Appendix 1

AZETS

Lothian Pension Fund

Draft 2021/22 Annual Audit Report to the Members of the Pensions Committee and the Controller of Audit

September 2022

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Key messages

This report concludes our audit of Lothian Pension Fund and Scottish Homes Pension Fund (‘the Funds) for 2021/22.

This section summarises the key findings and conclusions from our audit.

Financial statements audit

Audit opinion	Our independent auditor's report includes: • an unqualified opinion on the financial statements; and • an unqualified opinion on other prescribed matters.
Key findings on audit risks and other matters	We have obtained adequate evidence in relation to the key audit risks identified in our audit plan. We are satisfied with the appropriateness of the accounting estimates and judgements used in the preparation of the financial statements. The accounting policies used to prepare the financial statements are in line with the Code of Practice on Local Government Accounting and are considered appropriate. All material disclosures required by relevant legislation and applicable accounting standards have been made appropriately. The Funds had appropriate administrative processes in place to prepare the annual report and accounts and the required supporting working papers.
Audit adjustments	We are required to communicate all potential adjustments, other than those considered to be clearly trivial. We are pleased to report that there were no material adjustments to the financial statements and no unadjusted differences identified. We identified disclosure and presentational adjustments, detailed in Appendix 2, during our audit, which have been reflected in the final set of financial statements.
Accounting systems and internal controls	We have applied a risk-based methodology to the audit. This approach requires us to document, evaluate and assess the Funds' processes and internal controls relating to the financial reporting process. Our audit is not designed to test all internal controls or identify all areas of control weakness. However, where, as part of our testing, we identify any control weaknesses, we have included these in this report. No material weaknesses or significant deficiencies were noted.

Wider Scope audit

Financial Sustainability	**Auditor judgement** LPF has adequate arrangements in place to ensure ongoing financial sustainability. The focus of the Funds' investment strategy is to ensure a sufficient return over the long term to meet the funding objectives outlined by the Funding Strategy Statement. LPF has delivered strong absolute performance in 2021/22 of 10.8% annual return on investments, which is higher than the benchmark returns of 8.8% while maintaining lower risk. The five-year and ten-year annualised investment returns remain below benchmark, due to significant below benchmark returns on equities in 2020/21 resulting from the defensive positioning.
Financial Management	**Auditor judgement** Lothian Pension Fund has effective arrangements for financial management and the use of resources. The Funds reported a net increase in the funds held. Lothian Pension Fund reported a net withdrawal position in dealings with members of £5.771 million. Scottish Homes reported a net withdrawal position of £6.836 million. Annual operating plan updates are provided to each Pensions Committee meeting clearly explaining changes in group performance.

Auditor judgement

Governance & Transparency

Governance arrangements at the Funds are appropriate. Our assessment has been informed by a review of the corporate governance arrangements in place, the information provided to the Board and Committees as well as the risk management arrangements in place.

Project Forth, a proposed merger between Lothian and Falkirk Pension Funds was approved by Lothian Pension Fund's Pensions Committee in September 2021, subject to the approval of City of Edinburgh Council as administering authority. The Council is due to consider the proposal in later in the year.

Auditor judgement

Value for Money

The Funds' investment performance is subject to regular review by the Pensions Committee.

The Funds have appropriate arrangements in place to secure value for money through appropriate monitoring of performance of investments and the administration of the Funds.

Performance remains strong with nine out of the ten performance measures met. However, investment performance over the rolling five-year period is noted as being below benchmark.

Definition

Our wider scope audit involves consideration of the Board's arrangements as they relate to financial sustainability, financial management, governance and transparency, and value for money. We have used the following grading to provide an overall assessment of the arrangements in place in each of the four dimensions.

There is a fundamental absence or failure of arrangements in place
There is no evidence to support improvement
Substantial unmitigated risks affect achievement of corporate objectives

Arrangements are inadequate or ineffective
Pace and depth of improvement is slow
Significant unmitigated risks affect achievement of corporate objectives

No major weaknesses in arrangements but scope for improvement exists
Pace and depth of improvement are adequate
Risks exist to achievement of operational objectives

Effective and appropriate arrangements are in place
Pace and depth of improvement are effective
Risks to achievement of objectives are managed

Introduction

We carried out our audit in accordance with Audit Scotland's Code of Audit Practice and maintained auditor independence.

Scope

1. We outlined the scope of our audit in our External Audit Plan, which we presented to the Pensions Committee in March 2022. The core elements of our work include:

- an audit of the 2021/22 annual report and accounts and related matters;
- consideration of the wider dimensions of public audit work, as set out in Exhibit 1;
- monitoring the Board's participation in the National Fraud Initiative (NFI); and
- any other work requested by Audit Scotland.

Exhibit 1: Audit dimensions within the Code of Audit Practice

Responsibilities

2. The Funds are responsible for preparing a set of annual report and accounts which show a true and fair view and for implementing appropriate internal control systems. The weaknesses or risks identified in this report are only those that have come to our attention during our normal audit work and may not be all that exist. Communication in this report of matters arising from the audit 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.

3. We do not accept any responsibility for any loss occasioned to any third party acting, or refraining from acting on the basis of the content of this report, as this report was not prepared for, nor intended for, any other purpose.

4. This is the final year of our appointment as external auditors under the current appointment contract. We would like to thank all management and staff for their co-operation and assistance during our audit.

Auditor independence

5. International Standards on Auditing in the UK (ISAs (UK)) require us to communicate on a timely basis all facts and matters that may have a bearing on our independence.

6. We confirm that we complied with the Financial Reporting Council's (FRC) Ethical Standard. In our professional judgement, we remained independent and our objectivity has not been compromised in any way.

7. We set out in Appendix 1 our assessment and confirmation of independence.

Adding value through the audit

8. All of our clients demand of us a positive contribution to meeting their ever-changing business needs. Our aim is to add value to the Funds through our external audit work by being constructive and forward looking, by identifying areas of improvement and by recommending and encouraging good practice. In this way, we aim to help the Funds promote improved standards of governance, better management and decision making and more effective use of resources.

Feedback

9. Any comments you may have on the service we provide, the quality of our work and our reports would be greatly appreciated at any time. Comments can be reported directly to any member of your audit team.

Openness and transparency

10. This report will be published on Audit Scotland's website www.audit-scotland.gov.uk.

Financial statements audit

The Funds' annual report and accounts are the principal means of accounting for the stewardship of its resources and its performance in the use of those resources.

Overall conclusion

11. The annual report and accounts for the year ended 31 March 2022 are due to be considered by the Pensions Committee on 29 September 2022. Our independent auditor's report is unqualified.

12. We received the unaudited annual report and accounts and supporting papers in line with our agreed audit timetable. Our thanks go to staff at the Funds for their assistance with our work.

Our audit opinion

Opinion	Basis for opinion	Conclusions
Financial statements	We conduct our audit in accordance with applicable law and International Standards on Auditing. Our findings / conclusions to inform our opinion are set out in this section of our annual report.	We have issued unqualified audit opinions.
Going concern basis of accounting	In the public sector when assessing whether the going concern basis of accounting is appropriate, the anticipated provision of the services is more relevant to the assessment than the continued existence of a particular public body. We assess whether there are plans to discontinue or privatise the Funds' functions. Our wider scope audit work considers the financial sustainability of the Funds.	In September 2021, the Pensions Committee agreed in principle to merge Lothian Pension Fund with Falkirk Pension Fund under 'Project Forth'. The decision is subject to the approvals of the City of Edinburgh Council and Falkirk Council as administering authorities of the Funds. We reviewed the proposal for Project Forth alongside financial forecasts for 2022/23. Project Forth would represent a transfer of services under combinations of public sector bodies, and hence does not negate the presumption of going concern. Our understanding of the legislative framework and activities undertaken provided us with sufficient assurance the Funds will

Opinion	Basis for opinion	Conclusions
		continue to operate for at least 12 months from the signing date. Our audit opinion is unqualified in this respect.
Matters prescribed by the Accounts Commission • Management Commentary • Annual Governance Statement • Governance Compliance Statement	We read all the financial and non-financial information in the annual report and accounts to identify material inconsistencies with the audited financial statements and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by us in the course of performing the audit. We plan and perform audit procedures to gain assurance that the statutory other information has been prepared in accordance with relevant legislation and regulations.	The annual report contains no material misstatements or inconsistencies with the financial statements. We have concluded that: • the information given in the Management Commentary is consistent with the financial statements and that report has been prepared in accordance with statutory guidance issued under the Local Government in Scotland Act 2003; • the information given in the Annual Governance Statement is consistent with the financial statements and that report has been prepared in accordance with the Delivering Good Governance in Local Government: Framework (2016); and • the information given in the Governance Compliance Statement is consistent with the financial statements and that report has been prepared in accordance with The Local Government Pension Scheme (Scotland) Regulations 2018.

