard.

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.

Our period of total uninterrupted appointment as at the end of 31 March 2023 was seven years.

Audit and non-audit services

The total fees charged to the Funds for the provision of services in 2022/23 were as follows:

	Current year £	**Prior year £**
Audit of Lothian Pension Fund (Auditor remuneration)	53,633	42,579
Audit of components (as audited by Azets)	20,020	18,200
Total audit	**73,653**	**60,779**
Non-audit services - Funds	-	-
Non-audit services – wider group	8,020	7,866
Total fees	**81,673**	**68,645**

The 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 detailed in the table below the non-audit services provided to both the Funds and the wider group, the threats to our independence and the safeguards we have put in place to mitigate these threats.

Non-audit service	**Service provided to**	**Type of threat**	**Safeguard**
Accounts preparation administration, Xero subscription	LPFE Ltd LPFI Ltd	Self-review	Management retains responsibility for decisions and judgments in preparation of the accounts.
Tax compliance	LPFE Ltd LPFI Ltd	Self-review	Management retains responsibility and judgments in relation to tax services. The services are provided by a team separate to the audit team and directed by a different partner.

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 as follows:

Rating	Assessment rationale
High	An issue that results in a severe impact to the achievement of objectives in the area audited.
Medium	An issue that results in a moderate impact to the achievement of objectives in the area audited.
Low	An issue that results in a small impact to the achievement of objectives in the area audited.

Current year action plan

1. Future funding levels	Medium
Observation	The results of the next triennial valuation at 31 March 2023 will be available in 2024. The draft results indicate a significantly increased level of funding, and well above 100%. This could mean potential changes to the employers' membership levels in the scheme, if for example, admitted employers elect to leave the Fund to take advantage of high funding levels.
Implication	A wide range of implications are possible, including a potential reduction in contribution level required to sustain the fund, to the change of the employer's membership structure, or the administrative support levels required at the Fund.
Recommendation	We would encourage Lothian Pension Fund to consider medium- and longer-term implications of the expected triennial valuation results, including potential exits from the fund by smaller bodies, and the impact this will have on the Fund's liability.
Management response	LPF are creating processes for assessing the risk of employer who may seek to exit given the increased potential for surpluses post triennial valuation. This is likely to be an on-going process however once the initial assessment has been completed this will inform the leadership team of LPF around the potential quantum of the reduction in employers and members. **Responsible officer:** David Vallery **Implementation date:** 31 December 2023

2. Project Forth	High
Observation	After three years of pursuing Project Forth and a merger between Lothian Pension Fund and Falkirk Pension Fund, the project has been put on hold due to lack of clarity over the future of the merger.
Implication	The Fund will require to assess its strategic vision and consider cost involved in pursuing Project Forth.
Recommendation	We recommend that after three years of pursuing the project the Fund makes a clear decision as to its strategic direction and examines the financial cost of Project Forth incurred to date. We would also expect this to be formally reflected in the Fund strategy and operational plans where appropriate.
Management response	The Pension Committee of LPF is expected to make the decision to formally cease Project Forth at the meeting on 27th September 2023. The strategy of LPF will be amended to reflect the situation and will have a continued focus on the potential for consolidation both across LGPS in Scotland as well as the consolidation of multi fund employers into LPF. **Responsible officer:** David Vallery **Implementation date:** 31 December 2023

3. Members training	Medium
Observation	Our review found that all, but one, current Pensions Committee and Board members met the requirement to have a minimum of 21 hours training.
Implication	Lack of training might lead to less efficient oversight and scrutiny of the Funds activities.
Recommendation	While the LPF Code of Conduct states that these requirements have to be met 'from time to time' we would encourage all the members to fulfil this obligation to allow an effective oversight of the Funds activities.
Management response	The matter has been raised with the member in question and will be escalated to the Pension Committee convenor. The Fund continues to provide training to its committee and board members. Additional resources have been allocated to the Secretariat team which will provide additional support and scrutiny to ensure a standard of knowledge is maintained. A revised training and induction framework will be issued later in the year which will set clear expectations and provide clear guidance on training. **Responsible officer:** David Vallery **Implementation date:** 31 December 2023

Appendix 3: Follow up of prior year recommendations

We have followed up on the progress the Funds has made in implementing the recommendations raised by the previous auditor last year which were reported as either new or ongoing.

1. 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 that if the unfunded benefits were paid directly from an LPF bank

1. Bank accounts	Action raised in 2017/18
	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.
Implementation date	**As soon as possible**
Ongoing	Following a competitive procurement process for a new financial ledger system, LPF has identified a preferred tenderer and is liaising with the company to finalise suitable contractual terms. This will include recognition of a further assurance review stage to be undertaken by a specialist provider, prior to implementation of the new system. The tender specification addressed the requirement for suitable configuration to provide "stand alone" payment and sales invoicing for LPF, independent of the City of Edinburgh Council. In respect of payments to pensioners for "unfunded" discretionary awards by former employers, LPF has attained external legal advice which reconfirms its understanding that should unfunded benefits be paid directly from an LPF bank account, then HMRC would regard such payments as unauthorised. The use of a Fund bank account for these "unfunded transfer payments", therefore, is prohibited. Consequently, for reasons of efficiency and simplicity, the pension payroll is combined and both funded and unfunded pension payments are made through a general fund bank account of the administering authority, City of Edinburgh Council. For the funded LGPS payments, the Fund transfers money from its own bank account to that of the City of Edinburgh Council's to cover the value of these

1. Bank accounts	Action raised in 2017/18
	benefits. For the unfunded payments, these are recharged to the employer body (or successor) which originally granted the discretionary benefits. Accordingly, LPF has asked for a (further) response from SPPA for its clarification that the current payment methods, as adopted consistently across all Scottish LGPS administering authorities, should not be interpreted as being in conflict with regulations. LPF's rationale, as asserted to SPPA, is as follows: "LPF transfers the funds to the CEC bank account on the same day as the pensions are paid so there is no question of LPF money sitting in a CEC bank account. The 2010 Regulations require that an administering authority must hold in a separate bank account all monies received by it. There is no stipulation that an authority must pay benefits directly from its bank account to a beneficiary. At the point LPF is paying pensions and other benefits, it is not holding money in an account, it is carrying out a transaction for the purposes of the fund. On that basis, we believe that there is sufficient scope for the SPPA to clarify the interpretation of the Regulations so that is clear that an administering authority may use an intermediary bank account for the purpose of making fund payments." SPPA in their response confirmed that is appropriate to keep the CEC bank account for the unfunded payments. In respect of these mandatory and discretionary compensation payments made by LGPS administering authorities to retired teachers (Teachers' Scheme rather than Local Government Pension Scheme (LGPS)), along with other Scottish LGPS administering authorities, the Fund has requested that responsibility should transfer to the Scottish Public Pensions Agency (SPPA). SPPA has sought information on the relevant scope and scale of the payments being made across those administering authorities wishing to transfer. On

1. Bank accounts	Action raised in 2017/18
	receipt of such, SPPA has committed to consider the matter. **2022/23 update:** Management are now comfortable with the position from CEC regarding funded benefits payments. The transition of the general ledger to XLedger will allow LPF to make supplier payments directly from their own bank accounts.

2. 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.
Implementation date	**Initial target date March 2019**
Ongoing	This is an ongoing issue in 2022/23; however, we did not identify any instances where journals were posted by inappropriate users. **2022/23 update:** LPF are in the process of transitioning financial ledgers to XLedger which will be hosted by LPF. The project has focused on ensuring appropriate access rights as part of systems implementation this and an ongoing review of access rights should address potential concerns around access to the ledger.