

Pensions Committee

10am, Wednesday, 13 March 2013

External Audit – Annual Audit Plan 2012-13

Item number	5.1
Report number	
Wards	All

Links

Coalition pledges

Council outcomes [CO26](#)

Single Outcome Agreement

Alastair Maclean

Director of Corporate Governance

Contact: John Burns, Pensions & Accounting Manager

E-mail: john.burns@edinburgh.gov.uk | Tel: 0131 469 3711

Executive summary

External Audit – Annual Audit Plan 2012-13

Summary

Audit Scotland, the external auditor to the Lothian Pension Funds, has detailed its planned programme of work to support the statutory audit 2012/13. This is shown at Appendix 1 - "Audit Scotland Annual Audit Plan 2012-13".

Audit Scotland intends to place formal reliance on internal audit work for certain aspects. This is detailed at Appendix 2 – "Review of the adequacy of the internal audit service: 2012/13". The Internal Audit plan, which will be reported separately, is aligned to deliver these requirements.

Stephen O'Hagan, Senior Audit Manager, Audit Scotland, has replaced his colleague, Jim Rundell, on the audit. Brian Battison, Audit Manager, will present the Annual Audit Plan 2012-13 to Committee.

Progress against the Annual Audit Plan 2012-13 will be reported to future meetings of the Pensions Audit Sub-Committee and thereafter the Pensions Committee.

The proposed audit fee for 2012/13 has been reduced from the previous year's £49,080 by £1,890 (3.8%) to total £47,190. This sum can be met from within the approved budget.

Recommendations

Pensions Committee is requested to:

1. Note the Annual Audit Plan 2012-13, as submitted by Audit Scotland;
2. Note the formal reliance placed on the work of Internal Audit;
3. Note that suitable budgetary provision has been made for the estimated audit fee; and
4. Note that progress against the Annual Audit Plan 2012-13 will be reported to future meetings of the Pensions Audit Sub-Committee and the Pensions Committee.

Measures of success

Progress against the Annual Audit Plan 2012-13 will be reported to future meetings of the Pensions Audit Sub-Committee, which is scheduled to meet for the first time in

June 2013, and thereafter the Pensions Committee. The prime objective of the Council, as administering authority of the Lothian Pension Fund, Lothian Buses Pension Fund and Scottish Homes Pension Fund, is to ensure an unqualified audit opinion of the Annual Report 2012-13. This will be determined in due course.

Financial impact

The proposed audit fee for 2012/13 of £47,190 represents a reduction of £1,890 (3.8%) reduction from the previous year, 2011/12. Suitable budgetary provision has been made.

Equalities impact

There are no adverse equalities impacts arising from this report.

Sustainability impact

There are no adverse sustainability impacts arising from this report.

Consultation and engagement

The Consultative Panel for the Lothian Pension Funds, comprising employer and member representatives, is integral to governance. The Pensions Audit Sub-Committee, which shall consider future progress reports against this Annual Audit Plan 2012-13, should further strengthen financial and risk management assurance.

Background reading / external references

The responsibilities of Audit Scotland, as independent auditor, are established by the Local Government (Scotland) Act 1973 and the Code of Audit Practice, as approved by the Auditor General for Scotland and the Accounts Commission. Appropriate cognisance is also taken of ethical guidance of the auditing profession.

Links

Coalition pledges

Council outcomes CO26 – The Council engages with stakeholders and works in partnerships to improve services and deliver agreed objectives.

Single Outcome Agreement

Appendices Appendix 1 - Audit Scotland Annual Audit Plan 2012-13
Appendix 2 - Review of the adequacy of the internal audit service: 2012/13

Lothian Pension Funds

Annual Audit Plan 2012/13



Prepared for members of the Pensions Committee
February 2013

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

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Summary plan

Summary of planned audit activity

Based on our analysis of the risks facing Lothian Pension Fund, Lothian Buses Pension Fund and Scottish Homes Pension Fund, our planned work in 2012/13 includes:

- an audit of the financial statements and provision of an opinion on whether:
 - they give a true and fair view of the financial position of the Funds as at 31 March 2013 and its income and expenditure for the year then ended
 - the accounts have been properly prepared in accordance with the Local Government (Scotland) Act 1973 and the 2012 Code of practice on local authority accounting in the United Kingdom (the Code)
- provision of the annual report on the audit addressed to elected members (i.e. members of the Council's Pensions Committee and more widely the members of the City of Edinburgh Council as the administering authority for the Funds) and the Controller of Audit
- a review and assessment of the Funds' governance and performance arrangements in a number of key areas including the review of the adequacy of internal audit and arrangements to support the governance compliance statement and information in the annual report.