Opinion	Basis for opinion	Conclusions
Matters reported by exception	We are required to report on whether: • adequate accounting records have not been kept; or • the financial statements and the audited part of the Remuneration and Staff Report are not in agreement with the accounting records; or • we have not received all the information and explanations we require for our audit.	We have no matters to report.

An overview of the scope of our audit

13. The scope of our audit was detailed in our External Audit Plan, which was presented to the Pensions Committee in March 2022. The plan explained that we follow a risk-based approach to audit planning that reflects our overall assessment of the relevant risks that apply to the Funds. This ensures that our audit focuses on the areas of highest risk. Planning is a continuous process and our audit plan is subject to review during the course of the audit to take account of developments that arise.

14. At the planning stage we identified the significant risks that had the greatest effect on our audit. Audit procedures were then designed to mitigate these risks.

15. In our audit, we test and examine information using sampling and other audit techniques, to the extent we consider necessary to provide a reasonable basis for us to draw conclusions. We obtain evidence through performing a review of the significant accounting systems, substantive procedures and detailed analytical procedures.

Significant risk areas

16. Significant risks are defined by professional standards as risks that, in the judgement of the auditor, require special audit consideration. In identifying risks, we consider the nature of the risk, the potential magnitude of misstatement, and its likelihood. Significant risks are those risks that have a higher risk of material misstatement.

17. The significant risk areas described in the table below are those that had the greatest effect on our audit strategy, the allocation of resources in the audit and directing the efforts of the audit team. Our audit

procedures relating to these matters were designed in the context of our audit of the annual report and accounts as a whole, and not to express an opinion on individual accounts or disclosures. Our opinion on the annual report and accounts is not modified with respect to any of the risks described below.

Significant risk areas

1. Management override	
Significant risk description	In any organisation, there exists a risk that management have the ability to process transactions or make adjustments to the financial records outside the normal financial control processes. Such issues could lead to a material misstatement in the financial statements. This is treated as a presumed risk area in accordance with *ISA (UK) 240 - The auditor's responsibilities relating to fraud in an audit of financial statements.*
How the scope of our audit responded to the significant risk	**Key judgement** There is the potential for management to use their judgement to influence the financial statements as well as the potential to override the Funds' controls for specific transactions. **Audit procedures** • Review of the Funds' accounting records and audit testing on transactions. • Adoption of data analytics techniques in carrying out testing. • Review of judgements and assumptions made in determining accounting estimates as set out in the financial statements to determine whether they are indicative of potential bias. This included a retrospective review of the prior year estimates against the current year estimates.
Key observations	We have not identified any indication of management override in the year. We did not identify any areas of bias in key judgements made by management and judgements were consistent with prior years.

2. Revenue recognition

Significant risk description	Under *ISA (UK) 240 - The auditor's responsibilities relating to fraud in an audit of financial statements* there is a presumed risk of fraud in relation to revenue recognition. The presumption is that the Funds' could adopt accounting policies or recognise income transactions in such a way as to lead to a material misstatement in the reported financial position.
How the scope of our audit responded to the significant risk	**Key judgements** Given the financial pressures facing the public sector as a whole, there is an inherent fraud risk associated with the recording of income around the year end. However, we do not deem this risk to be present for pension contributions due to a lack of incentive and opportunity to manipulate transactions **Audit procedures** • Evaluate each material revenue stream and review controls over revenue accounting. • Substantive testing on all material revenue streams. • Audit testing over the revenue recognition policy to ensure it is appropriate and applied consistently throughout the year.
Key observations	At the planning stage of our audit we concluded that the revenue recognition risk was present in all revenue streams except for the contributions received from member bodies. This view remained unchanged throughout the audit. Based on audit work performed, we gained reasonable assurance on the completeness and occurrence of all other material income streams and we are satisfied that income is fairly stated in the financial statements.

3. Expenditure recognition

Significant risk description	As most public sector bodies are net expenditure bodies, the risk of fraud is more likely to occur in expenditure. There is a risk that expenditure may be misstated resulting in a material misstatement in the financial statements.
How the scope of our audit responded to the significant risk	**Key judgements** Given the financial pressures facing the public sector as a whole, there is an inherent fraud of risk associated with the recording of accruals around the year end. However, we do not deem this risk to be present for expenditure due to the materially low levels of expenditure incurred. **Audit procedures** • As the Funds only material expenditure stream is in relation to pension payments, which are subject to separate tailored testing, no further audit procedures deemed required.
Key observations	At the planning stage of our audit we concluded that the expenditure recognition risk was not significant due to materiality. This view remained unchanged throughout the audit. Based on audit work performed, we gained reasonable assurance on the completeness and occurrence of expenditure and we are satisfied that expenditure is fairly stated in the financial statements.

4. Investment valuations (significant accounting estimate)

Significant risk description	The Funds held investments of £8.686 billion as at 31 March 2021, of which 30% (£2.645 billion) were classified as level 2 or level 3 financial instruments, meaning the valuation was not based on unadjusted quoted prices in active markets. Judgements are taken by the Investment Managers to value those investments whose prices are not publicly available. Investments of this nature are complex, difficult to value and include a significant degree of judgement from the investment manager. The material nature of this balance means that any error in judgement could result in a material valuation error.
How the scope of our audit responded to the significant risk	**Key judgements** There is the potential for management to use their judgement to influence the financial statements. **Audit procedures** • Evaluate the Funds' investment strategy and review the controls in place over accounting for investments. • Consider Funds' material investments and obtain evidence that investments have been appropriately valued at 31 March 2022 including challenging fair value classification. • Review investment transactions and obtain evidence that investment transactions are recorded in line with appropriate accounting policies and the policies have been applied consistently across the year. • Review management experts including the custodian and external investment managers. This includes reviewing auditor reports on the internal controls at the custodian and at each key investment manager.
Key observations	As at 31 March 2022, LPF investment assets increased to £9.529 billion, of which 33% (£3.175 billion) were classified as level 2 or level 3 financial instruments. We gained reasonable assurance over the valuation of investments at year end and are satisfied that investments and investment transactions are fairly stated in the financial statements.

5. Accounting for Investment Properties (significant accounting estimate)

Significant risk description	LPF hold a portfolio of investment properties which as at the 31 March 2021 was valued at £370 million. The management of the properties is undertaken by JLL, along with the Fund accounting for the portfolio. Investment properties are valued annually at fair value, in line with the Code. There is a significant degree of subjectivity in the measurement and valuation of investment properties. This subjectivity and the material nature of the Funds' investment property portfolio represents an increased risk of misstatement in the annual accounts.
How the scope of our audit responded to the significant risk	**Key judgements** There is the potential for management to use their judgement to influence the financial statements. **Audit procedures** • Evaluate the Funds' investment strategy and review the controls in place over accounting for investment properties. • Review management experts including the valuer and external investment manager. • Consider the disclosures within the annual report and financial statements to ensure they are consistent with the information provided by the valuer. • Challenge the assumptions, judgements and sources of data used in the valuation to ensure that management have appropriate assurance over the valuation of properties.
Key observations	LPF's investment properties were valued at £431 million as at 31 March 2022. The valuation undertaken by CBRE did not include a qualification for material valuation uncertainty. CBRE considers that sufficient market evidence exists upon which to base opinions of value. Based on our audit procedures and evaluation of expert's work we concur with this judgement. We gained reasonable assurance over the valuation of investment properties at the year end and are satisfied that investment properties are fairly stated in the financial statements.

6. Present Value of Retirement Obligations (significant accounting estimate)	
Significant risk description	An actuarial estimate of the pension fund asset/liability is calculated on an annual basis under IAS 26 and on a triennial funding basis by an independent firm of actuaries with specialist knowledge and experience. The estimates are based on the most up to date membership data held by the Funds and have regard to local factors such as mortality rates and expected pay rises with other assumptions around inflation when calculating the liabilities. There is a risk that the assumptions used are not appropriate.
How the scope of our audit responded to the significant risk	**Key judgements** A significant level of estimation is required in order to determine the valuation of pension assets/liabilities. Small changes in the key assumptions (including discount rates, inflation and mortality rates) can have a material impact on the pension asset/liability. **Audit procedures** • Review of the controls in place to ensure that the data provided from the pension fund to the actuary is complete and accurate. • Review the reasonableness of the assumptions used in the calculation against other local government pension fund actuaries and other observable data. • Agree the disclosures in the financial statements to information provided by the actuary. • Consider the competence, capability and objectiveness of the management expert in line with ISA (UK) 500 Audit Evidence.
Key observations	We reviewed the reasonableness of those assumptions used in the calculation against other local government pension fund actuaries and other observable data, with no issues identified. In addition, we reviewed the information in the actuarial report for completeness. We have considered the competence, capability and objectivity of the actuary in line with the requirements of ISA (UK) 500 'Audit Evidence'. From this review we did not identify any items which gave us cause for concern over the suitability of the actuary.

