Pensions Audit Sub-Committee

10am, Monday, 16 December 2013

Annual Report on the 2012/13 Audit of the Lothian Pension Funds

Item number	5.1
Report number	
Wards	All

Links

Coalition pledges	
Council outcomes	CO26
Single Outcome Agreement	

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Executive summary

Annual Report on the 2012/13 Audit of the Lothian Pension Funds

Summary

The purpose of this report is to present the Auditor's Annual Report on the 2012/13 Audit of the Lothian Pension Funds. The report from Audit Scotland is shown at Appendix 1. This includes commentary from the Investment & Pensions Manager on the planned management actions. The report will be presented to Committee by Stephen O'Hagan, Senior Audit Manager, Audit Scotland.

In addition to members of the Pensions Committee, Audit Scotland has also sent the report to the Controller of Audit and has advised that the report will be published on its web-site in due course.

Audit Scotland has already provided "an unqualified opinion that the financial statements (of the Lothian Pension Funds) give a true and fair view of the transactions of the funds during the year ended 31 March 2013, and of the amount and disposition at that date of their assets and liabilities".

The Fund will be preparing audit plans for internal and external audit work to be undertaken in the next financial year. It is proposed that these plans are developed in consultation with the Convener of the Pensions Audit Sub-Committee prior to consideration by the Pensions Committee in March 2014.

Recommendations

To recommend that the Committee should:-

1. Note the Annual Report on the 2012/13 Audit of the Lothian Pension Funds;

2. Note the Action Plan at Appendix B of the Report and seek appropriate updates on progress;

3. Agree that the plans for internal and external audit are developed in consultation with the Convener of the Pensions Audit Sub-Committee prior to consideration by the Pensions Committee in March 2014.

Measures of success

Planned management action in relation to the points raised by Audit Scotland is stated at Appendix B.

Financial impact

There are no financial implications arising directly from this report.

Equalities impact

There are no adverse equalities impacts arising from this report.

Sustainability impact

There are no adverse sustainability impacts arising from this report.

Consultation and engagement

The Consultative Panel for the Lothian Pension Funds, comprising employer and member representatives, is integral to the governance of the Funds.

Background reading / external references

Not applicable.

Links

Coalition pledges	
Council outcomes	CO26 – The Council engages with stakeholders and works in partnerships to improve services and deliver agreed objectives.
Single Outcome Agreement	
Appendices	Audit Scotland report on 2012/13 Audit of Lothian Pension Funds

Lothian Pension Funds

Annual report on the 2012/13 audit

AUDIT SCOTLAND

Prepared for City of Edinburgh Council as administering body for Lothian Pension Funds and the Controller of Audit

October 2013

Audit Scotland is a statutory body set up in April 2000 under the Public Finance and Accountability (Scotland) Act 2000. It provides services to the Auditor General for Scotland and the Accounts Commission. Together they ensure that the Scottish Government and public sector bodies in Scotland are held to account for the proper, efficient and effective use of public funds.

Contents

Key messages

2012/13 audit findings

Financial Statements

We have given an unqualified opinion that the financial statements give a true and fair view of the transactions of the Funds during the year ended 31 March 2013, and of the amount and disposition at that date of their assets and liabilities.

Financial Position (Funding)

Triennial funding valuations were carried out by the Funds' actuary as at March 2011. Exhibit 1 summarises the movement in funding levels between triennial valuations.

Exhibit 1: Triennial valuation funding levels

Funds	Triennial Funding Level at 31 March 2011	Triennial Funding Level at 31 March 2008
Lothian Pension Fund	96%	85%
Lothian Buses	112%	95%
Scottish Homes	86%	86%

Source: Triennial funding valuations at 31 March 2008 and 2011

The results of the triennial valuation determines employer contribution rates required over the next three year period (2012/13 to 2014/15) to attain the objective of a fully funded scheme at a set future date. This valuation resulted in the rates for the major employers being set within the range 16.9% to 17.2% (2011/12: 18.3% to 21.8%).

The actuarial statement for the Funds at 31 March 2013, which has no immediate effect on employer contribution rates, reported reduced funding levels for Lothian Pension Fund (87%), Lothian Buses (103%) and Scottish Homes (85%).

Financial Position (Administration costs)

The Funds' actual expenditure compared to the approved budget disclosed an underspend of £1.305 million for the year to 31 March 2013, mainly due to an underspend of £1.302 million on investment managers fees.

Governance and accountability

Overall the council's governance arrangements for the Funds in 2012/13 were adequate. No material weaknesses in the accounting and internal control systems were identified during the audit.

Best Value, use of resources and performance

The Fund has not been subject to a Best Value review however, it is covered by the overall Best Value arrangements of the administering authority. A Best Value audit of City of Edinburgh Council was completed during 2012/13 with a report being submitted in May 2013. There were no specific observations relating to pension fund management.

Annual employer performance against the pension administration standards, as set out in the Pension Administration Strategy (PAS), has been consistently poor since their introduction three years ago. None of the five employer targets set out in the PAS were achieved in 2012/13. The implementation of the Employer On-line Portal resulted in a significant improvement in performance in the last quarter of 2012/13.

During 2012/13 the Funds achieved an annual return equal to or greater than their scheme specific benchmarks. Over the three years to 31 March 2013, the Lothian Pension Fund delivered the same performance as its investment strategy but failed to achieve its higher target return (i.e. in excess of the strategy).

Outlook

The current period is a challenging one for pension fund management. With the global economic outlook and the uncertainty in the financial markets there are particular problems for investment management and strategy. With investment performance key to the funding position of the Local Government Pension Scheme (LGPS) this uncertainty may impact on employer contributions in the medium term.

