

# Pensions Committee

**2pm, Tuesday, 18 December 2012**

## **Annual Report on the 2011/12 Audit of the Lothian Pension Funds**

Item number	5.2
Report number	
Wards	All

### **Links**

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Coalition pledges

Council outcomes [CO26](#)

Single Outcome Agreement

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# Executive summary

## Annual Report on the 2011/12 Audit of the Lothian Pension Funds

### Summary

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The purpose of this report is to present the Auditor's Annual Report on the 2011/12 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 the Pensions Committee by Jim Rundell, Senior 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 2012, and of the amount and disposition at that date of their assets and liabilities".

### Recommendations

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To recommend that the Pensions Committee should:-

1. note the Annual Report on the 2011/12 Audit of the Lothian Pension Funds;
2. note the Action Plan at Appendix B of the Report and seek appropriate updates on progress.

### Measures of success

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

### Financial impact

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There are no financial implications arising directly from this report.

### Equalities impact

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There are no adverse equalities impacts arising from this report.

## Sustainability impact

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There are no adverse sustainability impacts arising from this report.

## Consultation and engagement

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As an integral part of governance, the Consultative Panel for the Lothian Pension Funds comprises employer and member representatives. The Panel members attend Pension Committee meetings, ten in a non-voting capacity and two with full voting rights.

## Background reading / external references

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Not applicable.'

## 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

Appendix 1 – Cover letter from Audit Scotland linked to Appendix 2

Appendix 2 – Audit Scotland report on 2011/12 Audit of Lothian Pension Funds

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Alastair MacLean  
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31 October 2012

Dear Alastair

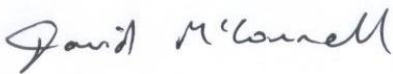
**Lothian Pension Funds**  
**Report to Members and the Controller of Audit on the 2011/12 Audit**

Following agreement to the draft version of the final report on the 2011/12 audit, I now enclose, for your records, a final version of the report.

In accordance with agreed procedures a copy of the report has also been sent to our Best Value and Scrutiny Improvement Group in Edinburgh. A copy of the report will be published on Audit Scotland's website in due course.

I would like to thank all staff contacted during the course of the audit for their assistance and co-operation.

Yours sincerely



**David McConnell**  
**Assistant Director**

By email: Sue Bruce, Chief Executive  
Clare Scott, Investment & Pensions Service Manager  
John Burns, Accounting and Pensions Manager  
Sharon Middlemass, Best Value & Scrutiny Improvement Group, Audit Scotland

# Lothian Pension Funds

## Annual report on the 2011/12 audit



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

October 2012

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.

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# Key messages

## 2011/12 audit findings

Lothian Pension Funds (the Funds) comprise three funds within the Local Government Pension Scheme: the Lothian Pension Fund; the Lothian Buses Pension Fund for employees of Lothian Buses plc which is now closed to new members and Scottish Homes Pension Fund, covering their former employees.

During 2011/12 we looked at the key strategic and financial risks faced by Lothian Pension Funds. We audited the financial statements and looked at aspects of governance, use of resources and performance. This report sets out our main findings, summarising key outcomes from the 2011/12 audit and the outlook for the period ahead.

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 2012, and of the amount and disposition at that date of their assets and liabilities.

As the administering authority, City of Edinburgh Council has statutory responsibility for the administration of the Funds with responsibility for the overall strategic direction of the funds delegated to the Pensions and Trusts Committee (the committee). The remit of the committee has been changed and it is now referred to as the Pensions Committee.

Triennial funding valuations were carried out by the Funds' actuary as at March 2011. The valuation established the extent to which, based on future assumptions, a Fund's assets meet its liabilities and concluded that the main Lothian Pension Fund was 96% funded, an improvement on the 2008 funding level of 85%. 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. No change in employer contribution rates was required. The funding levels for the other Funds were: Lothian Buses - 112% funded, up from 95% in 2008; and Scottish Homes - 86% funded at both valuations.

However, one year later, the funding levels have deteriorated due to lower real bond yields and lower asset returns than expected.

