



Lothian Pension Fund

2015/16 Annual audit report to Members and the Controller of Audit

September 2016

Key contacts

David McConnell, Assistant Director
dmccconnell@audit-scotland.gov.uk

Stephen O'Hagan, Manager
sohagan@audit-scotland.gov.uk

Neil Reid, Senior Auditor
nreid@audit-scotland.gov.uk

Audit Scotland

4th Floor (South Suite)

8 Nelson Mandela Place

Glasgow

G2 1BT

Telephone: 0131 625 1500

Website: www.audit-scotland.gov.uk

The Accounts Commission is a statutory body which appoints external auditors to Scottish local government bodies (www.audit-scotland.gov.uk/about/ac/). Audit Scotland is a statutory body which provides audit services to the Accounts Commission and the Auditor General (www.audit-scotland.gov.uk/about/).

The Accounts Commission has appointed David McConnell as the external auditor of Lothian Pension Funds for the period 2011/12 to 2015/16. This report has been prepared for the use of City of Edinburgh Council as Lothian Pension Funds administrator and no responsibility to any member or officer in their individual capacity or any third party is accepted.

The information in this report may be used for the Accounts Commission's annual overview report on local authority audits published on its website and presented to the Local Government and Regeneration Committee of the Scottish Parliament.

Contents

Key messages	3
Introduction	5
Audit of the 2015/16 financial statements.....	6
Financial management and sustainability – Lothian Pension Fund	11
Governance and transparency	16
Best Value.....	21
Appendix I: Significant audit risks	25
Appendix II: Summary of Lothian Pension Funds local audit reports 2015/16	27
Appendix III: Action plan.....	28

Key messages

Audit of financial statements

- An unqualified auditor's report was issued on the 2015/16 financial statements of Lothian pension, Buses and Scottish Homes Funds.
- No adjustments were required to the Funds' financial statements.

Financial management and sustainability

- Lothian Pension and Lothian Buses Funds' net assets increased by 6.4% to £5,434 million and 2.2% to £394.4 million, respectively, at 31 March 2016. Scottish Homes Pension Fund net assets decreased by 2.9% to £150.3 million at 31 March 2016.
- The Lothian Pension Fund currently receives more in contributions from employers and members than it pays in benefits to pensioners. The Lothian Buses and Scottish Homes Pension Funds receive less in contributions from employers and members than it pays in benefits to pensioners.
- This is the first year of LPFE being operational and has resulted in consolidated financial statements of LPF.
- Overall, satisfactory financial management arrangements are in place.

Governance and transparency

- Arrangements for the prevention and detection of fraud and corruption are satisfactory.
- New governance arrangements have operated effectively during 2015/16 with the Pensions Committee and Pension Board meeting concurrently.
- Appropriate systems of control were in place in 2015/16.
- Training of councillors and board members continues to be important to effective governance going forward and a training programme is in place.



Best Value

- The Funds' returns on investments for the 2015/16 financial year have met or exceeded relevant benchmarks.
- The Lothian Pension, Lothian Buses and Scottish Homes Funds have a ratio of management expenses to net assets (total expense ratio) of 0.66%, 0.45% and 0.15% respectively which compares well with other funds.



Outlook

- The global investment outlook remains volatile due to political and economic challenges including Brexit, a slowdown in the Chinese economy, weak growth in the Eurozone, recession in emerging markets and uncertainty about further interest rate rises in the USA.
- Scrutiny of investment performance and scheme management costs is likely to come under increasing scrutiny and Scottish Ministers have already expressed an interest in the views of the national scheme advisory board on fund structure and asset pooling. The Scheme advisory board have convened a working group with a view to producing an options paper in December.

Introduction

1. This report is a summary of our findings arising from the 2015/16 audit of Lothian Pension Funds (the Funds). The report is divided into sections which reflect our public sector audit model.
2. The management of the Funds is responsible for:
 - preparing financial statements which give a true and fair view
 - implementing appropriate internal control systems
 - putting in place proper arrangements for the conduct of its affairs
 - ensuring that the financial position is soundly based.
3. Our responsibility, as the external auditor of the Funds, is to undertake our audit in accordance with International Standards on Auditing, the principles contained in the Code of Audit Practice issued by Audit Scotland in May 2011 and the ethical standards issued by the Auditing Practices Board.
4. An audit of financial statements is not designed to identify all matters that may be relevant to those charged with governance. It is the auditor's responsibility to form and express an opinion on the financial statements; this does not relieve management of their responsibility for the preparation of financial statements which give a true and fair view.
5. **Appendix I** lists the audit risks that we identified in the annual audit plan we issued in March 2016. It also summarises the assurances provided by management to demonstrate that risks are being addressed as well as the conclusions of our audit work.
6. **Appendix II** is an action plan setting out our recommendations to address the high level risks we have identified during the course of the audit. Officers have considered the issues and agreed to take the specific steps in the column headed "Management action/response". We recognise that not all risks can be eliminated or even minimised. What is important is that the Funds understands its risks and has arrangements in place to manage these risks. The Pension Committee and senior management should ensure that they are satisfied with proposed action and have a mechanism in place to assess progress and monitor outcomes.
7. We have included in this report only those matters that have come to our attention as a result of our normal audit procedures; consequently, our comments should not be regarded as a comprehensive record of all deficiencies that may exist or improvements that could be made.
8. 2015/16 is the final year of the current five year audit appointment. From 2016/17 the auditor of the Funds will be Scott Moncrieff. In accordance with agreed protocols and International Standards on Auditing we will be liaising with the incoming auditors as part of this transition.
9. The cooperation and assistance afforded to the audit team during the course of the audit is gratefully acknowledged.