The Public Service Pensions Act received Royal Assent on 24 April 2013. The Act implements the key recommendations of Lord Hutton's Commission as follows:

- the end of final salary benefit arrangements with the introduction of the career average revalued earnings basis
- retirement age linked to state pension age
- cost control system to provide affordability and sustainability
- measures to strengthen governance
- the latest date for commencement of new schemes under the Act is 6 April 2015.

Proposed changes to the LGPS will impact on administrative workloads going forward as will any further severance activity by employers. Additionally auto enrolment requirements affect information requirements and administration arrangements. Actions such as the introduction of the employer on-line system resulted in an improved employer performance in the final quarter of 2012/13 which will help towards minimising the impact of increases in administrative workloads in the medium term.

The co-operation and assistance given to us by members of the Pension Committee, officers and staff of the Investment and Pensions Division is gratefully acknowledged.

Introduction

1. This report is the summary of our findings arising from the 2012/13 audit of Lothian Pension Funds. The nature and scope of the audit were outlined in the Audit Plan presented to the Pensions Committee on 13 March 2013, and follow the requirements of the Code of Audit Practice prepared by Audit Scotland in May 2011. The purpose of the annual audit report is to summarise the auditor's opinions (i.e. on the financial statements) and conclusions, and to report any significant issues arising. The report is divided into sections which reflect the public sector audit model.

2. Appendix B is an action plan setting out the high level risks we have identified from the audit. Officers have considered the issues and agreed to take the specific steps in the column headed "planned management action". We do not expect all risks to be eliminated or even minimised. What we expect is that those charged with governance understand the risks and have arrangements in place to manage these risks. The administering body should ensure that those charged with governance are satisfied with the proposed management action and have a mechanism in place to assess progress.

3. This report is addressed to City of Edinburgh Council as administering body for Lothian Pension Funds and the Controller of Audit. It should be made available to the public and other stakeholders where appropriate. Audit is an essential element of accountability and the process of public reporting. This report will be published on our website after consideration by those charged with governance.

4. The management of Lothian Pension Funds is responsible for preparing financial statements that show a true and fair view and for implementing appropriate internal control systems. Weaknesses or risks identified by auditors are only those which have come to their attention during their normal audit work, and may not be all that exist. Communication by auditors of matters arising from the audit of the financial statements or of risks or weaknesses does not absolve management from its responsibility to address the issues raised and to maintain an adequate system of control.

Financial statements

5. Audited bodies' financial statements are an essential part of accounting for their stewardship of the resources made available to them and their performance in the use of those resources.

6. Auditors are required to audit financial statements in accordance with the timescales set by Audit Scotland, which may be shorter than statutory requirements, and give an opinion on:
   - whether they give a true and fair view of the financial transactions of the Funds during the year ended 31 March 2013 and of the amount and disposition at that date of its assets and liabilities
   - whether they have been properly prepared in accordance with relevant legislation, the applicable accounting framework and other reporting requirements.

7. Auditors review and report on, as appropriate, other information published with the financial statements, including the sections titled Review of the Year, About the Funds and Investment and Financial Performance and the Governance Compliance Statement. This section summarises the results of our audit on the financial statements.

Audit opinion

8. We have given an unqualified opinion that the financial statements of Lothian Pension Funds for 2012/13 give a true and fair view of the financial transactions of the Funds during the year ended 31 March 2013 and of the amount and disposition at that date of its assets and liabilities.

Legality

9. Through our planned audit work we consider the legality of the Pension Fund's financial transactions. In addition the Pensions and Accounting Manager has confirmed that, to the best of his knowledge and belief, the financial transactions of the Pension Fund were in accordance with relevant legislation and regulations. There are no legality issues arising from our audit which require to be brought to the attention of those charged with governance.

Governance compliance statement

10. Regulation 27 of the Local Government Pension Schemes (Administration) (Scotland) Regulations 2008 (SSI 2008/228) requires that the administering authority prepare a Governance Compliance Statement stating where their arrangements complied with Scottish Ministers Guidance, and where they did not. Although the regulations allow for this statement to be referred to in the annual report, the Funds took the decision to include the full statement. We are satisfied that this statement covers the areas and levels of compliance required by the Scottish Government's guidance.

Annual report

11. The Scottish Government Guidance requires that the annual report for the Pension Fund incorporates the following:
    - the financial statements
    - a report about the management and financial performance of the Funds during the year
    - a report explaining the authority's investment policy and reviewing the performance during the year of the investments of each Fund, and a report of the arrangements made during the year for the administration of the Funds
    - a statement by the actuary of the level of funding disclosed by their valuation
    - a governance compliance statement, funding strategy statement, and statement of investment principles (or details of where these statements may be obtained)
    - the extent to which levels of performance set out in the pension administration strategy have been achieved
    - any other material which the authority considers appropriate.
12. We are satisfied that the report incorporates the above sections and that the other sections are consistent with the audited accounts.

Accounting issues

13. Local authority bodies in Scotland are required to follow the Code of Practice on Local Authority Accounting in the United Kingdom 2012/13 (the 2012 Code) and the Service Reporting Code of Practice 2012/13, supported by International Financial Reporting Standards (IFRSs). We are satisfied that the financial statements have been prepared in accordance with the 2012 Code requirements.

Accounts submission

14. The Fund's unaudited financial statements were submitted to the Controller of Audit prior to the deadline of 30 June 2013. This enabled us to conclude the audit and certify the financial statements by the target date of 30 September 2013.

