

# Pensions Audit Sub Committee

2.30 p.m., Tuesday, 16 December 2014

## Report by the External Auditor on the Annual Report 2014 of Lothian Pension Fund, Lothian Buses Pension Fund and Scottish Homes Pension Fund

Item number	5.2
Report number	
Wards	All

### Executive summary

This report presents the External Auditor's Annual Report on the 2013/14 audit of the Lothian Pension Funds. The report from Audit Scotland is shown at Appendix 1. This includes commentary from the Investment & Pensions Service Manager as to planned management actions. The report will be presented to Committee by Stephen O'Hagan, Senior Audit Manager, Audit Scotland.

Audit Scotland has already provided "an unqualified opinion that the financial statements (of the Lothian Pension Fund, the Lothian Buses Pension Fund and the Scottish Homes Pension Fund) give a true and fair view of the transactions of the funds during the year ended 31 March 2014, and of the amount and disposition at that date of their assets and liabilities".

### 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

## **Report by the External Auditor on the Annual Report 2014 of Lothian Pension Fund, Lothian Buses Pension Fund and Scottish Homes Pension Fund**

### **Recommendations**

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#### **1.1 Committee is requested to:**

- note the Annual Report on the 2013/14 audit of the Lothian Pension Fund, Lothian Buses Pension Fund and Scottish Homes Pension Fund;
- note the Action Plan at Appendix II of the report and seek appropriate updates on progress;
- 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 2015;
- highlight any points that it would like to raise at the Pensions Committee on 17 December 2014.

### **Background**

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#### **Unqualified audit opinion**

- 2.1 Audit Scotland has already provided “an unqualified opinion that the financial statements (of the Lothian Pension Fund, Lothian Buses Pension Fund and Scottish Homes Pension Fund) give a true and fair view of the transactions of the funds during the year ended 31 March 2014, and of the amount and disposition at that date of their assets and liabilities”.

### **Main report**

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#### **Report on the 2013/14 audit by the External Auditor**

- 3.1 The purpose of this report is to present the External Auditor’s Annual Report on the 2013/14 audit of the Lothian Pension Funds. The report from Audit Scotland is shown at Appendix 1. This includes commentary from the Investment & Pensions Manager as to planned management actions. The report will be presented to Committee by Stephen O’Hagan, Senior Audit Manager, Audit Scotland.
- 3.2 In addition to members of the Pensions Committee and Pensions Audit Sub-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.

- 3.3 On pages 3 and 4 of the report, Audit Scotland has highlighted the financial position of Lothian Pension Fund at 31 March 2014, with 'net assets representing 80% of estimated promised retirement benefits'. It is important, however, to emphasise that a significant degree of caution should be applied to any assertion of funding level calculated on this basis. The figures are only prepared for the purposes of International Accounting Standard (IAS)26 and have no validity in other circumstances. In particular, it is not relevant for calculations undertaken for funding purposes. Financial positions for the Lothian Buses Pension Fund and Scottish Homes Pension Fund have been derived using the same methodology. The 2014 actuarial valuation process will assess the funding positions, for the purposes of setting employer contribution rates.
- 3.4 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 2015.

### **Measures of success**

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

### **Financial impact**

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- 5.1 There are no financial implications arising directly from this report.

### **Risk, policy, compliance and governance impact**

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- 6.1 This annual report summarises the opinions and conclusions of Audit Scotland, in accordance with International Standards on Auditing (UK and Ireland) and the principles contained in the Code of Audit Practice issued by Audit Scotland in May 2011. Appendix I (of the Audit Scotland report) sets out the significant audit risks identified at the planning stage and how the auditor addressed each risk in arriving at his opinion on the financial statements. Appendix II is an action plan setting out the high level risks identified from the audit. Officers have considered the issues and agreed to take the specific steps in the column headed "Management action/response".

### **Equalities impact**

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- 7.1 There are no adverse equalities impacts arising from this report.

### **Sustainability impact**

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- 8.1 There are no adverse sustainability impacts arising from this report.
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## Consultation and engagement

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- 9.1 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

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None

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## Links

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### 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 the 2013/14 audit of Lothian Pension Funds



## **Lothian Pension Funds**

### **Annual report on the 2013/14 audit**

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

October 2014

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## Key messages

### Financial statements

- We have given an unqualified opinion on the financial statements of Lothian Pension Funds for 2013/14.

### Financial position

- Lothian Pension Fund (main fund) had net assets of £4,377 million at 31 March 2014. The actuarial value of estimated promised retirement benefits at 31 March 2014 was £5,483 million.
- The net assets of the Lothian Buses and the Scottish Homes Pension Funds were £337 million and £136 million, respectively, at 31 March 2014. The actuarial value of estimated promised retirement benefits at 31 March 2014 for Buses and Homes were £358 million and £138 million, respectively.

### Governance & accountability

- The Funds have effective governance arrangements that include a Pensions Committee and a Pensions Audit Sub-Committee. An Investment Strategy Panel provides advice to City of Edinburgh Council's Director of Corporate Governance who has delegated authority for implementing the Funds' investment strategy.

### Best Value, use of resources & performance

- Investment performance for the Funds is measured against benchmarks which were agreed by the Pensions Committee in December 2012. For all 3 funds the return on investments for the 2013/14 financial year has met or exceeded these benchmarks.