Introduction

1. Our audit is focused on the identification and assessment of the key challenges and risks to Lothian Pension Fund, the Lothian Buses Pension Fund and the Scottish Homes Pension Fund (collectively referred to as The Funds) in achieving their business objectives. We also assess the risk of material misstatement or irregularity in the Funds' financial statements. This plan summarises specific governance and other risks that may affect the financial statements of the funds and sets out the audit work that we propose to undertake in 2012/13 to address these. Our annual audit plan reflects:
 - the risks and priorities facing Lothian Pension Funds
 - current national risks relevant to local circumstances
 - the impact of changing international auditing and accounting standards
 - our responsibilities under the Code of Audit Practice as approved by the Accounts Commission
 - issues brought forward from previous audit reports.

Our responsibilities

2. Our responsibilities, as independent auditor, are established by the Public Finance and Accountability (Scotland) Act 2000 and the Code of Audit Practice approved by the Accounts Commission, and guided by the auditing profession's ethical guidance.
3. Audit in the public sector goes beyond simply providing assurance on the financial statements and the organisation's internal control environment. We are also required to provide a view on performance and the organisation's use of resources. In doing this, we aim to support improvement and accountability.
4. In carrying out our audit, we seek to gain assurance that the Funds:
 - have good corporate governance arrangements in place which reflect the three fundamental principles of openness, integrity and accountability
 - have systems of recording and processing transactions which provide a sound basis for the preparation of financial statements and the effective management of its assets and interests
 - prepare financial statements which give a true and fair view of the position at 31 March 2013 and income and expenditure for the year then ended, in accordance with the Local Government (Scotland) Act 1973 and other applicable laws and regulations, including the 2012 Code of practice on local authority accounting in the United Kingdom (the Code)
 - have systems of internal control which provide an adequate means of preventing or detecting material misstatement, error, fraud or corruption
 - comply with established policies, procedures, laws and regulations
 - proactively manage and review their performance in line with its strategic and operational objectives
 - have made proper arrangements for securing best value in its use of resources.

Our approach

5. Our audit approach is based on an understanding of the characteristics, responsibilities and principal activities, risks and governance arrangements of the Funds, and identification of the key audit risks and challenges in the local government sector generally. This approach includes:
 - understanding the business of the Funds and the risk exposure which could impact on the financial statements
 - assessing the key systems of internal control, and considering how risks in these systems could impact on the financial statements
 - identifying major transaction streams, balances and areas of estimation, understanding how the Funds will include these in the financial statements and developing procedures to audit these

- assessing the risk of material misstatement in the financial statements, in conjunction with our evaluation of inherent risk, the control environment and control risk as part of our risk assessment
 - determining the nature, timing and extent of our testing programme to provide us with sufficient appropriate audit evidence as to whether the financial statements are free of material misstatement.
6. Through this approach we have also considered and documented the sources of assurance which will make best use of our resources and allow us to focus testing on higher risk areas during the audit of the financial statements. The main areas of assurance for the audit come from planned management action and reliance on systems of internal control. Management action being relied on for 2012/13 includes:
- comprehensive closedown procedures for the financial statements accompanied by a timetable issued to all relevant staff (the fund utilises the financial systems of City of Edinburgh Council and follows the closedown procedures and timetables of the Council)
 - clear responsibilities for provision of accounts and working papers being agreed
 - delivery of unaudited accounts to agreed timescales
 - a comprehensive working papers package and supporting records
 - completion of the internal audit programme for 2012/13
 - delivery of an annual report and governance compliance statement to agreed timescales.
7. Auditing standards require internal and external auditors to work closely together to make optimal use of available audit resources. We seek to rely on the work of internal audit wherever possible and, as part of our planning process we carry out an early assessment of the internal audit function. Internal audit is provided by the internal audit section within City of Edinburgh Council, on a co-sourced basis with PricewaterhouseCoopers (PwC). Based on our review of internal audit we plan to place formal reliance on the areas of work set out in Appendix D.
8. Our approach to the audit of the financial statements is based on an integrated assessment of risk across the Code of Audit Practice responsibilities in relation to governance, performance and opinion.
9. At the completion of the audit we will provide the Pensions Committee and the Controller of Audit with an annual report on the audit containing observations and recommendations on significant matters which have arisen in the course of the audit. As a matter of courtesy we will also make our report available to elected members more generally in their capacity as members of the administering authority.