Significant findings (ISA260)

15. During the course of the audit we identified a number of issues regarding the appropriateness of accounting policies or accounting estimates and judgements, the timing of transactions, the existence of material unusual transactions or the potential effect on the financial statements of any uncertainties. The key issues identified are detailed in the following paragraphs.
16. **Investment Management Expenses:** Investment management expenses disclosed in the Pension Fund Account and supporting notes do not fully reflect the fees charged. Fees relating to private equity funds are accounted for within 'changes in market value of investments' and 'investment income'. However, the calculation of the fees is a complex area, particularly in regard to pooled investment funds, and it is not always possible to separately

identify these fees. The CIPFA Code on Local Authority Accounting in the UK 2012/13 recommends that investment management expenses be shown as a separate item in the fund account and further analysed in a note. Consequently the current presentation does not fully comply with the Code. This matter does not relate solely to Lothian Pension Funds but also applies to other Pension Funds in Scotland.

Resolution: The Investment and Pensions Service Manager will aim to improve the transparency of management fees in accordance with CIPFA's stated requirements by consulting with CIPFA, other Local Authority Pension Funds, the Fund's investment managers and custodian.

17. **Employee Contributions-Lothian Pension Fund:** Officers compiled a reconciliation of the employee contributions received from the seven largest employers, comparing the expected amount per the pension administration system to the actual amounts received. The reconciliation indicated that contributions received were £117,993 more than anticipated with the largest overpayment being from Midlothian Council (£39,131). This equates to 0.34% of the contributions receivable by the Fund for the seven employers. Officers have confirmed that these should represent valid contributions and the reconciliation differences arose very largely due to delays in the notification of the entry of new members to the scheme.

18. **Change in Accounting Policy:** The results for the year ended 31 March 2012 have been restated to reflect a change in the accounting policy on income generated by unquoted private equity and infrastructure investments. Previously all distributions arising from these investments were treated as capital and included in the Fund accounts as a 'change in market value of investments'. The new policy splits distributions into capital and income elements with the latter being classed as 'investment income' in the Fund account. The new policy reflects the Fund's increasing investment in infrastructure which produces a significant part of its distributions as income. The effect of the change was to increase the prior year 'investment income' received by £6,547,000 and to reduce the prior year 'change in market value of investments' by the same amount. This restatement had no impact on the net assets of the Fund brought forward from 2011/12.

Presentational and monetary adjustments to the unaudited accounts

19. In line with International Standards on Auditing 260 *Communication of audit matters to those charged with governance*, we reported the conclusions of our audit to the Pensions Audit Sub-Committee on 20 September 2013 and to the Pensions Committee on 24 September 2013. The report was also noted by the City of Edinburgh Council at its meeting on 24 October 2013. A number of presentational adjustments were identified within the financial statements during the course of our audit. These were discussed with senior finance officers who agreed to amend the unaudited financial statements. No monetary adjustments were identified.

Financial position

20. Audited bodies are responsible for conducting their affairs and for putting in place proper arrangements to ensure that their financial position is soundly based.

21. Auditors consider whether audited bodies have established adequate arrangements and examine:

- financial performance in the period under audit
- compliance with any statutory financial requirements and financial targets
- ability to meet known or contingent, statutory and other financial obligations
- responses to developments which may have an impact on the financial position
- financial plans for future periods.

22. These are key areas in the current economic circumstances. This section summarises the financial position and outlook for the Funds.

Financial results

23. The Funds' actual expenditure compared to the budget disclosed an underspend of £1.305 million for the year to 31 March 2013. The main areas of underspend were supplies and services (£0.132 million), investment managers fees (£1.302 million), employee costs (£0.071 million) and central support costs (£0.046 million).

24. Investment manager's fees are dependent on market values and on a performance element for some managers. The savings on investment manager fees mainly arose as a result of changes in fund management arrangements including the termination of active currency overlay contracts.

Funding position

25. The latest triennial valuation of the three Funds was completed at 31 March 2011. The results of the triennial valuation determines employer contribution rates required over the next three year period to attain the objective of a fully funded scheme at a set future date.

26. The results of the valuation are disclosed in Exhibit 2. The valuation discloses that Lothian Pension Fund actual funding level rose from 85% at the 2008 valuation to 96% at 2011. This valuation resulted in the rates for the major employers in Lothian Pension Fund being set for 2012/13 within the range 16.9% to 17.2% (2011/12: 18.3% to 21.8%). Lothian Buses Pension Fund funding level rose from 95.5% to 112.4% and Scottish Homes Pension Fund showed a slight increase from 85.9% to 86.3%.

Exhibit 2: Movement in valuations 2008 to 2013

Fund Details	31 March 2008* £'m	31 March 2011* £'m	31 March 2013** £'m
Lothian Pension Fund			
Assets	2,903	3,477	4,095
Liabilities	3,427	3,619	4,707
Net Liability	(524)	(142)	(612)
Funding Level	85%	96%	87%
Lothian Buses Fund			
Assets	199	257	312
Liabilities	208	229	303
Net Asset / (Liability)	(9)	28	9
Funding Level	96%	112%	103%
Scottish Homes Fund			
Assets	126	124	140
Liabilities	147	144	165
Net Asset / (Liability)	(21)	(20)	(25)
Funding Level	86%	86%	85%

*Sources: * Triennial Valuations reports 2008 and 2011; ** Projected figures based on year end net assets value and funding level identified in 2012/13 actuarial statement for each fund*

27. In accordance with accounting standard IAS 26 'Accounting and Reporting by Retirement Benefit Plans' the present value of promised retirement benefits (actuarial value) is disclosed by way of a note to the Pension Funds financial statements. This liability is projected using a roll forward approximation from the latest formal funding valuation at 31 March 2011. Exhibit 2 includes these figures for each Pension Fund at 31 March 2013. The figures are only prepared for the purposes of the accounts and are not relevant for calculations undertaken for funding purposes and setting contributions payable to the Funds.