### Outlook

- The most significant area of risk for the Funds concerns investment returns. Although there was a resurgence of financial markets during the financial year, the longer term economic environment of weak growth and continuing European fiscal deficits, means that investment performance will be a key issue going forward.

### Financial statements

We have given an unqualified audit opinion that the financial statements of the Lothian Pension Funds for 2013/14 give a true and fair view of the financial transactions of the funds during the year ended 31 March 2014, and of the amount and disposition at that date of their assets and liabilities.

### Financial position – Funding

Lothian Pension Fund had net assets of £4,377 million as at 31 March 2014. The actuarial value of promised retirement benefits at 31 March 2014 has been estimated by the actuary as £5,483 million. This actuarial estimate would mean a net liability of £1,106 million as at 31 March 2014 (£1,366 million as at 31 March 2013), with net assets representing 80% of estimated promised retirement benefits.

The estimated liability prepared by the actuary is not a full actuarial statement but rather a figure prepared for the purposes of statutory accounting.

The Lothian Buses Pension Fund was closed to new members in 2008. As at 31 March 2014, the Fund had net assets of £337 million. The actuarial value of promised retirement benefits at the accounting date has been estimated by the actuary as £358 million. The actuarial estimate would mean a net liability of £21 million with net assets representing 94% of estimated promised retirement benefits.

As at 31 March 2014, the Scottish Homes Pension Fund had net assets of £136 million. The actuarial value of promised retirement benefits at the accounting date has been estimated by the actuary as £138 million. The actuarial estimate would mean a net liability of £2 million, with net assets representing 99% of estimated promised retirement benefits. There are no active members of the fund, while the Scottish Government acts as guarantor.

The actuary undertakes a triennial valuation on each fund to calculate funding levels, and this is used to set employer contribution rates. At the last triennial revaluations in 2011, the funding levels for the main Pension Fund, Lothian Buses Pension Fund and Scottish Homes Pension Fund were 96%, 112% and 86% respectively. The 2014 triennial valuation is currently being prepared by the actuary and will be used to set contribution rates from April 2015.

### Financial position – Administration

The Funds' actual expenditure compared to the approved budget disclosed an underspend of £0.959 million for the year to 31 March 2014, mainly due to an underspend of £0.381 million on investment managers fees.

### Governance and accountability

The Funds have effective governance arrangements that include a Pensions Committee supported by a Pensions Audit Sub-

## Key messages

Committee and an advisory Consultative Panel with representatives from employers, pensioners and trade unions.

We also concluded that the Pension Funds have adequate internal controls (including internal audit) and satisfactory arrangements for the prevention and detection of fraud and corruption.

## Best Value and performance

The performance of the Funds' investments is measured against benchmarks agreed by the Pensions Committee in 2012. Three different benchmarks were approved to accommodate the different asset types held by the Funds. For 2013/14 investment performance for Lothian Pension Fund was 1.6% ahead of the benchmark level (Lothian Buses was 3.8% ahead, Scottish Homes matched the benchmark). The longer term periods of assessment used by the Funds outperformed benchmark levels by a smaller margin for Lothian Pension Fund and Lothian Buses Pension Fund with Scottish Homes again matching the benchmark.

## Outlook

Global financial markets have provided positive returns for investors in 2013/14, however sustaining this performance in the long term will be challenging. A combination of factors will likely impact on the performance of investments; fragile European public finances; the prospects of monetary policy tightening in the US and a loss of economic momentum, particularly in China where policy makers are grappling with high levels of credit. With investment performance

key to the funding position of the LGPS, this may impact on employer contributions in the longer term.

The Public Services Pensions Act 2013 passed by UK parliament will mean changes to the way local government pension funds operate and pension benefits are accrued by members. Changes to meet the new Act are required to be implemented by 6 April 2015.

Parts of the changes mean that the accrual of benefits by members will now be provided for on a CARE (Career Averaged Revalued Earnings) basis. Member's benefits accrued after 1 April 2015 will be based on a fraction of their pensionable pay for every year they are a member of the LGPS. These changes will entail additional administrative and record keeping obligations being placed on employers and Lothian Pension Fund in determining member benefits. The Funds' pension administration system is being developed to address this challenge.

The triennial valuation at 31 March 2014 which will set the employer contribution rates for the next three years starting from 1 April 2015 will be finalised in early 2015. Lothian Pension Funds' expectation is that the monetary value of its deficit will have increased, driven by the low gilt yields serving to reduce the discount.

The implementation of the investment strategies 2012-2017 continue with the key focus of reducing risk primarily through changing the Funds' equity holdings, or reducing these and moving into index-linked assets and alternatives, where appropriate.

