

Pensions Audit Sub Committee

2.00p.m., Monday, 5 December 2016

Lothian Pension Fund – Internal Audit Update 2016/17

Item number	5.5
Report number	
Executive/routine	
Wards	All

Executive summary

The purpose of this report is to provide a summary of Internal Audit Activity during the period 1 September 2016 to 30 November 2016.

The activity planned for the financial year 2016/17 was based on the allocation of internal audit resource across the City of Edinburgh Council's (CEC) services and was approved by the Pensions Committee and by the Governance, Risk and Best Value Committee in March 2016.

Three internal audit reviews were planned for the 2016/17 year:

- A review of the procedures surrounding internally managed investments;
- An external vulnerability assessment for online modules accessible to employers and members of the Lothian Pension Funds; and
- A review of governance arrangements for the Lothian Pension Fund group.

The review of internally managed investments was considered at the September Pensions Audit Sub-Committee meeting. The other reviews are considered in this report.

Links

Coalition pledges

Council outcomes [CO26](#)

Single Outcome Agreement

Lothian Pension Fund – Internal Audit Update 2016/17

Recommendations

- 1.1 Committee is requested to:
- note the Internal Audit activity during the period 1 April to 31 August 2016;
 - note the matters arising from the Internal Audit review undertaken in this period; and
 - note the status of management actions from audits undertaken in 2015/16, and in 2016/17.

Background

Internal Audit Plan 2016/17

- 2.1 The internal audit plan for the Lothian Pension Fund (LPF) was set out in the Internal Audit report to the Pensions Committee on 15 March 2016.
- 2.2 The internal audit plan for the Fund is risk based with a focus on governance, risk and controls. The areas identified for inclusion in the plan were determined following discussions with LPF management and examination of risk registers.
- 2.3 The plan for 2016/7 included three planned Internal Audit reviews:
- a review of the procedures surrounding internally managed investments;
 - an external vulnerability assessment for online modules accessible to employers and members of the Lothian Pension Funds; and
 - a review of governance arrangements for the Lothian Pension Fund group.
- 2.4 The review of internally managed investments was reported to the Pensions Audit Sub-Committee in September. The other reviews are considered in this report.

Main report

Third party ICT supplier risk

- 3.1 We completed an external vulnerability assessment for online modules accessible to employers and members of the Lothian Pension Fund, which are operated by third party ICT suppliers. This review identified one high and one medium risk finding. Due to the sensitive nature of these findings, it is suggested that this audit report is considered in private as a 'B' agenda item.

Governance arrangements at the Lothian Pension Fund group

- 3.2 LPFE Ltd. and LPFI Ltd. were incorporated in February 2015 as arm's length companies within the Lothian Pension Fund group. We carried out a 'Review Recommend' over the Group's governance and HR arrangements: we identified the controls currently in place, assessed whether they were appropriate for the LPF Group in its current state of development, and identified areas where management may wish to enhance their processes and controls as the companies establish themselves and activity increases.
- 3.3 We also conducted a compliance audit of payroll controls, HMRC returns including corporation tax, employment taxes and V.A.T., and Companies House returns.
- 3.4 This review identified one medium and one low risk finding:

Summary of finding & management response	Grading
<p><i>Reward strategy</i></p> <p>Transparency of remuneration for LPFE Ltd employees would be enhanced by defining a reward strategy, which we would recommend is referred to the Pensions Committee for scrutiny as a 'B' agenda item.</p>	<p>Medium</p>
<p><i>Management response</i></p> <p>The LPFE Ltd Board is in the process of reviewing the reward strategy, which will be communicated to stakeholders.</p>	
<p><i>Companies House: termination of appointments</i></p> <p>There were delays in removing ex officio directors from the board of LPFE Ltd and LPFI Ltd when they left the Council, and in notifying Companies House. Companies House should be notified within 2 weeks when an appointment is terminated.</p>	<p>Low</p>
<p><i>Management response</i></p> <p>LPF accept this finding and will ensure that these matters are dealt with in a timely manner going forward.</p>	

- 3.5 For greater detail on the findings of this audit, including good practice identified and advisory findings from our 'Review Recommend' of HR and Governance arrangements, please see the full report which is in Appendix 1.