28. The Lothian Pension Fund (funding level of 87%) and Lothian Buses (funding level of 103%) have fallen. The present value of promised retirement benefits for Lothian Pension Fund rose by £761 million in 2012/13 mainly as a result of a change in assumptions used by the actuary which increased the actuarial present value liability by £482 million.

Membership

29. During the year overall membership of the Lothian Pension Fund increased from 66,354 to 69,888 per Exhibit 3. One of the key changes of the Pensions Act 2011 was the introduction of auto enrolment. To ensure the Pension Fund is auto enrolment compliant the Pension Fund membership was opened to casual workers. The inclusion of these workers explains the increase in Pension Fund membership in 2012/13. Active members increased by 441 and pensioners increased by 1,564.The total number of members retiring early was 686 of which 271 (2011/12: 607) related to members retiring as a result of employers offering Voluntary Early Release Arrangements (VERA).

Exhibit 3: Membership at 31 March 2013 - Lothian Pension Fund

Status	Membership at 31 March 2011	Membership at 31 March 2012	Membership at 31 March 2013
Active	28,919	28,337	28,778
Deferred	15,218	15,392	16,577
Pensioners	17,894	18,905	20,469
Dependants	3,682	3,720	4,064
Total	**65,713**	**66,354**	**69,888**

Source: Audited Financial Statements

30. The Funds have recognised the significant impact of the early release programmes in the Funding Strategy Statement which states that "the Fund shall undertake a regular review of its investment strategy to ensure appropriate alignment with its liabilities. Employer covenant and membership maturity profile reflecting any decision to close the Scheme to new entrants are both risk factors which may impact on liabilities and therefore will be taken into account by the Fund in its review of investment strategy."

31. The Funds are liaising with Hymans Robertson to explore the feasibility of developing a financial model to provide greater insight into cash flow forecasting as the Lothian Pension Fund is expected to move from net positive cash flows from dealings with members to a negative position. In the short term, as Fund maturity increases, investment income will be required to pay pension benefits. The sale of assets may be required to pay pension benefits but the Fund's actuary has advised that this not likely to happen for a number of years.

32. Cash flow monitoring reports are prepared monthly to ensure that sufficient cash balances are held to meet on-going pension commitments, and that any excess balances are passed periodically to the Fund’s investment portfolios. These cash flow reports are submitted to management and a summary is reported to the Investment Strategy Panel.

Outlook

2013/14 budget

33. The 2013/14 annual budget for administration costs is £13.49 million, an increase of £0.19 million from 2012/13. The most significant increases are:
    - employee costs (£0.25m) as result of two new posts (bond manager and solicitor / risk manager) plus three transferred posts in respect of the new pension payroll
    - third party payments (£0.24 million) offset by a reduction in support costs of £0.15 million due to the transfer of the pension payroll function to the LPF.

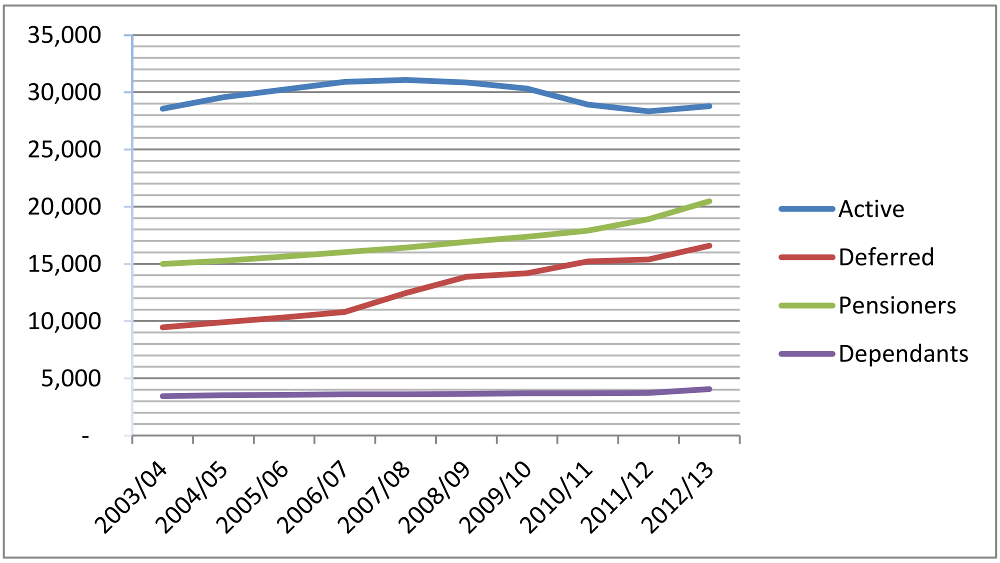
34. The Service Plan progress report presented to the September 2013 Pensions Committee projects an underspend of £0.43 million, mainly as a result of a reduction in investment managers fees.

Forecasts beyond 2013/14

35. Looking ahead, it is clear that the outlook for public spending for the period 2013/14 to 2015/16 remains very challenging. There are a number of ongoing developments in the public sector pension environment that could have a significant impact on the operation of local government pension schemes.

36. As a result of widespread severance schemes and recruitment freezes across participating employer bodies, it is likely that the membership profile of the fund will increasingly have a higher proportion of pensioner members compared to active members. Exhibit 4 tracks the movements on membership for the last 10 years which shows a convergence between active members and deferred / pensioner members.