Other risk factors

Other impacts of COVID-19 on the annual accounts

18. COVID-19 continues to present unprecedented challenges to the operation, financial management and governance of organisations, including public sector bodies. In response to the pandemic we identified potential areas of increased risk of material misstatement to the financial statements and/or our audit opinion. Our conclusions are set out in the table below.

Area considered	Description	Conclusion
Access to audit evidence	Our audit this year has been carried out remotely. As a consequence, we identified a risk that access to and provision of sufficient, appropriate audit evidence in support of our audit opinion may be impacted by the inherent nature of carrying out our audit remotely.	We have employed a greater use of technology to examine evidence, but only where we have assessed both the sufficiency and appropriateness of the audit evidence produced. We stayed in close contact with finance colleagues to ensure all relevant issues were satisfactorily addressed.

Estimates and judgements

19. We are satisfied with the appropriateness of the accounting estimates and judgements used in the preparation of the financial statements.

20. As part of the planning and fieldwork stages of the audit we identified all accounting estimates made by management and determined which of those were key to the overall financial statements. Consideration was given to asset valuations, impairment, depreciation and amortisation rates, provisions for legal obligations, and accruals. We identified three accounting estimates listed below.

21. Our audit work consisted of reviewing these keys areas for any indication of bias and assessing whether the judgements used by management are reasonable. We have summarised our assessment of this below, categorised between Prudent, Balanced and Optimistic.

Estimates and judgements	
Present value of retirement obligations	Balanced

Management consider the present value of retirement obligations on an annual basis. The valuation is carried out by the actuarial firm Hymans Robertson. We considered key assumptions against other sources of evidence and did not identify any indication that the valuation was materially misstated as at 31 March 2022.

The assumptions of the actuary, Hyman Robertson, were in the middle of our expected range.

Investment Asset valuation	Balanced

Monthly valuation exercises of the investment portfolio exercises are carried out to confirm that the valuation provided by the Custodian, Northern Trust, is appropriate and in line with management's expectation.

As at 31 March 2022, the Funds' internal valuation exercise resulted in a valuation of £9.513 billion, a valuation £10.6 million (0.12%) lower than the Custodian's valuation which is included in the accounts. The difference relates to timing of when information was received and the availability of information on certain foreign holdings. The Funds confirm that the valuation included in the accounts is materially in line with the internal exercise and that the Custodian's valuation better reflects information known at 31 March 2022.

We considered investment valuations against other sources of evidence and did not identify any indication that the valuation was materially misstated as at 31 March 2022.

Investment Property Valuation	Balanced

Management consider the valuation of investment property on an annual basis. The valuation is carried out by the chartered valuation firm CBRE. We considered key assumptions against other sources of evidence and did not identify any indication that the valuation was materially misstated as at 31 March 2022.

Materiality

22. Materiality is an expression of the relative significance of a matter in the context of the financial statements as a whole. A matter is material if its omission or misstatement would reasonably influence the decisions of an addressee of the auditor's report. The assessment of what is material is a matter of professional judgement and is affected by our assessment of the risk profile of the organisation and the needs of users. We review our assessment of materiality throughout the audit.

23. Whilst our audit procedures are designed to identify misstatements which are material to our audit opinion, we also report to the Funds and management any uncorrected misstatements of lower value errors to the extent that our audit identifies these.

24. We based our initial assessments of materiality levels on the information available at the time i.e. prior years audited accounts. For the Lothian Pension Fund's financial statements, the initial materiality was set at £128 million. On receipt of 2021/22 unaudited annual accounts, we reassessed materiality and updated it to £140 million. We consider that our updated assessment has remained appropriate throughout our audit.

25. Our initial assessment of materiality for Scottish Homes' financial statements was £2.3 million. On receipt of the unaudited 2021/22 annual accounts, we reassessed materiality and concluded that our initial assessment remained appropriate. We consider that our assessment has remained appropriate throughout our audit.

26. ISA (UK) 320 states that in certain circumstances it is appropriate to set a materiality amount for particular classes of transactions for which lesser amounts than the overall materiality could influence the decisions of users of the accounts. As set out in our Annual Audit Plan, we consider transactions when dealing with members (i.e., contributions and expenditure incurred providing payments to pensioners) to be of key interest to the users.

27. Our initial assessment of materiality for dealing with members for LPF was £12.5 million. On receipt of the 2021/22 unaudited annual accounts, we reassessed materiality and updated it to £13 million. We consider that our updated assessment has remained appropriate throughout our audit.

28. Our initial assessment of materiality for dealing members for Scottish Homes financial statements was £0.37 million. On receipt of the 2021/22 unaudited annual accounts, we reassessed materiality and updated it to £0.34 million. We consider that our updated assessment has remained appropriate throughout our audit.

Materiality – Lothian Pension Fund

Overall materiality

£140,000,000

100%

Accounts materially misstated where total errors exceed this value

Performance materiality

£105,000,000

75%

Work performed to capture individual errors at this level

Trivial threshold

£250,000

Audit Scotland threshold

All errors greater than this level are reported

Materiality – Lothian Pension Fund (Dealings with Members)

Overall materiality

£13,000,000

100%

Accounts materially misstated where total errors exceed this value

Performance materiality

£9,750,000

75%

Work performed to capture individual errors at this level

Trivial threshold

£250,000

Audit Scotland threshold

All errors greater than this level are reported

Materiality – Scottish Homes

Overall materiality

£2,300,000

100%

Accounts materially misstated where total errors exceed this value

Performance materiality

£1,725,000

75%

Work performed to capture individual errors at this level

Trivial threshold

£115,000

5%

All errors greater than this level are reported

Materiality – Scottish Homes (Dealings with Members)

Overall materiality

£340,000

100%

Accounts materially misstated where total errors exceed this value

Performance materiality

£255,000

75%

Work performed to capture individual errors at this level

Trivial threshold

£17,000

5%

All errors greater than this level are reported

Materiality	Our assessment is made with reference to Lothian Pension Fund and Scottish Home Pension Fund net investment assets. The Funds hold significant investment assets, which form the largest part of the net asset statements for each pension fund. The primary business of the Funds is to hold sufficient assets to generate returns to meet future pension obligations. Our assessment of materiality equates to approximately 1.5% of the Pension Funds net investment assets as disclosed in the 2021/22 unaudited annual accounts. Our assessment of materiality in relation to dealings with members equates to approximately 5% of the Pension Funds gross expenditure as disclosed in the 2021/22 unaudited annual accounts. The above approach and percentages are consistent with prior year's. In performing our audit we do apply a lower level of materiality to the audit of the Remuneration Report. Our materiality is set at £5,000.
Performance materiality	Performance materiality is the working level of materiality used throughout the audit. We use performance materiality to determine the nature, timing and extent of audit procedures carried out. We perform audit procedures on all transactions, or groups of transactions, and balances that exceed our performance materiality. This means that we perform a greater level of testing on the areas deemed to be at significant risk of material misstatement. Performance materiality is set at a value less than overall materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of the uncorrected and undetected misstatements exceed overall materiality.
Trivial misstatements	Trivial misstatements are matters that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any quantitative or qualitative criteria.

Group audit

29. Lothian Pension Fund prepares its financial statements on a group basis. The group consists of Lothian Pension Fund and two special purpose vehicles, LPFE Ltd and LPFI Ltd. As group auditors under ISA (UK) 600 we are required to obtain sufficient appropriate audit evidence regarding the financial information of the components and regarding the consolidation process to express an opinion on whether the group financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. The following table sets out the components within the group.

Component	Significant	Level of response required	Planned audit approach
Lothian Pension Fund	Yes	Comprehensive	Full scope statutory audit
LPFI Ltd	No	Analytical	Desktop review
LPFE Ltd	No	Analytical	Desktop review

Comprehensive The component is of such significance to the group as a whole that an audit of the component financial statements is required for group reporting purposes.

