

# Annual governance report

Lancashire County Pension Fund

Audit 2011/12



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# Key messages

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## **This report summarises the findings from my 2011/12 audit of the Pension Fund financial statements which is substantially complete.**

As at 10 September 2012, my audit is substantially complete and I expect to issue an unqualified audit opinion and issue audit reports on the financial statements of the Pension Fund. The reports will cover:

- the Pension Fund's financial statements as presented in the Lancashire Pension Fund Annual Report; and
- the Pension Fund's financial statements as presented in the administering authority's accounts for Lancashire County Council.

### **Internal Control Environment**

The Fund has an adequate control environment in place overall. Officers have dealt effectively with significant events during the year without detriment to the control environment, including:

- implementation of new pensions payroll arrangements;
- the change in custodian arrangements including ensuring the accurate and complete transfer of assets;
- management of the new bank account arrangements;
- the procurement of new equity fund managers for 2012/13; and
- the purchase of new style infrastructure investments.

However, I report to you the need to address the potential misclassification of accounting entries between the County Council and the Pension Fund. This has continued despite the introduction of a separate bank account for the pension fund. Management action has been agreed to address this issue during 2012/13.

# Before I give my opinion

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**My report includes only matters of governance interest that have come to my attention in performing my audit. I have not designed my audit to identify all matters that might be relevant to you.**

## Independence

I can confirm that I have complied with the Auditing Practices Board's ethical standards for auditors, including ES 1 (revised) – Integrity, Objectivity and Independence.

I am aware of the following relationship that might constitute a threat to independence and that I am required to report to you. I have therefore put in place the following safeguard to reduce the threat.

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Table 1: **Threats and safeguards**

Threat	Safeguard
A member of the audit team is related to an officer within the pension administration section (Your Pension Service).	Our member of staff does not undertake, or have responsibility for the review of, any of our work relating to the work of the Pensions Service.

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The Audit Commission's Audit Practice has not undertaken any non-audit work for the Pension Fund during 2011/12.

## I ask the Audit Committee to:

- take note of the adjustments to the financial statements included in this report (page 5 and appendix 2);
- take note of the issues raised at page 7 and 8; and
- approve the letter of representation, provided alongside this report, on behalf of the Council and Pension Fund before I issue my opinion.

# Financial statements

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**The Pension Fund's financial statements are an important mechanism for the Pension Fund to account for its stewardship of public funds. As Members you have final responsibility for these statements. It is important that you consider my findings before you adopt the financial statements.**

## Opinion on the financial statements

Subject to satisfactory clearance of outstanding matters, I plan to issue an audit report including an unqualified opinion on the financial statements included within the Authority's Statement of Accounts and the financial statements included within the Pension Fund Annual Report. Appendix 1 contains copies of my draft audit reports.

## Uncorrected errors

There are no uncorrected errors within the financial statements of the Fund.

## Corrected errors

The audit work undertaken has identified the following item where the primary financial statements have been corrected.

- The investment assets balance and investments liabilities balance had been understated by £0.7m (as detailed at appendix 2).

In addition, a small number of amendments have been made to the accompanying disclosure notes to ensure disclosure requirements have been fully met and to improve accuracy.

None of the amendments have affected the underlying financial position of the Pension Fund.

## Specific risks and my findings

I reported to you in my 23 January 2012 Audit Plan the significant risks and areas where additional audit work was required, that I identified and considered relevant to my audit of your financial statements. In the table below I report to you my findings against each of these risks.