At 31 March 2012 the Lothian Pension Fund had net assets of £3.581 billion (31/03/11-£3.476 billion) and in excess of 100 scheduled and admitted bodies. Investment performance, risk and activity are reported to the Investment Strategy Panel on a quarterly basis. At the year end, an annual report on investment performance and activity is produced and reported to committee. During 2011/12 Lothian Pension Fund achieved an annual return of 2.3% against its scheme specific benchmark of 2.7%. Lothian Buses Fund achieved an annual return of 5.0% against its scheme specific benchmark of 4.5%. Scottish Homes Fund achieved an annual return of 12.7% against a benchmark of 12.6%.

The Funds' Pension Administration Strategy for was approved by the committee in March 2010. It contains the standards which are required of the participating employers and the Funds 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 with performance being reported to the committee. Administration performance of the Funds was satisfactory but that of employers has been disappointing in 2011/12 and discussions are ongoing with employers to determine ways to improve performance.

## Outlook

These are challenging times 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.

It is against this backdrop, and at a time of continued austerity in the public sector, that the new Public Service Pensions Bill has been published. The bill signals more changes ahead for the LGPS, with some changes aimed at reducing costs, and others at setting a common legislative framework and improving governance arrangements.

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.

An Administration Strategy was implemented for the first time in 2010/11. This sets out the standards required of participating employers to enable the efficient administration of the pension fund. The report to the Pensions and Trusts Committee on the Strategy in June 2012 indicated that performance in a number of areas fell short of the targets required. Meetings have been, and will continue to be, held with employers to discuss ways to improve performance and the transfer of data to Lothian Pension Fund. Management expect that the introduction of a new Employer on-line system in 2013 will also help to improve performance.

The co-operation and assistance given to us by members of the Pension & Trusts 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 2011/12 audit of Lothian Pension Funds. The nature and scope of the audit were outlined in the Audit Plan presented to the Pensions and Trusts Committee on 28 March 2012, 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. A number of reports have been issued in the course of the year in which we make recommendations for improvements (Appendix A). We do not repeat all of the findings in this report, but instead we focus on the financial statements and any significant findings from our wider review of the administering authority's arrangements for the management of the fund.
3. 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 Funds should ensure that those charged with governance are satisfied with the proposed management action and have a mechanism in place to assess progress.
4. This report is addressed to City of Edinburgh Council as administering body for Lothian Pension Funds and the Controller of Audit and should form a key part of discussions with the Pensions Committee, either prior to, or as soon as possible after, the formal completion of the audit of the financial statements. Reports should be available to the Scottish Parliament, other stakeholders and the public, where appropriate. Audit is an essential element of accountability and the process of public reporting.
5. This report will be published on our website after consideration by those charged with governance. 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 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

7. 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.
8. 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 2012 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.
9. Auditors review and report on, as appropriate, other information published with the financial statements, including the foreword by the Director of Corporate Governance, the annual governance statement and the governance compliance statement. This section summarises the results of our audit on the financial statements.

## Audit opinion

10. We have given an unqualified opinion that the financial statements of Lothian Pension Funds for 2011/12 give a true and fair view of the financial transactions of the Funds during the year ended 31 March 2012 and of the amount and disposition at that date of its assets and liabilities.

## Legality

11. 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.

## Annual Governance statement

12. An Annual Governance Statement has been included in the Funds' annual report; the Code of Practice on Local Authority Accounting in the UK (the Code) does not require this statement to be provided, so the funds have demonstrated good practice by its inclusion. This statement provides a high level overview of the governance arrangements that are in place, what internal controls the funds place reliance on, and a review of their effectiveness. We are satisfied by the disclosures in the Annual Governance Statement.

## Governance compliance statement

13. 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.

## Annual Report

14. 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.
15. We are satisfied that the report complies with Scottish Government guidance and that the other sections are consistent with the audited accounts.

## Accounting issues

16. Local authority bodies in Scotland are required to follow the 2011/12 Code of Practice on Local Authority Accounting in the United Kingdom (the 2011/12 Code). Further guidance was issued for 2011/12, requiring more detailed disclosure in the annual accounts. We were satisfied that the financial statements have been prepared in accordance with the 2011/12 Code.

## Accounts submission

17. The fund's unaudited financial statements were submitted to the Controller of Audit by the deadline of 30 June 2012. This enabled us to conclude the audit and certify the financial statements by the target date of 30 September 2012.

