

# Internal audit assurance for the Pension Fund Committee

## 1 Introduction

- 1.1 Lancashire County Council, as the administering authority of the Lancashire County Pension Fund, has prepared a governance policy statement that sets out the role of the council's Pension Fund Committee, Investment Panel and Pension Board. The Pension Board's terms of reference include the requirements that it should, "monitor internal and external audit reports" and "review the outcome of internal and external audit reports in relation to the Fund".
- 1.2 The terms of reference for the county council's Audit, Risk and Governance Committee give it a wider remit to oversee internal audit activity, and its terms of reference address its oversight of the work of the Internal Audit Service in some detail. This includes a requirement to,
- "Consider reports from the head of internal audit on internal audit's performance during the year, including the performance of external providers of internal audit services. These will include updates on the work of internal audit including key findings, issues of concern and action in hand as a result of internal audit work...."
- 1.3 The council's Internal Audit Service's annual programme of work includes work relating to the Pension Fund and the Audit, Risk and Governance Committee considers both the annual plan and the outcomes of the work during the year.
- 1.4 This report is therefore presented to the Pension Fund Committee for information regarding the outcomes of the internal audit work done during 2018/19 and the work included in the annual plan for 2019/20 relating to the Lancashire County Pension Fund. It focusses on the work of the council's Internal Audit Service but also refers to the work undertaken by Deloitte for the Local Pension Partnership Ltd.

## 2 Internal audit work 2018/19

- 2.1 Details of the work undertaken by the Internal Audit Service and the assurance it provides for 2018/19 are set out below, and explanations of the assurance provided are set out in section 5 of this report.

Audit work	Assurance
<b>Oversight of the Lancashire County Pension Fund</b>	
Performance management	Substantial
New custodianship arrangements for the Lancashire Pension Fund	Substantial
Accounting for the Pension Fund through the council's general ledger	Substantial
Follow-up of the action arising from audit work during 2017/18 relating to oversight of the Lancashire Pension Fund	Action complete
<b>Obtaining and understanding the assurance provided by Local Pensions Partnership Limited own internal auditors</b>	
Assessment of the assurance provided by Deloitte over the Fund's administration and investment operations outsourced to Local Pensions Partnership Limited (LPP)	Limited: see paragraph 3.4 below

### **Performance management**

- 2.2 The council's Governance Policy Statement sets out the roles of the Pension Fund Committee, Pension Board and senior post-holders in relation to the governance and oversight of the Fund. This includes oversight of the Fund's performance and particularly the performance of its investments.
- 2.3 The Pension Fund Committee takes the role of scheme manager and receives regular reports from the head of service for the Pension Fund and LPP. The committee is advised by the Investment Panel and assisted by the Pension Board whose independent advisors and chair respectively have been appointed for their expertise, and is provided with sufficient, relevant information to assess and effectively challenge the performance of the Fund.

### **New custodianship arrangements**

- 2.4 The Pensions Act requires the Pension Fund to have adequate internal control mechanisms in place, including arrangements for safe custody and security of the assets of the scheme. The Fund therefore requires a custodian to hold its assets.
- 2.5 The custodian appointed by the council (Northern Trust) holds £1.6 billion of the £7.9 billion of assets belonging to the Pension Fund: the remaining assets are held by the custodian for LPP (BNY Mellon). Northern Trust obtains information from BNY Mellon and presents information on the whole fund to the council.
- 2.6 We identified no unmitigated risks in the course of our audit and no further action is required of management.

### **Cash flow management**

- 2.7 The Pension Fund disburses approximately £20 million per month as pensions and other expenses are paid, offset by contributions and other income. The Fund's policy is to maintain a minimum balance of £70 million, held in cash or other highly liquid assets. This is managed by the county council and is separate from the funds invested by LPP. Any surplus cash should be invested in accordance with the investment strategy to minimise risk and ensure liquidity.
- 2.8 As at 1 January 2019 the balance of cash and short-term liquid assets was £154 million. This higher balance has arisen due to payments in advance by employers to address deficits following the last valuation in 2016: employers were offered a discount on their deficit payments if they paid these in 2017, and many employers took up this offer.
- 2.9 The Pension Fund Treasury Management Strategy sets out how surplus cash is managed the short term and we confirmed that surplus cash is managed in accordance with this strategy.

