



# OCCUPATIONAL PENSION SCHEME GOVERNANCE - ASSURANCE ABOUT INTERNAL CONTROLS

GUIDE

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## 1. Introduction

This paper addresses occupational pension schemes which are set up under trust, governed by a board of trustees and regulated by the Pensions Regulator (tPR). See the Appendix for further information about the number of trust schemes in the UK.

The **European Directive IORP II** (the 'Directive') requires occupational pension schemes to have an 'internal audit' function. The UK government transposed the Directive into UK law in January 2019, with **regulations**<sup>1</sup> requiring schemes to have an effective system of governance including internal controls proportionate to the size, nature, scale and complexity of the activities of the occupational pension scheme.

To address this governance requirement, tPR will develop a Code of Practice setting out how trustees can establish an effective system of governance including internal controls.

It is important to understand how different sources of assurance available to trustees can play a part in the assessment of controls designed to mitigate risk. Assurance techniques can take many forms from self-assurance to independent assurance. This paper describes how independent audit assurance can play a part in the governance of UK pension arrangements; and in particular differentiates the roles of statutory audit and internal audit.

In section 5 there are some key questions for trustees to consider when designing suitable assurance arrangements for their occupational pension scheme.

## 2. Statutory audit vs internal audit

**Statutory audit** is designed to provide the trustees with an independent opinion about the statutory financial statements of the pension scheme and in most cases an opinion about contributions payable to the scheme, which is set out in UK legislation as follows:

The **Occupational Pension Schemes (requirement to obtain Audited Accounts and a Statement from the Auditor) Regulations 1996 No. 1975** (the 'Audited Accounts Regulations') requires certain schemes to appoint an independent statutory auditor to give 'statutory audit opinions' as follows.

- a) the financial statements presented for audit show a true and fair view of the financial transactions of the Scheme during the Scheme year and of the amount and disposition at the end of the Scheme year of the Scheme assets and liabilities, other than liabilities to pay pensions and benefits after the end of the Scheme year, and contain the information specified in the Schedule to the Audited Accounts Regulations;
- b) contributions for the Scheme year have in all material respects been paid to the Scheme at least in accordance with the schedule of contributions/payments schedule, or where there is no schedule of contributions in relation to the whole or part of the Scheme year, on whether or not contributions payable to the Scheme during that year or part have been paid in accordance with the scheme rules or contracts under which they were payable and with the recommendations

of the actuary. If the statement is negative or qualified, the statutory auditor includes a statement of the reasons.

In order to properly understand the assurance provided by the statutory audit, it is important that the trustees engage in a dialogue with their auditors to understand the limited scope of the statutory audit. Concepts such as 'true and fair' and 'materiality' should be explained. Furthermore, the pension scheme financial statements do not include liabilities to pay pensions and benefits after the end of the scheme year and therefore these liabilities are not within the audit scope.

Trustees should also be clear about the difference between the audit of the 'financial statements' and 'other information' included in the annual report in understanding the scope of the audit. The audit report includes the following explanation:

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated.

A common misconception is that the statutory audit 'confirms that the benefits paid are correct' - this is a very wide statement which in many respects is beyond the scope of the statutory audit required by legislation.

However, there are circumstances where the statutory auditor may offer extended assurance services to trustees over and above the statutory audit. It is important that the statutory auditor explains to scheme trustees the extent to which the auditor can provide such extended assurance services without breaching the auditor's ethical guidelines.

**Internal audit** can have a much wider scope than the statutory audit, covering non-financial processes and controls that are not directly relevant to financial reporting for example member communications and trustee governance. The scope and nature of internal audit work can be tailored to meet trustee requirements.

Note that the ethical standards prevent the statutory auditor from holding the office of 'internal auditor'. In selecting a suitable internal auditor candidate, the trustees should consider conflicts of interest, independence, knowledge of the subject matter and professional experience in auditing and reporting techniques.

Every pension scheme is different with unique objectives, challenges and risks. An internal audit charter agreed between the trustees and its internal audit function is a common way to agree and describe how internal audit will provide value to the scheme, the nature of the services it will provide, and the specific focus or emphasis required of internal audit to help the scheme achieve its objectives.

Having an internal audit charter also formalizes the internal audit role within the scheme, including the reporting lines, authorising access to records, personnel, and physical properties relevant to the performance of engagements; and also defining the scope of internal audit activities. It can also be a reference point for measuring the effectiveness of internal audit.

### **3. Other independent assurance**

The ICAEW has produced various other assurance frameworks<sup>ii</sup> which are used in the pensions sector. If reliance is to be placed on these reports, it is important that the users of these reports read them in full to properly understand the scope of these reports and the extent to which they provide assurance and their limitations. ICAEW Chartered Accountants undertaking this work are expected to demonstrate the highest standards of professional conduct and are bound by a code of ethics.

*ICAEW AAF 01/06 Assurance reports on internal controls of service organisations made available to third parties (revised July 2016)(TECH 01/06AAF)*

Trustees may also be in receipt of assurance reports from their service organisations, such as the pensions administrator, investment managers and investment custodians. These reports are

typically produced annually by the service organisation and include an assurance report from an independent Reporting Accountant.

