

Appendix 'A'

Lancashire County Council: Pension Fund

Internal Audit Service

Annual report for the year ended 31 March 2012,

including the proposed internal audit plan 2012/13



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1 Introduction

- 1.1 Internal Audit is an assurance function that primarily provides an independent and objective opinion on the adequacy of the organisation's control environment. The CIPFA Code of Practice for Internal Audit in Local Government in the United Kingdom requires the head of internal audit to provide a written report to those charged with governance, timed to support the Annual Governance Statement, which includes an opinion on the overall adequacy and effectiveness of the organisation's governance arrangements, including the control environment. This report presents our opinion based upon the work we have performed.
- 1.2 This report covers the period 1 April 2011 to 31 March 2012.

Acknowledgements

- 1.3 We are grateful for the assistance that has been provided to us by staff in the County Treasurer's Department in the course of our work.

2 Assessment of internal controls

Overall opinion

- 2.1 Based on the internal audit work undertaken during the year we are able to provide **substantial** assurance over the internal control environment for the pension fund and pension administration.
- 2.2 It is our opinion that there is a generally sound system of internal control which is adequately designed and controls are being consistently applied in the majority of areas reviewed, although there are some areas where control needs to be strengthened.
- 2.3 Management responses to the findings from our work have been positive and indicate that action has or will be taken where issues have been identified. Whilst recognising there are a small number of control issues which need to be addressed, our detailed findings identify good areas of effective control.

Key issues and themes arising during the period

- 2.4 The level of change managed by the teams involved with the pension fund has been significant again this year, with the transfer of the pension payroll to the Altair system, the transfer of the global custody arrangements to Northern Trust, the introduction of the pension fund bank account, in addition to the introduction of the new investment strategy. Given this situation, it is particularly pleasing to report that adequate and effective internal control arrangements have continued to

be maintained within the systems operated during 2011/12. The findings of the individual reviews are briefly set out in the following paragraphs.

- 2.5 We are able to provide substantial assurance over the pensions administration procedures operated during the year which included consideration of the:
- transfer of the payment of pensions to the Altair system;
 - authorisation of new members;
 - retirement calculations;
 - death grant calculations;
 - employee and employer contributions to the scheme and
 - transfers into and out of the scheme.
- We have made one recommendation to ensure the appropriate cancellation of tasks within the Altair system, in order that performance statistics can be fully relied upon.
- 2.6 In relation to pension fund assets and investments our work has encompassed four reviews consisting of the new global custodian arrangements with Northern Trust, the new investment strategy, the new bank account arrangements for the pension fund and third party assurance reports produced for three of the investment managers.
- 2.7 The audit work we performed for the new global custodian allows us to provide substantial assurance over the internal control environment. We were satisfied that investment balances were satisfactorily reconciled from the previous custodian to Northern Trust on the transfer of the service. In addition, information on investment activity was received from the global custodian and from investment managers on a regular basis, and was accurately reconciled within the Treasury and Investment Team during the year.
- 2.8 We have made one recommendation to ensure that invoices for management fees are received on a regular basis.
- 2.9 Our review of the new investment strategy focused specifically on the role of the Investment Panel in making individual investment decisions during the year rather than simply placing funds with investment managers.
- 2.10 In particular we reviewed that :
- The composition of the Investment Panel is consistent with the agreed terms of reference;
 - Investment opportunities are presented to the Panel and discussed in detail;

- A detailed due diligence report is compiled for each investment opportunity, signed off by the Deputy County Treasurer and debated by the panel;
- Only investment opportunities that receive unanimous support of the Investment Panel professionals are approved by the Treasurer to the Fund; and
- Decisions to invest, and the reasons for doing so, are clearly presented at the next meeting of the Pension Fund Committee.

2.11 We are able to provide substantial assurance over the systems operated. There were no areas identified that would have a major impact on the achievement of the pension fund's objectives. We have made one recommendation to further enhance the governance arrangements in this area.

2.12 A separate bank account was set up for the pension fund in April 2011, in accordance with the requirements of Local Government Pension Scheme Regulations 2009. Our review of the arrangements introduced in 2011/12 allowed us to provide full assurance over the controls in operation in this area. In particular we noted:

- Reconciliation procedures are fully documented and reconciliations had been undertaken accordingly during the year;
- There is a system in place to identify the required cash transfers from the council's bank account to the pension fund account. Transfers were undertaken correctly and regularly during the year and
- An appropriate segregation of duties was in operation between individual members of staff transferring funds, creating journals and reconciling the pension fund bank account.

2.13 Our review of the third party assurance reports produced for three of the fund manager's systems enabled us to provide full assurance on the control environment in operation within these fund managers' systems.

2.14 The re-tendering of the fund's property management contract has been delayed due to other priorities during the year; consequently we were not able to undertake the intended review of the procurement arrangements for this contract.