## **3 Internal audit work undertaken by Deloitte during 2018/19**

- 3.1 Local Pensions Partnership Limited has appointed Deloitte as its internal auditor and the committee should note the scope of work undertaken for this service provider to the Lancashire County Pension Fund. Deloitte disclaims any liability to the county council and Lancashire County Pension Fund for any reliance they may place on this work but have agreed that their conclusions may be reported to the council's Audit, Risk and Governance Committee and Pension Fund Committee.

## Internal audit assurance for the Pension Fund Committee

- 3.2 During 2018/19 Deloitte has completed and reported two audits under the second year of its three-year risk-based audit plan and the final audit from the first year of its plan.

Control area	Assurance
Investment operations (2017/18)	Effective with scope for improvement
GDPR readiness assessment (2018/19)	Effective with scope for improvement
Investments: Markets in Financial Instruments Directive ('MIFID II') compliance (2018/19)	Effective

- 3.3 Deloitte's classification scheme differs slightly from that used by the council's Internal Audit Service, and an explanation of the assurance provided is set out in section 5 of this report.
- 3.4 Deloitte's intention at the start of the year was to undertake nine audits but, during the year, the audits of administration transformation (phase 2) and of core systems and infrastructure were removed from the plan. Since only two of the remaining seven audits have been completed and formally reported, the assurance that the council can take over the Fund's administration and investment operations outsourced to LPP is limited. LPP is expected to report Deloitte's findings on the following areas of its plan for 2018/19 over the summer of 2019:
- Cyber security
  - Core financial controls: management information and reporting
  - Investments: third party oversight
  - Investments: legal and regulatory compliance
  - Benefits administration

## 4 Internal audit plans 2019/20

- 4.1 The following work relating to the Lancashire County Pension Fund has been included on the internal audit plan for the county council in 2019/20.

Operational area of activity	Audit work
Collecting contributions from employers	Assessment of the controls over the collection of contributions from employers.
Employers' satisfaction with the Fund's administration	Support to management through an independent survey of the employers' satisfaction with the Fund's administration.
Accounting for the Pension Fund through the council's general ledger	Compliance testing of key controls.
LPP's compliance with its contractual obligations	Review of the accuracy of the performance data reported by LPP to demonstrate its achievement of its contractual performance targets.
Obtaining and understanding the assurance provided by the Pension Fund's own internal auditors.	Assessment of the assurance provided by Deloitte over the operation of the Fund by LPP.

## Internal audit assurance for the Pension Fund Committee

4.2 In addition to completing work for 2018/19, the work that Deloitte plans to undertake for LPP during 2019/20 is as follows:

Coverage	Key risk areas
Contributions	A key element of managing the administration of a pension scheme is ensuring that LPP is receiving all the contributions due per the Schedule of Rates.
Benefit administration	There is significant variation in the complexity of benefit awards that the LPP Administration calculates and pays to members of the participating funds. The calculation of these benefits are performed by a number of geographically dispersed teams. This audit will focus on accuracy benefit calculations for retirements at Normal Retirement Age, early retirement, dependent pensions and ill health and approval of payments.
Core financial controls	The design and operation of core financial controls is essential to enable effective function of LPP. A number of new procedures have been recently implemented to monitor LPP's cash flow and this will audit will consider these, along with the wider cash flow and liquidity related processes.
Investment portfolio monitoring	For an investment portfolio to derive the desired returns, ongoing portfolio performance and risk monitoring is essential. It is expected that in March/ April 2019 the new portfolio and order management system will be procured and by December 2019 Local Pension Partnership Investments Ltd will be operating a combined portfolio model.  The audit will consider the processes for ongoing monitoring of portfolio from a risk and return perspective in order to identify the investments that have performance or risk concerns. This review would also assess the management information in place, after implementation of the new systems, to report the portfolio performance and risk measurement against the risk limits.
Senior Managers and Certification Regime (SMCR)	The extension of the Senior Managers and Certification Regime to almost all regulated firms will be implemented on 9 December 2019. This audit will consider management's plans on implementing SMCR.
Data quality	In addition to the requirements of the Pensions Regulator, the triennial valuation of the local government pension schemes, as at 31 March 2019, will be undertaken during 2019/20 and therefore it is essential that LPP is able to demonstrate that it holds accurate and complete member data and data held in manual spreadsheet reconciles to the data held in Altair. As part of this review we will also consider the process and controls in place to ensure the security of member data held outside of the Altair system.
HR and payroll compliance	An essential part of delivering LPP's business model is the maintenance of an effective HR and payroll function.
Core systems and infrastructure (phase 2)	Migration of the LPP network on to a private cloud is a key enabling activity for further change within the LPP businesses.