Open recommendations

- 4.1 At the end of each month, Internal Audit prepares a complete listing of all open recommendations across the Council and shares these with Management on a divisional or line of service basis. Internal Audit then invites management to identify which recommendations they consider to have been addressed or which are no longer relevant.
- 4.2 Internal Audit will review Management's supporting evidence for recommendations that Management consider to be closed and feedback their view on whether this is the case. Recommendations that are agreed as closed have their status updated in Internal Audit's records.
- 4.3 We conducted 3 Pension Fund specific reviews in 2015/16, and 1 review in Q1 2016/17. All recommendations from previous audit years are closed.

Review	Findings		
	High	Medium	Low
Immediate Payments	-	2	3
Pension Compliance	-	2	2
Externally managed investments	-	-	-
Total 15/16	-	4	5
Internally managed investments	-	-	3
Total 16/17	-	-	3

- 4.4 The total number of audit actions which remain open is set out below:

Review	Findings		
	High	Medium	Low
Pension Compliance	-	1	-
Internally Managed Investments	-	-	-
Total	-	1	-

- 4.5 There is one outstanding audit action from the Pension Compliance review completed in 2015/16. This concerned the requirement under Local Government Pension Scheme regulations to ring-fence any monies held by a local authority on behalf of a pension scheme in a separate account with a deposit taker.
- 4.6 Strain payments and pension contributions are now paid directly into the LPF bank account, and the holding account is cleared fully each month, which substantially reduces the amount held by the Council on behalf of LPF at any point in time. LPF has also been investigating setting up separate purchase and sales ledgers for the Fund, but this is dependent on the implementation of the Council's new ERP system which has been delayed until April 2017. As such this action remains open.

Measures of success

- 5.1 Alignment of the Internal Audit Plan to the key risks faced by the Fund to ensure governance is improved, responsibility is taken for corrective action and confidence in the management of risk is increased.

Financial impact

6.1 There are no direct financial implications.

Risk, policy, compliance and governance impact

7.1 There are no adverse impacts arising from this report.

Equalities impact

8.1 There are no adverse equalities impacts arising from this report.

Sustainability impact

9.1 There are no adverse sustainability impacts arising from this report.

Consultation and engagement

10.1 The Pension Board, comprising employer and member representatives, is integral to the governance of the Funds.

Background reading / external references

None.

Magnus Aitken, Chief Internal Auditor

E-mail: magnus.aitken@edinburgh.gov.uk | Tel: 0131 469 3143

Links

Coalition pledges

Council outcomes CO26 – The Council engages with stakeholders and works in partnerships to improve services and deliver agreed objectives.

Single Outcome Agreement

Appendices Appendix 1 – Governance of LPF Group

The City of Edinburgh Council

Internal Audit

Lothian Pension Fund

Governance of LPF Group

Final Report

November 2016

Contents

Executive summary	1
1. Background and scope	2
2. Review recommend	4
3. Detailed findings	6
Appendix 1 – Basis of our classifications	7
Appendix 2 – Terms of reference	8

This internal audit review is conducted for the City of Edinburgh Council under the auspices of the 2016/17 internal audit plan approved by the Governance, Risk and Best Value Committee in March 2016. The review is designed to help the City of Edinburgh Council assess and refine its internal control environment. It is not designed or intended to be suitable for any other purpose and should not be relied upon for any other purpose. The City of Edinburgh Council accepts no responsibility for any such reliance and disclaims all liability in relation thereto.

The internal audit work and reporting has been performed in line with the requirements of the Public Sector Internal Audit Standards (PSIAS) and as a result is not designed or intended to comply with any other auditing standards.

Although there is a number of specific recommendations included in this report to strengthen internal control, it is management's responsibility to design, implement and maintain an effective control framework, and for the prevention and detection of irregularities and fraud. This is an essential part of the efficient management of the City of Edinburgh Council. Communication of the issues and weaknesses arising from this audit does not absolve management of this responsibility. High and Critical risk findings will be raised with senior management and elected members as appropriate.