Analytical The component is not significant to the Group and audit risks can be addressed sufficiently by applying analytical procedures at the Group level.

30. LPFE Ltd and LPFI Ltd are fully consolidated. We did not consider either to be of individual financial significance to the group or, due to the specific nature or circumstances, include a significant risk of material misstatement to the group financial statements.

31. As part of our audit we reviewed the consolidation entries made within the group accounts and confirmed those entries back to the financial statements.

32. Azets is also the appointed auditor to the LPFI Ltd and LPFE Ltd. During our audit we liaised with the audit teams to confirm that their programme of work is adequate for our purposes.

33. We have nothing to report in respect of the following matters:

- No significant deficiencies in the system of internal control or instances of fraud were identified by the LPFI Ltd and LPFE Ltd auditors; and
- There were no limitations on the group audit.

Audit differences

34. We are pleased to report that there were no material adjustments to the financial statements or unadjusted audit differences.

35. We identified some disclosure and presentational adjustments during our audit which have been detailed in Appendix 2.

Internal controls

36. As part of our work we considered internal controls relevant to the preparation of the financial statements such that we were able to design appropriate audit procedures. Our audit is not designed to test all internal controls or identify all areas of control weakness. However, where, as part of our testing, we identify any control weaknesses, we report these to the Pensions Committee. These matters are limited to those which we have concluded are of sufficient importance to merit being reported.

Area	Assessment	Comment
Control and process environment	**Satisfactory**	We consider the control environment within the entity to be satisfactory. We have however identified recommendations which would further strengthen the Board's internal control environment. These are detailed in Appendix 3.
Quality of supporting schedules	**Satisfactory**	The supporting schedules received during the course of the fieldwork were sufficient for our audit purposes.
Responses to audit queries	**Satisfactory**	Management's responses to our audit queries were appropriate and received on a timely basis.

Follow up of prior year recommendations

37. We followed up on progress in implementing actions raised in the prior year as they relate to the audit of the financial statements. Full details of our findings are included in Appendix 3.

Other communications

Accounting policies, presentation and disclosures

38. Our work included a review of the adequacy of disclosures in the financial statements and consideration of the appropriateness of the accounting policies adopted by the Funds.

39. The accounting policies, which are disclosed in the annual accounts, are considered appropriate.

40. There are no significant financial statements disclosures that we consider should be brought to your attention. All the disclosures required by relevant legislation and applicable accounting standards have been made appropriately.

41. Overall, we found the disclosed accounting policies, and the overall disclosures and presentation to be appropriate.

Fraud and suspected fraud

42. We have previously discussed the risk of fraud with management. We have not been made aware of any incidents in the period nor have any incidents come to our attention as a result of our audit testing.

43. Our work as auditor is not intended to identify any instances of fraud of a non-material nature and should not be relied upon for this purpose.

Non-compliance with laws and regulations

44. As part of our standard audit testing, we have reviewed the laws and regulations impacting the Board. There are no indications from this

work of any significant incidences of non-compliance or material breaches of laws and regulations that would necessitate a provision or contingent liability.

Written representations

45. We will present the final letter of representation to the Pensions Committee to sign at the same time as the financial statements are approved.

Related parties

46. We are not aware of any related party transactions which have not been disclosed.

Confirmations from third parties

47. All requested third party confirmations in respect of bank and legal confirmations have been received.

Financial sustainability

Financial sustainability looks forward to the medium and longer term to consider whether the Funds are planning effectively to continue to deliver their services and the way in which they should be delivered.

Auditor judgement

Lothian Pension fund has adequate arrangements in place to ensure ongoing financial sustainability.

The focus of the Funds' investment strategy is to ensure a sufficient return over the long term to meet the funding objectives outlined by the Funding Strategy Statement.

Lothian Pension Fund has delivered strong absolute performance in 2021/22 of 10.8% annual return on investments, which is higher than the benchmark returns of 8.8% while maintaining lower risk. The five-year and ten-year annualised investment returns remain below benchmark, due to significant below benchmark returns on equities in 2020/21 resulting from the defensive positioning.

Significant audit risk

48. Our audit plan identified one significant risk in relation to financial sustainability:

Financial sustainability

The Funds held investments of £8.842 billion as at 31 March 2021. Investment strategies are in place for each of the funds which outline the Funds approach to ensure that all members and their dependents receive their benefits when they become payable. The investment strategy was updated and approved by the Pensions Committee in June 2021.

The primary objective of the Funds is to ensure that there are sufficient funds available to meet all pension and lump sum liabilities as they fall due for payment. The funding objectives for each Fund are documented in the Committee's Funding Strategy Statement, which is reviewed at least triennially. The funding objectives, together with the rates of return being targeted and levels of risk to be tolerated, are central to each Fund's investment strategy and govern the allocation across various asset classes.

The investment objectives of the Funds are to achieve a return on Fund assets which is sufficient over the long term to meet the funding objectives as outlined in the Funding Strategy Statement. Investment returns are generated by a combination of income (from dividends, interest and rents) and gains or losses on capital.

While it is noted that the Funds investment strategy is designed in such a way to withstand market volatility in the long term, we have noted that COVID-19 and other worldwide political events had a significant impact on the market in 2019 and 2020. While 2021 saw a return to improved performance, a significant risk remains particularly in relation to the tapering off of government support, impact of the increased inflation and uncertainty over the new COVID variants. There is a risk that the value of investments is significantly impacted by events within the wider environment..

Noted in the 2021/22 External Audit Plan

49. Our detailed findings on the Funds' financial framework for achieving long term financial sustainability are set out below.

Funding Strategy

50. The Funds' objectives, as set out in the Funding Strategy Statement, are to generate sufficient long term returns to pay promised pensions. This must be balanced with making the scheme affordable to employers now and in the future.

51. Liabilities will be met by asset returns, resulting from the Investment Strategy, and contributions, resulting from the Funding Strategy. A core funding objective is to maximise asset returns, within reasonable and considered risk parameters, in order to minimise the cost to employers.

52. Funding levels can be volatile, due to intrinsic uncertainties over asset returns particularly when considered only in the short term. Minimising short term changes in contribution rates is an objective of the Funds'. Funding and investment strategies must be set with appropriate tolerances to adapt to market volatility.

Market Volatility

53. Global events continue to result in significant market volatility with strong initial market conditions as a result of optimism over COVID-19 vaccine rollouts tempered by downwards growth forecasts and rising energy costs. Conflict in Ukraine drove further volatility in March 2022. Concerns around inflation have materialised with corresponding effects on government bond yields.

54. Strong growth has continued in returns to 31 March 2022, but at a slower rate than experienced in 2020/21 when the markets rebounded strongly from COVID-19. While UK Equities reported a 14.5% (2021: 26.7%) return for the 12 months, the strongest returns for the same period were in relation to UK Property at 20.1% (2020: 2.5%).

55. Lothian Pension Fund has described their investment position as 'defensive'. The approach is generally expected to deliver outperformance when equity market returns are poor. In volatile market conditions seen at the start of 2022, the position has boosted the Fund's returns against benchmark.

56. Lothian Pension Fund revised the investment strategy in June 2021. The improved position reported at the triennial valuation provided scope to reduce investment risk while generating sufficient returns to remain fully funded. The Fund's allocation of asset held in equities has decreased to 58.5% (2020: 60%).

57. The funding level of Scottish Homes Pension Fund at the 2020 Triennial Valuation was 117.7% (2017: 104.7%), reaching full funding faster than anticipated. The Scottish Government, as Guarantor, was consulted on future funding options. The decision was reached was to maintain the current approach, which minimises investment risk.

58. While Scottish Homes Pension Fund holds mainly UK Gilts in line with the Fund's funding strategy, both Fund's hold significant cash reserves. For Scottish Homes Pension Fund, this was equivalent to two years' pension payments. This provides an important buffer against short term

market volatility affecting meeting pension liabilities as they fall due.

Investment Strategy

59. The Fund has undertaken an in-depth review of its investment strategy following the finalisation of the 2020 triennial valuations. A revised investment strategy was presented to the Pensions Committee in June 2021.

60. The investment strategy has a significant impact on the investment performance, ultimately impacting the funding level and contribution rates. Hyman Robertson, as scheme actuary, undertook asset liability modelling to assess the impact of investment strategies.

