



## **Pensions Committee**

29 June 2022, 2pm

### **Lothian Pension Fund - Internal Audit Opinion and Annual Report for the Year Ended 31 March 2022**

#### **1. Recommendations**

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The Pensions Committee is requested to:

- note the Internal Audit opinion for Lothian Pension Fund (LPF) for the year ended 31 March 2022.

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# Lothian Pension Fund - Internal Audit Opinion and Annual Report for the Year Ended 31 March 2022

## 2. Executive Summary

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- 2.1 This report details Internal Audit's (IA) annual opinion for Lothian Pension Fund (LPF) for the year ended 31 March 2022. Our opinion is based on the outcomes of four audits included in the LPF 2021/2022 IA annual plan, and the status of LPF's open and overdue IA findings at 31 March 2022.
- 2.2 IA considers that the LPF control environment and governance and risk management frameworks require some improvement, and is therefore reporting a limited 'amber' (some improvement required) rated opinion (see Appendix 1), with our assessment towards the lower end of this category, moving towards the green (effective) category, which is aligned with the 2020/21 IA opinion.
- 2.3 This opinion is 'limited' as IA does not provide assurance across the full population of LPF risks.
- 2.4 Consequently, the Committee should consider the assurance outcomes provided by other sources when forming their view on the design and effectiveness of LPF's control environment and governance and risk management frameworks.
- 2.5 The key themes emerging from the outcomes of the four completed 2021/22 audits confirm that whilst LPF continues to effectively manage the risks associated with ongoing operational fund management activities, further improvement to both the established risk and project management frameworks would be beneficial. These areas for improvement are particularly important as LPF may now be moving into a period of significant strategic and operational change.
- 2.6 LPF management has advised that activities are in progress to further improve the established risk and project management frameworks, including enhanced technology and change governance arrangements; leveraging good practice from external project management consultants engaged to support LPF; and establishing a new supplier management framework. It is IA's opinion that if these frameworks are appropriately designed and effectively implemented, this will support more effective delivery of projects and identification; assessment; and ongoing management or both strategic and operational risks.

## 3. Background

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- 3.1 The Public Sector Internal Audit Standards (PSIAS) provide a coherent and consistent internal audit framework for public sector organisations. Adoption of the PSIAS is

mandatory for IA teams within UK public sector organisations, and PSIAS require annual reporting on conformance.

- 3.2 It is the responsibility of the Council's Chief Internal Auditor to provide an independent and objective annual opinion on the adequacy and effectiveness of LPF's control environment and governance and risk management frameworks in line with PSIAS requirements. The opinion is usually provided to the Pensions Audit Sub-Committee, and should be used to inform the LPF Annual Governance Statement.
- 3.3 Our opinion is based on the outcome of LPF audits completed in the 2021/22 financial year, and the status of open internal audit findings at 31 March 2022.
- 3.4 Whilst LPF's dependence on the City of Edinburgh Council for support services has significantly reduced following the transition of LPF technology services from the Council to external third parties, some elements remain (for example, dependence on Procurement; Information Governance; and Committee Services). Consequently, we have considered the outcomes of any relevant audits completed in these areas as part of the LPF annual opinion.
- 3.5 The Council's 2021/22 annual IA opinion will be presented to the Governance, Risk, and Best Value Committee in August 2022. A further update will be provided to the next Pensions Committee on the potential impact of the Council's annual opinion outcomes on LPF.

## **4. Main Report**

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### **4.1 2021/22 Internal Audit Opinion**

- 4.1.1 IA considers that the LPF control environment and governance and risk management frameworks require some improvement, and is therefore reporting a limited 'amber' rated opinion (see Appendix 1), with our assessment towards the lower end of this category, moving towards the green (effective) category, which is aligned with the 2020/21 IA opinion.
- 4.1.2 The opinion reflects some moderate and minor areas of weakness in the LPF control environment and governance and risk management frameworks identified from the audits performed, and the risks associated with open IA findings as at 31<sup>st</sup> March 2022 that could potentially impact achievement of LPF's organisational objectives.
- 4.1.3 The opinion is 'limited' as IA does not provide assurance across the full population of LPF risks.
- 4.1.4 IA is not the only source of assurance provided to LPF as there are a number of additional assurance sources (for example, external audit who provide assurance on the LPF financial statements and key financial controls, and reviews performed by BDO; Mercer; and Bridewell) that the Committee should consider when forming

their view on the design and effectiveness of the LPF control environment and governance and risk management frameworks.