Responsibility for the preparation of accounts

10. It is the responsibility of the Pensions and Accounting Manager, as Proper Officer, to prepare the financial statements in accordance with the Code. This means:
 - acting within the law and ensuring the regularity of transactions by putting in place systems of internal control to ensure that financial transactions are in accordance with the appropriate authority
 - maintaining proper accounting records
 - preparing financial statements timeously which give a true and fair view of the financial transactions of the Funds during the year ended 31 March 2013 and of the amount and disposition at that date of their assets and liabilities
 - preparing an annual report which provided a commentary on the performance of the Funds including the financial results for the year
 - reviewing the main components of the system of internal control, including the arrangements for internal audit. This should include consideration of issues identified as part of the audit process
 - preparing an explanatory foreword.

Format of the accounts

11. The financial statements should be prepared in accordance with the Code which constitutes proper accounting practice for the purposes of section 12 of the Local Government Scotland Act 2003.

Audit issues and risks

12. Based on our experience, discussions with staff, attendance at committee meetings and a review of supporting information, we have identified the following main financial statements risk areas for the Funds.

Funding Position and Sustainability

13. In accordance with Regulation 76 of the Local Government Pension Scheme (Scotland) Regulations 1998, an actuarial valuation of all three funds was carried out as at 31 March 2011.
14. For Lothian Pension Fund, the funding level has increased from 85% at the previous valuation at 31 March 2008 to 96% at this valuation. This has resulted in the deficit reducing from £524m at 31 March 2008 to £142m at 31 March 2011. The triennial valuation determines employer contribution rates required over the next three year period. Based on the 31 March 2011 funding level, the actuary has calculated a common employer contribution rate for the period 2012-15 of 18.0%. This rate means that for most participating employers, including all Councils, there is no increase in contribution rates for the period 2012-15.

15. Our 2011/12 Annual Audit Report identified an increase in the number of pensioners and deferred members in relation to the overall membership of the fund and it is likely that this trend will continue as more and more organisations reduce their workforce. Should this pattern continue there is a risk that this may have an impact on fund's cash flow and on the longer term sustainability of the fund. We note that some of the changes in the Public Service Pension Bill (see paragraph 22) in April 2015 and the Pensions Act 2011 have elements that are aimed at reducing costs and making pension funds more sustainable.

Fund staffing

16. A key provision of the Pensions Act 2011 is the requirement that all employers must make arrangements to ensure that their eligible jobholders become active members of a pension scheme. Although most of the work required will fall on employers, it is important that Lothian Pension Fund considers their administration arrangements and the information requirements of employers and members as a result of auto enrolment. The pressure on staff workloads will increase with auto enrolment but there is also the pressure from undertaking the payroll migration project and having two temporary staff vacancies across 2012/13 and 2013/14. There is a risk that increasing workloads on fund staff may adversely impact on the performance of the pensions division.

Employer Default

17. The current economic and funding pressures on employers has focussed attention on the need to protect against employer default on contributions where admitted bodies have become bankrupt or gone into administration. On the cessation of admitted bodies to the fund, the fund actuary completes a cessation valuation and provides a certificate showing any additional revised contributions due as a result of the cessation. These revised contributions could be substantial.
18. For Lothian Pension Fund, the admission of employers is delegated to the Investment and Pension Services Manager (through the scheme of delegation) for the approval of individual cases. An additional requirement per the Fund's policy (introduced in 2006) on new admissions stipulates that all new bodies joining Lothian Pension Fund must have a guarantor (ultimately, the overall Fund is the guarantor). There is a risk that some admitted bodies may not be able to maintain their on-going contributions. We note that this is a symptom of the wider issue of admitted bodies recognising that the scheme may not be suitable for their organisation e.g. recognising the volatility on their balance sheet.