Fraud/ special investigations

2.15 There were no days used in the investigation of suspected financial irregularities in relation to the pension fund.

National Fraud Initiative (NFI)

- 2.16 In addition to the planned audit reviews we have also undertaken work relating to the National Fraud Initiative (NFI). As part of the county council's duty to protect public funds, the Audit Commission requires all local authorities to participate in the NFI. Previously this has been a two-yearly exercise that matches electronic data held by public sector organisations to highlight potentially fraudulent activity. One of the tests included relates to identifying pension claimants that may have died or may have additional employment affecting their pension.
- 2.17 The 2010/11 NFI exercise identified 2,256 matches for Lancashire, an increase of 407 matches on the 2008/09 exercise. Your Pension Service (YPS) has processed approximately 75% of these matches to date and has identified overpayments to the value of £92,000 for 32 claimants. YPS is currently in the process of pursuing these overpayments.
- 2.18 We will be undertaking this exercise on an annual basis in the future, in order to ensure that any overpayments are identified and recovered at the earliest opportunity.

Implications for the Annual Governance Statement

- 2.19 On the basis of our work during 2011/12, we are aware of no internal control weakness that requires disclosure in the Annual Governance Statement.

3 Internal audit work undertaken

- 3.1 Work carried out during 2011/12 was in accordance with the audit plan presented and approved by the Pension Fund Committee in April 2011. Details of the assurance provided, and key issues identified for each of the areas covered are set out in the 'Summary of our Findings and Assurance' table attached at page 8. This shows that 82 days were spent on delivering the audit plan against planned audit activity of 110 days.
- 3.2 This work has been undertaken with regular liaison with the council's external auditors to minimise any duplication in planned coverage.
- 3.3 A number of areas of work were completed on or just after the end of the financial year. Two reports were still in draft (global custodian arrangements, and pension administration) at the time of writing this report. As all reports have been discussed with the appropriate managers, we feel it is appropriate to include our opinion for these reviews in the summary of findings.

4 Internal audit plan 2012/13

- 4.1 Our work will continue to take maximum advantage of existing management assurance processes and reports, and follow an approach in line with guidance issued by the Society of County Treasurers and CIPFA.
- 4.2 The plan again focuses on two distinct areas which cover the governance and management of the pension fund's assets and pension administration. The audit reviews identified under each of these areas is explained in more detail below.

Pension Fund

- 4.3 We have included audit resources again within the 2012/13 plan to review that arrangements for investing pension funds are in accordance with the approved investment strategy. We will again consider the arrangements for making investment decisions through the Investment Panel as well as reviewing the arrangements for monitoring the performance of funds placed with investment managers. (25 days)
- 4.4 The county council is upgrading a number of its financial systems from April 2012. As part of this project, the pension fund has been established as a separate organisation with a separate general ledger within the overall Oracle environment. We intend to review the adequacy and effectiveness of these new accounting arrangements. (10 days)
- 4.5 Our work will continue to take maximum advantage of existing management assurance processes and reports, and follow an approach in line with guidance issued by the Society of County Treasurers and CIPFA. This will involve using statutory reporting from the investment managers and custodian in the first instance. These documents will be used to gain assurance over the external investment management activities where appropriate. (5 days)

Pension administration

- 4.6 We propose to focus this year's work on testing the effectiveness of the key controls we have documented over the last two years, in addition to specifically reviewing the ICT control arrangements operated for the Altair system. (25 days)

Follow Up

- 4.7 Audit resources have been identified to ensure that all reviews are followed up and our findings are re-assessed as the actions previously agreed with management are implemented. (5 days)

General Management

- 4.8 An allocation of 5 days has also been made to cover other management and tasks in support of the internal audit service to the pension fund:
- Attendance at meetings;
 - Liaison with the Audit Commission; and
 - Central reporting.
- 4.9 The proposed plan amounts to 75 days.

5 Scope, responsibilities and assurance

- 5.1 Details of the scope of our work, and management's and internal audit's responsibilities regarding systems of risk management, internal control are explained in pages 9 and 10. This sets out the basis of our assessment and limitations on the assurance that we can provide.

Access to this report and responsibility to third parties

- 5.2 We have prepared this report solely for Lancashire County Council, and the Pension Fund Committee. As you are aware, this report forms part of a continuing dialogue between the Internal Audit Service, the Treasurer to the Fund, and the Pension Fund Committee. It is not therefore intended to include every matter that came to our attention during each internal audit review.
- 5.3 We acknowledge that this report may be made available to other parties, such as the external auditors. We accept no responsibility to any third party who may receive this report for any reliance that they may place on it and, in particular, we expect the external auditors to determine for themselves the extent to which they choose to utilise our work.

6 Summary of findings

Overall summary and assurance provided

- 6.1 We have set out in the table on page 8 below a brief summary of each review undertaken during this year. This sets out the planned and actual days we have spent on each review, and a summary of the assurance we have been able to provide in relation to each system or operational area of your business. The key issues/comments encapsulate the significant issues and areas where key recommendations were made. They reflect the findings at the time the work was carried out.
- 6.2 We have distilled the assurance into an assessment of the adequacy of each system, and its effectiveness in operation.