61. The modelling highlights the sensitivity of the funding level on gilt yields. While the investment risk is largely driven by equities, modelling illustrates that the Fund must invest in assets with returns above those of UK gilts to achieve its objectives. A revised strategy was therefore proposed which reduces the funds exposure to equities from a strategic allocation of 65% of assets to 60% (actual: 58.8%), with corresponding increases in real assets and gilts.

Climate Change

62. Principal 11 of the Statement of Investment Principles notes the Funds' commitment to responsible investment, while stating that divestment is inconsistent with the Funds' fiduciary duties to members and employers. This covers the Funds' approach to climate change, amongst other significant areas.

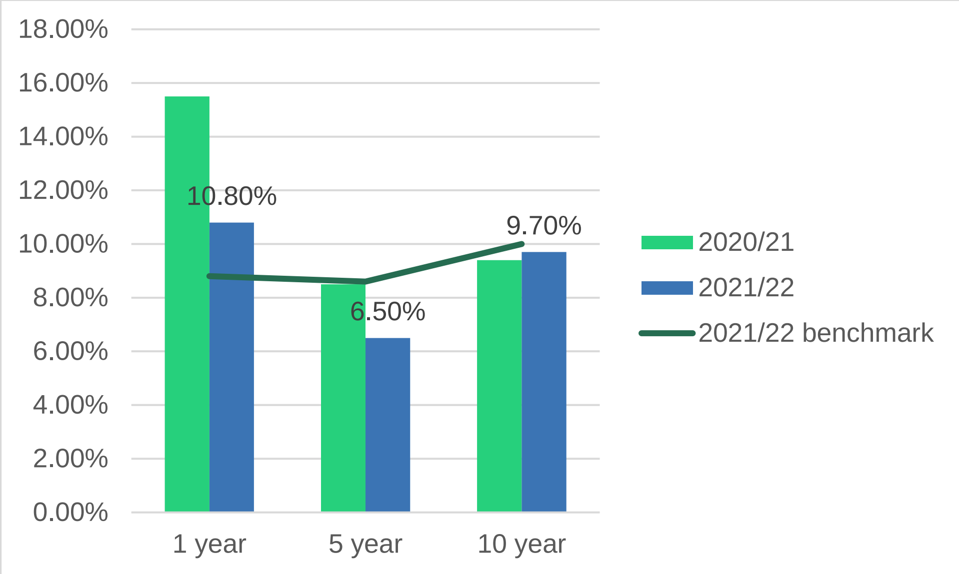
63. The Investment Strategy review provided an opportunity for the impact of climate change on the Funds to be assessed. Uncertainty is high in in climate modelling, but the modelling suggested that, on balance, there is a risk of deterioration of the financial position due to climate change. Reduction in exposures to equities was suggested as a prudent measure to mitigate the most pessimistic climate scenarios, which is being implemented.

Investment Performance

64. Lothian Pension Fund aims to achieve a return in line with its strategic benchmark allocation, over the long term, with a lower-than-benchmark level of risk.

65. Annual performance was strong to March 2022 with overall annual returns of 10.8% (2021: 15.5%). Performance was above the benchmark of 8.8% while maintaining investment in lower risk equities. Lothian Pension Fund's performance against benchmark and prior year is given at Exhibit 2.

Exhibit 2: Performance of Lothian Pension Fund against benchmark and prior year



Source: Unaudited Lothian Pension Fund Annual Report and Accounts

66. The impact of slowing market conditions can be seen on the returns. Despite absolute performance being lower than in 2020/21, the Fund's defensive market positioning helped the Fund outperform the annual benchmark.

67. The Fund reported the third highest (2020: second lowest) annual return and was one of only three LGPS to exceed annual benchmark returns. See Exhibit 3 for Lothian Pension Fund's annual performance against other Scottish LGPS Schemes.

68. The same defensive positioning resulted in underperformance against the benchmark in 2020/21 and continues to impact five- and ten-year returns.

69. The Fund continues to report the second lowest (2020: second lowest) five-year return. However, the gap between the return and benchmark continues to narrow. Comparison of Lothian Pension Fund's performance against other Scottish LGPS Schemes is given in Exhibit 4.

70. Lothian Pension Fund notes that it is absolute returns which allow the Fund to meet pension liabilities as they fall due. However, maximising asset returns within the risk tolerances reduces the cost to the members in the long term.

Ukraine

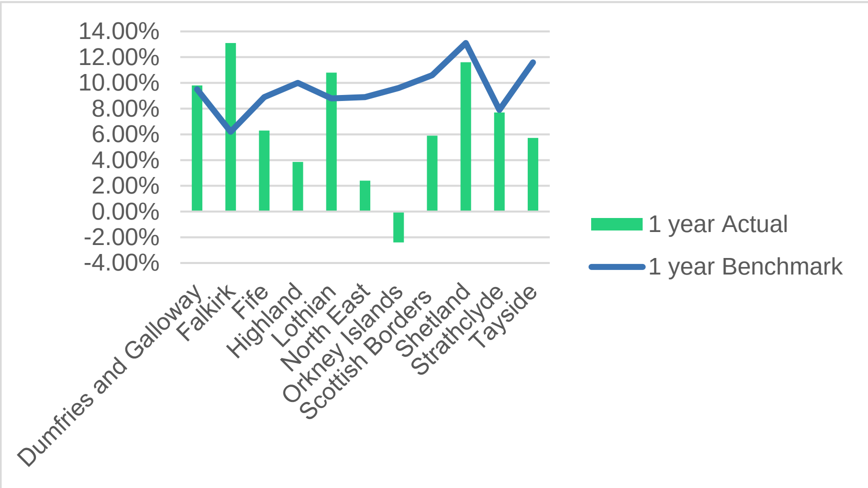
71. In the immediate aftermath of the invasion, there was a fall in the Fund's asset values. However, over the remainder of March 2022, the Fund's assets will have broadly recovered to similar levels to before the invasion.

72. The Fund held investments where the country of risk was the Russian Federation. Over the year, the Funds took action to divest where legal and appropriate to do so. At 31 March 2022, only trivial holdings in Russia linked investments remained.

Scottish Homes Pension Fund

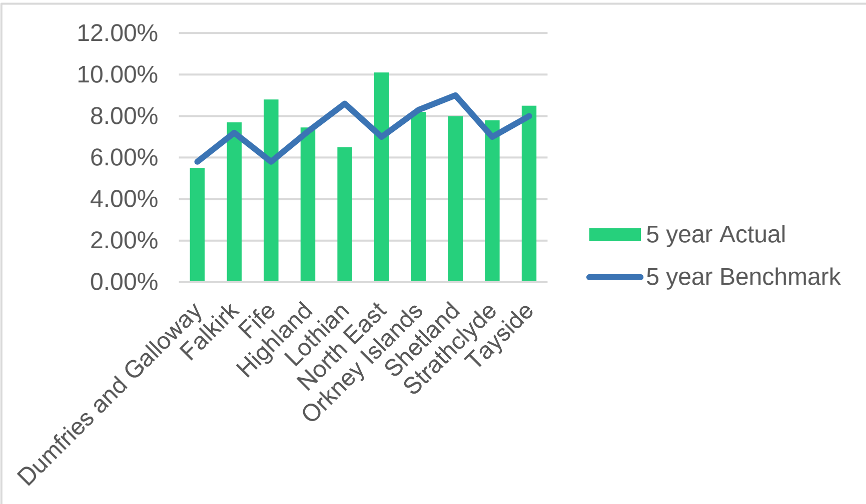
73. Scottish Homes Pension Fund is fully funded and closed to new members. No benchmarks are set for the Fund as investments are mandated by the Scottish Government to be held in gilts. The Fund seeks to match cash flows from gilt income to expected liabilities from pension payments. In 2021/22, gilt redemptions of £7.2 million helped fund £6.3 million in pension payments.

Exhibit 3: Annual return across LGPS Scotland Funds against benchmark



Source: Unaudited Annual Report and Accounts[1]

Exhibit 4: Annualised 5 year returns across LGPS Scotland Funds against benchmark



Source: Unaudited Annual Report and Accounts

[1] Scottish Borders do not publish their five-year annualised returns

Financial management

Financial management is concerned with financial capacity, sound budgetary processes and whether the control environment and internal controls are operating effectively.

Auditor judgement

Lothian Pension Fund has effective arrangements for financial management and the use of resources.

The Funds reported a net increase in the funds held. Lothian Pension Fund reported a net withdrawal position in dealings with members of £5.771 million. Scottish Homes reported a net withdrawal position of £6.836 million.

Annual operating plan updates are provided to each Pensions Committee meeting clearly explaining changes in group performance.