- 4.1.5 This opinion is subject to the inherent limitations of IA (covering both the control environment and the assurance provided over controls) as set out in Appendix 2.

## **4.2 Audit outcomes**

- 4.2.1 Four IA reviews were completed during the year, with three assessed as 'Effective' (green); and one as 'Some Improvement Required' (amber). Further detail is included below and also at Appendix 3.

### **Technology Model Development – some improvement required (amber)**

- 4.2.2 Our review of the key project management controls established to support implementation of the new LPF technology and assurance arrangements confirmed that whilst the project was effectively delivered, some improvement was required. This outcome reflected a significant key person dependency for project delivery, and the need to improve project governance, risk management, and testing arrangements.

- 4.2.3 Three medium (amber) rated IA findings were raised highlighting the need to ensure that for future projects:

- a project risk appetite is established to support decision making;
- more granular plans are developed to support elements of the project (for example data cleansing and migration);
- assurance recommendations are recorded and their implementation progress monitored throughout the project;
- comprehensive 'go/no go' decision criteria are established;
- all project decisions are recorded; and
- a post implementation review is completed.

### **Risk Management – Some Improvement Required (green)**

- 4.2.4 Our review of LPF's risk management arrangements confirmed that the established risk management processes and governance arrangements are appropriately designed given the size and scale of LPF, and operating effectively.

- 4.2.5 One medium and two low rated findings were raised reflecting the need for LPF to:

- confirm completeness of the current population of corporate risks and align them with strategic objectives;
- provide a clear definition for ratings currently used to assess risk;
- ensure that risks and controls are clearly articulated in operational risk registers;
- include risk management training in the new employee induction process.

- 4.2.6 Whilst the overall report rating and the rating of findings raised have been agreed, LPF and IA are currently agreeing LPF's management responses to IA's recommendations. It is expected that these will be finalised by September 2021, with the final report then presented to the Pensions Audit Sub-Committee for review and scrutiny.

#### **Capital Calls – effective (green)**

- 4.2.7 We confirmed that the LPF capital calls process (where investment firms drawdown of a portion of funds committed to them by an investor) was adequately designed and operating effectively, providing assurance that all capital calls are processed in line with established capital call agreements.
- 4.2.8 One low rated finding was raised reflecting the need to update one procedure document supporting the capital calls process.

#### **Employer Contributions**

- 4.2.9 We also confirmed that the LPF employers contribution process was adequately designed and operating effectively, providing assurance that employer contributions are paid to the Fund in line with Fund regulations and requirements.
- 4.2.10 Four low rated findings were raised highlighting the need to:
- regularly review policies and procedures to confirm alignment with current legislation and work practices;
  - ensure that all differences between actual and expected employer contributions are investigated and resolved in a timely manner;
  - recommend that the Pensions Committee delegates authority to LPF to deal with an exceptions that fall below an agreed materiality threshold;
  - upgrade the technology portal currently used to enable automated comparison between actual and expected contributions.

#### **4.3 Status of Internal Audit Findings as at 31 March 2022**

- 4.3.1 LPF had one medium overdue IA finding as at 31 March 2022 that related to the Settlement and Custodian Services review completed in June 2020 highlighting the need to improve regulatory and risk management oversight of custodian processes performed by Northern Trust.
- 4.3.2 Evidence had been provided by LPF on 9th February 2021 to support closure of this finding, however this did not fully address the risks raised in the original finding.
- 4.3.3 Implementation progress was then reviewed as part of the Risk Management audit completed in June 2022, and this finding has now been closed. Management has also confirmed that supplier risks will be an area of focus in the new supplier management framework that is currently being implemented.