# Introduction

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1. This report is a summary of our findings arising from the 2013/14 audit of the Lothian Pension Funds. The purpose of the annual audit report is to summarise the auditor's opinions and conclusions, and to report any significant issues arising from the audit. The report is divided into sections which reflect our public sector audit model.
2. Our responsibility, as the external auditor of the Lothian Pension Funds, is to undertake our audit in accordance with International Standards on Auditing (UK and Ireland) and the principles contained in the Code of Audit Practice issued by Audit Scotland in May 2011.
3. The management of the Lothian Pension 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.
4. This report is addressed to the members of City of Edinburgh Council and the Controller of Audit and should form the basis of discussions with the Pensions Committee as soon as possible after it has been issued. Reports should be made available to stakeholders and the public, as audit is an essential element of accountability and the process of public reporting.
5. This report will be published on our website after it has been considered by the Pensions Committee. The information in this report may be used for the Accounts Commission's annual overview report on local authority audits. The overview report is published and presented to the Local Government and Regeneration Committee of the Scottish Parliament.
6. The concept of audit risk is of key importance to the audit process. 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. We set out in our annual audit plan the related sources of assurance and the audit work we proposed to undertake to secure appropriate levels of assurance. Appendix I sets out the significant audit risks identified at the planning stage and how we addressed each risk in arriving at our opinion on the financial statements.
7. Appendix II 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 "Management action/response".
8. We recognise that not all risks can be eliminated or even

## Introduction

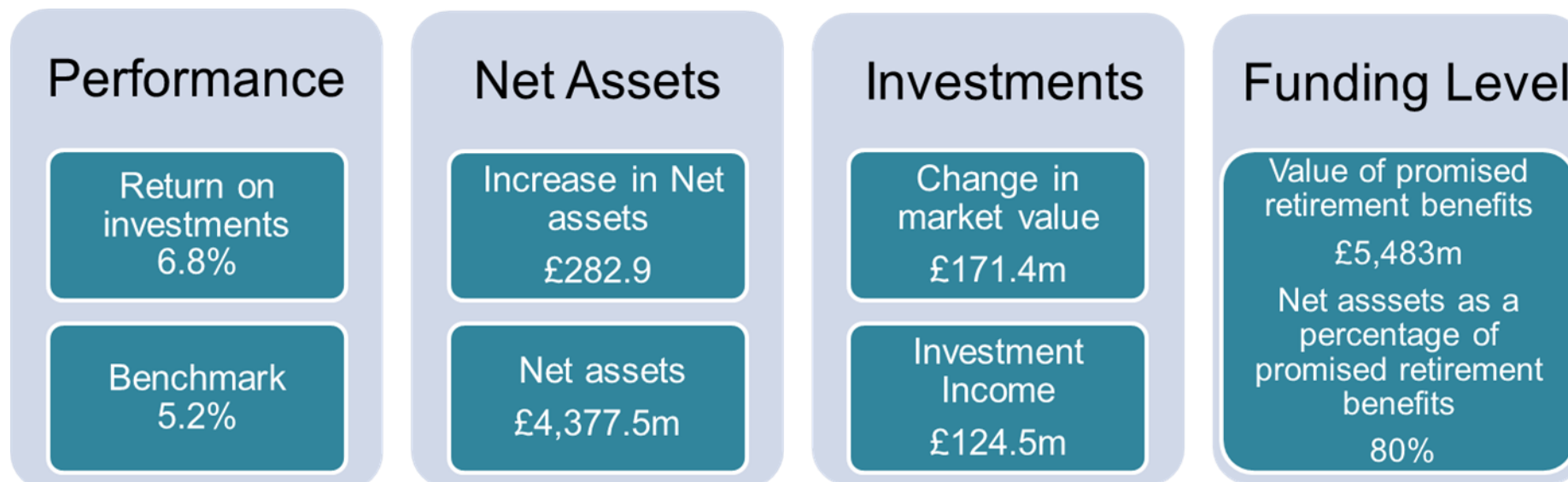
minimised. What is important is that Lothian Pension Funds understands its risks and has arrangements in place to manage these risks. The Pension Funds and the Proper Officer should ensure that they are satisfied with proposed management action and have a mechanism in place to assess progress and monitor outcomes.

9. 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.

## Acknowledgement

10. The co-operation and assistance given to us by officers during the conduct of our audit is gratefully acknowledged.

# Financial statements



Source: Lothian Pension Funds Financial Statements – main fund data

## Audit opinion

11. We have given an unqualified opinion that the financial statements of the Lothian Pension Funds for 2013/14 give a true and fair view of the financial transactions of the funds during the year ended 31 March 2014, and of the amount and disposition at that date of their assets and liabilities.

## Other information published with the financial statements

12. Auditors review and report on other information published with the financial statements, including the sections titled Review of the Year, How the Fund Works, Investments and Financial Performance, the Annual Governance Statement and the Governance Compliance Statement. We have nothing to report in respect of these statements.

### Legality

13. Through our planned audit work we consider the legality of the Pension Funds' 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 are 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.

### Accounting issues arising

#### *Presentational and monetary adjustments*

14. A number of presentational adjustments were identified during the course of the audit. These were discussed and agreed with management who agreed to amend the unaudited financial statements.
15. Additionally, there was one monetary error identified during the course of the audit, relating to the accounting for a rebate of custodian system fees received. Paragraph 24 of this report provides more details on this issue. Officers considered this error to be immaterial to the financial statements and we concurred with this view. No amendment was made to the accounts as a consequence.
16. Local authority bodies in Scotland are required to follow the

Code of Practice on Local Authority Accounting in the United Kingdom 2013/14, supported by International Financial Reporting Standards (IFRS). We concluded that the financial statements had been prepared in accordance with extant guidance.