Administration Performance

19. As stated in our 2011/12 Annual Audit Report, administration performance in relation to employers was 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. As part of their response to this performance the Fund 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. The project has prioritised roll out to larger employers with smaller employers being added in 2013/14. In addition, the Investment and Pensions Service Manager has raised this as a key priority issue at face-to-face meetings with senior managers of the major employers.

20. We note the efforts being made by Lothian Pension Funds on an issue that is common across the pensions industry in both public and private sectors. There is a risk that delays in information provision may impact on the delivery of accurate and timely services to members.

Public Service Pensions Bill

21. The Public Service Pensions Bill signals more changes ahead for the Local Government Pension Scheme (LGPS), with some changes aimed at reducing costs, and others at setting a common legislative framework and improving governance arrangements. The changes are to be implemented by April 2015. Therefore, within the next two years the fund must develop the necessary pension systems and processes to allow compliance with the requirements of the new pension scheme. Regular updates are provided to committee on proposals for public sector pension scheme reform and other significant changes affecting the scheme. We will continue to monitor this development.

Summary assurance plan

22. Within these identified risk areas there is a range of more specific risks and these are summarised at Appendix A. In all cases, actions to manage these risks are underway. Details of the sources of assurance that we have received for each of these risks and any audit work we plan to undertake are also set out in Appendix A. In the period prior to the submission of the unaudited financial statements, we will liaise with senior officers on any new or emerging issues.

Materiality

23. We consider materiality and its relationship with audit risk when planning the nature, timing and extent of our audit and conducting our audit programme. Specifically with regard to the financial statements, we assess the materiality of uncorrected misstatements, both individually and collectively.

International Standard on Auditing 320 states that, "Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements; judgements about materiality are made in light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and judgements about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered."

24. When considering, in the context of a possible qualification to the audit opinion, whether the misstatement of an item, or a number of items taken together, is material in terms of its monetary value, we use professional judgement, experience and internal guidelines from peers as broad guidance in regard to considering whether the results of tests of detail are material.
25. An item may be judged material for reasons other than its monetary or quantitative value. An inaccuracy, which would not normally be regarded as material by amount, may be important for other reasons. When such an item affects a critical point in the accounts, its materiality has to be viewed in a narrower context (for example the failure to achieve a statutory requirement, an item contrary to law, or areas affected by central government control). Again we use professional judgement, experience and internal guidelines from peers to determine when such matters would fall to be covered in an explanatory paragraph, rather than as a qualification to the audit opinion.

Reporting arrangements

26. Under the Local Government (Scotland) Act 1973, there is a requirement for unaudited financial statements to be presented to Lothian Pension Funds and the Controller of Audit within 3 months of the financial year end i.e. 30 June. The non-statutory target for audit completion is 30 September. To achieve this target, it is important that a timetable for the audit of the accounts is agreed with us. An agreed timetable is included at Appendix B of this plan, which takes account of submission requirements, planned committee dates and audit resources.
27. Matters arising from our audit will be reported on a timely basis and will include agreed action plans. Draft management reports will be issued to the Investments and Pension Services Manager to confirm factual accuracy. Responses to draft reports are expected within two weeks of submission.
28. A copy of all final agreed reports will be sent to the Director of Corporate Governance, Investments and Pension Services Manager, Pensions and Accounting Manager (as Proper Officer), Internal Audit and Audit Scotland's Best Value & Scrutiny Improvement Group. In addition key findings will be submitted to the Pensions Committee for their consideration.
29. In order to discharge our responsibilities, it is important that we engage with and report our findings to those charged with governance, in this case the Pensions Committee, before we conclude our audit. A report in accordance with International Standard on Accounting (ISA 260) - communication of audit matters with those charged with governance - will be discussed with the Director of Corporate Governance, the Investments and Pension Services Manager and the Pensions and Accounting Manager (as Proper Officer) before being considered by the Pensions Committee. The report will cover significant issues arising from the audit and will be considered by the committee before we formally issue our audit opinion. This allows time for appropriate action to be taken on any significant matters.

30. We will provide an independent auditor's report to elected members in their role as quasi trustees of the funds and the Accounts Commission for Scotland confirming that the audit of the financial statements has been completed in accordance with applicable statutory requirements, including an opinion on those financial statements. An annual report to elected members and the Controller of Audit will also be produced to summarise all significant matters arising from the audit and overall conclusions about Lothian Pension Funds management of key risks.
31. All annual reports produced by Audit Scotland are published on our website www.audit-scotland.gov.uk
32. A full range of the outputs to be delivered by the audit team is summarised in Exhibit 1.

