

## **Appendix 'A'**

**Lancashire County Council: Pension Fund**

**Internal Audit Service**

**Annual report for the year ended 31 March 2011**





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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 2010 to 31 March 2011.

### ***Acknowledgements***

- 1.3 We are grateful for the assistance that has been provided to us by staff across 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 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 Lancashire Pensions Service has been under particular pressure during 2010/11 arising from the additional work involved both in processing the abnormal level of redundancies required this year across the scheme's employers and also from the implementation of the new pensions administration system, Altair. Given this backdrop it is particularly pleasing to report that we are able to provide substantial assurance over the pensions administration procedures operated during the year which included consideration of the:

- transfer of data to the new system and the integrity of data held on the new system;
- authorisation of new members;
- retirement calculations;
- death grant calculations;
- employee and employer contributions to the scheme;
- transfers into and out of the scheme;
- payments through the pensions payroll system and;
- purchase of additional pension contributions.

- 2.5 In relation to the pension fund itself our work has encompassed three reviews consisting of the current global custodian arrangements, the property fund and third party assurance reports produced for three of the investment managers.
- 2.6 Due to the delay in tendering for the new global custodian contract we were not able to undertake the intended review of the new arrangements as indicated in our audit plan but instead we considered the adequacy and effectiveness of the transactional operations of the global custodian arrangements in 2010/11.
- 2.7 The audit work we performed allowed us to provide substantial assurance over the internal control environment. 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 Management Section. In addition, we verified that the management fees charged were correct.
- 2.8 The audit work we have undertaken for the property fund allows us to provide substantial assurance over the property portfolio. The activities and performance of the property fund investment manager is monitored on a regular basis by the Investment Panel and the Pension Fund Committee, and we were able to verify that the correct management fees had been charged.
- 2.9 We note that the fund's property management contract has not been tendered for over 25 years. Whilst performance of the property portfolio can be compared to benchmark returns and compared to other local authority property portfolio returns, there is no assurance that the charges being paid are currently competitive. We acknowledge that this position had already been identified by management and action is being taken to re-tender the contract at the earliest opportunity.

- 2.10 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.

***Fraud/ special investigations***

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

***Implications for the Annual Governance Statement***

- 2.12 On the basis of our work during 2010/11, we are aware of no internal control weakness that require disclosure in the Annual Governance Statement.

**3 Internal audit work undertaken**

- 3.1 Work carried out during 2010/11 was in accordance with the audit plan presented and approved by Audit Committee in April 2010 and the Pension Fund Committee in July 2010. 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. This shows that 101 days were spent on delivering the audit plan against planned audit activity of 120 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. Our report on pensions administration is still in draft but we feel it is appropriate to include our opinion in the summary of findings.
- 3.4 Action plans have been agreed in respect of all finalised audit reports. These set out the management responses to each of our recommendations, and indicate that positive action has been, or will be taken. Implementation of these plans will be followed up as part of our 2011/12 work.

***Internal audit plan 2011/12***

- 3.5 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.
- 3.6 The plan 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**

- 3.7 We have included audit resources to review the arrangements for investing funds under the revised investment strategy which was approved in December 2010. The revised strategy requires the fund to make a wider range of individual investment decisions, rather than simply placing funds with investment managers, and will involve implementing new procedures and processes.
- 3.8 We plan to undertake an overview of the governance arrangements currently operated for the pension fund which will include consideration of the current committee structure, and the liaison and reporting lines between members and senior officers in addition to the roles and responsibilities of key individuals associated with the pension fund. We also propose to review the new arrangements which will be introduced during the coming year following the re-tendering of the global custodian services. It is intended that there will be a more direct link between the new global custodian's own systems and the council's Oracle Financials system and we plan to audit the security and integrity of data passing over this link. We also plan to review the ongoing oversight by the council over the new global custodian's activity.
- 3.9 As part of the pension fund's 2011/12 business plan it is the intention to review the current fund manager mandates, with a view to re-tendering a number of them. We will review the adequacy of the processes employed for the procurement of one of the new investment managers.
- 3.10 From April 2011 the pension fund will have its own bank account, separate from that of the county council, and we propose to review the controls introduced for this new arrangement.
- 3.11 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.

## **Pension administration**

- 3.12 In the same way that we are required to consider controls over the county council's corporate financial systems, any assessment of the risks to the pension fund will require our assurance over the key controls over the administration of the fund. This year's work will be focussed on testing the key controls we documented as part of last year's review and the implementation of a new pensioner payroll system integrated within the pensions administration system.

## **4 Scope, responsibilities and assurance**

- 4.1 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***

- 4.2 We have prepared this report solely for Lancashire County Council. As you are aware, this report forms part of a continuing dialogue between the Internal Audit Service, the chief executive, Audit Committee and management of the council. It is not therefore intended to include every matter that came to our attention during each internal audit review.
- 4.3 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.

## **5 Summary of findings**

### ***Overall summary and assurance provided***

- 5.1 We have set out in the table on pages 7 to 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.
- 5.2 We have distilled the assurance into an assessment of the adequacy of each system, and its effectiveness in operation.



- 5.3 **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.
- 5.4 **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.
- 5.5 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.
- 5.6 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.
- 5.7 Ideally, a system will be adequately designed to achieve its control objectives, and operated effectively in practice.
- 5.8 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	
<b>Audit Areas</b>						
<b>Pensions administration – manual controls</b>	30	30	0	✓	✓	A draft report was issued in June 2011. The system is adequately designed and effectively operated. Since our last audit Lancashire Pensions Service has transferred over to the new Altair pensions administration system. During our audit we examined the controls surrounding the transfer of data to the new system and were satisfied with the reconciliations undertaken.
				Substantial assurance		
<b>Pensions administration – ICT controls</b>	20	7	13	-	-	Due to the pressures experienced by Lancashire Pensions Service this review has been delayed and will be completed and reported as part of 2011/12 audit plan, when we consider the new pension payment arrangements through the Altair system.
<b>Global custodian</b>	25	17	8	✓	✓	The final report was issued in May 2011. Information on investment activity is received from the global custodian and from investment managers and reconciled on a regular basis. Arrangements are in place to record transactions on the general ledger, though this needs to be done by manual journals. The process would be more efficient if the global custodian system interfaced with the general ledger. It is acknowledged that the Treasury Management Section is attempting to have this interface with the new global custodian contract.
				Substantial assurance		
<b>Property fund</b>	15	22	(7)	✓	✓	The final report was issued in April 2011. The main area of concern relating to the absence of tendering arrangements for a significant period of time has been recognised by management and action is being taken to rectify this position at the earliest opportunity.
				Substantial assurance		

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Review area	Audit days			Assurance		Key issues / Comments
	Planned	Actual	Variation	Adequacy	Effectiveness	
<b>Third party assurance reports</b>	10	11	(1)	✓	✓	The final report was issued in April 2011. 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		
<b>New bank account</b>	15	0	15	-	-	The new bank account was only introduced in April 2011 and this review has been rolled forward into the 2011/12 audit plan.
<b>Planning and management</b>	5	6	(1)	-	-	This time relates to the production of the annual plan and report, planning/ progress meetings and general advice.
<b>Prior year work</b>	0	8	(8)	-	-	This relates to the finalisation of the previous year's audit reviews.
<b>Total Days</b>	<b>120</b>	<b>101</b>	<b>19</b>			

## 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 Audit Committee and 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.