### Report to those charged with governance

17. We presented our report to those charged with governance (ISA 260) to the Pensions Audit Sub-Committee, on 22 September 2014, and the Pensions Committee on 23 September 2014. The primary purpose of that report is to communicate the significant findings arising from our audit prior to finalisation of the independent auditor's report. The main points are set out in the following paragraphs.
18. **Investment Management Expenses:** In 2012/13 we highlighted that investment management expenses disclosed in the Pension Fund Accounts and supporting notes did not fully reflect the fees charged. CIPFA recently published guidance on accounting for pension scheme management costs, to assist fund comparability.
19. Whilst the June 2014 publication date for this guidance made it too late in the accounts preparation cycle for pension funds generally to apply it in 2013/14, Lothian Pension Funds' officers had been working closely with CIPFA on the development of the guidance.

20. Information from investment managers allowed the fund to apply the principles of the CIPFA guidance and recognise these particular investment management costs as a cost in the fund account, rather than a reduction in the change in market value of investments. As part of our audit we reviewed the reasonableness of the methodology applied and sample checked the calculations undertaken to determine the investment management costs.

### Refer to Action Plan Point 1

21. **Additional Voluntary Contributions (AVCs):** The financial statements include disclosure notes setting out AVCs made by employees in the Lothian Pension Fund and Lothian Buses Pension Fund. However, the notes did not separately identify the contributions and fund values between funds. Officers sought the required information from fund managers to facilitate reporting of additional voluntary contributions separately for the Lothian and Lothian Buses Pension Funds. This was subsequently provided but too late for inclusion in the 2013/14 accounts. Suitable assurance has been obtained for 2014/15.
22. Further narrative was added to accompany the AVC notes in each Fund. It emphasised that the sums presented relate to both Lothian Pension Fund and Lothian Buses Pension Fund members.
23. **Group Transfer:** The Lothian Pension Fund account disclosed

a group transfer out of £5.287 million. The transfer related to 37 employees of the Edinburgh College of Art who transferred employment to the University of Edinburgh in August 2011. Unlike individual transfers, which are recognised in the fund accounts on a cash basis, group transfers should be accounted for on an accruals basis. However, no accrual was included in the accounts for 2011/12 or 2012/13 as the respective actuaries had not agreed the transfer value. Further narrative was included in Lothian Pension Fund account to provide detail on the characteristics of this transfer.

24. **Custodian Fees:** During 2013/14 it was highlighted to officers by the custodian system provider, Northern Trust, that the Funds were due a rebate on custodian fees previously paid. The rebate due to Lothian Pension Fund and Lothian Buses Pension Fund was £0.219 million and £0.021 million respectively. Although the discount partly related to fees paid in prior years (£0.131 million for Lothian and £0.015 million for Buses), the rebate amounts were recognised fully in the current financial year. This accounting treatment was assessed as having no material effect on the financial statements and we concurred with this assessment.
25. **Unfunded Pension Payments:** The unaudited Lothian Pension Fund Account included a debtor balance of £2.869 million on the balance sheet which related to unfunded benefit payments. These amounts were items such as the award of discretionary years, where the pension costs are met by the

## Financial statements

individual employers. In prior years, they were recognised on the City of Edinburgh Council ledger, however following system access changes they were posted to the Pension Fund ledger for 2013/14.

26. The debtors balance on the Lothian Pension Fund account was reduced by £2.869 million to recognise this is properly a City of Edinburgh Council debtor. A compensating increase of £2.869 million was made to the City of Edinburgh holding account balance, to recognise the pay over of the £2.869 million is no longer due. The impact of these adjustments on the current assets in the pension fund accounts was nil.

## Outlook

27. The financial statements of the Pension Funds are prepared in accordance with the Code of Practice on Local Authority Accounting in the United Kingdom (the Code). The main new standards to be adopted in 2014/15 include:
- IFRS 13 Fair value measurement
  - IAS 32 Financial Instruments: Presentation
  - Annual improvements to IFRSs 2009-2011 cycle
28. These new standards are not expected to have a significant impact on the Pension Funds financial statements.
29. The revised Local Authority Accounts (Scotland) Regulations 2014 apply to financial years 2014/15 onwards. The
- regulations set out in more detail what is required in respect of financial management and internal control, and in respect of the annual accounts themselves. The significant changes include:
- the requirement for the unaudited accounts to be considered by the Pensions Committee. This can take place following submission to the auditor and up to 31 August if necessary. In addition the audited accounts must be considered and approved for signature by the Pensions Committee by 30 September with publication on the Authority's website by 31 October.
  - the Pensions Committee will be required to carry out an annual review of the fund's system of internal control, together with the requirement to approve an annual governance statement or equivalent.
  - the Pensions Committee will be required to consider the efficiency and effectiveness of internal audit.
30. The Pension Funds' already undertake a number of the revised regulation requirements. Going forward, the Funds will need to ensure that all the conditions of the revised regulations are implemented.

## Financial position

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31. Audited bodies are responsible for conducting their affairs and for putting in place proper arrangements to ensure that their financial position is soundly based.
32. 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.
33. These are key areas in the current economic circumstances. This section summarises the financial position and outlook for the Fund.

## Financial results

34. Lothian Pension Funds prepares an annual administration budget for the delivery of its service plan to members. This budget for administration related costs is routinely reported to

the Pensions Committee, where any variances are reviewed.

35. As detailed in the 2013/14 financial statements, there was a total underspend of £0.959 million against budgeted administration costs for the financial year. The most significant element of underspend was down to savings realised through the use of in-house investment management.