Audit of the 2015/16 financial statements

Audit opinion	<ul style="list-style-type: none">We have completed our audit and issued an unqualified independent auditor's report.
Going concern	<ul style="list-style-type: none">The financial statements of the Lothian Pension, Lothian Buses and Scottish Homes Funds have been prepared on the going concern basis. We are unaware of any events or conditions that may cast significant doubt on the pension funds' ability to continue as a going concern.
Annual report & other information	<ul style="list-style-type: none">We review and report other information published with the financial statements, including the management commentary, annual governance statement and governance compliance statement. We have nothing to report as a result of our review.

Submission of financial statements for audit

10. We received the unaudited financial statements on 10 June 2016, in accordance with the agreed timetable. The working papers were of a good standard and pension fund staff provided good support to the audit team which assisted the delivery of the audit to deadline.

Overview of the scope of the audit of the financial statements

11. Information on the integrity and objectivity of the appointed auditor and audit staff, and the nature and scope of the audit, were outlined in our Annual Audit Plan presented to the Pension Committee on 15 March 2016.

12. As part of the requirement to provide full and fair disclosure of matters relating to our independence, we can confirm that we have not undertaken non-audit related services. The 2015/16 agreed fee for the audit was set out in the Annual Audit Plan and, as we did not carry out any work additional to our planned audit activity, the fee remains unchanged.
13. The concept of audit risk is of central importance to our audit approach. During the planning stage of our audit we identified a number of key audit risks which involved the highest level of judgement and impact on the financial statements and consequently had the greatest effect on the audit strategy, resources and effort.

14. We set out in our Annual Audit Plan the audit work we proposed to undertake to secure appropriate levels of assurance. [Appendix I](#) sets out the significant audit risks identified during the course of the audit and how we addressed each risk in arriving at our opinion on the financial statements.
15. Our audit involved obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error.

Materiality

16. Materiality can be defined as the maximum amount by which auditors believe the financial statements could be misstated and still not be expected to affect the decisions of users of financial statements. A misstatement or omission, which would not normally be regarded as material by amount, may be important for other reasons (for example, an item contrary to law).
17. We consider materiality and its relationship with audit risk when planning the nature, timing and extent of our audit and conducting our audit programme. Specifically with regard to the financial statements, we assess the materiality of uncorrected misstatements, both individually and collectively.
18. We summarised our approach to materiality in our Annual Audit Plan and set materiality at 0.5% of net assets and 1% of total contributions received for each separate Fund. We set a lower level, known as performance materiality, when defining our audit

procedures. Based on the unaudited financial statements, we revised our materiality for 2015/16 as illustrated at **Exhibit 1**.

Exhibit 1: Materiality levels.

Financial statements	Materiality £000s	Performance Materiality £000s
Lothian Pension Fund		
Net assets	27,170	20,380
Fund account	2,055	1,540
Reporting threshold - £100k		
Lothian Buses Pension Fund		
Net assets	1,970	1,480
Fund account	95	70
Reporting threshold - £15k		
Scottish Homes Pension Fund		
Net assets	750	565
Fund account	7	5
Reporting threshold - £1k		

Source: Lothian Pension Funds audited financial statements 2015/16

Evaluation of misstatements

19. There were no misstatements identified during the audit which exceeded our misstatement threshold. Therefore, no amendments have been made to the financial statements which impact upon either the net returns on investments for the year or the net assets position at 31 March 2016.
20. A number of presentational issues were identified within the financial statements during the course of our audit. These were discussed with relevant officers who agreed to amend the unaudited financial statements.

Significant findings from the audit

21. International Standard on Auditing 260 requires us to communicate to you significant findings from the audit, including:
 - The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures.
 - Significant difficulties encountered during the audit.
 - Significant matters arising from the audit that were discussed, or subject to correspondence with management.
 - Written representations requested by the auditor.
 - Other matters which in the auditor's professional judgment, are significant to the oversight of the financial reporting process.

22. **Table 1** below details those issues or audit judgements that, in our view, require to be communicated to those charged with governance in accordance with ISA 260.

Table 1: Significant findings from the audit

Significant findings from the audit in accordance with ISA260

Investment management fees: The Funds' officers have previously worked closely with CIPFA on the development of guidance on accounting for pension scheme management costs. CIPFA introduced guidance to increase transparency of investment costs relevant to fund of funds and for 2015/16, LPF has continued to identify fund of funds transactions. However, during 2015/16 further guidance has been released which indicates that the Funds should only report direct costs. Going forward, officers have indicated that they plan to continue to provide this detailed analysis as they feel that it is fully transparent for investment costs.

Officers require to consider the new CIPFA guidance on how best to reflect the investment management fees within the financial statements going forward.

See Action Plan No.1

Contributions Received: Officers compile an annual reconciliation of the employee contributions received from the seven largest employers of the Lothian Pension Fund, comparing the expected amount per the pension administration system to the actual amounts received. As at 7 September 2016, the reconciliation indicated that contributions received were £0.113m more than anticipated within the Pension administration system. This equates to 0.3% of the contributions receivable by the fund for the seven employers.

Solution

Officers have confirmed that these should represent valid contributions and the reconciliation differences arose due to delays in the notification of the entry of new members to the scheme. We have concluded that this is not material and no further action is required.

Future accounting and auditing developments

Code of Audit Practice

23. A new Code of Audit Practice will apply to all audits from financial year 2016/17. There will be a focus on four areas:
- Financial sustainability
 - Financial management
 - Governance and transparency; and
 - Value for money
24. The new Code increases the transparency of our work by making more audit outputs available on Audit Scotland's website. In addition, as well as the annual audit report, other significant outputs, such as the annual audit plan, will be published on Audit Scotland's website. This is irrespective of whether the body meets in public or makes documents such as Audit Committee papers routinely available on its own website.

Code of Practice on Local Authority Accounting

25. The financial statements of pension funds are prepared in accordance with the Code of Practice on Local Authority Accounting in the UK (the Code) which interprets and adapts International Financial Reporting Standards (IFRS) to the local authority context.