Exhibit 1: 2012/13 Planned Outputs

Planned outputs	Target delivery date
Governance	
Review of the Adequacy of Internal Audit	By 31 January 2013
Annual Audit Plan	By 28 February 2013
Financial statements	
Report to Pensions Committee in terms of ISA 260 (Communication of audit matters to those charged with governance)	September (exact date to be confirmed)
Independent auditor's report on the financial statements	By 30 September 2013
Annual report to the Pensions Committee and the Controller of Audit	By 31 October 2013

Quality control

33. We are committed to ensuring that our audit reflects best practice and demonstrates best value to Lothian Pension Funds and the Accounts Commission. We operate a strong quality control framework that seeks to ensure that your organisation receives a high quality service. The framework is embedded in our organisational structures and processes and includes an engagement lead for every client; in your case this is Brian Battison, who is responsible for ensuring that our work is carried out on time and to a high quality standard.
34. As part of our commitment to quality and continuous improvement, we may periodically seek your views. We would be grateful for any feedback on our services.

Fees and resources

35. The agreed fee for the 2012/13 audit of Lothian Pension Funds is £47,190 (2011/12: £49,080). Our fee covers:
- all of the work and outputs described in this plan
 - a contribution towards the costs of national performance studies and statutory reports by the Controller of Audit and the work of the Accounts Commission
 - attendance at Pensions Committee and Pension Audit Sub-Committee meetings
 - access to advice and information on relevant audit issues.
36. In determining the agreed fee we have taken account of the risk exposure of the Funds, the management assurances in place and the level of reliance we plan to take from the work of internal audit. We have been assured that the receipt of the draft accounts and supporting working papers will be available for audit by 1 July 2013.
37. In 2011/12 Audit Scotland were successful in delivering all of our work for less than the budgeted costs, largely as a result of our cost cutting plans continuing to be achieved faster than planned. As a result City of Edinburgh Council, as the administering authority, will receive a one off rebate equivalent to 6% of the 2011/12 indicative fees and this includes an element for the Funds.
38. We reserve the right to charge an additional fee for further audit work in such instances as late receipt of the draft financial statements, the lack of agreed management assurances or being unable to take planned reliance from the work of internal audit. An additional fee may be required if our audit cannot proceed as planned.
39. The local audit team will be led by Brian Battison who will be responsible for the day to day management of the audit and who will be your primary contact. Details of the experience of our team are provided at Appendix C. The core audit team will call on other specialist and support staff as necessary.

Independence and objectivity

40. Auditing and ethical standards require the appointed auditor to communicate any relationships that may affect the independence and objectivity of audit staff. Audit Scotland is an admitted body of the Lothian Pension Fund and represents around 1% of fund membership. Staff involved in the audit are members of the fund. While this merits disclosure, it is not considered to represent a conflict of interest for the organisation or individuals involved. We are not aware of any other relationships which may affect the independence of the audit team.
41. We comply with ethical standards issued by the Financial Reporting Council (FRC) and with Audit Scotland's requirements in respect of independence and objectivity, as summarised at Appendix E.

Appendix A - Summary assurance plan

In this section we identify a range of governance and other risks that may affect the financial statements of the Funds, the related source of assurance received and the audit work we propose to undertake to secure additional assurance. The management of risk is the responsibility of Lothian Pension Fund and its officers, with the auditor's role being to review the arrangements put in place by management. Planned audit work, therefore, will not necessarily address all residual risks.

Risk	Source of Assurance	Planned audit action
<p>Funding position and sustainability</p> <p>The actuarial valuation at 31 March 2011 indicated a 96% funding level for the main pension fund.</p> <p>In recent years there has been a significant increase in the number of pensioners and deferred members in relation to the overall membership of the fund.</p> <p>There is a risk that this may impact on the fund's cash flow and the longer term sustainability of the fund.</p>	<ul style="list-style-type: none"> • Actuarial valuation carried out every 3 years • Levels of employer contributions established as part of valuation • Interim valuation reports produced by the actuary between formal valuations. 	<ul style="list-style-type: none"> • Review of annual and triennial actuarial statements • Review PwC report on actuarial assumptions • Monitor levels of pensioners and deferred pensioners in relation to overall membership • Provide an update in the annual report
<p>Fund staffing</p> <p>The pressure on staff workloads will increase with auto enrolment, payroll migration and having temporary staff vacancies during 2012/13 and 2013/14.</p> <p>There is a risk that increasing workloads on fund staff may adversely impact on the performance of the pensions division.</p>	<ul style="list-style-type: none"> • Workforce / succession planning • Preparations and implementation of auto enrolment • Payroll migration project updates 	<ul style="list-style-type: none"> • Monitor levels of early retirement, unfilled posts and retention of staff • Review revenue monitoring reports • Monitor implementation of payroll migration project (liaise with internal audit)