Financial Performance

74. The Funds have developed an annual Operating Plan which sets out the strategic aims of the Funds. A two-year budget to 2022/23 supports the delivery of the Plan which considers the Group as a whole.

75. Operating Plan updates are provided to each Pensions Committee meeting. The updates note progress of the Funds against the budget along with performance indicators and cashflow monitoring.

76. While the budget splits out the group into constituent components, budget reporting considers the Group as a whole. Due to the structure of the group, movements in year can affect performance of all group entities. The changes in financial performance for the group are supported by clear explanations.

77. Performance of the individual Funds can be scrutinised by the cashflow monitoring update provided in each Operating Plan update. This details the Funds' dealing with members for the year to date and the projected year end position on a cash basis.

78. While the information is presented such that it can be compared with the annual accounts, no information is provided on how performance to date compares with expectation, or prior year.

Financial Position

79. Lothian Pension Fund reported a net withdrawals position in dealings with members in line with forecast.

80. In line with forecast, Scottish Homes Pension Fund reported a net withdrawals position in dealings with members. This is shown in Exhibit 5.

81. The increase in the market value of investments meant both Funds have reported an overall net increase in the Fund. Consequently, an increase in net assets position was reported.

82. The present value of the retirement benefit obligations are presented as a note to the accounts. An increase in the discount rate, driven by higher gilt rates, has resulted in a lower obligation. The movement in the net asset position and present value of retirement obligations is shown in Exhibit 6.

Systems of Internal Control

83. We have evaluated the Funds' key financial systems and internal financial controls to determine whether they are adequate to prevent material misstatements in the annual accounts. Our approach has included documenting the key internal financial controls and performing walkthroughs to confirm that they are operating as intended.

84. No significant issues were identified from our audit work. We consider the system of control in place at the Funds to be satisfactory.

Exhibit 5 – Forecast versus Actual Net Withdrawals from the Funds

	2021/22 Forecast (£'000)	2021/22 Cash Basis (£'000)	2021/22 Accruals Basis
Lothian Pension Fund	7,000	6,005	(5,771)
Scottish Homes Pension Fund	(7,350)	(6,869)	(6,837)

Source: Lothian Pension Funds Annual Report and Accounts

Exhibit 6 – The Funds' Financial Position

	Net Assets			Present Value of Retirement benefits		
	2021/22 (£'million)	2020/21 (£'million)	Movement (%)	2021/22 (£'million)	2020/21 (£'million)	Movement (%)
Lothian Pension Fund	9,607	8,698	10%	10,049	10,374	-3%
Scottish Homes Pension Fund	154	157	-2%	116	125	-7%

Source: Lothian Pension Funds Annual Report and Accounts

Prevention and detection of fraud and irregularity

85. Our audit was planned to provide a reasonable expectation of detecting material misstatements in the financial statements resulting from fraud and irregularity.

86. Lothian Pension Fund was not required to participate in the National Fraud Initiative but has done so voluntarily. The Fund has completed work to provide data to the scheme.

87. Lack of notification of the deaths of members is a significant fraud risk area for the Funds.

Standards of Conduct

88. In our opinion the Funds' arrangements in relation to standards of conduct and the prevention and detection of bribery and corruption are adequate.

89. Our conclusion has been informed by a review of the arrangements for adopting and reviewing standing orders, financial instructions and the scheme of delegation and for complying with national and local codes of conduct.

National fraud initiative

90. The National Fraud Initiative (NFI) is a counter-fraud exercise co-ordinated by Audit Scotland working together with a range of Scottish public bodies to identify fraud and error.

91. The most recent NFI exercise commenced in 2020. We completed a questionnaire and submitted this to Audit Scotland earlier this year. Overall, we concluded that NFI arrangements are satisfactory, and that the Fund has taken a reasonable and proportionate approach to investigating matches.

Internal Audit

92. An effective internal audit service is an important element of the Funds' governance arrangements. The City of Edinburgh Council provide the Funds' internal audit service. During our audit we considered the work of internal audit wherever possible to avoid duplication of effort and make the most efficient use of the Funds' audit resource.

93. Internal Audit presented a limited, amber opinion to the Pensions Committee for the year to 31 March 2022. A limited opinion was given as Internal Audit do not consider LPF's subsidiaries and hence do not cover all risks. Internal Audit considers that the LPF control environment, governance and risk management arrangements require some improvement. The opinion is in line with the opinion given in 2020/21.

94. LPF has considered the assurances provided by Internal Audit as part of the Annual Governance Statement. The opinion is considered within the context of the wider assurance framework including assurances provided by the Section 95 Officer for the LPF Group and the Head of Finance at the City of Edinburgh Council.

95. In 2021/22 we did not place formal reliance on the work of internal audit; however, we have considered their findings in respect of our wider scope responsibilities and we are grateful to the internal audit team for their assistance during the course of our work.

Governance and transparency

Governance and transparency is concerned with the adequacy of governance arrangements, leadership and decision making, and transparent reporting of financial and performance information.

Auditor judgement

Governance arrangements at the Funds are appropriate. Our assessment has been informed by a review of the corporate governance arrangements in place, the information provided to the Board and Committees as well as the risk management arrangements in place.

Project Forth, a proposed merger between Lothian and Falkirk Pension Funds was approved by Lothian Pension Fund's Pensions Committee in September 2021, subject to the approval of City of Edinburgh Council as administering authority. The Council is due to consider the proposal in later in the year.

Governance and transparency

Governance Structure

96. The Pensions Committee has been delegated responsibility for governance of the Funds by the administering authority, the City of Edinburgh Council. The Pensions Committee is supported by an Audit Sub-Committee.

97. The Pensions Committee's responsibilities, as set out in the City of Edinburgh Council's Scheme of Delegation, include the administration and management of the Funds including setting the investment strategy.

98. In line with the requirements of the Public Service Pension Act 2013 the Pensions Committee is supported by a Pensions Board.

99. The Pensions Board is responsible for establishing arrangements that ensure proper conduct of the affairs of the Board and meet quarterly on a concurrent basis with the Pensions Committee.

100. The Funds complied with best practice and appointed an independent professional observer to the Board and Committee.

101. In line with legislation, if more than half of the members of the Pension Board disagree with a decision of the Pensions Committee then they can request in writing that the Committee review that decision. There have been no requests to review decisions in 2021/22.

102. Due to the specialised nature of the Funds, it is vital that members have the appropriate knowledge and understanding to provide appropriate challenge and operate effectively. Training is therefore seen as a fundamental requirement for all Committee and Board members.

103. Our review found that all current Pensions Committee and Board members met the requirement to have a minimum of 21 hours training.

Project Forth

104. In September 2021, Lothian Pension Fund agreed in principle to merge Lothian Pension Fund with Falkirk Pension Fund, subject to further work including approvals by the City of Edinburgh Council and Falkirk Council, as administering authorities. The intention to merge was publicly announced on 24th May 2022.

105. The aim and business case behind Project Forth is that a merger will result in substantial cost savings, achieve economies of scale and provide a future proofed best in class governance model fit for the increasing legal and regulatory landscape of the LGPS.

106. The proposed structure agreed by the Pensions Committee was a joint venture between the City of Edinburgh Council and Falkirk Council, as administering authorities. This would be a company limited by guarantee holding nominal membership pro-rated to contributing assets.

107. Under the original timeline, the administering authorities were due to consider the proposal in February 2022. However, further due diligence

was proposed by the City of Edinburgh Council, delaying the approval first to September and then to December 2022, at the earliest. The two Councils intend to align the timing of when the proposal is considered for approval.

108. Due diligence undertaken to date has not identified any fundamental issues with the proposed plans. However, further work is being undertaken over the proposed structure and the impact on the Funds' VAT recovery. A revised proposal will be considered by the administering authorities when the full due diligence process has been completed.

Joint Investment Strategy Panel

109. The Pensions Committee has delegated responsibility for investment strategy to the Executive Director of Resource who takes advice from a Joint Investment Strategy Panel made up of:

- the Chief Investment Officer, LPFI Ltd;
- a second senior investment officer of LPFI Ltd; and
- two external independent investment advisers.

110. The Joint Investment Strategy Panel covers joint working arrangement with Falkirk Pension Fund and Fife Pension Fund.

111. The Joint Investment Strategy Panel meets quarterly and considers the appropriate investment management structure required to implement the Funds' investment strategy. In addition, it is responsible for:

- making recommendations about investment strategy; and
- directing and monitoring strategy implementation and risk.