26. From 2016/17, the following changes to the code will apply:
- Amendments to the format of the accounts to be consistent with the new Financial Reports of Pension Schemes – A Statement of Recommended Practice 2015.
 - New disclosure requirements for investments measured at fair value.
 - Recommendations for a new disclosure on investment management transaction costs.

Financial management and sustainability – Lothian Pension Fund



Financial management

27. In this section we comment on the pension fund’s financial outcomes and assess financial management arrangements.
28. Pension fund finances are independently assessed every three years by the fund actuary. This assessment determines the employer contribution rates and deficit funding payments for the upcoming 3 year period and takes account of the strength of employer covenants and the fund’s investment strategy.
29. Setting the fund’s investment strategy and monitoring performance against it is a key part of financial management. Investment strategy is a complex area and has to take account of factors such as the overall fund deficit, cash flows from dealing with members and the maturity of fund membership. Balancing the risks and rewards from various asset types and approaches is something that the fund takes advice on from professional advisors.
30. The strategy of lowering risk was rewarded over 2015/16 as the Funds’ produced the following returns compared to benchmark (See **Exhibit 2**).

Exhibit 2: Investment returns compared to benchmark 2015-16

Fund	1 year Return / benchmark	5 years Return / benchmark	10 years Return / benchmark
Lothian	+6.5 % / +0.2%	+9.1% / +7.1%	+6.5% /+5.1%
Buses	+3.1% / +1.2%	+9.6% / +7.8%	+7.8% / +6.3%
Scottish Homes	+1.7% / +1.9%	+9.6% / +9.6%	+8.6% / +8.4%

Source: Lothian Pension Funds audited financial statements 2015/16

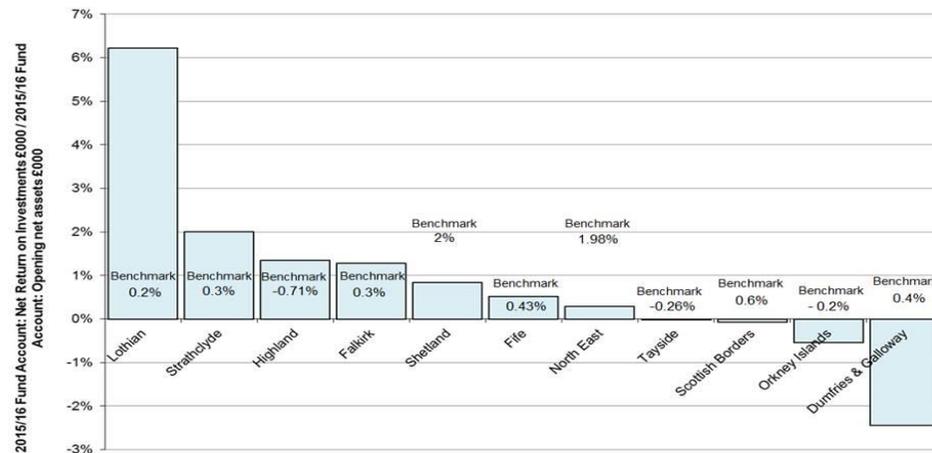
31. Getting the investment strategy right for the Funds is vitally important and often overshadows other aspects of financial management in relation to areas such as administration cost, for example. However, with financial pressures on pension funds and other employers these areas are coming under increased scrutiny.

Financial outcomes

32. The Lothian Pension Fund reported an increase in net assets of £327.8 million (6.4%). This relates mainly to investment valuations, both realised and unrealised, which showed a significant increase on the year before (£5,106.2 million) and illustrates the volatility associated with investment returns. There was also a decrease of £7.9 million of net additions from dealing with members from 2014/15.

33. Lothian Buses reported an increase in net assets of £8.7 million and a decrease of £0.505 in net withdrawals from dealing with members compared to 2014/15.
34. Scottish Homes Pension Fund reported a decrease in net assets of £4.4 million and an increase of £0.206 million in net withdrawals from dealing with members compared to 2014/15.
35. Invest performance is the main constituent on movements in net assets. In terms of Investment performance, 2015-16 has not been a good year for Scottish pension funds, however, the Funds performance contrasts with the general trend noted at **Exhibit 3**.

Exhibit 3: Net return on investments 2015-16



Source: draft Scottish Pension Funds financial statements 2015/16

Financial management arrangements

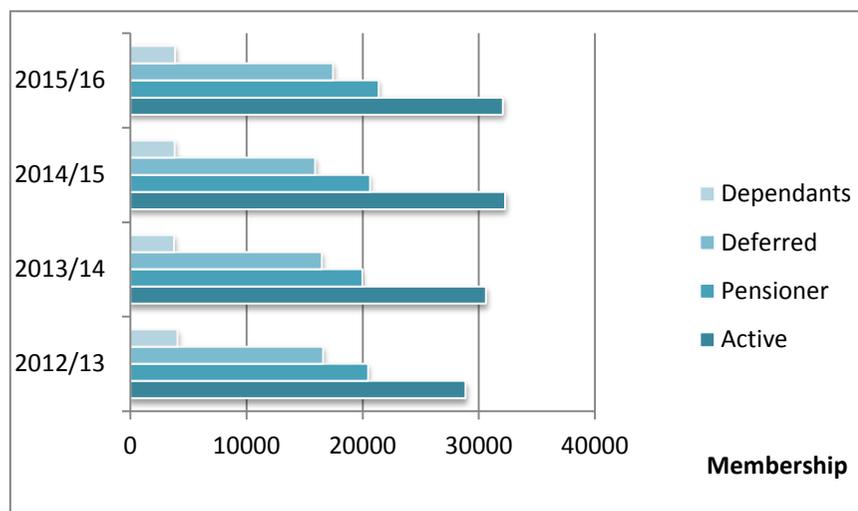
36. As auditors, we need to consider whether the pension fund has established adequate financial management arrangements. We do this by considering a number of factors, including whether:
 - the proper officer and fund manager have sufficient status within the council to be able to deliver good financial management
 - financial regulations are comprehensive, current and adhered to
 - reports monitoring performance against budgets are accurate and provided regularly to members
 - monitoring reports do not just contain financial data but are linked to information about performance
 - members provide a good level of challenge on significant variances and under performance.
37. We assessed the role and status of the proper officer against CIPFA’s “Statement on the role of the Chief Financial Officer in Local Government” and concluded that the Funds’ comply with the statement’s five principles.
38. Our review noted that the proper officer (the Chief Finance Officer) has sufficient status to deliver good financial management of the Funds.
39. The Funds do not have their own financial regulations, however they comply with City of Edinburgh Council’s (administering authority) financial regulations. Our review of the Council’s financial regulations concluded that they are comprehensive and current. The financial regulations are available on the council’s website.