## Presentational and monetary adjustments to the unaudited accounts

18. 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 Audit Committee on 27 September 2012. Two errors were identified during the audit. One error relating to the accrual of death benefits was not considered to be material and was unadjusted while the other error relating to an historic over valuation of one private equity limited partnership was amended in the signed financial statements.

# Financial position

19. Audited bodies are responsible for conducting their affairs and for putting in place proper arrangements to ensure that their financial position is soundly based.
20. 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.
21. These are key areas in the current economic circumstances. This section summarises the financial position and outlook for the Funds.

## Financial results

### Budgetary control

22. The Funds' actual expenditure compared to the budget disclosed an underspend of £2,350,000 for the year to 31 March 2012. The main areas of underspend were supplies and services (£134,000), investment managers fees (£1,883,000) and central support costs (£77,000).
23. Investment manager's fees are dependant on market values and on a performance element for some managers. The main performance related saving arose in respect of Lothian Buses Pension Fund (£561,000). A further saving of £1,370,000 arose as a result of two external fund managers not being used for part of the year.

### Financial position

24. In accordance with accounting standard IAS 26 'Accounting and Reporting by Retirement Benefit Plans' the actuarial present value of proposed retirement benefits (actuarial value) is disclosed by way of a note to the pension funds financial statements. Employer bodies are required to recognise their share of the net liabilities for the pension fund in their balance sheets. Exhibit 1 sets out the net assets for each of the funds and compares them with the actuarial value of the retirement benefits to produce a net asset/liability position. The figures are only prepared for the purposes of IAS 26 and are not relevant for calculations undertaken for funding purposes and setting contributions payable to the Fund.

**Exhibit 1: Financial position of the funds at 31 March 2012 (IAS 26 basis)**

Description	Net Assets £m	PV of promised retirement benefits £ m	Net asset/(liability) £m
Lothian Pension Fund	3581	4185	(604)
Lothian Buses Fund	271	269	2
Scottish Homes Fund	131	131	0
<b>Total</b>	<b>3983</b>	<b>4585</b>	<b>(602)</b>

Source: Financial Statements

25. The Lothian Pension Fund discloses a deficit position. In calculating the actuarial value for accounting purposes, the long term view of the fund in meeting its future commitments is considered having taken employers' contribution rates and revenues generated from investments into account.
26. The triennial valuation of the three funds was completed at 31 March 2011. The results of the valuation are disclosed in Exhibit 2. The valuation discloses that Lothian Pensions Fund actual funding level rose from 85% at the 2008 valuation to 96% at 2011. 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%. Although funding levels had increased over the three year inter-valuation period the funding levels at 31 March 2012 have reduced due to lower bond levels and lower asset returns than expected.

**Exhibit 2: Funding levels at triennial valuation 31 March 2011**

Description	Market value of assets £ million	Past Service liabilities £ million	Funding level
Lothian Pension Fund	3,477	3,619	96%
Lothian Buses Fund	257	229	112.4%
Scottish Homes Fund	124	144	86.3%

Source: Triennial Valuation 2011

27. During the year overall membership of the Lothian Pension Fund increased from 65,713 to 66,354. Active members, however, decreased by 582 and pensioners increased by 1,011. This continues the trend from recent years. The total number of members retiring was 1,310 of which 607 (2010/11-622) related to members retiring as a result of employers offering Voluntary Early Release Arrangements (VERA). This trend in early retirements is likely to

continue for the next few years. However, the Lothian Pension Fund may see increased membership due to auto enrolment.

28. 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."
29. The Funds are liaising with Hymans Robertson to explore the feasibility of developing a financial model to provide greater insight into cashflow forecasting as the Lothian Pension Fund is expected to move from net positive cashflows from dealings with members to a negative position. As Fund maturity increases, investment income will be required to be used to pay pension benefits. Based on current projections eventually the drawdown of investment assets will be required although the Fund's actuary has advised that this not likely to happen in the short term.
30. Cashflow monitoring reports are prepared monthly to ensure that sufficient cash balances are held to meet ongoing pension commitments, and that any excess balances are passed periodically to the fund's investment portfolios. These cashflow reports are submitted to management but are not submitted to the Pensions and Trusts committee.