## Funding position

36. The most recent triennial valuation for Lothian Pension Funds was reported in February 2012. The report highlighted that the main fund's assets valued at 31 March 2011 were sufficient to meet 96% of its liabilities accrued up to that date, resulting in a funding shortfall of £142 million. This represents an improved position from the previous triennial valuation (as at March 2008) which reported a funding position of 85% (a funding shortfall of £524 million).
37. The movement in funding position has been significantly influenced by recent changes including pension increases being linked to the Consumer Price Index and the way life expectancy is treated. These movements are summarised in **Exhibit 1**.

### Exhibit 1: Movement in main fund valuations 2008 to 2011

Fund Details	2008 £million	2011 £million
<b>Assets</b>	2,903	3,477
<b>Liabilities</b>	(3,427)	(3,619)
<b>Net Liability</b>	(524)	(142)
<b>Funding Level</b>	85%	96%

*Source: actuary's valuations from 2008 and 2011*

38. The funding levels calculated at the last triennial revaluations in 2011 for the Lothian Buses Pension Fund and Scottish Homes Pension Fund were 112% and 86% respectively. The 2014 triennial valuations are currently being prepared by the actuary and will be used to set contribution rates from April 2015.
39. The actuarial values of promised retirement benefits for each fund are calculated annually by the actuary for the purposes of international accounting standards. These annual values are not relevant for calculating funding levels or setting employer contribution levels.
40. The Lothian Pension Fund actuarial annual statement at 31 March 2014 estimated a value of promised retirement benefits as £5,483 million (2012/13: £4,946 million). Net assets of £4,377 million at 31 March 2014 were sufficient to meet 80% of this value. This increase in the net liability is mainly due to a fall

in real bond yields. The liability is not a full actuarial valuation, but an estimate of the present value of the future liabilities of the fund, based on the fund actuary's assumptions regarding the future discount rate, longevity of members and rate of inflation.

41. Based on the 31 March 2014 actuarial annual statement for the Lothian Buses Pension Fund, the net assets of £337 million represent 94% of existing promised benefits of £358 million. This fund stopped admitting new members in 2008; consequently the long term trend will be for the number of active members to decrease.
42. The Scottish Homes Pension Fund has no active members contributing to the fund. Based on the 2013/14 actuarial statement, net assets of £136 million at 31 March 2014 represent 99% of estimated promised retirement benefits of £138 million. As guarantor of the fund, the Scottish Government is liable to meet any shortfall in funding.
43. The Funds' actuary carried out a modelling exercise during 2012/13 to provide updated cash flow projections based on Fund membership at 31 March 2013. This work produced a contribution stability mechanism, designed to provide certainty of pension contributions for certain Fund employers for future years, whilst still maintaining appropriate funding levels to the Fund.
44. The modelling exercise also confirmed that Lothian Pension

## Financial position

Fund is expected to move to a negative cash flow position in the near future. The Fund will use investment income to pay pensions when this occurs, rather than reinvesting. As identified in our Annual Audit Plan, the Funds are taking action to monitor the membership profile over the long term.

financial position will require careful consideration of the types of investments that are made. Any investments in alternative products by the Funds will require vigilant management to limit their exposure to any downside risks and ensure a reliable rate of return.

## Outlook

45. The longer term outlook for the Funds will remain challenging as significant budget reductions continue to be required by Local Government employers in future years. Member bodies are likely to seek to deliver efficiencies through reductions in staffing levels and recruitment, which would impact on the number of active members in Lothian Pension Fund. Reductions in the number of active members will place a greater emphasis of the Funds' investments for the generation of income to meet payments for members' benefits.
46. In the short-term, the introduction of auto enrolment has contributed to an increase in active membership numbers from 28,869 to 30,622. These numbers may increase further as other employers progress through the auto enrolment process.
47. In addition to the Funds' obligations to members, their financial position is determined by the performance of their investments. In the current environment of low Bond yields and interest rates, obtaining the required rates of return to sustain the

# Governance and accountability

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48. Members of the Pensions Committee and the Pensions and Accounting Manager are responsible for establishing arrangements for ensuring the proper conduct of the affairs of the Funds and for monitoring the adequacy and effectiveness of these arrangements.

## Corporate governance

49. 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 Director of Corporate Governance has delegated authority for the implementation of the Funds' investment strategy. An Investment Strategy Panel provides advice on these matters.
50. Based on our observations and audit work our overall conclusion is that the governance arrangements within the Funds are operating effectively.

## Governance processes and committees

51. 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.

52. The Council has delegated the administration, management and investment of the Pension Funds to the Pensions Committee. The committee comprises councillors from City of Edinburgh Council and representatives from employers and members of the schemes.
53. A Consultative Panel exists to enhance participation in the development and scrutiny of matters relating to the Pension Fund. It 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.
54. Day to day administration of the Funds 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. However for the Lothian Pension Funds, this Section 95 responsibility has been delegated to the Pensions and Accounting Manager.

## Investment Operations

55. A review of investment governance arrangements of the pension funds was instigated in December 2013 at the request of the Director of Corporate Governance. External consultants were appointed to review investment operations, particularly those relating to internally managed investments.

### *Investment controls*

56. The review by the external consultants concluded that the existing systems and controls were generally sufficient for the Funds' current investment activities. A number of key risks were identified including those around the investment staff remuneration and retention policies. It was noted by the consultants that the Funds did not externally benchmark salaries and that notice period provisions in investment staff contracts were not in line with market practice. The consultants also noted that adherence to the council's human resources policies and procedures limited the Funds' ability to mitigate these staffing risks.
57. One of the options identified was the creation of a special purpose vehicle separate from the council which would allow the board of this vehicle to decide on appropriate terms and conditions. The vehicle would be wholly owned by the council. At the September 2014 meeting of the Pensions Committee members agreed in principle that a special purposes vehicle should be established. This option was subsequently approved by City of Edinburgh Council.