Risk	Source of Assurance	Planned audit action
<p>Employer default</p> <p>Due to the current economic and funding pressures on employers there is a greater need to actively monitor their financial position to mitigate the risks of employer default.</p> <p>There is a risk that some admitted bodies may be unable to maintain their contributions and these are ultimately borne by other pension fund employers.</p>	<ul style="list-style-type: none"> • Plans for monitoring situation with admitted bodies • Funding strategy statement • New admission rules around admitted bodies having a guarantor 	<ul style="list-style-type: none"> • Monitor fund's arrangements for mitigating the risk of employer default
<p>Administration performance</p> <p>Administration performance in relation to employers was disappointing in 2011/12 with none of the five targets being achieved.</p> <p>There is a risk that delays in information provision may impact on the delivery of accurate and timely services to members.</p>	<ul style="list-style-type: none"> • Face-to-face meetings with senior managers of major employers • Employer On-line system 	<ul style="list-style-type: none"> • Review administration performance targets for the current year • Monitor roll out of employer on-line system

Appendix B - Financial statements audit timetable

Key stage	Date
Testing and review of internal control systems and transactions	By 30 June 2013
Provision of closedown procedures to audit	By March 2013
Meetings with officers to clarify expectations of detailed working papers and financial system reports	By March 2013
Planned approval of unaudited financial statements	By 30 June 2013
Latest submission of unaudited financial statements with working papers package	By 30 June 2013
Progress meetings with lead officers on emerging issues	As required during audit process
Latest date for final clearance meeting with senior officers	To be confirmed
Agreement of unsigned financial statements and issue of report to the Pension Committee on the audit of the financial statements (ISA 260)	To be confirmed
Pensions Committee date	September 2013 (exact date to be confirmed)
Independent Auditors Report signed	By 30 September 2013
Certified accounts and annual report presented to Pensions Committee	By 31 October 2013

Appendix C - Audit team

Summarised curriculum vitae for each core team member are set out below:

Brian Battison, CA
Audit Manager

Brian has worked with Audit Scotland for 12 years. He has audited a variety of organisations across central government and associated agencies, local government (including pension funds) and the NHS. Previously Brian worked in the National Audit Office and the private sector on a wide range of public sector audits.

Brendan Clark, CA
Senior Auditor

Brendan has fourteen years experience in public sector audit after many years working in senior positions in local government. Brendan is also a Non Executive on the board of NHS Forth Valley.

Ross McDonald
Trainee

Ross joined Audit Scotland's Health and Local Government Team in October 2011 and will be embarking on his Second Year of the ICAS training programme in July 2013.

Appendix D - Reliance on internal audit

Auditing standards require internal and external auditors to work closely together to make optimal use of available audit resources. We seek to rely on the work of internal audit wherever possible and as part of our planning process we carry out an early assessment of the internal audit function. Our review of the internal audit service concluded that the internal audit service provided by the City of Edinburgh Council's Internal Audit Section operates in accordance with the CIPFA code of practice for internal audit in local government.

We therefore plan to place reliance on the work of internal audit on the following:

- audit work carried out in support of the governance statement for inclusion with the financial statements;
- assurance on key controls within the pension administration functions; and
- assurance from work on the pension payroll migration, pre and post implementation.

The reliance on internal audit work in these areas will allow us to maximise audit resources and focus on high risk audit areas.

We note that the internal audit service has been below planned resourcing levels during the transition to a co-sourced arrangement with PricewaterhouseCoopers (PwC), although we have been assured that this will not impact on the areas of internal audit work where we plan to place reliance.