112. The primary focus of the panel during 2021/22 has been the implementation of existing strategies for Lothian Pension Fund and Scottish Homes Pension Fund, as well as the implementation of the strategies of the collaborative partner funds.

113. Special areas considered by the panel in 2021/22 include:

- Annual review of investment strategy;
- Responsible investment principles; and
- The implications of a merger of the Lothian and Falkirk funds.

114. Lothian Pension Fund continues to operate four investment strategies recognising the different membership profiles and requirements of the admitted and scheduled employers.

115. Scottish Homes Pension Fund achieved full funding at the 2017 and 2020 actuarial valuations and therefore the strategy is low risk and designed to protect from short term market changes..

Value for money

Value for money is concerned with using resources effectively and continually improving services. In this section we report on our audit work as it relates to the Funds' reporting of performance.

Auditor judgement

The Funds' investment performance is subject to regular review by the Pensions Committee.

The Funds have appropriate arrangements in place to secure value for money through appropriate monitoring of performance of investments and the administration of the Funds.

Performance remains strong with nine out of the ten performance measures met. However, investment performance over the rolling five-year period is noted as being below benchmark.

Investment Manager Operations

116. Lothian Pension Fund operates two special purpose vehicles: LPFE Ltd and LPFI Ltd. Both companies are wholly owned and controlled by the Council.

117. The special purpose vehicles were established to support the investment programme of the in-house investment team by providing organisational arrangements consistent with the capability, systems and controls of authorised investment companies.

118. In 2021/22, the proportion of funds managed internally remained at 92%, with the last significant movement in 2019/20 when the transfer of the property portfolio management to an in-house team was undertaken. External investment managers are primarily used in the management of overseas equities and corporate bonds.

119. Lothian Pension Fund reported management expenses of £40 million in 2021/22, a decrease of 3% on the prior year. Management expenses are split into three main categories: administrative costs; investment manager expenses and oversight and governance costs. Investment management expenses account for 86% of total management expenses.

120. In year, Lothian Pension Fund's investment manager expenses (excluding indirect expenses) decreased marginally as a proportion of net assets. This is broadly in line with trends across the Local Government Pension Funds as shown in Exhibit 7.

121. Investment manager expenses can vary due to a number of factors including actual returns on investments and the nature of the investment assets held.

122. The Funds include detailed analysis over investment expenses in the 2021/22 Annual Report. Disclosures on investment management expenses exceed the requirements of CIPFA guidance on cost transparency as LPF consider that the CIPFA methodology would result in under-reporting indirect management expenses.

123. The Funds undertake annual benchmarking exercises using externally provided data, covering 37 LGPS funds and a wider global universe of 325 funds. Analysis of investment costs is carried out by an independent provider, CEM Benchmarking Inc.

124. The benchmarking exercise reported in March 2022 covers investment performance in 2020/21. For this year, Lothian Pension Fund reported an actual investment cost of 0.35% of net assets which was below the benchmark of 0.46%.

125. The Funds credit the strong performance against benchmark to two factors. The first is the high percentage of assets managed internally which allows the Funds to control costs effectively. Additionally, the Funds have accessed private market investments at a lower fee than the benchmark group.

126. In relation to the pension administration benchmarking exercise undertaken by CEM, the Funds were categorised as 'low cost; high service standard'. The Funds' cost per member was £25.59

compared with a benchmark of £41.15. This was supported by an improved service score of 67 out of 100 driven by the Funds' noted speed at paying lump sums and strong social media presence.

Monitoring investment performance

127. There is an annual review of investment performance published in June for each of the Funds. The report provides a detailed analysis of each of the Fund's investment performance against its investment strategy. We concluded that the Pensions Committee and Board Members are engaged in monitoring the performance of investments.

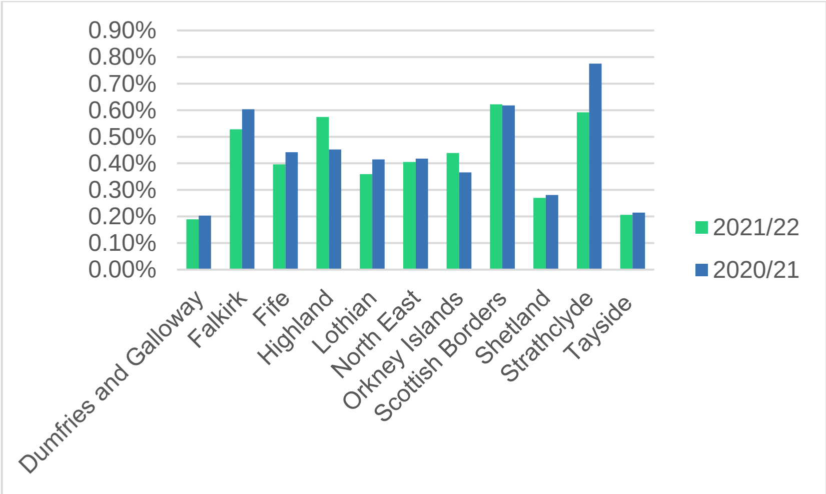
128. In addition to monitoring at a Committee level the Funds' performance is calculated by an external provider on a monthly basis. The external provider compiles information covering monthly, quarterly, and 1, 3, 5, 10 yearly performance measures. This information is presented to the Joint Investment Strategy Panel to allow for scrutiny of the investment performance of the Funds.

Administration Performance

129. The Funds have developed an annual Operating Plan which sets out the strategic aims of the Funds. The aims are supported by performance indicators which are reported to each Pensions Committee meeting as part of the Operating Plan Update.

130. The annual results for 2021/22 are presented in the Funds' Management Commentary. Performance remains strong with nine out of the ten performance measures met. Investment performance and risk over a rolling five year period is noted as being below benchmark. This has been further discussed under our Financial Sustainability section.

Exhibit 7 – Management expenses as a proportion of net assets



Source: Unaudited Annual Report and Accounts

Appendices

Appendix 1: Respective responsibilities of the Funds and the Auditor

The Code of Audit Practice (2016) sets out the responsibilities of both the Board and the auditor and are detailed below.

Funds' responsibilities

The Funds have primary responsibility for ensuring the proper financial stewardship of public funds, complying with relevant legislation and establishing effective arrangements for governance, propriety and regularity that enable them to successfully deliver their objectives.

Area	Responsibilities
Corporate governance	The Funds' are responsible for establishing arrangements to ensure the proper conduct of its affairs including the legality of activities and transactions, and for monitoring the adequacy and effectiveness of these arrangements. Those charged with governance should be involved in monitoring these arrangements.
Financial statements.	The Funds' have responsibility for: • preparing financial statements which give a true and fair view of its financial position and their expenditure and income, in accordance with the applicable financial reporting framework and relevant legislation; • maintaining accounting records and working papers that have been prepared to an acceptable professional standard and that support its financial statements and related reports disclosures; • maintaining proper accounting records; and • preparing and publishing, along with the financial statements, an annual governance statement, management commentary (or equivalent) and a remuneration report that is consistent with the disclosures made in the financial statements. Management commentary should be fair, balanced and understandable and also address the longer term financial sustainability of the Funds. Management is responsible, with the oversight of those charged with governance, for communicating relevant information to users about the entity and its financial performance, including providing adequate disclosures in accordance with the applicable financial reporting framework. The relevant information should be communicated clearly and concisely. The Funds' are responsible for developing and implementing effective

Area	Responsibilities
	systems of internal control as well as financial, operational and compliance controls. These systems should support the achievement of its objectives and safeguard and secure value for money from the public funds at its disposal. They are also responsible for establishing effective and appropriate internal audit and risk-management functions.
Standards of conduct for prevention and detection of fraud and error	The Funds' are responsible for establishing arrangements to prevent and detect fraud, error and irregularities, bribery and corruption and also to ensure that its affairs are managed in accordance with proper standards of conduct.
Financial position	The Funds' are responsible for putting in place proper arrangements to ensure the financial position is soundly based having regard to: • Such financial monitoring and reporting arrangements as may be specified; • Compliance with statutory financial requirements and achievement of financial targets; • Balances and reserves, including strategies about levels and their future use; • Plans to deal with uncertainty in the medium and long term; and The impact of planned future policies and foreseeable developments on the financial position.
Best value	The Funds have a specific responsibility to ensure that arrangements have been made to secure best value. They are responsible for ensuring that these matters are given due priority and resources, and that proper procedures are established and operate satisfactorily.