**Refer Action Plan no. 1**

## Outlook

### 2012/13 budget

31. The 2012/13 annual budget for administration costs is £13.299 million, an increase of £0.429 million from 2011/12. The most significant increases are investment managers (£0.481 million), custody fees (£0.139 million) and employee costs (£0.100 million) offset by increased income from securities lending of £0.300 million.
32. The most recent administration budget monitoring report to committee, as at period 4 in 2012/13, showed an underspend of £0.154 million.

### Financial forecasts beyond 2012/13

33. 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. At some point in the future this 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 28.

**Refer Action Plan no. 2**



34. 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.

# Governance and accountability

35. The three fundamental principles of corporate 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.
36. 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.
37. 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.
38. Consistent with the wider scope of public audit, auditors have a responsibility to review and report on audited bodies' corporate governance arrangements as they relate to:
  - corporate 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.
39. In this part of the report we comment on key areas of governance.

## Corporate governance

### Processes and committees

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.

40. During the year 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 with a quorum of two. We observed that 4 members were present at the committee on three occasions and 3 attended the other meeting.

- 41. Day to day administration of the fund is carried out by the Investment and Pensions Division which is a division of the council's Corporate Governance department. The Pensions and Accounting Manager was appointed as the S95 Officer at the Policy and Strategy Committee on 28 February 2012.
- 42. There was a new requirement in 2011/12 for pension funds 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.
- 43. Given the complex nature of pensions and investments, it is important that the committee receive continuous training and support to enable effective scrutiny. There are likely to be many legislative and regulatory changes over the coming years, so it is essential that members receive sufficient training to keep them up to date with current events. This is particularly important for those members who are new to the committee as a result of the Scottish local government elections in May 2012.

## Internal Audit

- 44. 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 section. 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.
- 45. In terms of International Standard on Auditing 610 (Considering the work of internal audit), we placed formal reliance on internal audit's testing in relation to employer and employee contributions, lump sums and pension payments and on their review of pension fund investments.
- 46. The council's internal audit service is going through a period of transition. The Chief Internal Auditor retired at the end of July 2012 and a manager from PricewaterhouseCoopers was appointed to manage the service on an interim basis. At the end of September 2012 a further six internal auditors retired.
- 47. Tenders have been issued for the provision of an internal audit service with two options being proposed - full outsourcing or co-sourcing. Tenders were returned on 10 October 2012 and are due to be evaluated on 22 October 2012. The outcome of this exercise will determine the future shape of the internal audit function. Until then internal audit will be running below full strength and this will impact on the amount of work that can be carried out. There is a risk that the internal service will not be able to deliver on its plans in respect of Lothian Pension Funds.

**Refer Action Plan no. 3**

## Internal control

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.

- 48. The fund's financial systems run alongside those of the City of Edinburgh Council and its financial ledger and payroll system are used to process transactions. There are specific systems and lines of responsibility for pension administration and for investment transactions.
- 49. No material weaknesses in the accounting and internal controls systems were identified in the Investments and Pensions Division during our audit.
- 50. As part of our work, we took assurance from key controls within the fund's systems, with some controls being tested by internal audit. A follow up report detailing progress on the risks identified in the 2010/11 annual audit report was submitted to management in June 2012. No significant control weaknesses were identified during this work.

## Prevention and detection of fraud and irregularities

- 51. Audited bodies are responsible for establishing arrangements to prevent and detect fraud and other irregularity. Auditors review and report on these arrangements.
- 52. 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 are pleased to note that the Funds continue to have appropriate arrangements in place to minimise the risk of fraud and corruption.

## NFI in Scotland

- 53. 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 exercise started in October 2010 and was reported upon in May 2012. The next round of NFI is due to commence in June 2012, and will look to expand the range of data sets and bodies.
- 54. 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.
- 55. 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. With regard to pensions, there were 521 matches that identify people who are in receipt of pension but also appear on DWP and registrars records as being deceased, or who appear on another payroll system. 38 cases were identified with a value of £45,996 of which £23,896 has been recovered.

## **Standards of conduct and arrangements for the prevention/detection of bribery and corruption**

56. 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. 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.