Coverage	Key risk areas
Covenant reporting	LPP provides a covenant risk advice to the Shareholder companies to assist the funds in managing their risk of an employer loss event. In order to manage its own risk LPP will need to make sure it has common processes in place to: deliver service; retain sufficient and appropriate evidence for advice given; and communicate finding to shareholders so they can make informed decisions on the level of employer risk they are prepared to accept.

## 5 Audit assurance levels and classification of residual risks

5.1 The assurance levels and classification of risks within Lancashire County Council's Internal Audit Service for 2018/19 are as follows.

### Assurance levels

Assurance may address the adequacy of the control framework's design, the effectiveness of the controls in operation, or both. The wording below addresses all of these options.

**Substantial assurance:** the framework of control is adequately designed and/or effectively operated.

**Moderate assurance:** the framework of control is adequately designed and/or effectively operated overall, but some action is required to enhance aspects of it and/or ensure that it is effectively operated throughout the service, system or process.

**Limited assurance:** there are some significant weaknesses in the design and/or operation of the framework of control that put the achievement of the service, system or process' objectives at risk.

**No assurance:** there are some fundamental weaknesses in the design and/or operation of the framework of control that could result in failure to achieve the service, system or process' objectives.

### Classification of residual risks requiring management action

**Extreme residual risk:** critical and urgent in that failure to address the risk could lead to one or more of the following: catastrophic loss of the county council's services, loss of life, significant environmental damage or significant financial loss, with related national press coverage and substantial damage to the council's reputation. Remedial action must be taken immediately.

**High residual risk:** critical in that failure to address the issue or progress the work would lead to one or more of the following: failure to achieve organisational objectives, significant disruption to the council's business or to users of its services, significant financial loss, inefficient use of resources, failure to comply with law or regulations, or damage to the council's reputation. Remedial action must be taken urgently.

**Medium residual risk:** failure to address the issue or progress the work could impact on operational objectives and should be of concern to senior management. Prompt specific action should be taken.

**Low residual risk:** matters that individually have no major impact on achieving the service's objectives, but where combined with others could give cause for concern. Specific remedial action is desirable.

**Internal audit assurance for the Pension Fund Committee**

5.2 The overall risk ratings applied by Deloitte to its reports, and the descriptions of risk mitigation and control effectiveness are as follows.

<b>Overall report rating</b>	<b>Description of risk mitigation and control effectiveness</b>
Ineffective	Risk mitigation or control absent or ineffective – high risk of failure in prevention, detection, and risk mitigation and/ or control activities for audited functions, processes and activities. Multiple high priority findings/ issues or significant number of either high or medium priority findings/ issues.
Effective with scope for improvement	Risk mitigation activities and controls may be compromised or fail – moderate risk of failure in risk mitigation and control with some need and justification to improve risk mitigation and control activities for audited functions, processes and activities. Some high priority issues or a significant number of medium and low priority findings/ issues.
Effective	Compliant (adequate in the circumstances) – low risk of failure in risk mitigation and control and some scope or justification to improve risk mitigation and control activities for audited functions, processes and activities. No high priority findings/ issues. Some moderate and low priority findings/ issues.

<b>Risk rating</b>	<b>Description of risk mitigation and control effectiveness</b>
High	The issue presents a risk that involves a direct exposure to significant assets or a significant potential financial loss. Lack of appropriate controls could have a considerable impact on operations, compliance with laws and regulations, or financial results.
Medium	The issue presents a risk, which involves an indirect exposure to significant assets and could have a moderate impact on operations, compliance with laws and regulations, or financial results.
Low	The issue and associated risks have limited impact on operations, compliance with laws and regulations, or financial results.