Appendix E - Independence and Objectivity

Auditors appointed by the Auditor General for Scotland are required to comply with the Code of Audit Practice and standing guidance for auditors, which defines the terms of appointment. When auditing the financial statements auditors are also required to comply with the auditing and ethical standards issued by the Financial Reporting Council (FRC). The main requirements of the Code of Audit Practice, standing guidance for auditors and the standards are summarised below.

International Standards on Auditing 260 requires that the appointed auditor communicates:

- A statement that the engagement team and others in the firm as appropriate, the firm and, when applicable, network firms have complied with the FRC's Ethical Standards for auditors
- All relationships and other matters between the firm, network firms, and the entity that, in the auditor's professional judgment, may reasonably be thought to bear on independence. This shall include total fees charged during the period covered by the financial statements for audit and non-audit services provided by the firm and network firms to the entity and components controlled by the entity. These fees shall be allocated to categories that are appropriate to assist those charged with governance in assessing the effect of services on the independence of the auditor
- The related safeguards that have been applied to eliminate identified threats to independence or reduce them to an acceptable level.

The standard defines "those charged with governance" as "the person(s) or organization(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process." In your case, the appropriate addressees of communications from the auditor to those charged with governance are the s95 officer and the Pensions Committee. The auditor reserves the right to communicate directly with members on matters which are considered to be of sufficient importance.

Our Code of Audit Practice has an overriding general requirement that appointed auditors carry out their work independently and objectively, and ensure they do not act in any way that might give rise to, or could reasonably be perceived to give rise to, a conflict of interest.

The standing guidance for auditors includes a number of specific requirements. The key requirements relevant to this audit appointment are as follows:

- auditors should not perform non-audit work for an audited body, consultancy or otherwise, without the prior approval of Audit Scotland
- auditors should, in all but exceptional circumstances, be changed at least once every five years in line with Audit Scotland's rotation policy
- auditors are required to carry out their duties in a politically neutral way
- auditors must abide by Audit Scotland's policy on gifts and hospitality.

Address:
7th Floor, Plaza Tower
East Kilbride G74 1LW

Website:
www.audit-scotland.gov.uk

Telephone:
0845 146 1010

Email:
info@audit-scotland.gov.uk



Alastair MacLean
Director of Corporate Governance
City of Edinburgh Council
Waverley Court
4 East Market Street
Edinburgh
EH8 8BG

22 January 2013

Dear Alastair

**Lothian Pension Funds
Review of the adequacy of the internal audit service: 2012/13**

Audit Scotland's Code of Audit Practice (the 'Code') sets out the wider dimension of public sector audit. The Code requires external auditors to carry out an annual assessment of the adequacy of the internal audit function. Also, based on this assessment we plan to rely on areas of internal audit work in terms of International Standard on Auditing 610 (*Considering the Work of Internal Audit*).

We have now completed our assessment of the Pension Fund's internal audit function which is provided by City of Edinburgh Council's internal audit service. To minimise the audit burden and efficiently deploy audit resources, Audit Scotland's City of Edinburgh Council audit team conducted the review of the adequacy of the council's internal audit service. This included a review of the range and quality of work carried out by internal audit. Overall, we concluded that the internal audit service operates in accordance with the CIPFA code of practice for internal audit in local government.

For our financial statements audit responsibilities we plan to place formal reliance on aspects of internal audit's work in the following areas:

- Audit work carried out in support of the annual governance statement for inclusion with the financial statements
- Assurance on key controls within the pension administration functions
- Assurance from work on the pension payroll migration, pre and post implementation

The reliance on internal audit work in the above areas will allow us to direct our resources to the financial systems and governance areas we have assessed as being of higher audit risk.

We note that the internal audit service has been below planned resourcing levels during the transition to a co-sourced arrangement with PriceWaterhouseCoopers (PwC), although we have been assured that this will not impact on the areas of internal audit work where we plan to place reliance.

We will continue to monitor and review completed internal audit assignments to ensure that work on which we are placing reliance has been delivered. Any failure to complete areas where formal reliance has been agreed could impact on our plan and agreed audit fee.

If you have any questions on this matter please do not hesitate to contact me.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Stephen O'Hagan', with a long horizontal flourish extending to the right.

Stephen O'Hagan
Senior Audit Manager

By email: Sue Bruce, Chief Executive
Clare Short, Investment and Pensions Service Manager
John Burns, Pensions and Accounting Manager
Lorna Stewart, Head of Internal Audit