Table 2: **Risks and findings**

Risk	Finding
<p><b>Valuation of Private Equity and Infrastructure Investments</b></p> <p>The Fund has material investments of £287.5m at 31/3/12 placed in private equity funds and infrastructure assets. These assets are not traded on open markets, and the valuations are therefore subject to significant estimation.</p>	<p>I have evaluated and tested the controls operated by the pension fund and custodian in relation to the valuation of these assets. I have completed additional testing of a sample of valuations back to audited fund values taking into account subsequent transactions. I have not identified any issues to bring to your attention.</p>
<p><b>Implementation of New Pensions Payroll System</b></p> <p>A new pension payroll system was implemented during 2011, resulting in the payroll being run directly from the pension administration system. The ledger file development for the new system was not completed until February 2012 resulting in a significant delay in postings to the ledger for the new pensions payroll. The implementation of any new major financial system brings with it inherent risks of material misstatement and this is increased in this case due to the delay in being able to post entries to the ledger.</p>	<p>I have evaluated and tested the controls operating over the new payroll system including those to ensure an accurate and complete transfer of the figures into the ledger. I evaluated and relied upon internal audit testing of a sample of pension payments to ensure they were made to bona-fide pensioners, calculated and accounted for correctly. I completed a predictive analytical review based on previous years figures and known changes to obtain assurance about the overall completeness of the pension payments. The issues caused by the delay in being able to post amounts to the ledger have been resolved. I have not identified any issues to bring to your attention.</p>
<p><b>New Custodian</b></p> <p>The Fund entered into a new custodian contract that commenced in August 2011. This involved a change in provider of custodian services, and a resultant transfer of assets between custodians.</p>	<p>I have evaluated and tested the controls operated by the pension fund to ensure a complete and accurate transfer of assets between the Custodians. I have also reviewed the controls assurance report provided by the new custodian to ensure that their controls provide me with the expected level of assurance over the accuracy of the figures included within the pension fund financial statements. I have not identified any issues to bring to your attention. I have also tested the values provided by the custodian back to information from the various fund managers and pension fund records.</p>

## Significant weaknesses in internal control

It is the responsibility of the Pension Fund to develop and implement systems of internal financial control and to put in place proper arrangements to monitor their adequacy and effectiveness in practice. My responsibility as your auditor is to consider whether the Pension Fund has put adequate arrangements in place to satisfy itself that the systems of internal financial control are both adequate and effective in practice.

I have tested the controls of the Pension Fund only to the extent necessary for me to complete my audit. I am not expressing an opinion on the overall effectiveness of internal control. However, I have identified the following control weakness which I wish to bring to your attention.

In previous years the transactions of the pension fund have been made through the Council's bank account because a separate bank account was not maintained for the pension fund. This gave rise to a potential risk of misallocation of monies between the County Council and the Pension fund. Each year detailed work has been completed to ensure that the cash position between the County Council and the Pension Fund was correctly stated. Each year an adjustment was made between the pension fund and the Council to achieve a balanced position for the pension fund. This 'balancing adjustment' was thought to be necessary because of timing differences between the recording of transactions and the physical movement of cash. However, the amount was never fully reconciled.

From 30 March 2011, a separate pension fund bank account has been in operation. As a result, this issue was expected to be resolved.

However, it was considered impractical to move straight to a position where all transactions were made directly via the pension fund bank account. Instead daily transfers of cash were made between the Council's and pension fund's bank accounts on the basis of recorded transactions. In order to close the pension fund accounts a balancing adjustment of £1.2m between the Council and Pension Fund was required this year.

From the 1 April 2012, following the implementation of the new ledger system and a separate ledger for the pension fund, the bank account has operated fully. All transactions now go directly into the pension fund bank account. Finance staff plan to investigate the adjustment of £1.2m during 2012/13 with the aim of clearing this balance from the ledger by 31 March 2013. They also intend to ensure such un-reconciled balances do not exist going forwards. The new arrangements from 1 April 2012 should facilitate this with a monthly closedown possible and therefore earlier identification and resolution of any imbalance, should it occur.

I have performed detailed testing around this issue. I am satisfied that although there is potential for a non-material misclassification error between the two sets of accounts, there is unlikely to be a material error affecting either Lancashire Pension Fund or Lancashire County Council.

### Recommendation

**R1** Priority should be given to reconciling the pension fund balance on a monthly basis during 2012/13 with the aim of investigating any unexplained differences as quickly as possible. This work should include ensuring that the balance brought forwards from 2011/12 of £1.2m is investigated and addressed appropriately.

## Other matters

I am required to communicate to you significant findings from the audit and other matters that are significant to your oversight of the Pension Fund's financial reporting process including the following.

- Qualitative aspects of your accounting practices.
- Matters specifically required by other auditing standards to be communicated to those charged with governance. For example, issues about fraud, compliance with laws and regulations, external confirmations and related party transactions.
- Other audit matters of governance interest.

Changes to IAS 24 for 2011/12 require the inclusion of an extended disclosure note about the compensation of key management personnel. The CIPFA code for 2011/12 includes a specific dispensation from this requirement, instead following the regulatory disclosure requirements around remuneration of members and staff. The code is silent on whether this dispensation applies to the accounts of the pension fund. No disclosure has been made within the pension fund accounts of the compensation of key management personnel, but will be kept under review by the County Treasurer until the guidance is clarified.