Executive summary

Total number of findings

Critical	0
High	0
Medium	1
Low	1
Advisory	2
Total	4

Summary of findings

LPFE Ltd. and LPFI Ltd. were incorporated in February 2015 as arm's length companies within the Lothian Pension Fund group. LPFI Ltd was dormant throughout 2015/16, receiving FCA authorisation in July 2016, while the transition of staff from City of Edinburgh Council to LPFE Ltd took place during 2015/16. A 'Review Recommend' was carried out over the Group's governance and HR arrangements given that the LPF Group companies are only recently established: we identified the controls currently in place, assessed whether they were appropriate for the LPF Group in its current state of development, and identified areas where management may wish to enhance their processes and controls as the companies establish themselves and activity increases.

We also conducted a compliance audit of payroll controls, of HMRC returns including corporation tax, employment taxes and V.A.T., and of Companies House returns.

From the review the following areas of good practice were identified:

- HMRC returns are submitted accurately and on time.
- Payments to LPFE Ltd employees are valid, complete and accurate.
- There is clear accountability for and oversight of the activities of LPFE Ltd and LPFI Ltd, and transparency over the use of public funds.
- There is clarity over the HR policies and procedures which apply to employees of LPFE Ltd.
- There is adequate scrutiny of remuneration for LPFE Ltd employees.

The following areas for improvement were identified:

- Transparency of remuneration would be enhanced by defining a reward strategy.
- Companies House should be notified within 2 weeks when an ex officio directorship is terminated because the officer has left the Council.

There were two advisory findings arising from the 'review recommend' of HR and governance arrangements:

- As LPFI Ltd begins to offer investment services to external bodies, management should consider

developing a standard reporting package to give those organisations information about investment strategy and performance, and assurance over investment controls in place at LPFI Ltd.

- Management should satisfy themselves that auditor independence is not impaired by non-audit services and consider obtaining audit committee approval for non-audit services provided by the external auditors of LPFI and LPFE Ltd.

Our detailed findings and recommendations are laid out within Section 2: *Review Recommend* and Section 3: *Detailed findings*.

1. Background

Background

LPFE Ltd. (LPFE) and LPFI Ltd. (LPFI) were incorporated as limited companies wholly owned by the City of Edinburgh Council in February 2015. They were set up to enable Lothian Pension Fund (LPF) to develop its investment management function and seek FCA authorisation for LPFI (awarded in July 2016). 11 members of the LPF investment and management teams transferred their employment to LPFE in 2015. These staff are seconded to LPFI, City of Edinburgh Council (as administrators of LPF) and to Falkirk Council.

This audit took two parts: a compliance audit of payroll controls, HMRC returns including corporation tax, employment taxes and V.A.T., and of Companies House returns; and a 'Review Recommend' of the developing governance and HR arrangements. See Appendix 2 for the full terms of reference.

Payroll and Compliance

LPFE has appointed Scott Moncrieff as its payroll service provider with 121 HR Solutions providing HR support. Scott Moncrieff maintains payroll records, processes the monthly payroll, and administers PAYE and other HMRC returns. Scott Moncrieff also administers corporation tax for LPFE and LPFI.

We reviewed the design and operating effectiveness of payroll controls, and the accuracy of a sample of payments. There was sufficient segregation of duties over the monthly payroll at LPFE, with payroll input approved by 2 authorised signatories before it is processed by Scott Moncrieff, and variation reports and BACS reports then reviewed by 2 of the 4 authorised signatories before the payment is processed. The payments in the sample reviewed were found to be accurate.

Companies House and HMRC returns were timely and accurate, with the exception of notifications due to Companies House when a new director is appointed. See Finding 2.

Governance and HR Arrangements

LPFE and LPFI operate as arm's length external organisations, with City of Edinburgh Council (as Lothian Pension Fund) their primary client. This is a new arrangement and as such it is important that there is clarity over the governance arrangements to maintain accountability and transparency over the use of public funds, while enabling LPF to develop its investment management function through the two companies.

LPFE was set up as an employment services company, with 11 members of the investment and management teams transferring their employment to LPFE from CEC in 2015. LPFE appointed 121 HR Solutions Ltd to provide HR services and advise on the development of employment contracts and HR policies. PwC were appointed to benchmark salaries against market rates and advise on remuneration. Salaries were approved by the Board in December 2015, and employment contracts were signed in April 2016.

We have reviewed the governance and HR arrangements currently in place at LPFE and LPFI, and assessed their suitability for the Group in its current stage of development. Our assessment is detailed in Section 2: *Review Recommend*.