40. Regular reporting on budget monitoring and investment performance updates is provided to the Pensions Committee members on a regular basis throughout the year.
41. Reports are comprehensive and we have observed a good level of review and scrutiny by board members. We have concluded that the Funds' overall financial management arrangements are satisfactory.

Financial sustainability

42. The Funds give their members a guarantee that in exchange for contributions during their employment, the fund will pay a pension until the end of each member's life.
43. There is a timing difference of many years between the receipt of contributions and the payment of pensions. Financial sustainability means that the fund maintains the capacity to meet the current and future needs of its members, despite changes of investment performance and life expectancy.
44. In assessing financial sustainability we are concerned with whether:
 - the Funds liabilities are greater or smaller than the Funds' assets (the actuarial position)
 - contribution rates strike an appropriate balance between the needs of the schemes and the needs of employers
 - where there is a deficit, long term recovery measures are in place
- the Funds' investments have a profile of risk that is consistent with expected cash flows.
45. Effective investment strategy, investment management and regular actuarial review are crucial to sustainability.
46. The Lothian Pension Fund is a multi-employer fund with schedule bodies and admitted bodies. Given the nature of these employers the funding risk associated with default is seen as relatively low and the fund currently plans to recoup deficits over a 20 year period for most of the employers liabilities.
47. The new LGPS includes a cost sharing arrangement which will cap employer costs in relation to current service and help ensure that the schemes remains affordable for employers.
48. Additionally, the retirement age for most LGPS members going forward is linked to the state retirement age and this may also act to limit scheme liabilities for active members.
49. The current membership profile is shown at **Exhibit 4**. The combined impact of active members outweighing pensioners and the set levels of contributions rates by the actuary means that contribution rates continue to exceed benefits payable.

Exhibit 4: Membership



Source: Lothian Pension Funds audited financial statements 2015/16

- 50. The split of employer contributions between current service, past service and deficit funding is shown in **Exhibit 5**.
- 51. Contribution rates and fixed payments required to support the Funds back to its fully funded status will be re-reviewed by the Actuary following the next triennial funding valuation as at 31 March 2017.

Exhibit 5: Employer contributions

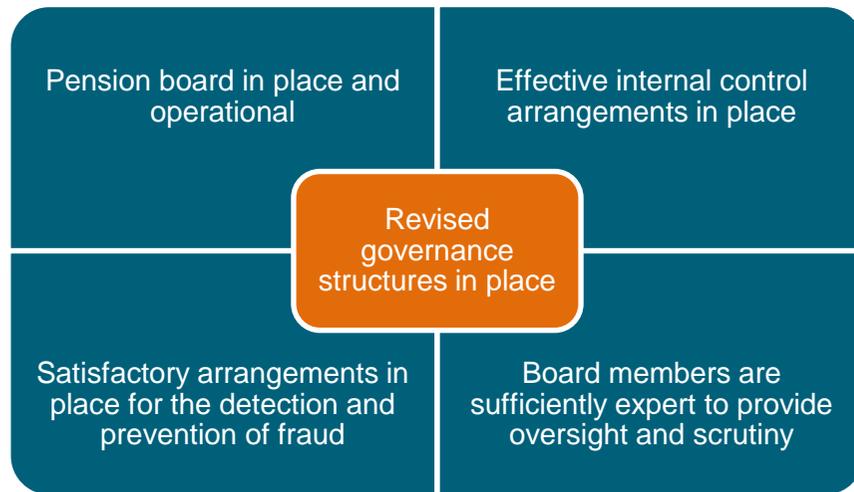
Employer	Current service £m	Deficit funding contributions £m	Strain on the fund £m	Total £m
Lothian Pension	133.035	7.357	19.480	159.872
Lothian Buses	7.425	0	0.113	7.538
Scottish Homes	0.100	0.575	0	0.675

Source: Lothian Pension Funds audited financial statements 2015/16

Outlook

- 52. The financial outlook across the public sector and in local government in particular remains challenging. Recent revisions to the LGPS should help ensure that the scheme is affordable to employers going forward whilst the scheme remains attractive to employees.
- 53. It is perhaps inevitable that management costs and investment performance will come under increasing scrutiny given the financial pressures faced by employers and employees alike. As a result, pension funds may need to be more radical in their approaches to administration and investments going forward.

Governance and transparency



- 54. City of Edinburgh Council is the administering body for the Funds. The council has delegated responsibility for governance to the Pensions Committee.
- 55. Members of the Pensions Committee, supported by the pensions board, is responsible for establishing arrangements to ensuring the proper conduct of the affairs of the Funds in accordance with the law and proper standards and for monitoring the adequacy and effectiveness of these arrangements. We concluded that the council has effective overarching and supporting governance arrangements

which provide an appropriate framework for organisational decision making.

- 56. As part of our work we reviewed various aspects of governance that apply to the fund including standing orders, financial regulations, Codes of Conduct for officers and members, anti-fraud and corruption arrangements, and arrangements for reporting to the Pension Regulator on breaches of regulation.
- 57. Members of the Funds should be able to hold the Funds to account for the services these provide. Transparency means that fund members should have access to understandable, relevant and timely information about how the fund is taking decisions and how it is using its resources.
- 58. Overall, we concluded that the council is open and transparent.