Exhibit 4: Membership of Lothian Pension Fund for 10 years to 31 March 2013



Source: Lothian Pension Funds Annual Reports

37. Auto enrolment may lessen the impact on the profile of the Fund. At some point in the future the increase in pensioner numbers will result in monthly income not being sufficient to meet the Fund's monthly commitments, requiring the use of investment income to pay pension benefits. This has been considered as part of the Fund's review of its Investment strategy highlighted in paragraph 30 and 31.

Refer Action Point no. 1

Governance and accountability

38. The three fundamental principles of governance – openness, integrity and accountability – apply to all audited bodies, whether their members are elected or appointed, or whether they comprise groups of people or an individual accountable officer.

39. Through its chief executive or accountable officer, each body is responsible for establishing arrangements for ensuring the proper conduct of its affairs including the legality of activities and transactions, and for monitoring the adequacy and effectiveness of these arrangements. Audited bodies usually involve those charged with governance (including audit committees or similar groups) in monitoring these arrangements.

40. Consistent with the wider scope of public audit, auditors have a responsibility to review and report on audited bodies' governance arrangements as they relate to:

- governance and systems of internal control
- the prevention and detection of fraud and irregularity
- standards of conduct and arrangements for the prevention and detection of corruption.

41. In this part of the report we comment on key areas of governance.

Corporate governance

Processes and committees

42. As the administering authority, City of Edinburgh Council has statutory responsibility for the administration of the Funds. Its functions are carried out in accordance with the Local Government Pension Scheme (Scotland) Regulations 1998 and the Superannuation Act 1972.

43. Responsibility for the overall strategic direction of the Funds is delegated by the council to the Pensions Committee (the committee) which is comprised of elected members of the council and employer and member representatives. This replaced the Pensions and Trusts Committee in December 2012 as part of the overall review of governance arrangements in the council.

44. The committee meets quarterly to consider Pension Fund matters including reports on investment monitoring, budget monitoring and service plans. The committee's current membership consists of five councillors, one member representative and one employer representative with a quorum of three.

45. A Pensions Audit Sub-Committee consisting of 3 members was established in 2012/13 and is responsible for the audit scrutiny of the Pension Funds. The sub-committee reports to the Pensions Committee. The auditor's ISA260 report and proposed audit opinion were all reported to members of this committee. It is expected to meet three times per year and should

cover issues relating to financial statements, internal and external audit and risk control framework.

46. The Consultative Panel is the main mechanism for engagement with the Funds' stakeholders and enables their involvement in the decision-making process. The panel meets quarterly on the same cycle as the committee. Two members of the panel are also members of the Pensions Committee.

47. Day to day administration of the Fund is carried out by the Investment and Pensions Division which is part of the council's Corporate Governance department. The Head of Finance serves as the Section 95 Officer for all of the council’s accounting arrangements, including those of the Lothian Pension Funds. For the Lothian Pension Funds, however, this Section 95 responsibility has been delegated to the Pensions and Accounting Manager.

Governance Compliance Statement

48. Pension Funds are required to produce a governance compliance statement, setting out areas where it does and does not comply with guidance issued by the Scottish Government on committee governance arrangements. The guidance covers membership of the pension committee, frequency of meetings, training of members and several other areas. The governance compliance statement produced by the Funds meets the requirements of this guidance.

Annual Governance Statement/Governance Compliance Statement

49. The Fund's financial statements currently include a Governance Compliance Statement and an Annual Governance Statement. The Code of Practice on Local Authority Accounting in the UK (the Code) does not require an Annual Governance Statement to be included in the financial statements. Guidance issued for the 2012/13 financial statements indicated that a single statement, covering key areas, is preferable. However, this is an area currently under consideration by CIPFA/LASAAC and it is likely that further guidance will be issued clarifying expectations in this area.

Internal Audit

50. Internal Audit holds a key role in the authority's governance arrangements, providing an independent appraisal service to management by reviewing and evaluating the effectiveness of the internal control system. The Fund's internal audit service is provided by the City of Edinburgh's internal audit function. Following a change in the arrangements in 2012/13, PricewaterhouseCoopers provide the internal audit function for the council and Pension Fund on a co-sourcing basis.

51. Our review of internal audit was conducted as part of the audit of the City of Edinburgh Council. The review found that the work is conducted in accordance with CIPFA's Code of Practice for Internal Audit in Local Government and we were generally able to place reliance on their work for the 2012/13 audit. The level of sample selection used by Internal Audit was below that requested by external audit. For those areas (transfers in and out and pension

payments) additional samples were selected and tested by external audit during the financial statements audit.

Internal control

52. While auditors concentrate on significant systems and key controls in support of the opinion on the financial statements, their wider responsibilities require them to consider the financial systems and controls of audited bodies as a whole. However, the extent of this work should also be informed by their assessment of risk and the activities of internal audit. As part of our work, we took assurance from key controls within the Fund's systems, with some controls being tested by internal audit. No significant control weaknesses were identified during this work.

53. The Fund's financial systems are run alongside those of the City of Edinburgh Council and some of its systems are used by the Investments and Pensions Division. We obtained confirmation from the external auditors of the council that there were no significant weaknesses in the internal controls for those systems utilised by the Investments and Pensions Division for 2012/13.

Prevention and detection of fraud and irregularities

54. Audited bodies are responsible for establishing arrangements to prevent and detect fraud and other irregularity. Auditors review and report on these arrangements. The Funds have arrangements in place to prevent and detect fraud, corruption and inappropriate conduct. These arrangements include standing orders and financial regulations, a whistle blowing policy, an anti-fraud and corruption policy and codes of conduct for elected members and staff. We have concluded that the arrangements in Lothian Pension Funds are satisfactory and we are not aware of any specific issues that we need to identify in this report.