2. Review Recommend


Objective	Existing Controls	Findings
<p>There is clear accountability for and oversight of the activities of LPFE Ltd and LPFI Ltd, and transparency over the use of public funds.</p>	<ul style="list-style-type: none"> - The Pensions Audit Sub-Committee is responsible for the scrutiny of LPF arm's length companies. It receives an annual report, which includes an overview of the governance arrangements and activity during the year, and the audited financial statements. - The Pensions Audit Sub-Committee has been briefed on the strategic direction of LPFI Ltd at key stages. Due to the commercial sensitivity of LPFI's activities, these updates have appeared on the 'B' agenda, which seems appropriate. - The Pensions Committee will continue to receive annual reports on the performance of the Funds, investment controls and the investment strategy. - The Council's Executive Director of Resources is a director of both LPFE and LPFI. An elected member and Chair of the Pensions Committee also acts as Chair of the LPFE Board. - LPFI is currently recruiting a non-executive director to enhance scrutiny and bring membership in line with the UK Corporate Governance Code. 	<p>Investment reporting (Advisory)</p> <p>We consider that the current governance and reporting arrangements in the LPF Group are satisfactory. Members and senior Council officers will continue to receive full reporting on investment strategy, performance and controls for the Lothian Pension Funds. This reporting should enable members to assess the impact of increased activity by LPFI on the Funds.</p> <p>As LPFI grows and offers investment advisory services to external organisations, management should review the investment reporting package. Depending on the services provided by LPFI, LGPS clients are likely to require a suite of reports to enable their Investments and Pensions Committees to monitor the performance of funds and to give them assurance over the controls in place at LPFI. As a minimum we would expect this to include an investment strategy, investment performance reporting, and a controls report.</p> <p><i>Management response: LPFI will not necessarily have an ongoing relationship with each pension fund once the investment is made, or a role in monitoring and reporting on the investments. Nevertheless, where appropriate to the relationship with that pension fund, we agree that reporting will need to be reviewed.</i></p>

<p>There is clarity over the HR policies and procedures which apply to employees of LPFE Ltd.</p>	<ul style="list-style-type: none"> - All LPFE Ltd employees have signed an employment contract which is supported by an employee handbook. The handbook sets out the policies of LPFE Ltd, including a code of conduct, relevant financial sector policies such as anti-bribery, and performance and absence management policies. The handbook was developed with the support of an external HR provider. 	<p>None</p>
<p>There is adequate scrutiny of remuneration for LPFE Ltd employees.</p>	<ul style="list-style-type: none"> - An external provider was appointed to benchmark salaries and recommend a pay structure. The starting salaries of LPFE employees are within the recommended ranges. - Pay scales and starting salaries were approved by the LPFE Board. - Three of the four members of the LPFE Board are not employees of LPFE. Membership comprises an elected member and Chair of the Pensions Committee, the Council's Head of HR, the Council's Executive Director of Resources, and the Chief Executive of Lothian Pension Fund. 	<p>Reward strategy (Medium)</p> <p>The LPFE Board has not yet defined a reward strategy establishing the principles they will use to set remuneration. The benchmarking exercise is currently being repeated to determine salaries for 2016/17, and inform the development of a performance-related pay scheme, if the Board decides to introduce one.</p> <p>Given that the establishment of an employment service company is a new development for the Council, it is likely to attract significant scrutiny from members. Defining a reward strategy may be an effective way of assuring members that salaries are set at a level which does deliver best value, and within agreed parameters.</p> <p><i>See Finding 1.</i></p> <p>Non-audit services (Advisory)</p> <p>Scott Moncrieff is the payroll provider for LPFE and also its external auditor. This arrangement is permitted for a non-regulated company such as LPFE, but we would recommend that management satisfy themselves that there is sufficient separation between Scott Moncrieff's payroll and audit services, and that it does not affect the firm's ability to provide an independent</p>

		<p>audit. We would also recommend that management consider obtaining audit committee approval for non-audit services provided by the company's external auditor.</p> <p><i>Management response: Agreed. We will report to Committee on non-audit services provided by Scott Moncrieff by 31 March 2017.</i></p>
--	--	---