### *Financial Conduct Authority (FCA) authorisation*

58. On 24 March 2014, the Pensions Committee agreed that the Lothian Pension Funds would seek Financial Conduct Authority (FCA) authorisation.

59. The purpose of seeking this authorisation is to
- further strengthen the governance of the investment activities of the pension funds,
  - ensure that the current activities of the Funds' investment function continue to be carried out within the appropriate regulatory regime
  - further facilitate the ongoing development of this team to generate further cost efficiencies and savings for the benefit of the stakeholders of the Funds.
60. At their October 2014 meeting, City of Edinburgh Council approved the creation of one or, if appropriate following legal and tax advice, two special purpose vehicles wholly owned and controlled by City of Edinburgh Council for the purposes of:
- seeking Financial Conduct Authority (FCA) authorisation for the activities of this team
  - directly employing certain key staff associated with Lothian Pension Fund's investment function.
61. The costs and efficiencies generated by these special purpose vehicles will be borne by and attributed to the pension funds.
62. Creation of the special purpose vehicles will have a number of implications for the audit of the pension funds in future years. The impact of these changes will be considered as part of the

planning process for the 2014/15 audit of the Pension Funds.

### Governance Compliance Statement

63. Pension administration regulations require an administering authority to prepare and publish a governance compliance statement to measure their pension fund's governance arrangements against the standards set out in the guidance issued by the Scottish Ministers. Having reviewed the governance compliance statement we are satisfied that it complies with the guidance issued by the Scottish Ministers.
64. The governance structures have been seen to be working well with no issues with regard 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.
65. The Code of Practice on local authority accounting in the United Kingdom 2014/15 has been amended to require pension fund bodies to include either:
- a separate statement on system of internal financial control (SSIFC), or
  - additional disclosures, reports or statements as necessary in order to meet the requirements of that statement.

66. The Funds have addressed this in 2013/14 and in previous years by including an Annual Governance Statement in their annual report as a matter of best practice. This statement has been based primarily on the content of the council's Annual Governance Statement. Whilst some of the content within the council's statement is pertinent to the Funds, there are aspects which are of less relevance.

**Refer to Action Plan Point 2**

### Internal control

67. 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 is also informed by an assessment of risk and the activities of internal audit.
68. The Funds' financial systems are run alongside those of the City of Edinburgh Council and some of the council's 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 2013/14.
69. As part of our work we also took assurance from key controls within the Funds' financial systems. From our work on these

systems, no significant control weaknesses were identified.

### Internal audit

- 70. Internal audit is an important element of the Funds' governance structure. The internal audit service is provided by City of Edinburgh Council via a co-source arrangement with PricewaterhouseCoopers.
- 71. We reviewed internal audit at the planning stage of our audit and concluded that they operated in accordance with the Public Service Internal Audit Standards and had sound documentation standards and reporting procedures in place.
- 72. During 2013/14, internal audit carried out a review of the implementation of the Funds' new payroll module. The work concluded that the project was being appropriately managed with sufficient governance and risk management controls and safeguards being in place. This work was considered in our assessment of the internal controls put in place by the Funds.
- 73. 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. 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.

- 74. Internal audit provided an opinion in compliance with the above requirements, and it was presented to the Pensions Committee on 17 June 2014 along with other key assurance statements, as part of the consideration of the unaudited financial statements.

### Arrangements for the prevention and detection of fraud

- 75. The Funds comply with the relevant fraud and irregularity policies of Edinburgh City Council and these have been reviewed as part of the council wide audit. Overall we concluded that arrangements for the prevention and detection of fraud are adequate and there are no issues which we require to include in this report.
- 76. The Funds participate in the National Fraud Initiative (NFI). The NFI uses electronic data analysis techniques to compare information held on individuals by different public sector bodies and different financial systems, to identify data matches that might indicate the existence of fraud or error.
- 77. As part of our local audit work we monitor City of Edinburgh

Council's approach to participation in NFI both in terms of the submission of the required datasets and their approach to and progress investigating the subsequent data matches. A total of 1,086 pension matches were identified from the most recently completed 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.

78. During 2013/14, the Pension and Investment Division officers were engaged in investigating matches and resolving outcomes. The Division identified overpayments £0.3 million from the matches reviewed, with these amounts currently being recovered.

### Arrangements for maintaining standards of conduct and the prevention and detection of corruption

79. 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.

80. Pension staff, as employees of the council, are bound by the council's employee Code of Conduct. Additionally, committee members are expected to have high standards of character and personal conduct and must declare their interests where relevant. Furthermore, committee members receive training on standards in public life.

### Outlook

81. Progress continues to be made by the Funds towards the implementation of the new Local Government Pensions Scheme (LGPS) in Scotland.
82. There are a number of challenges for the Funds including the move to pensions on a career average basis. 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 not only increase administrative workload initially, but will also undoubtedly generate many more enquiries from fund members seeking clarification on their benefits on an ongoing basis.
83. Each pension fund in Scotland will also be required to establish a Pension Board by 1 April 2015 which will be responsible for assisting with compliance with scheme regulations and the requirements of the pensions regulator.