NFI in Scotland

55. Audit Scotland has co-ordinated another major counter-fraud exercise working together with a range of Scottish public bodies, external auditors and the Audit Commission to identify fraud and error. These exercises, known as the National Fraud Initiative in Scotland (NFI), are undertaken every two years as part of the statutory audits of the participating bodies. The latest round of NFI commenced in June 2012, and will look to expand the range of data sets and bodies.

56. The NFI works by using data matching to compare a range of information held on bodies' systems to identify potential inconsistencies or circumstances that could indicate fraud or error which are called 'matches'. Where matches are identified these are made available to bodies to investigate via a secure web application. Bodies investigate these and record appropriate outcomes based on their investigations.

57. As part of our local audit work we monitor the council's approach to participation in NFI both in terms of the submission of the required datasets and strategies for investigating the subsequent data matches. For the council, internal audit plays a key role in co-ordinating the

investigation of matches with priority given to 'recommended matches' (i.e. indication of higher risk). Service departments are responsible for investigating matches within their area of remit.

58. With regard to pension matches being investigated by the Investment and Pensions Division, there were 1,086 from the most recent NFI data matching exercise. Of these, 330 were 'recommended matches'. These matches identify people who are in receipt of a pension but also appear on DWP and registrars records as being deceased, or who appear on another payroll system. The latest report summary in September 2013 indicates that, so far, 99 cases have been investigated and 15 are still being investigated. The Investment and Pensions Division intend to review all 'recommended matches' and expect to have this work completed by the end of March 2014. We will continue to monitor progress.

Standards of conduct & arrangements for the prevention / detection of bribery & corruption

59. Audited bodies are responsible for ensuring that their affairs are managed in accordance with proper standards of conduct and have proper arrangements in place for implementing and monitoring compliance with standards and codes of conduct, standing orders and financial instructions. Auditors consider whether bodies have adequate arrangements in place. Overall we concluded that arrangements are adequate and there are no issues that we require to include in this report.

Pension reform agenda

60. The Public Service Pensions Act received Royal Assent on 24 April 2013. The Act implements the key recommendations of Lord Hutton's Commission as follows:

- the end of final salary benefit arrangements with the introduction of the career average revalued basis
- retirement age linked to state pension age
- cost control system to provide affordability and sustainability
- measures to strengthen governance
- The latest date for commencement of new schemes under the Act is 6 April 2015.

61. The proposed changes to the LGPS will impact on administrative workloads going forward as will any further severance activity by employers. Auto enrolment requirements will also affect information requirements and administration arrangements. The Funds' Pensions Administration Strategy sets out standards for exchange of information, including the requirement for the employer to keep the Fund informed about planned changes to their pension provision including bulk transfers of staff and any outsourcing. The Fund engages with employers on a regular basis as follows:

- monthly bulletins are issued to employer contacts highlighting relevant issues
- employer events are held throughout the year
- by providing dedicated resource in the form of an Employer Relations Officer

62. The changes to relevant regulations and policies and the implications of these changes are communicated to employers, with consultation exercises carried out where appropriate.

Outlook

63. There are on-going developments that may have a significant impact on the form and operation of local government pension schemes. For example, the full extent of the recommendations made in the Hutton report and how they impact upon pension schemes in Scotland remains uncertain. Other Government initiatives, including workplace pension reforms and the creation of single Police and Fire Services, are also likely to have an impact on operational processes.

64. Auto-enrolment is now being implemented across employers who are members of the Funds. This will inevitably have an impact on administrative workloads, and early preparation for the changes is required to ensure continuing compliance with guidance. We will continue to keep this are under review in 2013/14.

65. The Funds should ensure that they prepared for the introduction of career average pensions. There will be a requirement to maintain pension records for each individual that will bring together a range of entitlements arising from benefits built up under different pension regimes. This will increase administrative workload initially, and there is a likelihood that there will be more queries and enquiries from Fund members seeking clarification on benefits.

66. We will continue to monitor the Funds' arrangements for dealing with these changes and any potential risks that arise.

Best Value, use of resources and performance

67. Audited bodies have a specific responsibility to ensure that arrangements have been made to secure Best Value.

68. Auditors of local government bodies also have a responsibility to review and report on the arrangements that specified audited bodies have made to prepare and publish performance information in accordance with directions issued by the Accounts Commission.

69. As part of their statutory responsibilities, the Accounts Commission may procure, through Audit Scotland, examinations of the use of resources by audited bodies and publish reports or guidance. Auditors may be requested from time to time to participate in:
    - a performance audit which may result in the publication of a national report
    - an examination of the implications of a particular topic or performance audit for an audited body at local level
    - a review of a body's response to national recommendations.

70. Auditors may also consider the use of resources in services or functions, where the need for this is identified through local audit risk assessments.

71. During the course of their audit appointment auditors should also consider and report on progress made by audited bodies in implementing the recommendations arising from reviews in earlier years.

72. This section includes a commentary on the Best Value and performance management arrangements within the Pension Fund. We also note any headline performance outcomes/ measures used by the members and any comment on any relevant national reports and the body's response to these.