## **Outlook**

57. Responsibility for the overall strategic direction of the fund is delegated by the council to the Pensions and Trusts Committee (the committee) which in 2011/12 was comprised of elected members of the council. The Director of Corporate Governance submitted a report to the committee in June 2012 setting out proposals for the review of pension governance. The main changes are as follows:
- removal of the governance of charitable trusts from the committee
  - an increase in the membership of the committee from 5 to 7 including 2 non City of Edinburgh stakeholders selected from the Consultative Panel to represent employers and members
  - establishment of an Audit Sub-Committee of the Pensions Committee
  - reduction of the number of members of the Lothian Pensions' Fund Consultative Panel.
58. Management anticipate that the new governance arrangements as highlighted in paragraph 57 above will improve scrutiny of the pension funds and encourage stakeholder participation. We will monitor developments in this area including any post-implementation review to assess their effectiveness.
59. These proposals were accepted by City of Edinburgh Council on 20 September 2012.
60. A number of measures will be introduced in 2012/13 as part of the Pensions Act 2011. This act is part of the legislation passed by government aimed at reforming workplace pensions and encouraging individuals to save for their retirement. One key provision of the act is auto enrolment. The requirement is that all employers must make arrangements to ensure that their eligible jobholders become active members of an auto enrolment pension scheme from their auto enrolment staging date. This provision directly impacts on the Local Government Pension Scheme, and the administration section of the fund.

61. Prior to this requirement being implemented, the Fund has conducted a review to assess the employers' preparations for the introduction of auto enrolment. It was found that good progress has been made but a substantial amount of work is still needed by employers in preparation for auto enrolment.
62. The future shape of LGPS in Scotland remains uncertain. However, it is likely that proposed changes will impact on administrative workloads going forward. We will continue to monitor the fund's arrangements in preparing for these changes and any potential risks that arise.

# Best Value, use of resources and performance

63. Audited bodies have a specific responsibility to ensure that arrangements have been made to secure Best Value.
64. 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.
65. 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.
66. Auditors may also consider the use of resources in services or functions, where the need for this is identified through local audit risk assessments.
67. 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.
68. 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

69. 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.

### Investment Performance

70. 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.

- 71. At the year end, an annual report on overall investment performance and activity is produced and reported to committee. The main performance issues arising from the report are described in paragraphs 73 to 79.
- 72. 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.

### **Lothian Pension Fund**

- 73. During 2011/12 the fund achieved an annual return of 2.3% against its scheme specific benchmark of 2.7%. This underperformance has resulted in the main from poor returns from four managers in 2011/12. Of the fund's 8 investment managers, 5 underperformed against the benchmarks applied to them in 2011/12.
- 74. The fund achieved a 10 year annualised return of 6.2% against the benchmark of 5.3%.
- 75. The global equity mandate managed by one manager was terminated in December 2011 and assets were managed internally on an interim basis in preparation for the appointment of new global equity managers following an EU tender process. The tender process concluded with six global equity managers being appointed to a framework arrangement.

### **Lothian Buses Pension Fund**

- 76. During 2011/12 the fund achieved an annual return of 5% against its scheme specific benchmark of 4.5% as a result of a strong performance in property investment.
- 77. The fund achieved a 10 year annualised return of 7.4% which is above the benchmark of 6.5%.

### **Scottish Homes Pension Fund**

- 78. During 2011/12 the fund achieved an annual return of 12.7% against its scheme specific benchmark of 12.6%.
- 79. The fund achieved an annualised return since its inception in July 2005 of 8.2% against the benchmark of 8.3%.

### **Administration Performance**

- 80. The Funds' Administration Strategy was approved by the Pensions and Trusts Committee in March 2010. 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.
- 81. 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.



82. Proposed changes to the LGPS will impact on administrative workloads going forward as will any further severance activity by employers. Additionally auto enrolment begins for some employers in 2012/13 and this 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. 4**

## **Employers' Performance**

83. Administration performance in relation to employers has been disappointing in 2011/12 with none of the five targets being achieved. Retirement notification within 20 days of retiral only achieved 39% of target whilst notification of death in service within ten days only achieved 30% of target.