#### *ICAEW Master Trust Supplement to AAF 02/07 (TECH 12/16AAF)*

Some trustees of master trusts have adopted assurance reporting using ICAEW Master Trust Supplement to AAF 02/07. These reports are typically produced annually by the trustees and include an assurance report from an independent Reporting Accountant.

#### *ICAEW Relevant Trustee Supplement to AAF 02/07 (TECH 04/13AAF)*

Some professional trustee organisations obtain assurance reports over their administrative and accounting procedures in relation to its own business operations for providing pensions trustee services. These reports are typically produced annually by the trustees and include an assurance report from an independent Reporting Accountant.

### **4. Assurance mapping**

Assurance mapping is a mechanism for linking assurances from various sources to the risks that threaten the achievement of the pension scheme's outcomes and objectives. They can be at various levels, dependent upon the scope of the mapping and indeed this goes beyond assurances provided from external and internal audit alone.

A concept for helping to identify and understand the different contributions the various sources can provide is the 'Three Lines of Defence' model.

- First line of defence: functions that own and manage risks – operational management, responsible for identifying, assessing, controlling and mitigating risks on a day-to-day basis.
- Second line of defence: the various risk control and compliance oversight functions established by management.
- Third line of defence: functions that provide independent assurance – independent auditors provide the trustees and pensions management team with assurance on the effectiveness of governance, risk management and internal controls including the way in which the first and second lines of defence are working.

This approach ensures that independent audit is not used as a substitute for the first two lines of defence where internal resources are limited.

By defining the sources of assurance in three broad categories, it helps to understand how each contributes to the overall level of assurance provided and how best they can be integrated and mutually supportive. It also shows that there may be a need to redirect audit and other resources in a different way using a properly shaped assurance framework.

Sometimes the Three Lines of Defence model is described as Four Lines of Defence where there is an existing internal audit function operating in the entity as the third line, and the external independent auditors are termed the Fourth Line of Defence.

### **5. Key questions to help assess trustee assurance arrangements**

- 5.1 Does your scheme have a risk register which addresses key risks, mitigating controls and sources of assurance?
- 5.2 Have you considered developing an assurance map to evaluate the required quality and quantity of assurance over each key risk in the trustee arrangements?
- 5.3 Do you understand the scope and limitations of the statutory audit?
- 5.4 Can your statutory auditor provide additional assurance services?
- 5.5 Have you considered appointing an internal auditor?
- 5.6 Does your internal audit function have a clear remit, for example an internal audit charter?
- 5.7 Do your service organisations provide internal controls assurance reports and if so, do you understand the scope of these reports, the extent to which they apply to your scheme and their limitations?

## **Appendix – Occupational Pension Schemes (Trust Schemes)**

There are 41 million members of trust schemes of which 15 million are actively accruing benefits.<sup>iii</sup>

There are nearly 6,000 defined benefits (DB) schemes of which 14% are open, 43% are closed to new members, 40% are closed to future accrual and 3% are winding up.<sup>iv</sup>

There are 32,000 Defined Contribution (DC) schemes of which 93% are micro schemes (up to 11 members).<sup>v</sup>

From 1 October 2018, DC master trust pension schemes have six months to apply to tPR for authorisation. The membership of master trusts has increased from 270,000 at the start of 2012 to almost 14 million in 2019.<sup>vi</sup>

It is expected that the number of DB and DC schemes will continue to decrease over a period of time due to scheme wind ups and consolidation.

## References

<sup>i</sup> The Occupational Pension Schemes (Governance) (Amendment) Regulations 2018 No. 1103) <http://www.legislation.gov.uk/ukxi/2018/1103/regulation/2/made>

<sup>ii</sup> <https://www.icaew.com/technical/audit-and-assurance/assurance/standards-and-guidance>

<sup>iii</sup> The Office for National Statistics Occupational Pensions Schemes Survey UK: 2017 published in September 2018  
<https://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/pensionssavingsandinvestments/bulletins/occupationalpensionschemessurvey/uk2017>

<sup>iv</sup> TPR's publication 'Defined benefit pensions 2018'  
<https://www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/db-pensions-landscape-2018.ashx>

<https://www.thepensionsregulator.gov.uk/en/document-library/research-and-analysis> and scroll down to DB pension schemes)

<sup>v</sup> TPR's publication 'DC trust: presentation of scheme return data 2017 – 2018'  
<https://www.thepensionsregulator.gov.uk/en/document-library/research-and-analysis/dc-trust-2018>

<sup>vi</sup> TPR Press release dated 20.2.19 'First master trust granted authorisation'  
[https://www.thepensionsregulator.gov.uk/en/media-hub/press-releases/first-master-trust-granted-authorisation?\\_ga=2.60518565.905328900.1552559346-782839633.1552559346](https://www.thepensionsregulator.gov.uk/en/media-hub/press-releases/first-master-trust-granted-authorisation?_ga=2.60518565.905328900.1552559346-782839633.1552559346)

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