2. Detailed findings

1. Reward strategy

Findings	
<p>The salaries of LPFE Ltd employees were finalised in February 2016 following a benchmarking exercise undertaken by PwC. The starting salaries approved by the LPFE Board were within the range recommended by PwC, and in the lower- to mid- quartiles when benchmarked against similar roles.</p> <p>Pay brackets for each role were approved by the Board, but at present there is no mechanism (such as a performance-related pay scheme) for employees to progress from their starting salary within that bracket. As such, the benchmarking exercise has been repeated, and the Board will be considering options for salary points and performance-related pay in the near future.</p> <p>We note that stakeholders have expressed a wish to be briefed on reward at LPFE Ltd, now that the employees are removed from the Council's pay structure. There are barriers to doing this in a public forum due to the commercial sensitivity of the payroll information, and that, due to the small number of employees, individuals would be identifiable.</p>	
Business Implication	Finding Rating
<p>The Pensions Board and elected members may not have the desired assurance that salaries are reasonable and constitute best value for LPF, while addressing the staff recruitment and retention risk.</p>	

Action plans	
Recommendation	Responsible Officer
<p>We recommend that the LPFE Ltd Board agrees a Reward Strategy, which is referred to the Pensions Committee as a 'B' agenda item. This should set out the principles the Board uses in setting pay (for example, pay is benchmarked every 3 years to the lower quartile), the salary range for each banding, and an outline of how employees can progress within their banding.</p> <p>We note that, as a director of LPFE Ltd, the chief executive's salary is published anyway. It may therefore be appropriate to obtain Committee approval for this pay point.</p>	Chief Executive Officer
Agreed Management Action	Estimated Implementation Date
<p>Agreed. The LPFE Board is in the process of reviewing reward strategy and this will be communicated to stakeholders.</p> <p>Committee's approval for the Chief Executive Officer remuneration will be obtained.</p>	31 March 2017

2. Companies House: Termination of Appointment

Findings

Companies are required to register a change of director with Companies House within 2 weeks of the appointment or termination.

We reviewed Companies House records and noted that:

- Alistair Maclean was listed as a director of LPFI Ltd and LPFE Ltd until 19 January and 19 February 2016 respectively, but left the Council in December 2015. The termination of his appointment was not filed with Companies House until 23 March 2016.
- Linda Holden left the Council in July 2015 but remained a director of LPFE Ltd until 10 December 2015. The termination of her appointment was not filed with Companies House until 23 March 2016.
- Martin Glover is currently listed as a director of LPFE Ltd, but left the Council in August 2016.

Business Implication

- A former employee of the Council who no longer attends board meetings is legally a director of LPFE Ltd.
- Companies House filing deadlines have not been met.

Finding Rating

Low

Action plans

Recommendation

Where a Council officer is a board member in an ex officio post, the appointment should be terminated when they resign from their Council post. Arrangements should be made with the Council's HR department and the director themselves to ensure that the LPF Group is notified promptly when a director tenders their resignation, and that all necessary paperwork to remove them as legal directors of the company is completed before they leave the Council.

The resignation or appointment of a director should be registered with Companies House within 2 weeks.

Responsible Officer

Chief Risk Officer

Agreed Management Action

Agreed. We will ensure that matters are dealt with in a timely manner going forward.

Estimated Implementation Date

31 December 2016

Appendix 1 - Basis of our classifications

Finding rating	Assessment rationale
Critical	<p>A finding that could have a:</p> <ul style="list-style-type: none"> • Critical impact on operational performance; or • Critical monetary or financial statement impact; or • Critical breach in laws and regulations that could result in material fines or consequences; or • Critical impact on the reputation or brand of the organisation which could threaten its future viability.
High	<p>A finding that could have a:</p> <ul style="list-style-type: none"> • Significant impact on operational performance; or • Significant monetary or financial statement impact; or • Significant breach in laws and regulations resulting in significant fines and consequences; or • Significant impact on the reputation or brand of the organisation.
Medium	<p>A finding that could have a:</p> <ul style="list-style-type: none"> • Moderate impact on operational performance; or • Moderate monetary or financial statement impact; or • Moderate breach in laws and regulations resulting in fines and consequences; or • Moderate impact on the reputation or brand of the organisation.
Low	<p>A finding that could have a:</p> <ul style="list-style-type: none"> • Minor impact on the organisation's operational performance ; or • Minor monetary or financial statement impact; or • Minor breach in laws and regulations with limited consequences; or • Minor impact on the reputation of the organisation.
Advisory	<p>A finding that does not have a risk impact but has been raised to highlight areas of inefficiencies or good practice.</p>

Appendix 2 – Terms of Reference

To: Hugh Dunn

From: Gemma Dalton
Principal Audit Manager

Date: 16 August 2016

Cc: Clare Scott, John Burns, Struan Fairbairn

This review is being undertaken as part of the 2016/17 internal audit plan approved by the Pension Committee in March 2016.