## Governance and accountability

84. Regular updates have been provided to the pensions committee on progress being made with implementing the changes, however, the timescales involved are short and there is a risk that not all the required changes will be made in time.

**Refer to Action Plan Point 3**

## Best value, performance and use of resources

### Best Value

85. The Pension Funds have not been subject to a Best Value review; however, it is covered by the overall Best Value arrangements of the administering authority.

### Performance

#### *Investment Performance*

86. 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 2** shows the allocation of investments to fund managers for Lothian Pension Fund as at 31 March 2014.
87. Approximately 45% of the Lothian Buses Pension Fund is managed by in-house investment managers, with the remainder allocated between 2 separate external investment managers.
88. The Scottish Homes Pension Fund investments are managed exclusively by external investment managers. The Fund's equity and bond investments account for 95% of its assets at

31 March 2014. These have been managed passively by external investments managers, State Street, since 2010.

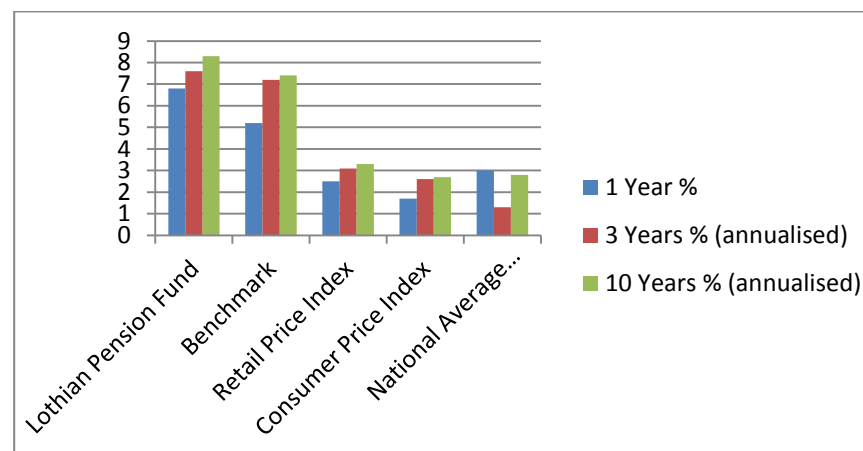
**Exhibit 2: Fund managers' allocation 2013-14 (main fund)**

Fund Manager	Market Value £'000	% of Total Fund Value
Ballie Gifford	152,847	3.5
Cantillon	238,423	5.5
Harris	175,955	4.1
Invesco	140,806	3.2
In-house Investment Managers	2,781,112	64.1
Mondrian	92,455	2.1
Nordea	163,920	3.8
Standard Life	322,037	7.4
Rogge	184,569	4.2
UBS	91,186	2.1
Total	4,343,310	100

*Source: Lothian Pension Fund audited financial statements 2013/14*

89. 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.
90. Investment returns of Lothian Pension Fund have outperformed benchmark targets over the short, medium and longer term, as illustrated in **Exhibit 3**. The table also shows that over a period of one, three and ten years the pension fund has outperformed measures of inflation i.e. the consumer price index, the retail price index and national average earnings.
91. Lothian Buses Pension Fund investment returns exceeded the required performance benchmark levels for 2013/14. The portfolio as a whole made returns of 8.9% against the benchmark target of 5.1%.
92. Scottish Homes Pension Fund investment returns met the required performance benchmark levels for 2013/14 of 2.1%. As described at paragraph 86, these are managed passively.

**Exhibit 3: Investment Performance – Lothian Pension Fund**



Source: Pensions Committee, Investment Performance Update, June 2014

## Administration performance

93. The Funds' Administration Strategy was approved by the Pensions and Trusts Committee in March 2010. A revised strategy has since been approved by the 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.
94. In accordance with Regulation 60A of the LGPS

(Administration) (Scotland) Regulations 2008, the Funds' annual report discloses performance against the measures detailed in the Pension Administration Strategy. In relation to 2013/14 the Funds' performance was broadly in line with the annual targets set. Two targets – concerning stakeholder satisfaction and employer contributions payments - were narrowly missed.

### Investment strategies

95. The Funds' investment strategies 2012-17, as agreed by the Pensions Committee in October 2012, have continued to be implemented during 2013/14. The key objective of the Funds' investment strategies is to reduce risk. For the main Fund and Lothian Buses Pension Fund, this has been progressed in 2013/14 through changes within equity portfolios to equities with less volatility, along with an increased exposure to index-linked assets and alternatives.
96. For alternatives, new investments have been made in the main fund, however, there has only been a small change in the percentage of the fund assets in alternatives because of the growth of the fund size. For Lothian Buses, increasing their exposure to alternatives is dependent on identifying attractive opportunities with the fund continuing to appraise investment opportunities.
97. For the Scottish Homes Pension Fund, the strategy has been to reduce the allocation to equities and property and increase

the allocation to bonds. In 2013/14, as the actual funding level moved closer to the target funding level, the long term strategy was accelerated which resulted in the current and long term strategies matching.