Governance structure

- 59. The corporate governance framework for the Funds is centred on the Pensions Committee which is supported by a Pensions Audit Sub-Committee. City of Edinburgh Council's Acting Executive Director of Resources has delegated authority for the implementation of the Funds' investment strategy.
- 60. Based on our observations and audit work our overall conclusion is that the governance arrangements within the Funds are operating effectively and are open and transparent.

Governance processes and committees

- 61. City of Edinburgh Council acts as the administering authority for the Funds. It is responsible for managing and administering the scheme for scheduled and admitted bodies.
- 62. The Council has delegated the administration, management and investment of the Funds to the Pensions Committee. The committee comprises councillors from City of Edinburgh Council and representatives from employers and members of the schemes.
- 63. The Public Service Pension Act 2013 introduced new governance arrangements for LGPS pension funds and from 1 April 2015, funds were required to introduce local pension boards. The remit of the Pension Board is to support the Pension Committee in compliance with regulations and with requirements imposed by the Pension Regulator. The Pension Board meets quarterly on the same cycle as the committee.
- 64. The Pension Board consists of five employer representatives and five union representatives. The Chair is alternated on an annual basis between the representatives. If at least half the members of the Pension Board disagree with a decision of the Pension Committee then they can request in writing that the Pension Committee review that decision. There have been no requests to review decisions in 2015/16.
- 65. A key aspect to the operating effectiveness of the Pensions Board is the retention of knowledge and understanding to support the role.
- 66. A register of training for committee members is maintained by the Funds' detailing a range of training opportunities and time spent training. Our review noted that all Pension Board and Pension Committee members undertook at least 3 days training during 2015/16.
- 67. As the Council is the administering authority for the Lothian Pension Funds the day to day administration of the Funds is carried out by the Investment and Pensions Division. The Chief Finance Officer has been delegated section 95 responsibility for the Funds.

Pension Regulator public service code

- 68. The Pension Regulator issued a code on the governance and administration of public service pension schemes in January 2015. The Funds have undertaken a high level review against the code in 2015-16 and have concluded that they are compliant in all major respects.

Investment Operations

- 69. The Pensions Committee and subsequently City of Edinburgh Council, agreed in October 2014 to the creation of two special purpose vehicles wholly owned and controlled by the council to be established for the purpose of seeking Financial Conduct Authority (FCA) authorisation for the activities of this team and directly employing certain key staff associated with the Funds investment function to minimise the risk of not retaining staff.

- 70. The employment of the internal investment team was transferred to LPFE Limited in May 2015 with revised terms and conditions of employment agreed including longer notice periods which have reduced the risk to the Funds.
- 71. LPFE Limited has also been established to support the investment programme of the in-house investment team by providing operational efficiencies and carrying out business from a vehicle authorised by the Financial Conduct Authority (FCA). Authorisation from the FCA is pending and is expected in the summer of 2016.
- 72. The impact of creating the special purpose vehicles in relation to the accounting treatment and presentation within the financial statements was discussed in detail with the Funds' officers during 2015/16.
- 73. Following accounting guidance provided by Scott-Moncrieff and Audit Scotland, it was agreed that the two companies should be consolidated into the Lothian Pension Fund with a recharge of costs to the other two pension funds,
- 74. Taking account of the group transactions, there is no material difference for LPF. The only key change being the retirement benefit obligation of £0.180 million within the group.

Annual Governance Statement and Governance Compliance Statement

- 75. The Code of Practice on local authority accounting in the United Kingdom 2014/15 has been amended to require the Funds Annual

Report and Financial Statements to include both an annual governance statement and an annual compliance statement.

- 76. Our review of the 2015/16 Annual Governance Statement noted a positive development from previous years where it had been based primarily on the content of the council's Annual Governance Statement.
- 77. The governance compliance statement is designed to compare the Funds' governance arrangements against the standards set out in the guidance issued by the Scottish Ministers. We reviewed the governance compliance statement and are satisfied that it complies with the guidance issued by the Scottish Ministers.
- 78. The governance structures have been working well with no issues relating to openness, reporting or scrutiny. The information reported in the governance compliance statement is consistent with our knowledge and understanding of the Funds' governance arrangements, based on our audit knowledge, attendance at meetings, and review of papers and minutes.

Internal control

- 79. The Accounts Regulations 2014 require the Pension Committee to consider the findings of an annual review of the system of internal control and to approve the Annual Governance Statement for the Funds.

80. The Funds' financial systems are run alongside those of the City of Edinburgh Council. We obtained confirmation from the external auditors of the council that there were no significant weaknesses in the internal controls for those systems for 2015/16.
 81. As part of our work we also took assurance from key controls within the Funds' financial systems. We concluded that no material weaknesses in the accounting and internal control systems were identified which could adversely affect the ability to record, process, summarise and report financial and other relevant data so as to result in a material misstatement in the financial statements.
- ## Internal audit
82. Internal audit is an important element of the Funds governance structure. Internal audit provides the Pensions Sub-Audit Committee, Pension Committee members and management of the Funds' with independent assurance on risk management, internal control and corporate governance processes. We are required by international auditing standards to make an assessment of internal audit to determine the extent to which we can place reliance on its work. To avoid duplication, we place reliance on internal audit work where possible.
 83. The internal audit service is provided by City of Edinburgh Council via a co-source arrangement with PricewaterhouseCoopers. Our review of internal audit concluded that it complies with the main requirements of the Public Sector Internal Audit Standards and has sound documentation standards and reporting procedures in place.
 84. The Public Sector Internal Audit Standards require internal audit to deliver an annual internal audit opinion and report that can be used by the organisation to inform its governance statement.
 85. The annual internal audit opinion should conclude on the overall adequacy and effectiveness of the organisation's framework of governance, risk management and control. It should also contain certain information, including a summary of the work that supports the opinion; a statement on conformance with the Public Sector Internal Audit Standards and the results of the quality assurance and improvement programme.
 86. Internal Audit conducted three pension fund reviews during 2015/16 on immediate payments, pension compliance and externally managed investments. This work was considered in our assessment of the internal controls put in place by the Funds.
 87. Internal Audit has not identified any fundamental weaknesses in the framework of governance, risk management and control. Therefore, Internal Audit provided an opinion in compliance with the above requirements, and it was presented to the Pensions Audit Sub Committee on 22 June 2016 along with other key assurance statements, as part of the consideration of the unaudited financial statements. Overall, we concluded that the internal audit service operates in accordance with Public Sector Internal Audit Standards.