Management arrangements

Best Value

73. The Pension Fund has not been subject to a Best Value review however, it is covered by the overall Best Value arrangements of the administering authority. A Best Value audit of City of Edinburgh Council was completed during 2012/13 with a report being submitted in May 2013. The report focussed on the two judgements at the centre of the current Best Value audit approach:
    - how well the council is performing in relation to services and outcomes. On this the report assessed the council's overall performance as "good"
    - the council's prospects for future improvement, based on leadership and management, partnership working and resource use. Because many of the changes the council has

made are relatively recent and improvements are required in key aspects of Best Value, the report concluded that the council has "fair" prospects for improvement

74. The audit focused on the council and there is no expected impact on the Investments and Pensions Division. The Commission has asked the Controller of Audit to report on the council's progress in around eighteen months' time, from May 2013. The full report can be found on Audit Scotland's website: www.audit-scotland.gov.uk

Investment Performance

75. Investment advice and support is provided to the Fund by its Investment Strategy Panel (ISP) which is comprised of investment advisers and senior officers. The role of the ISP includes the development of investment strategy and the monitoring of the Funds' investments.

76. To ensure value for money is obtained the Funds carry out a structured procurement process which includes the consideration of fees. In addition the managers are monitored and their performance discussed at regular meetings. The results of the monitoring are reported to the Investment Strategy Panel. Fund management arrangements were reviewed during 2012/13 for Lothian Pension Fund resulting in the termination of active currency overlay contracts.

77. At the year end, an annual report on overall investment performance and activity is produced and reported to committee. A summary of investment performance for each Fund has been included in Exhibit 5.

Exhibit 5: Annualised Returns to 31 March 2013 (% per year)

Fund	1 Year Bench mark	1 Year Actual return	3 Year Bench mark	3 Year Actual return	10 Year Bench mark	10 Year Actual return
Lothian	13.9%	13.9%	8.1%	8.1%	9.5%	10.3%
Lothian Buses	13.8%	16.4%	8.7%	10.4%	10.1%	11.3%
Scottish Homes*	13.0%	13.0%	11.1%	11.2%	8.8%*	8.8%*

** Based on return from July 2005, inception date*

Source: Audited Financial Statements 2012/13

78. Over the three years to 31 March 2013, the Lothian Pension Fund delivered the same performance as its investment strategy but failed to achieve its higher target return which is in excess of the strategy.

79. Following the review of the investment strategy in 2012, the indicator for the investment performance of the Lothian Pension Fund has been amended. The target of outperforming the benchmark by 1% has been removed and replaced with a target of delivering benchmark return over the long-term with lower volatility of returns.

80. The Investment and Pensions Division reviewed the investment strategies of all their Pension Funds following the 2011 actuarial valuations. The review concluded that there was scope to

reduce the investment risk over the next few years and increase the focus on investment income to reduce returns volatility over the coming years. For Lothian Pension Fund and Lothian Buses Pension Fund the implementation of the new strategies involves increasing the amount of assets managed by the internal team. This work is progressing and is expected to be completed in the coming months. For Scottish Homes, the proportion of Funds invested in equities was reduced from 40% to 35% to reduce the risk in-line with the new investment strategy.

81. We note that this change in investment strategy for Lothian Pension Fund and Lothian Buses means that decisions by the Investment Strategy Panel and the internal investment team will influence the Funds' return to a greater extent, once the new strategies are in place. The Pensions Division is assessing the risks of these changes and we will consider the conclusions and the actions taken by the Pension's division to mitigate, manage and monitor any additional risks from the new strategies.

Administration Performance

82. The Funds' Administration Strategy was approved by the Pensions and Trusts Committee in March 2010 and was reviewed in 2012/13. It contains the standards which are required of the participating employers to ensure that the Fund meets its statutory obligations and is able to deliver services efficiently. The strategy contains a variety of performance measures against which the Fund and the participating employers are assessed.

83. In accordance with Regulation 60A of the LGPS (Administration) (Scotland) Regulations 2008, the Fund's annual report discloses performance against the measures detailed in the Pension Administration Strategy.

84. In relation to its own performance the Fund met all key performance targets with the exception of staff satisfaction with present job and investment performance.

85. The changes to the LGPS as a result of the Public Service Pensions Act will impact on administrative workloads going forward as will any further severance activity by employers. Auto enrolment will also affect information requirements and administration arrangements. There is a risk that the increased workload will increase pressure on staff and key tasks and statutory requirements will not be delivered.

Refer Action Plan no. 2

Employer Performance

86. Annual employer performance against the pension administration standards, as set out in the Pension Administration Strategy (PAS), has been consistently poor since their introduction three years ago. None of the five employer targets set out in the PAS were achieved in 2012/13. Exhibit 6 summarises the performance against target.

Exhibit 6: Employer performance against target

		2011/12		2012/13	
	Target (working days)	Number received	% within target	Number received	% within target
New member: paper forms	20	111	64	31	74
New member: electronic	20	1,779	90	2,693	89
Leaver information	20	1,049	69	592	64
Retirement information	20	917	39	803	39
Death in service information	10	39	30	37	19

Source: Audited Annual Report and Accounts 2012/13

87. The Employer On-line Portal for pension administration was implemented on a phased basis from November 2012. All employers currently have access to the system. The implementation of the system resulted in a significant improvement in performance in the final quarter of 2012/13.

Refer Action Plan no. 3

National performance reports

88. Audit Scotland carries out a national performance audit programme on behalf of the Accounts Commission and the Auditor General for Scotland. Reports in the last year which may be of interest to members and officers are detailed in Exhibit 7 below.

Exhibit 7: A selection of National Performance Reports 2012/13

- Managing performance: are you getting it right
- Responding to challenges and change - An overview of local government in Scotland 2013
- The National Fraud Initiative in Scotland
- How Councils work: using cost information to improve performance
- Managing early departures from the Scottish public Sector
- National Scrutiny Plan for Local Government

Source: www.audit-scotland.gov.uk

89. We suggest that officers review relevant national performance reports as they become available and consider any findings which may impact on the Pension Fund.