Auditor responsibilities

Auditor responsibilities are derived from statute, the Code of Audit Practice, International Standards on Auditing (UK), professional requirements and best practice. These are to:

- undertake statutory duties, and comply with professional engagement and ethical standards;
- provide an opinion on the financial statements;
- review and report on, as appropriate, other information such as annual governance statements, management commentaries and remuneration reports;
- notify the Controller of Audit when circumstances indicate that a statutory report may be required; and
- demonstrate compliance with the wider scope of public audit.

Wider scope of audit

The special accountabilities that attach to the conduct of public business, and the use of public money, mean that public sector audits must be planned and undertaken from a wider perspective than in the private sector. This means providing assurance, not only on the financial statements, but providing audit judgements and conclusions on the appropriateness, effectiveness and impact of corporate governance and performance management arrangements and financial sustainability.

The Code of Audit Practice frames a significant part of our wider scope responsibilities in terms of four audit dimensions: financial sustainability; financial management; governance and transparency; and value for money.

We have concluded that the full application is not appropriate due to the size of the organisation. As part of our annual audit we consider and report against:

- appropriateness of the disclosures in the governance statement; and
- financial sustainability of the body and the services that it delivers over the medium to longer term.

Independence

In accordance with our profession's ethical guidance and further to our External Audit Annual Plan issued confirming audit arrangements there are no further matters to bring to your attention in relation to our integrity, objectivity and independence.

We confirm that Azets Audit Services and the engagement team complied with the FRC's Ethical Standard. We confirm that all threats to our independence have been properly addressed through appropriate safeguards and that we are independent and able to express an objective opinion on the financial statements.

Audit and non-audit services

The total fees charged to the Funds for the provision of services in 2021/22 (with prior year comparators) is as follows:

	Current year £	Prior year £
Audit of Lothian Pension Fund (Auditor remuneration)	£42,579	£41,388
Total audit	**£42,579**	**£41,388**
Non-audit services	-	-
Total fees	**£42,579**	**£41,388**

FRC's Ethical Standard stipulates that where an auditor undertakes non audit work, appropriate safeguards must be applied to reduce or eliminate any threats to independence. No non-audit services were provided to the Funds.

Audit quality

The Auditor General and the Accounts Commission require assurance on the quality of public audit in Scotland through comprehensive audit quality arrangements that apply to all audit work and providers. The audit quality arrangements recognise the importance of audit quality to the Auditor General and the Accounts Commission and provide regular reporting on audit quality and performance.

Audit Scotland maintains and delivers an Audit Quality Framework.

The most recent audit quality report which covers our work at LPF since appointment can be found at https://www.audit-scotland.gov.uk/publications/quality-of-public-audit-in-scotland-annual-report-202122

Appendix 2: Adjusted and unadjusted errors identified during the audit

Corrected and uncorrected misstatements

We did not identify any corrected or uncorrected misstatements during our audit of the Funds' annual report and accounts.

Disclosure amendments

No	Detail
1	Performance Report – update to the disclosure of management expenses to align with financial statements.

Appendix 3: Follow up of prior year recommendations

We have followed up on progress in implementing actions raised in the prior year/s. The table below summarises progress made by the Funds in implementing these actions.

Investment Performance – action raised in 2020/21			
Recommendation	Lothian Pension Fund has not met its investment objective to deliver benchmark returns at below benchmark risk. The Fund attributes this to the defensive positioning of the Fund which delivers good but below benchmark returns in strong equities markets. The positioning of the Fund is a significant driver of performance which has been discussed by the Pension Committee. However, the positioning is not documented in the Funding Strategy Statement or Statement of Investment Principles. The Investment Strategy should document the Fund's approach to the overall positioning of the Fund and the implications on achieving investment objectives.		
Rating	**Other deficiency**	**Implementation date**	Initial target date: June 2022
Complete	The positioning of the fund has been satisfactorily covered in the updated investment strategy.		

Bank Accounts – action raised in 2017/18	
Recommendation	The Local Government Pension Scheme (Management and Investment of Funds) (Scotland) Regulations 2010 require that after 1st April 2011 all pension fund monies are held in a separate bank account to the administering body and that all future monies received are directly to a pension fund bank account. There are a limited number of occasions where LPF needs to issue sales invoices to recover charges made to employers and members. The amounts involved are insignificant in comparison to the value of pension contributions. As the CEC finance system, as currently configured, does not allow LPF to raise sales invoices in its own name,

Bank Accounts – action raised in 2017/18			
	the invoices go out under the name of CEC and payments are collected in a CEC bank account. However, the amounts involved are clearly identified and are held for the benefit of LPF. As regards purchase ledger payments, the CEC finance system, as currently configured, does not allow LPF to pay suppliers directly from an LPF bank account. However, the amounts involved are clearly identified and netted off against the sales ledger receipts mentioned above. Purchase ledger payments exceed sales ledger receipts by a considerable margin and LPF makes regular monthly payments to CEC. In LPF's opinion, the Regulations do not require payments to LPF suppliers to be made directly from an LPF bank account. As is typical within the Local Government Pension Schemes (LGPS), arrangements exist whereby unfunded benefits are paid to teachers and other people on behalf of employers as part of the LPF pension payroll. Based on LPF's current understanding, there is a danger that if the unfunded benefits were paid directly from an LPF bank account, HMRC could regard such payments as unauthorised. For that reason, all benefit payments are made from a CEC bank account with LPF paying the value of the funded benefits into that bank account and CEC covering the value of the unfunded benefits (the cost being recovered by CEC via sales invoices to employers). In LPF's opinion, the Regulations do not require payments to LPF pensioners to be made directly from an LPF bank account. We recommend the Funds put arrangements in place to ensure compliance with the regulations.		
Rating	**Other deficiency**	**Implementation date**	Initial target date: As soon as possible
Ongoing	Following a competitive procurement process for a new financial ledger system, LPF has identified a preferred tenderer and is liaising with the company to finalise suitable contractual terms. This will include recognition of a further assurance review stage to be undertaken by a specialist provider, prior to implementation of the new system. The tender specification addressed the requirement for suitable configuration to provide "stand alone" payment and sales invoicing for LPF, independent of the City of Edinburgh Council. In respect of payments to pensioners for "unfunded" discretionary awards by former employers, LPF has attained external legal advice which reconfirms its understanding that should unfunded benefits be		

Bank Accounts – action raised in 2017/18	
	paid directly from an LPF bank account, then HMRC would regard such payments as unauthorised. The use of a Fund bank account for these "unfunded transfer payments", therefore, is prohibited. Consequently, for reasons of efficiency and simplicity, the pension payroll is combined and both funded and unfunded pension payments are made through a general fund bank account of the administering authority, City of Edinburgh Council. For the funded LGPS payments, the Fund transfers money from its own bank account to that of the City of Edinburgh Council's to cover the value of these benefits. For the unfunded payments, these are recharged to the employer body (or successor) which originally granted the discretionary benefits. Accordingly, LPF has sought and is awaiting a (further) response from SPPA for its clarification that the current payment methods, as adopted consistently across all Scottish LGPS administering authorities, should not be interpreted as being in conflict with regulations. LPF's rationale, as asserted to SPPA, is as follows: "LPF transfers the funds to the CEC bank account on the same day as the pensions are paid so there is no question of LPF money sitting in a CEC bank account. The 2010 Regulations require that an administering authority must hold in a separate bank account all monies received by it. There is no stipulation that an authority must pay benefits directly from its bank account to a beneficiary. At the point LPF is paying pensions and other benefits, it is not holding money in an account, it is carrying out a transaction for the purposes of the fund. On that basis, we believe that there is sufficient scope for the SPPA to clarify the interpretation of the Regulations so that is clear that an administering authority may use an intermediary bank account for the purpose of making fund payments." In respect of these mandatory and discretionary compensation payments made by LGPS administering authorities to retired teachers (Teachers' Scheme rather than Local Government Pension Scheme (LGPS)), along with other Scottish LGPS administering authorities, the Fund has requested that responsibility should transfer to the Scottish Public Pensions Agency (SPPA). SPPA has sought information on the relevant scope and scale of the payments being made across those administering authorities wishing to transfer. On receipt of such, SPPA has committed to consider the matter.

User access controls– action raised in 2017/18			
Recommendation	While our audit review in respect of the 2017/18 financial year did not identify any indications of user access being manipulated, we recommend that the Funds' officers in conjunction with City of Edinburgh Council review user access controls for the financial ledger.		
Rating	**Other deficiency**	**Implementation date**	Initial target date: March 2019
Ongoing	This is an ongoing issue in 2021/22; however, we did not identify any instances where journals were posted by inappropriate users.		