Background

LPFE Ltd and LPFI Ltd were incorporated as limited companies wholly owned by the City of Edinburgh Council in February 2015. They were set up to enable Lothian Pension Fund (LPF) to develop its investment management function and seek FCA authorisation for LPFI (awarded in July 2016). 11 members of the LPF investment and management teams transferred their employment to LPFE Ltd in 2015. These staff are seconded to LPFI Limited, City of Edinburgh Council (as administrators of LPF) and to Falkirk Council.

Scope

The scope of this review will be to assess the LPF group's governance arrangements, and assess the design and operating effectiveness of the Council's controls relating to HR and payroll for staff employed by LPFE Ltd.

The sub-processes and related control objectives included in the review are:

Sub-process	Control Objectives
Governance	<ul style="list-style-type: none">• There is clear accountability for and oversight of the activities of LPFE Ltd and LPFI Ltd, and transparency over the use of public funds.• Required Companies House and other regulatory and/or statutory returns are submitted accurately and on time.• HMRC returns are submitted accurately and on time.
HR & Payroll	<ul style="list-style-type: none">• There is clarity over the HR policies and procedures which apply to employees of LPFE Ltd (e.g. employment contract, code of conduct, absence, performance, disciplinary).• There is adequate scrutiny of remuneration for LPFE Ltd employees.• Payments to LPFE Ltd employees are valid, complete and accurate.

Limitations of Scope

The scope of our review is outlined above. Testing will be undertaken on a sample basis for the period 1 May 2015 to 31 August 2016.

Approach

The City of Edinburgh Council
Internal Audit Report – Governance of LPF Group

Our audit approach is as follows:

- Obtain an understanding of LPF group governance, HR and payroll through discussions with key personnel, review of systems documentation and walkthrough tests;
- Identify the key risks around LPF group governance, taxation and HR and payroll;
- Evaluate the design of the controls in place to address the key risks; and
- Test the operating effectiveness of the key controls.

Internal Audit Team

Name	Role	Contact Details
Magnus Aitken	Chief Internal Auditor	0131 469 3143
Gemma Dalton	Principal Audit Manager	0131 469 3077

Key Contacts

Name	Title	Role	Contact Details
Hugh Dunn	Acting Executive Director of Resources	Review Sponsor	0131 469 3150
Clare Scott	Chief Executive Officer	Key contact	0131 469 3865
John Burns	Chief Finance Officer	Key contact	0131 469 3711
Struan Fairbairn	Chief Risk Officer	Key contact	0131 529 4689
Esmond Hamilton	Financial Controller	Key contact	0131 469 3521

Timetable

Fieldwork Start	30 August 2016
Fieldwork Completed	14 September 2016
Draft report to Auditee	16 September 2016
Response from Auditee	7 October 2016
Final Report to Auditee	14 October 2016

Follow Up Process

Where reportable audit findings are identified, the extent to which each recommendation has been implemented will be reviewed in accordance with estimated implementation dates outlined in the final report.

Evidence should be prepared and submitted to Audit in support of action taken to implement recommendations.

Actions remain outstanding until suitable evidence is provided to close them down.

Monitoring of outstanding management actions is undertaken via monthly updates to the Director and his business manager. The business manager liaises with service areas to ensure that updates and appropriate evidence are provided when required.

Details of outstanding actions are reported to the Governance, Risk & Best Value (GRBV) Committee on a quarterly basis.

Appendix 1: Information Request

It would be helpful to have the following available prior to our audit or at the latest our first day of field work:

- Legal pack for LPFE Ltd and LPFI Ltd
- Service agreements with CEC, LPFE/LPFI Ltd, and Falkirk Council
- Agreements with external service providers

This list is not intended to be exhaustive; we may require additional information during the audit which we will bring to your attention at the earliest opportunity.