## Pension Fund Annual Report

I have completed my review of the pension fund's draft report and the financial statements included within it. The annual report will be updated to reflect the agreed amendments on the Pension Fund accounts. I have also identified an inconsistency within the narrative within the report which refers to positive cash flows of £86.4m against the £94.3m presented in the accounts. Following amendment of the Annual report I expect to provide an unqualified report on the financial statements included in the Annual Report by 26 September 2012.



# Fees

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**I reported my planned audit fee in the 23 January 2012 Audit Plan.**

I will complete the audit within the planned fee.

# Appendix 1 – Draft independent auditor’s reports

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## **(i) DRAFT INDEPENDENT AUDITOR’S REPORT FOR THE FINANCIAL STATEMENTS OF THE COUNCIL**

### **INDEPENDENT AUDITOR’S REPORT TO THE MEMBERS OF LANCASHIRE COUNTY COUNCIL – PENSION FUND ELEMENT ONLY**

#### **Opinion on the pension fund financial statements**

I have audited the pension fund financial statements for the year ended 31 March 2012 under the Audit Commission Act 1998. The pension fund financial statements comprise the Fund Account, the Net Assets Statement and the related notes. The financial reporting framework that has been applied in their preparation is applicable law and the CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom 2011/12.

This report is made solely to the members of Lancashire County Council in accordance with Part II of the Audit Commission Act 1998 and for no other purpose, as set out in paragraph 48 of the Statement of Responsibilities of Auditors and Audited Bodies published by the Audit Commission in March 2010.

#### **Respective responsibilities of the County Treasurer and auditor**

As explained more fully in the Statement of the County Treasurer’s Responsibilities, the County Treasurer is responsible for the preparation of the Authority’s Statement of Accounts, which includes the pension fund financial statements, in accordance with proper practices as set out in the CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom, and for being satisfied that they give a true and fair view. My responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require me to comply with the Auditing Practices Board’s Ethical Standards for Auditors.

## Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the fund's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the County Treasurer; and the overall presentation of the financial statements. In addition, I read all the financial and non-financial information in the 'pensions fund operation and membership' section to identify material inconsistencies with the audited financial statements. If I become aware of any apparent material misstatements or inconsistencies I consider the implications for my report.

## Opinion on financial statements

In my opinion the pension fund's financial statements:

- give a true and fair view of the financial transactions of the pension fund during the year ended 31 March 2012 and the amount and disposition of the fund's assets and liabilities as at 31 March 2012; and
- have been properly prepared in accordance with the CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom.

## Opinion on other matters

In my opinion, the information given in the 'pensions fund operation and membership section' is consistent with the financial statements.

*[Signature]*

Karen Murray  
District Auditor

*[Address]*

*[Date]*

## **(ii) DRAFT INDEPENDENT AUDITOR'S REPORT FOR THE PENSION FUND ANNUAL REPORT**

### **INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF LANCASHIRE COUNTY COUNCIL**

#### **Opinion on the pension fund financial statements**

I have audited the pension fund financial statements for the year ended 31 March 2012 under the Audit Commission Act 1998. The pension fund financial statements comprise the Fund Account, the Net Assets Statement and the related notes. The financial reporting framework that has been applied in their preparation is applicable law and the CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom 2011/12.

This report is made solely to the members of Lancashire County Council in accordance with Part II of the Audit Commission Act 1998 and for no other purpose, as set out in paragraph 48 of the Statement of Responsibilities of Auditors and of Audited Bodies published by the Audit Commission in March 2010.

#### **Respective responsibilities of the County Treasurer and auditor**

As explained more fully in the Statement of the County Treasurer's Responsibilities, the County Treasurer is responsible for the preparation of the pension fund's financial statements and for being satisfied that they give a true and fair view. My responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require me to comply with the Auditing Practices Board's Ethical Standards for Auditors.

#### **Scope of the audit of the financial statements**

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the fund's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the County Treasurer; and the overall presentation of the financial statements. In addition, I read all the financial and non-financial information in the annual report to identify material inconsistencies with the audited financial statements. If I become aware of any apparent material misstatements or inconsistencies I consider the implications for my report.

#### **Opinion on financial statements**

In my opinion the pension fund's financial statements:

- give a true and fair view of the financial transactions of the pension fund during the year ended 31 March 2012 and the amount and disposition of the fund's assets and liabilities as at 31 March 2012; and
- have been prepared properly in accordance with the CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom 2011/12.

### **Opinion on other matters**

In my opinion, the information given in the annual report for the financial year for which the financial statements are prepared is consistent with the financial statements.

