

Pensions Audit Sub-Committee

2pm, Tuesday, 6 December 2022

Lothian Pension Fund - Internal Audit Review 2022

1. Recommendations

The Committee is requested to note and comment on:

- 1.1 The proposals being considered to extend and improve the scope and provision of Internal Audit services for the LPF Group and the intention to bring final proposals to the March 2023 Pension Committee for decision.

David Vallery

Chief Executive Officer, Lothian Pension Fund

Lothian Pension Fund - Internal Audit Review 2022

2. Executive Summary

- 2.1 The Boards of LPFI and LPFE have noted that it is now appropriate to review the current absence of internal audit of those companies and indicated an intention to introduce a programme of internal audit from the 2023/24 financial year. Further that any such programme would logically be planned and implemented as part of an integrated programme of internal audit with the Fund itself, and the second line assurance arrangements undertaken and arranged by the Risk function of LPF.
- 2.2 The intention then would be for a joint appointment of an internal audit provider to undertake a single integrated audit programme and prepare an unlimited Annual Audit Opinion unlike today's limited opinion (expressly excluding LPFI and LPFE from scope).
- 2.3 Options for this single audit provider will be considered and could be a continuation of the CEC Internal Audit team, supported by a co-source arrangement, or a direct appointment. The current terms of reference for the Pensions Committee give them the powers to make such an appointment.
- 2.4 A single provider, with the Pensions Committee and corporate Boards as clients would, if properly managed, enable a more tailored and efficient process to meet the needs of LPF and is aligned to the supplier strategy as articulated in the 2022/23 strategy and business plan.
- 2.5 Any future audit reports and Annual Audit Opinion will still be made available to CEC and therefore there is not expected to be any change in oversight by CEC in its role as Administering Authority.
- 2.6 Subject to feedback from the Committee, the intention would be to revert in March 2023 with final proposals including the proposed supplier of internal audit services, the costs of such services, and a more comprehensive articulation of the costs, benefits and implications of any proposals.
- 2.7 Officers would intend to confirm with CEC that there are no issues in progressing any proposals prior to consideration in March.

3. Background

- 3.1 As set out in the City of Edinburgh Council Committee Terms of Reference, the Pension Committee has the delegated authority to 'secure best value in the provision of services and reviewing the control and assurance environment (including internal audit processes) for the Lothian Pension Fund group.

- 3.2 The draft internal audits and plan are developed in consultation with the Convenor of the Audit Sub Committee and the CEO (LPF). The Audit Sub Committee (ASC) receives individual internal audit reports, and an annual audit opinion on behalf of the Pensions Committee, as well as updates on progress with any agreed actions resulting from the audits.
- 3.3 Delivery of the annual audit plan is currently the responsibility of the CEC Internal Audit team (“CEC IA”). CEC IA have a co-source arrangement with PWC and in recent years LPF audits have been carried out by a combination of CEC IA resource and PWC resource. The CEC IA methodology is used, and CEC IA manage delivery by PWC and sign-off all terms of reference and audit reports. Recently CEC have had an employed Chief Internal Auditor, a currently vacant position, and previously a PWC secondee in that role.
- 3.4 The use of PWC to undertake the audits means that LPF benefits from both specific financial services expertise and wider specialist expertise such as information security than is possible from within the CEC IA team.
- 3.5 Currently CEC officers are required to approve audit terms of reference, audit reports and are formally designated owners of actions.
- 3.6 Neither LPFE nor LPFI are currently included within the audit scope in preparing audit plans and the annual audit opinion of LPF. The Boards of LPFE and LPFI have previously been satisfied that there is no need for internal audit of those entities, and instead have relied on periodic external assurance reviews.
- 3.7 Throughout 2019-2022 period, covering three annual programmes, and for a variety of reasons the programme wasn’t delivered as effectively as desired. Changes were discussed in late 2021 although not proceeded with given the expectation of Project Forth. Although Forth remains the strategic intent it is not felt necessary or beneficial to delay seeking improvements.

4. Main Report

LPFE / LPFI

- 4.1 The Boards of LPFE and LPFI have recently considered the current absence of internal audit and recognised that with the evolution of those businesses, and especially LPFI, it is necessary to review whether an internal audit programme should be introduced.
- 4.2 The LPFI Board have noted that three lines of defence (“3LOD”), where the third line is internal audit, is an expectation of regulated financial services companies.
- 4.3 Both Boards recognise the inter connectivity between LPFE, LPFI and the provision of services in relation to the Fund. Therefore, any internal audit plan for LPFE and LPFI would need to be co-ordinated with that of LPF itself. A single party undertaking

audits isn't essential provided there is coordination of plans and appropriate sharing of results, but there is merit in a single provider and single method.

- 4.4 The Boards have noted the intention to review arrangements for the audit of the Fund and indicated support to develop proposals that would introduce a single integrated approach to audit.

LPF Internal Audit

- 4.5 The recent use of PWC to undertake most (2021/22) and all (2022/23) internal audits of the fund has given LPF the benefit of specific expertise and flexibility of resource rather than relying solely on CEC IA.
- 4.6 CEC could continue as the sole provider, or more likely lead supplier, manager and take the role of Chief Internal Audit to the LPF Group, being the Fund and corporate subsidiaries LPFE and LPFI.
- 4.7 Alternatively, the Committee and Boards could appoint an external party and contract directly with that party.
- 4.8 The intention will be to consider options more fully including:
- 4.8.1 CEC IA's willingness and ability to extend their scope to cover LPFE / LPFI.
 - 4.8.2 Whether a public procurement exercise is required either to vary the current arrangements with CEC to cover LPFE/I, for LPFE/I to appoint their own internal auditor, or for a new single supplier to be appointed.
 - 4.8.3 The benefits as well as risks in the LPF programme being managed alongside the wider CEC internal audit programme
- 4.9 LPF currently pays for internal audit services from both CEC IA and PWC and so the expectation would be that this change could be achieved at minimal additional cost. Any additional audits of LPFE and LPFI would be an additional cost and there may be additional costs if either an external firm or LPF itself took the role of Chief Internal Auditor.

LPF audits and CEC

- 4.10 Currently the results of LPF audits are noted within CEC but the reports are not considered within the relevant CEC Governance, Risk and Best Value Committee which acts as an audit committee for CEC. This could continue in the new arrangements.
- 4.11 Currently CEC officers have a role in approving the terms of reference, signing off reports and are named as action owners. This may provide additional value to CEC in its role as Administering Authority and this should be tested against its impact on

efficiency, effectiveness and accountability. Similarly, it will be possible to maintain input from CEC into the construct of the audit plan as currently happens.

Project Forth

- 4.12 These proposals are made independently of Project Forth although they are aligned with changes that would be required under that project where the governing body of the merged fund would be wholly accountable for internal audit arrangements.

5. Financial impact

- 5.1 There is not expected to be any significant difference in the costs of individual audits.
- 5.2 The overall cost of the audit programme will increase if additional audits are undertaken to give appropriate coverage to LPFI and LPFE. An element of these additional costs will be recovered from the corporate clients of these firms.
- 5.3 The cost of the Chief Internal Auditor may change if rather than being a recharge of a proportion of time of the CEC CIA, an alternative arrangement is made. This will be tested as part of further progressing the proposals.

6. Stakeholder/Regulatory Impact

- 6.1 There is no direct regulatory impact for LPF although the ASC should note that introducing internal audit for LPFI will remove one potential regulatory question given the expectation within regulated firms.