#### **4.4 Comparison to prior year**

- 4.4.1 An amber rated opinion was also reported in 2020/21 with IA's assessment towards the lower end of this category.
- 4.4.2 A direct comparison between annual Internal Audit opinions is not always possible as the scope of the audits included in the annual plans and the risks associated with open and overdue IA findings will vary in line with the changing LPF risk profile.
- 4.4.3 The 2020/21 low-category amber rated opinion was directly attributable to the outcomes of the two reviews completed, assessed as amber (some improvement required); and green (effective) with a total of 4 (1 high; 2 medium; and 1 low) IA findings raised.
- 4.4.4 Similarly, the outcomes of the four LPF audits completed in the 2021/22 financial year were assessed as one amber (some improvement required) and three green (effective) with a total of 12 (4 medium; and 8 low) IA findings raised, resulting in the assessment remaining at the lower end of this category.
- 4.4.5 This increased number of findings is mainly attributable to the nature of the areas reviewed (most notably the project management framework, which is an essential part of the LPF strategy) and their associated risks, and the increased number of audits (four) completed in the current year in comparison to 2020/21 (two).
- 4.4.6 Additionally, the status of open IA findings at 31 March 2022 remains aligned with the same medium rated finding remaining overdue. This finding has now been closed on the basis of work completed in the 2021/22 Risk Management review, and management's confirmation that ongoing focus on supplier risk will be included in the new supplier management framework that is currently being implemented.
- 4.4.7 Further detail is included at Appendices 3 and 4.

#### **4.5 Internal Audit Independence and Conformance with Public Sector Internal Audit Standards**

- 4.5.1 PSIAS require that IA must be independent and that internal auditors must be objective in performing their work. To ensure conformance with these requirements, IA has established processes to ensure that both team and personal independence is consistently maintained and that any potential conflicts of interest are effectively managed.
- 4.5.2 We do not consider that we have faced any significant threats to our independence during 2021/22, nor do we consider that we have faced any inappropriate scope or resource limitations when completing our work.
- 4.5.3 IA has fully conformed with PSIAS requirements during the period 1 April 2021 to 31 March 2022.

## 5. Financial impact

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- 5.1 There are no direct financial impacts arising from this report, although failure to close IA findings raised and address the associated risks in a timely manner may have some inherent financial impact where associated financial risks have been identified.

## 6. Stakeholder/Regulatory Impact

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- 6.1 IA findings are raised as a result of control gaps or deficiencies identified during audits. If agreed management actions are not implemented to support closure of Internal Audit findings, LPF will be exposed to the risks set out in the relevant IA reports.

## 7. Background reading/external references

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- 7.1 [Public Sector Internal Audit Standards](#)
- 7.2 [Agile Auditing and Consultancy Support – Paper 8.2](#)

## 8. Appendices

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- Appendix 1 Internal Audit Annual Opinion Definitions
- Appendix 2 Limitations and responsibilities of internal audit and management responsibilities
- Appendix 3 Prior Year Comparisons
- Appendix 4 Status of LPF Internal Audit Findings at 31 March 2022
- Appendix 5 Final report – Risk Management

# Appendix 1 – Internal Audit Annual Opinion Definitions

The PSIAS require the provision of an annual Internal Audit opinion, but do not provide any methodology or guidance detailing how the opinion should be defined. We have adopted the approach set out below to form an opinion for Lothian Pension Fund.

We consider that there are 4 possible opinion types that could apply to LPF. These are detailed below:

<b>1. Effective</b>	The control environment and governance and risk management frameworks have been adequately designed and are operating effectively, providing assurance that risks are being effectively managed, and the Council’s objectives should be achieved.
<b>2. Some improvement required</b>	Whilst some control weaknesses were identified, in the design and / or effectiveness of the control environment and / or governance and risk management frameworks, they provide reasonable assurance that risks are being managed, and the Council’s objectives should be achieved.
<b>3. Significant improvement required</b>	Significant and / or numerous control weaknesses were identified, in the design and / or effectiveness of the control environment and / or governance and risk management frameworks. Consequently, only limited assurance can be provided that risks are being managed and that the Council’s objectives should be achieved.
<b>4. Inadequate</b>	The design and / or operating effectiveness of the control environment and / or governance and risk management frameworks is inadequate, with a number of significant and systemic control weaknesses identified, resulting in substantial risk of operational failure and the strong likelihood that the Council’s objectives will not be achieved.

Professional judgement is exercised in determining the appropriate opinion, and it should be noted that in giving an opinion, assurance provided can never be absolute.

# Appendix 2 - Limitations and responsibilities of internal audit and management responsibilities

## Limitations and responsibilities of internal audit

The opinion is based solely on the internal audit work performed for the financial year 1 April 2021 to 31 March 2022. Work completed was based on the terms of reference agreed with management for each review. However, where other matters have come to our attention that are considered relevant, they have been considered when finalising our reports and the annual opinion.