### **Matters on which I report by exception**

I report to you if, in my opinion the governance compliance statement does not reflect compliance with the Local Government Pension Scheme (Administration) Regulations 2008 and related guidance. I have nothing to report in this respect.

*[Signature]*

Karen Murray  
District Auditor

*[Address]*

*[Date]*

# Appendix 2 – Corrected errors

I identified the following errors during the audit which management have addressed in the revised financial statements.

		Fund Account		Net Assets Statement	
Item of account	Nature of error	Dr £m	Cr £m	Dr £m	Cr £m
Investment Assets	The total value of Investment Assets had been understated by £0.7m.			4,360.7	
	Corrected Value			4,361.4	
Investment Liabilities	The total value of Investment Liabilities had been understated by £0.7m.			(0.8)	
	Corrected Value			(1.5)	

The above amounts relate to the treatment of the derivative investments.

# Appendix 3 – Action Plan

## Recommendations

### Recommendation 1

Priority should be given to reconciling the pension fund balance on a monthly basis during 2012/13 with the aim of investigating any unexplained differences as quickly as possible. This work should include ensuring that the balance brought forwards from 2011/12 of £1.2m is investigated and addressed appropriately.

<b>Responsibility</b>	Deputy County Treasurer
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<b>Priority</b>	High
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<b>Date</b>	31/3/2012
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# Appendix 4 – Glossary

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## **Annual Audit Letter**

Letter issued by the auditor to the Pension Fund after the completion of the audit that summarises the audit work carried out in the period and significant issues arising from auditors' work.

## **Annual Governance Report**

The auditor's report on matters arising from the audit of the financial statements presented to those charged with governance before the auditor issues their opinion.

## **Audit of the accounts**

The audit of the accounts of an audited body comprises all work carried out by an auditor under the Code to meet their statutory responsibilities under the Audit Commission Act 1998.

## **Audited body**

A body to which the Audit Commission is responsible for appointing the external auditor.

## **Auditing Practices Board (APB)**

The body responsible in the UK for issuing auditing standards, ethical standards and associated guidance to auditors. Its objectives are to establish high standards of auditing that meet the developing needs of users of financial information and to ensure public confidence in the auditing process.

## **Auditing standards**

Pronouncements of the APB that contain basic principles and essential procedures with which auditors must comply, except where otherwise stated in the auditing standard concerned.

## **Auditor(s)**

Auditors appointed by the Audit Commission.



**Code (the)**

The Code of Audit Practice for local government bodies issued by the Audit Commission and approved by Parliament.

**Commission (the)**

The Audit Commission for Local Authorities and the National Health Service in England.

**Ethical Standards**

Pronouncements of the APB that contain basic principles relating to independence, integrity and objectivity that apply to the conduct of audits and with which auditors must comply, except where otherwise stated in the standard concerned.

**Financial statements**

The annual statement of accounts that the Pension Fund is required to prepare, which report the financial performance and financial position of the Pension Fund in accordance with the Accounts and Audit (England) Regulations 2011 and the Code of Practice on Local Authority Accounting in the United Kingdom.

**Internal control**

The whole system of controls, financial and otherwise, that the Pension Fund establishes to provide reasonable assurance of effective and efficient operations, internal financial control and compliance with laws and regulations.

**Materiality**

The APB defines this concept as ‘an expression of the relative significance or importance of a particular matter in the context of the financial statements as a whole. A matter is material if its omission would reasonably influence the decisions of an addressee of the auditor’s report; likewise a misstatement is material if it would have a similar influence. Materiality may also be considered in the context of any individual primary statement within the financial statements or of individual items included in them. Materiality is not capable of general mathematical definition, as it has both qualitative and quantitative aspects’.

The term ‘materiality’ applies only to the financial statements. Auditors appointed by the Commission have responsibilities and duties under statute, as well as their responsibility to give an opinion on the financial statements, which do not necessarily affect their opinion on the financial statements.

## **Pension Fund Annual Report**

The annual report, including financial statements, that the Pension Fund must publish under Regulation 34 of the Local Government Pension Scheme (Administration) Regulations 2008.

## **Significance**

The concept of 'significance' applies to these wider responsibilities and auditors adopt a level of significance that may differ from the materiality level applied to their audit of the financial statements. Significance has both qualitative and quantitative aspects.

## **Those charged with governance**

Those entrusted with the supervision, control and direction of the Pension Fund. This term includes the members of the Authority, [the Pension Panel] and the Audit Committee.

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- any director/member or officer in their individual capacity; or
- any third party.