**Refer Action Plan no. 5**

84. In relation to its own performance the Fund exceeded or matched its target in four out of five categories with the exception being leavers where only 38% of target was achieved.
85. Following a competitive procurement, the Fund has now invested in an Employer On-line Portal for pension administration. This ICT enhancement provides the opportunity for transformational change in data transfer between employers and the Fund and therefore has the potential to provide radical improvement.
86. The Pension Administration Strategy (PAS) has been reviewed for the year 2012/13 and was strengthened in June 2012 by the addition of a Compliance Certificate. The Compliance Certificate is intended to formalise each employer's responsibility under the PAS. The document requires one senior manager from each employer to certify that that the employer understands and will undertake its various obligations under the Local Government Pension Scheme regulations.

## **User engagement**

87. There is regular communication with employers, members and pensioners with regard to the funds involving seminars, briefings, leaflets, newsletters and the website which is regularly updated.
88. The Consultative Panel (the Panel) is the main mechanism for engagement with the Fund's stakeholders and enables their involvement in the decision-making process. The Panel meets jointly with the committee.
89. Regular customer surveys are carried out for the funds and the results are included in the annual report. Overall 84% of respondents agreed that the service provided was excellent.
90. Members now have electronic access to their benefit statements.

## National performance reports

91. 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 3 below.

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### Exhibit 3: A selection of National performance reports 2011/12

- |   |  |
|---|--|
| <ul style="list-style-type: none"><li>• An overview of local government in Scotland - challenges and change in 2012</li><li>• Managing performance: are you getting it right</li><li>• Scotland's Public Finances-Addressing the Challenges</li></ul> | <ul style="list-style-type: none"><li>• The National Fraud Initiative in Scotland</li><li>• How Councils work: using cost information to improve performance</li></ul> |
|---|--|

Source: [www.audit-scotland.gov.uk](http://www.audit-scotland.gov.uk)

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92. We suggest that officers review national performance reports as they become available and consider any findings which may impact on the pension fund.

## Outlook

93. 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 minimise exposure to risk whilst still delivering the required returns.
94. 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.
95. 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 2011/12

Title of report or opinion	Date of issue	Date presented to Audit Committee
Annual Audit Plan	13 February 2012	28 March 2012
Governance follow-up report.	28 June 2012	27 June 2012
Report on financial statements to those charged with governance (ISA 260)	14 September 2012	27 September 2012
Audit opinion on the 2011/12 financial statements	14 September 2012 *	27 September 2012
Report to Members on the 2011/12 audit	31 October 2012	6 December 2012

\* Proposed audit opinion issued on 14 September and formally signed on 28 September following the Audit Committee of 27 September.

# Appendix B: action plan

## Key Risk Areas and Planned Management Action

Action Point	Refer Para No	Risk Identified	Planned Management Action	Responsible Officer	Target Date
1	30	<p>Cashflow reports are submitted to management but are not submitted to the Pensions and Trusts committee for review.</p> <p><b><i>Risk: Committee Members do not have the opportunity to scrutinise cash flow reports and address any issues identified by them.</i></b></p>	<p>Management monitor short-term (monthly) cashflow to ensure there is sufficient cash to pay benefits and to ensure excess cash can be invested as soon as practical. Short term cashflow can fluctuate significantly.</p> <p>The Investment Strategy Panel considers medium-term (up to 2 year) cashflow projections on a quarterly basis.</p> <p>Long-term cashflow, including projection, is reported to Committee as part of funding and investment strategy reviews as well as part of the annual accounts e.g. December 2010 (Contribution Stability Mechanism) and October 2012 (Investment Strategy Review).</p> <p>Additional monitoring of investment income and membership numbers is being put in place following the adoption of the revised investment strategies. Consideration will be given to the appropriate cashflow monitoring process.</p>	Investments & Pensions Service Manager	March 2013