Arrangements for the prevention and detection of fraud

88. The Funds comply with the relevant fraud and irregularity policies of City of Edinburgh Council and these have been reviewed as part of our audit of the Council. No issues have been identified for inclusion in this report.

Arrangements for the detection and prevention of fraud and corruption

89. Councillors and board members have received training on council policies in this area and have also considered the Pension Regulator toolkit on conflicts of interest.
90. There has been a proactive approach to the use of National Fraud Initiative data in relation to checks on deceased members' pensions. The Funds also promoted awareness of liberation fraud amongst its members.
91. The arrangements for the prevention and detection of corruption in the Funds are satisfactory and we are not aware of any specific issues that we need to record.

Transparency

92. The management commentary within the financial statements includes management's assessment of the financial performance of the fund, and the risks that are managed. It also includes indicators of administrative performance.

93. Financial monitoring reports are provided to attendees at the Pension Funds Sub-Audit Committee and Pension Board going forward. Information about the pension fund is published on the Funds' website and there is a good level of transparency around pension fund business. Overall we concluded that the Funds administration is open and transparent.

Outlook

94. The change to Career Average Related Earnings (CARE) and the introduction of new governance arrangements have been major changes for the pension fund which demand ongoing investment in terms of governance and administration. Changes to the state pension arrangements and the need for Guaranteed Minimum Pension reconciliations have also added to workloads.
95. Going forward the operation of cost sharing mechanisms may well increase levels of interest and scrutiny in pension fund business. We understand that preparations are underway for the Government Actuary Department (GAD) to undertake a review in relation to cost sharing on behalf of Scottish Ministers.
96. There is a move to the pooling of fund assets through collective investment vehicles south of the border and Scottish Ministers have already indicated that this is an area where the views of the national Scheme Advisory Board's may be requested in due course.

Best Value

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

Investment performance

99. Investments are managed both by external fund managers and the Funds' internal investment management team. Through the use of mandates, responsibility for the management of the Funds' investments has been divided up. **Exhibit 6** shows the allocation of investments to fund managers for the Lothian Pension Fund as at 31 March 2016.
100. Approximately 47% of the Lothian Buses Pension Fund is managed by in-house investment managers, with the remainder allocated between 2 separate external investment managers, Baillie Gifford (43%) and Standard Life (10%).
101. Approximately 40% of the Scottish Homes Pension Fund investments are managed by in-house investment managers, with the remainder allocated between 2 separate external investment managers State Street (55%) and Standard Life (5%).

Exhibit 6: Fund managers' allocation 2015-16 (Lothian Pension Fund)

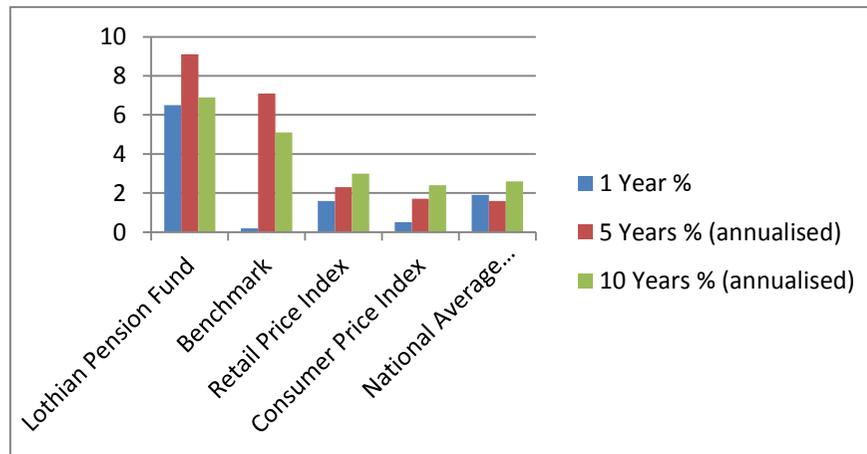
Fund Manager	Market Value £'000	% of Total Fund Value
In-house Investment Managers	4,565,947	84.6
Harris	186,652	3.5
Nordea	223,912	4.1
Standard Life	422,452	7.8
Total	5,398,963	100

Source: Lothian Pension Funds audited financial statements 2015/16

102. The main mechanism for measuring investment performance is through an analysis of the returns achieved by each of the Funds' fund managers. Each active Investment Manager has a defined performance benchmark and objective, against which performance will be measured. Their performance, in terms of achieving benchmarks, is subject to independent verification by an external specialist provider and is regularly reported to the Pensions Committee and investment strategy panel.
103. Investment returns of the Lothian Pension Fund have outperformed benchmark targets over the short, medium and longer term, as illustrated in **Exhibit 7**. The table also shows that over a period of one, five and ten years the pension fund has outperformed the relevant measures of inflation.

- 104. Lothian Buses Pension Fund investment returns exceeded the required performance benchmark levels for 2015/16. The portfolio as a whole made returns of 3.1% against the benchmark target of 1.2%.
- 105. Scottish Homes Pension Fund investment returns did not meet the required performance benchmark levels for 2015/16. The portfolio as a whole made returns of 1.7% against the benchmark target of 1.9%.