There may be additional weaknesses in the LPF control environment and governance and risk management frameworks that were not identified as they were not included in the 2021/22 LPF annual internal audit plan; were excluded from the scope of individual reviews; or were not brought to Internal Audit's attention. Consequently, management and the Committee should be aware that the opinion may have differed if these areas had been included, or brought to Internal Audit's attention.

Control environments, no matter how well designed and operated, are affected by inherent limitations. These include the possibility of poor judgment in decision-making; human error; control processes being deliberately circumvented by employees and others; management overriding controls; and the impact of unplanned events.

## Future periods

The assessment of controls relating to LPF is for the year ended 31 March 2022. Historic evaluation of effectiveness may not be relevant to future periods due to the risk that:

- the design of controls may become inadequate because of changes in operating environment, law, regulation or other areas; or
- the degree of compliance with policies and procedures may deteriorate.

## Responsibilities of Management and Internal Audit

It is Management's responsibility to develop; implement; and maintain effective control environments and governance and risk management frameworks that are designed to prevent and detect irregularities and fraud. Internal audit work should not be regarded as a substitute for Management's responsibilities for the design and operation of these controls.

Internal Audit endeavours to plan its work so that it has a reasonable expectation of detecting significant control weaknesses and, if detected, performs additional work directed towards identification of potential fraud or other irregularities. However, internal audit procedures alone, even when performed with due professional care, do not guarantee that fraud will be detected. Consequently, internal audit reviews should not be relied upon to detect and disclose all fraud, defalcations or other irregularities that may exist.

## Appendix 3 – Prior Year Comparisons

	2021/22				2020/21				2019/20				2018/19				2017/18			
Annual Opinion	Some Improvement Required				Some Improvement Required				Some Improvement Required				Some Improvement Required				Significant Improvement Required			
Reviews Completed	1. <b>Technology Model Development</b> 2. <b>Capital Calls</b> 3. <b>Employer Contributions</b> 4. <b>Risk Management</b>				1. <b>Bulk Transfers</b> 2. <b>Cessations</b>				1. <b>Charles River</b> 2. <b>Pension Entitlement</b> 3. <b>Settlement and Custodian</b>				1. <b>Stock Lending</b> 2. <b>Unitisation</b> 3. <b>Unlisted Investment Valuations and Admin Fees and Charges</b>				1. <b>Information Governance</b> 2. <b>IT Business Resilience / Disaster Recovery</b> 3. <b>Payroll Outsourcing</b> 4. <b>Pensions Tax</b>			
Findings raised	High	Med	Low	Total	High	Med	Low	Total	High	Med	Low	Total	High	Med	Low	Total	High	Med	Low	Total
	-	4	8	12	1	2	1	4	1	3	3	7	-	1	1	2	4	3	4	11
Overdue Findings	-	1	-		-	1	-	1	1	1	-	2	1	3	3	7	1	1	-	2

### Key:

**Green narrative** – effective (green) audit outcome

**Amber narrative** – some improvement required (amber) audit outcome

**Red narrative** – significant improvement required (red) audit outcome

## Appendix 4 – LPF Overdue Internal Audit Findings as at 31 March 2022

Review	High	Medium	Low	IA Recommendation	Status - 31 <sup>st</sup> March 2022
Settlement and Custodian Services – Regulatory and Risk Management Oversight (June 2020)	-	1	-	<p>1. Lothian Pension Fund (LPF) should maintain details of all relevant regulatory requirements that are applicable to custodian activities and confirm (via the established supplier management process and review of agreed regulatory key performance measures) that these continue to be applied by Northern Trust (NT).</p> <p>2. LPF should record the specific risks associated with delivery of custodian services by NT. Any new and emerging risks and actions to address them identified at regular supplier management meetings and site visits should also be recorded, with resolution progress monitored at ongoing supplier management meetings. Any significant custodian risks should also be escalated for inclusion in the LPF risk register.</p>	<p>Overdue (13 months) - original due date was 30<sup>th</sup> September 2020.</p> <p>Finding was proposed for closure by LPF on 9<sup>th</sup> February 2021, however this did not fully address the risks raised in the original finding.</p> <p>The finding was then agreed as part of the Risk Management review completed in June 2022.</p> <p>The finding has now been closed based on work completed during the 2021/22 Risk Management audit.</p> <p>Management has also confirmed that supplier risks will be an area of focus in the new supplier management framework that is currently being implemented.</p>