### National performance reports

98. 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 4.**

#### Exhibit 4: A selection of National Performance Reports 2013/14

Report	Key messages
How Councils Work – Charging for Services: Are You Getting It Right?	Councils should have clear policies in place for charging and concessions and councillors should have a lead role in determining these policies
Overview of Local Government in Scotland 2013/14	Underlines the need for councillors to maintain a good understanding of the rapidly changing economic, social and political context.
How Councils Work – Option Appraisals: Are You Getting It Right?	Councillors have a crucial role in option appraisals.

## Appendix I – Significant audit risks

The table below sets out the key audit risks identified at the planning stage and how we addressed each risk in arriving at our opinion on the financial statements.

Audit Risk	Assurance procedure
<p><b>Investment Manager Expenses</b></p> <p>Investment management expenses disclosed in the Funds' accounts and supporting notes do not currently reflect the full amount of investment management fees charged. Fees deducted from capital values are not shown.</p> <p><b>Risk:</b> <i>members cannot gauge whether best value is being obtained.</i></p>	<p>We reviewed the Funds' approach to investment manager fees deducted from capital against the final issued guidance * during our work on the 2013/14 financial statements.</p> <p><i>*The guidance was issued following the preparation of the financial statements (June 2014), however the Funds' officers had been working closely with CIPFA during the development of this guidance.</i></p>
<p><b>Payroll System Migration</b></p> <p>A new payroll system was implemented during the year. The system is integrated with the pre-existing pension administration system</p> <p><b>Risk:</b> <i>the new payroll system is not implemented with the necessary controls to ensure pension payments are processed in a secure and accurate manner</i></p>	<p>Internal Audit has performed a review of the project, considering whether it was appropriately managed with sufficient governance and risk management controls and safeguards being in place. There were no critical issues identified from the report, which was considered during our work reviewing the internal controls put in place by the fund.</p> <p>Our review of the Funds' internal controls also considered the controls in place for the payroll system used previously by the funds (council system) which continued to be in use during the 2013/14 year. No significant control issues were identified from our work on the council's payroll system.</p>

## Appendix II – Action plan

Action plan point / para	Issue, risk and recommendation	Management action/response	Responsible officer	Target date
1 / 20	<p><b>Investment Management Expenses</b></p> <p>As identified in our ISA260 report, the Funds have used information from Investment Fund Managers to calculate fees deducted from capital within their 2013/14 financial statements.</p> <p><b>Risk</b></p> <p><i>The methodology applied for calculating investment management fees is not consistent with the guidance on Investment management fees issued by CIPFA in June 2014. The application of the methodology is inconsistent across funds throughout Scotland, preventing meaningful comparison.</i></p> <p><b>Recommendation</b></p> <p>In relation to the 2014/15 financial statements, the Funds should review their approach to calculating management fees against the CIPFA guidance. Consideration should also be given to reviewing the approach taken against those of other Local Government Pension Schemes.</p>	<p>As the LPF Financial Controller “had been working closely with CIPFA during the development of this guidance”, it is not envisaged that there should be any material issue of non-compliance with published CIPFA guidance 2014/15. This will, of course, be verified.</p> <p>LPF will be very interested in the comparability of investment management fee disclosures and consequent benchmarking with other LGPS funds. It may not be possible to ascertain this, however, prior to the determination of suitable methodology and completion by other Funds of the 2014/15 accounts.</p>	Esmond Hamilton, <b>Financial Controller</b>	31 May 2015

## Appendix II – Action plan

Action plan point / para	Issue, risk and recommendation	Management action/response	Responsible officer	Target date
2 / 64	<p><b>Annual Governance Statement</b></p> <p>The Funds have included an Annual Governance Statement in their annual report as a matter of best practice. This statement has been based primarily on the content of the council's Annual Governance Statement. Whilst some of the content within the council's statement is pertinent to the Funds, there are aspects which are of less relevance.</p> <p><b>Risk</b></p> <p><i>There is a risk that the disclosures in the Annual Governance Statement are not focused on the governance arrangements of the Pension Funds.</i></p> <p><b>Recommendation</b></p> <p>The Funds consider the current format and content of the Annual Governance Statement.</p>	As is customary, the format and content of the Annual Governance Statement of the Lothian Pension Funds will be reviewed in the context of the Council's role as administering authority of the pension funds.	Clare Scott, <b>Investment &amp; Pensions Service Manager</b>	31 May 2015

## Appendix II – Action plan

Action plan point / para	Issue, risk and recommendation	Management action/response	Responsible officer	Target date
3 / 82	<p><b>Pension Reform</b></p> <p>Progress continues to be made by the Funds towards the implementation of the new Local Government Pensions Scheme (LGPS) in Scotland, including the introduction of career average pensions and Pension Boards by 1 April 2015.</p> <p>This is likely to increase administrative workload initially; generate more enquiries from fund members seeking clarification on their benefits on an ongoing basis, and require changes to the pension administration system.</p> <p><b>Risk</b></p> <p><i>The Funds will have insufficient resource to deal with the increased workload leading to delays in providing information to members. In addition, there is a risk that not all the required changes will be in place by 1 April 2015.</i></p> <p><b>Recommendation</b></p> <p>The funds should ensure that a comprehensive strategy is in place to manage the changes required by the Pensions Act.</p>	<p>The significant challenges represented by the implications of the LGPS 2015 are recognised. Project planning and preparatory work is underway to try to ensure successful implementation. Review of progress against targets will be undertaken</p>	Clare Scott, <b>Investment &amp; Pensions Service Manager</b>	31 March 2015 and implementation beyond