Outlook

90. Continuing to meet performance targets will become more challenging in the coming years. Investment targets are set based on advice from investment advisors and standard industry benchmarks. The Funds will have to remain vigilant, and ensure that they have the right diversification of Funds to deliver the required returns, whilst managing the investment risk.

91. Improvements that are being made to the pension administration system, and the way in which data is received, should improve performance going forward, although this is dependent on the provision of information timeously by scheduled and admitted bodies.

92. Increased workloads may affect staff morale and it is important that the Funds monitor workloads and plan accordingly.

Appendix A: audit reports

External audit reports and audit opinions issued for 2012/13

Title of report or opinion	Date of issue	Date presented to Committee
Annual Audit Plan	21 February 2013	13 March 2013
Report on financial statements to those charged with governance (ISA 260)	6 September 2013	20 September 2013 (Pension Audit Sub-Committee) 24 September 2013 (Pensions Committee)
Audit opinion on the 2012/13 financial statements	6 September 2013	20 September 2013
Report to Members on the 2012/13 audit	31 October 2013	16 December 2013 (Pension Audit Sub-Committee) 18 December 2013 (Pensions Committee)

Appendix B: action plan

Key Risk Areas and Planned Management Action

Action Point	1
Refer Para	37
Risk Identified	The changing profile of the Funds' membership may eventually result in monthly income not being sufficient to meet the Fund's monthly commitments, requiring the use of investment income to pay pension benefits. ***Risk: Financial plans prepared by the pension Funds are not achieved.***
Planned Management Action	Financial planning of the Funds continues to be reviewed regularly and appropriate cognisance is taken of actual and anticipated changes in membership profile. It should be emphasised that a reduction in contributions receivable in comparison to benefit expenditure, that is a move to a cash flow negative position requiring investment income to finance pension payments, is an inevitable consequence of a maturing Pension Fund. Management monitor short-term (monthly) cash flow to ensure there is sufficient cash to pay benefits and to ensure excess cash can be invested as soon as practical. Short term cash flow can fluctuate significantly. The Investment Strategy Panel considers medium-term (up to 2 year) cash flow projections on a quarterly basis. Long-term cash flow, including projection, is reported to Committee as part of funding and investment strategy reviews. The Fund has procured further long-term cash flow modelling from its actuary in order to provide requisite assurance in developing new contribution stability proposals, the results of which will be reported to the Pensions Committee in December 2013. The Fund will continue to monitor and manager cash flows.
Responsible Officer	Investment & Pensions Service Manager
Target Date	Ongoing

Action Point	2
Refer Para	85
Risk Identified	Changes to the LGPS as a result of the Public Pensions Act will impact on administrative workloads going forward as will any further severance activity by employers. Additionally auto enrolment will also affect information and administration arrangements. ***Risk: The increased workload will increase pressure on staff and key tasks and statutory requirements will not be delivered.***
Planned Management Action	It is recognised that impending reform of the LGPS in Scotland is likely to increase significantly the burden of pension administration. The risk is being managed. Lothian Pension Fund has included additional provision in its annual expenditure budget (from 2012/13) in anticipation of changes and has focused on enhancements both to operational efficiency and to data quality. Specifically, data quality improvements as a result of the system enhancements to transfer data electronically from employers to the Fund ("Employer On-line") should be most beneficial in the transition to a Career Average Revalued Earnings scheme. Communication to employers and other stakeholders of the LGPS reform issues by Lothian Pension Fund has been ongoing, with regular updates provided to both Pensions Committee and Consultative Panel. The most recent communication highlighted the proposed Heads of Agreement for the new scheme. The need to ensure that both employer HR / payroll systems and the pension administration software can cope with demands of a new scheme has already been raised at the Scottish Local Government Pensions Advisory Group (SLOGPAG) forum and also separately with CoSLA. Appropriate and timely liaison with the key system suppliers, at a national level, is therefore anticipated. There is certainly some degree of risk exposure for Lothian Pension Fund from the perspective of key staff expertise. During the year, steps have been taken to introduce greater flexibility in the organisational structure and also enhance career progression opportunity. Other measures have also been progressed with the intention of raising staff satisfaction levels. Hopefully, these should serve to alleviate such staff retention risk.
Responsible Officer	Investment & Pensions Service Manager
Target Date	Ongoing

Action Point	3
Refer Para	87
Risk Identified	Administration performance in relation to employers has been disappointing in 2012/13 with none of the five targets being achieved. ***Risk: delays in information provision may impact on the delivery of accurate and timely services to members.***
Planned Management Action	The Pensions Administration Strategy has been revised and approved by the Pensions Committee in September 2013, with an explicit objective to enhance employer data submission performance. Escalation procedures have been tightened and financial penalties for employer poor performance emphasised. On a positive note, as is stated, the investment in the "Employer On-line" portal has resulted in some improvement already to overall employer performance. This reflects the commitment of significant staff resources by the Fund to implement the project, supported by ongoing employer liaison. The intention is to capitalise on these initial gains and thereby secure excellence in service provision to customers. Progress is expected to be evolutionary, however, recognising the significant financial pressures facing public sector employers. Evidence from the England and Wales actuarial valuations 2013 has already pointed to reductions in overall pensions administration data quality arising from employer staffing cutbacks in HR and Payroll Sections.
Responsible Officer	Investment & Pensions Service Manager
Target Date	Ongoing