Exhibit 7: Investment Performance – Lothian Pension Fund



Source: Lothian Pension Funds audited financial statements 2015/16

Administrative performance

- 106. The Funds' Administration Strategy was approved by the Pensions Committee in September 2013. It contains the standards which are required of the participating employers to ensure that the Funds meet their statutory obligations and are able to deliver services efficiently. The strategy contains a variety of performance measures against which the Funds and the participating employers are assessed.
- 107. In accordance with Local Government Regulations, the Funds' annual report discloses performance against the measures detailed in the Pension Administration Strategy. In relation to 2015/16 the Funds' performance was broadly in line with the annual targets set.

Investment strategies

- 108. The Funds' investment strategies 2012-17, as agreed by the Pensions Committee in October 2012, have continued to be implemented during 2015/16. The key objective of the Funds' investment strategies is to maximise the investment return within reasonable and considered risk parameters, as illustrated in **Exhibit 8**.
- 109. The Lothian Pension Fund had a higher position in equities and was lower in alternatives compared to the interim strategy at 31 March 2016.

Exhibit 8: Allocation of Investments to Investment strategy

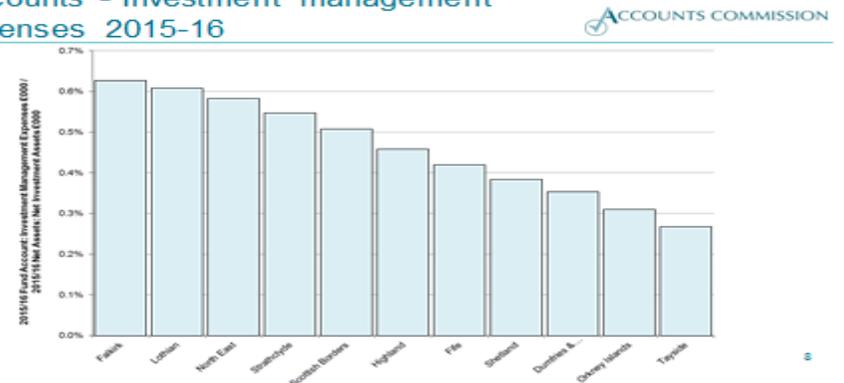
Funds	Allocation 31 March 2016 %	Strategy 31 March 2016 %
Lothian Pension Fund		
Equities	67.8	67.0
Index-Linked Assets	7.0	7.0
Alternatives	24.0	25.0
Cash	1.0	1.0
Lothian Buses Fund		
Equities	60.0	58.5
Index-Linked Assets	12.0	14.0
Alternatives	26.0	27.5
Cash	2.0	0
Scottish Homes Fund		
Equities	30.2	30.0
Bonds	64.5	65.0
Property	5.3	5.0

Source: Lothian Pension Committee June 2016 - Annual Investment updates

110. As illustrated in the table, a number of changes to existing allocations are required to bring into line with the agreed strategy and Funds are continuing to work towards this.

Management expenses

111. There are three main categories of management expense, with the largest being investment management costs. Other expenses are the cost of the administration services provided by the council and the governance fees for actuarial and audit services.
112. In 2015/16 the investment management costs of the Lothian Pension Fund rose from £25.951 million to £32.814 million. **Exhibit 9** shows provisional figures for total management costs for each Scottish pension fund based on unaudited financial statements.

Exhibit 9: Management costs as percentage of net assets of Scottish LGPS funds**Accounts - Investment management expenses 2015-16**

Source: Draft Scottish Pension Funds financial statements 2015/16

- 113. At 0.66%, the Lothian Pension Fund's management costs are comparatively low, which contributes to long term asset growth.
- 114. It is noted at this stage that there is inconsistency in the level of cost transparency between funds and that management costs will be heavily influenced by the asset allocation of a Fund.

Outlook

- 115. Recent developments in English Local Government Pension Schemes (LGPS) have seen the introduction of a National LGPS Framework being introduced in effort to reduce the cost of procurement of the LGPS sector. The framework, being coordinated by Norfolk County Council, sought to appoint companies to advise on actuarial, governance and benefit matters and is being backed by 7 English LGPS.
- 116. With financial austerity within the public sector likely to continue and increased pressure from employers to keep costs and contributions down makes it imperative for funds to be able to demonstrate best value and continued improvement. Just as council's themselves are having to look to new models of service delivery pension funds may need to reconsider the costs and benefits of shared services, procurement exercises and asset pooling.