Action Point	Refer Para No	Risk Identified	Planned Management Action	Responsible Officer	Target Date
2	33	<p>The changing profile of the funds' membership may result in monthly income not being sufficient to meet the fund's monthly commitments, requiring the use of investment income to pay pension benefits.</p> <p><b>Risk: <i>Financial plans prepared by the pension funds are not achieved.</i></b></p>	<p>Reviews and financial plans of the Fund are, and will continue to, be reviewed regularly. They do, and will, take into account membership profile and potential changes.</p> <p>The comments at Action point 1 are relevant in this context. In addition at the 2011 actuarial valuation the Fund ensured that the recovery of any past service deficit is achieved irrespective of any fluctuations in future payroll by expressing contributions for the recovery of deficits from 2012/13 as a fixed monetary amount. Also, the Fund will now consider requests from employers for a lower risk investment strategy to take into account changing membership profiles.</p> <p>It also should be stated that the a significant majority of members of the Local Government Pension Scheme are from employers with strong covenants, i.e. Scheduled Bodies, such as local authorities, which also must remain open to new entrants. Appropriate guarantors of pension liabilities are always sought prior to admission. Financial risk exposure to Lothian Pension Fund should therefore be viewed in this context.</p>	Investments & Pensions Service Manager	Ongoing

Action Point	Refer Para No	Risk Identified	Planned Management Action	Responsible Officer	Target Date
3	47	<p>The internal audit function is running below full strength and this could impact on the amount of work that can be carried out in relation to the 2012/13 financial year.</p> <p><b>Risk: The internal audit function may not be able to deliver on its planned programme of work in 2012/13.</b></p>	<p>The Internal Audit Plan 2012/13 (i.e. October 2012 to September 2013) was considered by Audit Committee on 27/9/12. The proposed activity for the Funds was a "Review of Quality Assurance Framework", which was allocated 40 (auditor work) days. As is stated, options for the future delivery of the Internal Audit service are being evaluated currently by the Council. The Funds will commission supplementary audit services for 2012/13. Discussions with Audit Scotland and the Acting Chief Internal Auditor are already underway.</p>	Investments & Pensions Service Manager	December 2013
4	82	<p>Proposed changes to the LGPS will impact on administrative workloads going forward as will any further severance activity by employers. Additionally auto enrolment begins for some employers in 2012/13 and this will also affect information requirements and administration arrangements.</p> <p><b>Risk: The increased workload will increase pressure on staff and key tasks and statutory requirements will not be delivered.</b></p>	<p>It is recognised that impending reform of the LGPS in Scotland is likely to increase significantly the burden of pension administration. There is certainly some degree of risk exposure for Lothian Pension Fund from both the perspective of key staff expertise and also ICT system supplier readiness. That said, Lothian Pension Fund has included additional resource in its budget from 2012/13 in anticipation of changes and is already focusing on enhancements both to operational efficiency and to data quality. Specifically, data quality</p>	Investment and Pensions Service Manager	Ongoing

Action Point	Refer Para No	Risk Identified	Planned Management Action	Responsible Officer	Target Date
			<p>improvements as a result of the system enhancements to transfer data electronically from employers to the Fund ("Employer On-line") should also be most beneficial in the transition to a Career Average Revalued Earnings scheme.</p> <p>The need to ensure that the pension administration computing system can cope with demands of a new scheme has already been raised at the Scottish Local Government Pensions Advisory Group (SLOGPAG) forum. Appropriate and timely liaison with the system supplier, at a national level, is therefore anticipated.</p>		
5	83	<p>Administration performance in relation to employers has been disappointing in 2011/12 with none of the five targets being achieved.</p> <p><b><i>Risk: delays in information provision may impact on the delivery of accurate and timely services to members.</i></b></p>	<p>Unfortunately, this overall poor performance from employers in the provision of information is by no means untypical across the pensions industry in both public and private sectors. Lothian Pension Fund, however, is not content with the status quo. The Investment &amp; Pensions Service Manager has raised this as a key priority issue at face-to-face meetings with senior managers of the major employers. The forthcoming phased implementation of "Employer On-line", which prioritises the largest memberships, also represents a significant</p>	Investment and Pensions Service Manager	Ongoing

Action Point	Refer Para No	Risk Identified	Planned Management Action	Responsible Officer	Target Date
			<p>opportunity for employers to embrace this new technology and deliver meaningful improvements to the provision of pension record data.</p> <p>It should be noted also that the Pension Administration Strategy, as approved by the Pensions &amp; Trusts Committee, includes the ultimate sanction of financial penalty on any employer failing to meet expected performance standards.</p>		