- 6.3 **System adequacy:** We have defined a system as adequate if its design enables it to achieve its core control objectives which, if operating as intended, serve to manage its inherent risks.
- 6.4 **System effectiveness:** We have defined a system as operating effectively if, after testing or other supporting evidence has been found, it is operating as intended.
- 6.5 It is therefore possible that a system would, if operated as intended, provide adequate control over its inherent risks, but that lapses in controls in practice leave the system exposed to risk.
- 6.6 It is also possible that a system may be inadequate in its design, but is nonetheless operating as intended, albeit with inbuilt weaknesses that mean that the control objectives cannot be met.
- 6.7 Ideally, a system will be adequately designed to achieve its control objectives, and operated effectively in practice.
- 6.8 The table below indicates briefly with simple ticks (✓) and crosses (x) our overall assessment of each system we have reviewed during the year and the assurance you may take from its operation in supporting effective internal control.

Summary of our findings and assurance

Review area	Audit days			Assurance		Key issues / Comments
	Planned	Actual	Variation	Adequacy	Effectiveness	
Audit Areas						
Pensions administration – manual controls	25	32	7	✓	✓	The draft report was issued in April 2012. We have received confirmation from management that the report and the recommendation made have been accepted.
				Substantial assurance		
Global custodian	20	12	(8)	✓	✓	The draft report was issued in April 2012. We have received confirmation from management that the report and the recommendation made have been accepted.
				Substantial assurance		
New investment strategy	30	12	(18)	✓	✓	The final report was issued in May 2012, following confirmation from management that the report and the recommendation made have been accepted.
				Substantial assurance		
New bank account	10	11	1	✓	✓	The final report was issued in February 2012.
				Full assurance		
Third party assurance reports	5	4	(1)	✓	✓	The final report was issued in May 2012. The three fund managers we reviewed were Legal and General, UBS and Newton. We noted that in all three cases, the expected key controls were in place and assurance was provided on them in the reports.
				Full assurance		
New investment manager (procurement arrangements)	15	3	(12)	-	-	The days relate to initial discussions and preparatory work. The retender of the property fund contract has been delayed due to other priorities during the year.
Planning and management	5	8	3	-	-	This time relates to the production of the annual plan and report, planning/ progress meetings and general advice.
Total Days	110	82	(28)			

Summary of our findings and assurance

1. Scope, responsibilities and assurance

Approach

- 1.1 In accordance with the CIPFA Code of Audit Practice, the scope of internal audit encompasses all of the Council's operations, resources and services including where they are provided by other organisations on their behalf.

Responsibilities of management and internal auditors

- 1.2 It is management's responsibility to maintain systems of risk management, internal control and governance. Internal audit is an element of the internal control framework assisting management in the effective discharge of its responsibilities and functions by examining and evaluating controls. Internal auditors cannot therefore be held responsible for internal control failures.
- 1.3 However, we have planned our work so that we have a reasonable expectation of detecting significant control weaknesses. We have reported all such weaknesses to you as they have become known to us, without undue delay, and have worked with you to develop proposals for remedial action.
- 1.4 Internal audit procedures alone do not guarantee that fraud will be detected. Accordingly, our examinations as internal auditors should not be relied upon solely to disclose fraud or other irregularities which may exist, unless we are requested to carry out a special investigation for such activities in a particular area.
- 1.5 Internal audit's role includes assessing the adequacy of the risk management processes, key internal control systems and corporate governance arrangements put in place by management and performing testing on a sample of transactions to ensure those controls were operating for the period under review.

Basis of our assessment

- 1.6 Our opinion on the adequacy of control arrangements is based upon the result of internal audit reviews undertaken during the period in accordance with the plan approved by the Pension Fund Committee. We have obtained sufficient, reliable and relevant evidence to support the recommendations that we have made.

Limitations to the scope of our work

- 1.7 No limitations have been placed on the scope or extent of the work we carried out during the year by the management or staff of the County Treasurer's Department.

Limitations on the assurance that internal audit can provide

- 1.8 There are inherent limitations as to what can be achieved by internal control and consequently limitations to the conclusions that can be drawn from our work as internal auditors. These limitations include the possibility of faulty judgement in decision making, of breakdowns because of human error, of control activities being circumvented by the collusion of two or more people and of management overriding controls. Also there is no certainty that internal controls will continue to operate effectively in future periods or that the controls will be adequate to mitigate all significant risks which may arise in future.
- 1.9 Decisions made in designing internal controls inevitably involve the acceptance of some degree of risk. As the outcome of the operation of internal controls cannot be predicted with absolute assurance any assessment of internal control is judgmental.

Audit assurance levels

- 1.10 The assurance we can provide over any area of control falls into one of four categories as follows:

Full assurance: there is a sound system of internal control which is adequately designed to meet the service objectives and is effective in that controls are being consistently applied.

Substantial assurance: there is a generally sound system of internal control, adequately designed to meet the service objectives, and controls are generally being applied consistently. However some weakness in the design and/ or inconsistent application of controls put the achievement of particular objectives at risk.

Limited assurance: weaknesses in the design and/ or inconsistent application of controls put the achievement of the service's objectives at risk.

No assurance: weaknesses in control and/ or consistent non-compliance with controls could result/ has resulted in failure to achieve the service objectives.