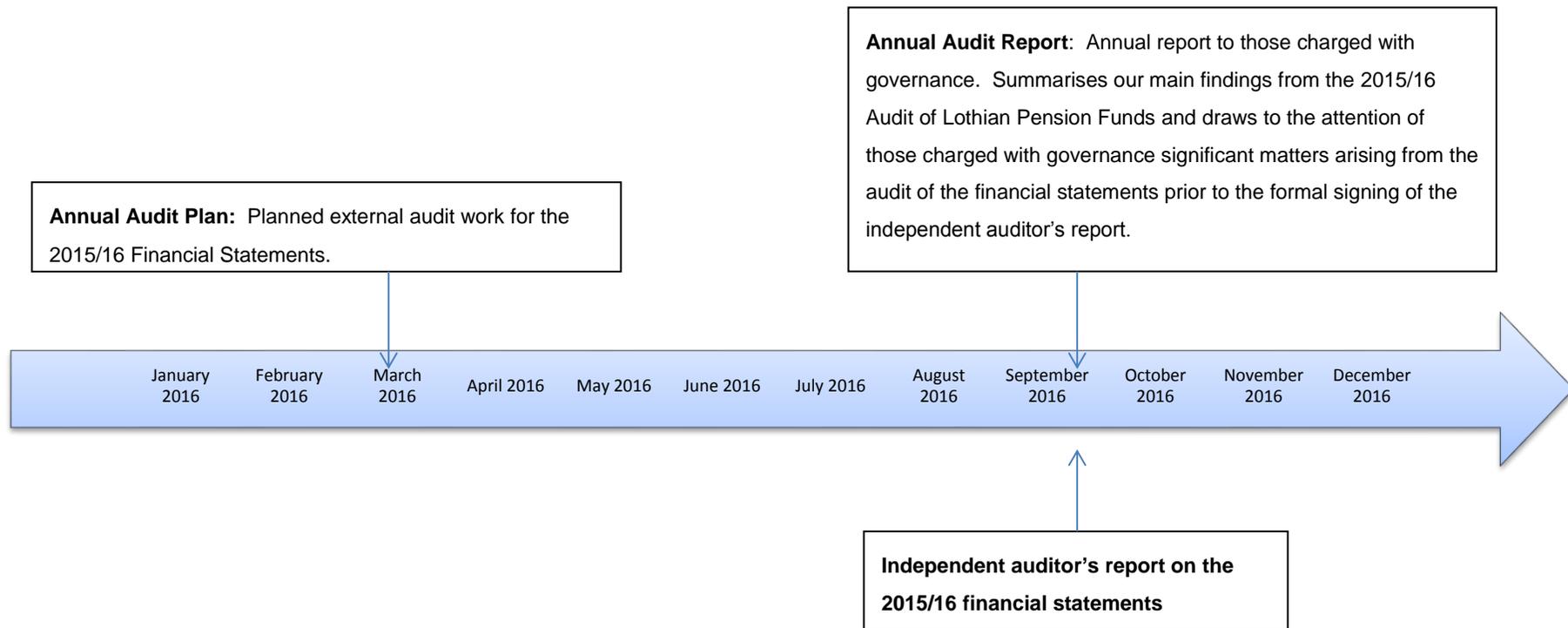
Appendix I: Significant audit risks

The table below sets out the financial statement audit risks we identified during the course of the audit and how we addressed each risk in arriving at our opinion on the financial statements.

Audit Risk	Assurance procedure	Results and conclusions
Risk of material misstatement		
<p>Management override of controls</p> <p>ISA 240 requires that audit work is planned to consider the risk of fraud, which is presumed to be a significant risk in any audit. This includes consideration of the risk of management override of controls in order to change the position disclosed in the financial statements.</p>	<ul style="list-style-type: none"> • Detailed testing of journal entries. • Review of accounting estimates for bias. • Evaluating significant transactions that are outside the normal course of business. 	<p>We undertook detailed testing of journal entries, accruals and prepayments. We also reviewed accounting estimates and transactions for appropriateness.</p> <p>We did not identify any incidents of management override of controls.</p> <p>Satisfactory</p>
<p>Group Accounting</p> <p>Investment and other senior staff have been transferred to a new company created to provide the Funds more flexibility in the terms and conditions on which staff are recruited and investment transactions. There is a risk that transactions between the Funds and the newly established company may not be recorded and disclosed in accordance with the accounting</p>	<ul style="list-style-type: none"> • Substantive testing of transaction between the Funds and the newly established company. • Review of the disclosures made in the Funds' 2015/16 financial statements concerning the relationship between the Funds and the company against the requirements of 'The Code' and sector specific guidance. 	<p>We discussed the impact of preparing group accounts for LPFE with management during 2015/16. We also undertook detailed testing of transactions between LPF and LPFE and reviewed group disclosure notes. We did not identify any material issues.</p> <p>Satisfactory</p>

Audit Risk	Assurance procedure	Results and conclusions
<p>requirements of 'The Code'.</p> <p>Changes to LGPS</p> <p>The Public Service Pension Act 2013 and associated regulations replaced a final salary scheme with a career average revalued earnings (CARE) scheme from 1 April 2015.</p> <p>There is a risk of increased complexity of pension calculations and increased workload of the Funds Administration which may result in an increase in errors.</p>	<ul style="list-style-type: none"> • Review of Funds performance reporting. • Substantive testing of pension calculations during financial statements audit. 	<p>We undertook detailed testing of pension calculations and no issues were noted. We also reviewed the Funds performance reported within the annual report and compared this to what has been reported to the Pensions Committee. No issues identified.</p> <p>Satisfactory</p>
<p>Annual governance statement</p> <p>The Funds Annual Governance Statement in the past has been based primarily on the content of the council's Annual Governance Statement. However, there is a risk that the disclosures are not focused on the governance arrangements of the Pension Funds.</p>	<ul style="list-style-type: none"> • Review of compliance as part of the detailed financial statements review for 2015/16. 	<p>We undertook a detailed review of the governance statement to ensure that it complied with the regulations and was more in-line with a more specific pension fund annual governance statement. No significant issues identified.</p> <p>Satisfactory</p>

Appendix II: Summary of Lothian Pension Funds local audit reports 2015/16



Appendix III: Action plan

No. AS ref.	Paragraph ref.	Issue/risk/Recommendation	Management action/response	Responsible officer / Target date
1.	21	<p>Issue: The Funds are correctly compliant with the required CIPFA guidance 2014 disclosures which promoted greater transparency of investment management fees. However, the new CIPFA guidance that comes into force in 2016/17 has revised their opinion resulting in fees incurred which the Funds have no control should not now be incurred by the Funds.</p> <p>Risk: The Funds may not be compliant with the new CIPFA guidelines.</p> <p>Recommendation: The Funds should review their disclosure arrangements for investment management fees in light of the new guidance.</p>	<p>CIPFA's guidance quotes the Government's criteria for the pooling of LGPS assets as follows: "To really drive savings within the Scheme, it is essential that these hidden costs are better understood and reported as transparently as possible. Although many of these costs are not paid out in cash, they do erode the value of the assets available for investment and so should also be scrutinised and the opportunities for savings explored."</p> <p>The Funds believe that CIPFA's revised guidance is inconsistent with the aim of transparency.</p> <p>The Pensions Committee, at its meeting on 28 September 2016 will be "recommended to instruct the Committee Clerk to communicate its disquiet, and that of the Convenor, on this matter not only to CIPFA, but also both to Audit Scotland and the Scheme Advisory Board (of the Local Government Pension Scheme in Scotland).</p>	n/a