ICP 10:
Internal Control

Basic-level Module

A Core Curriculum for Insurance Supervisors
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A financially sound insurance sector contributes to economic growth and well-being by supporting the management of risk, allocation of resources, and mobilization of long-term savings. The insurance core principles (ICPs), developed by the International Association of Insurance Supervisors (IAIS), are key international standards relevant for sound financial systems.

Effective implementation of the ICPs requires skilled and knowledgeable insurance supervisors. Recognizing this need, the World Bank and the IAIS partnered in 2002 to develop a “core curriculum” for insurance supervisors. The Core Curriculum Project, funded and supported by various sources, accelerates the learning process of both new and experienced supervisors. The ICPs provide the structure for the core curriculum, which consists of a set of modules that summarize the most relevant aspects of each topic, focus on the practical application of supervisory concepts, and cross-reference existing literature.

The core curriculum is designed to help those studying it to:

- Recognize the risks that arise from insurance operations
- Know the techniques and tools used by private and public sector professionals
- Identify, measure, and manage these risks
- Operate effectively within a supervisory organization
- Understand the ICPs and other IAIS principles, standards, and guidance
- Recommend techniques and tools to help a particular jurisdiction observe the ICPs and other IAIS principles, standards, and guidance
- Identify the constraints and identify and prioritize supervisory techniques and tools to best manage the existing risks in light of these constraints.
Welcome to ICP 10: Internal Control module! This is a basic-level module on internal control in an insurer that does not require specific prior knowledge of this topic. The module should be useful to either a new insurance supervisor or an experienced supervisor who has not dealt extensively with the topic—or is simply seeking to refresh and update knowledge.

Start by reviewing the objectives, which will give you an idea of what a person will learn as a result of studying the module. Then proceed to study the module either on an independent, self-study basis or in the context of a seminar or workshop. The amount of time required to study the module on a self-study basis will vary but it is recommended that it be addressed over a short time, broken into sessions on parts if desired.

To help you engage and involve yourself in the topic, we have interspersed the module with a number of hands-on activities for you to complete. These are intended to provide a checkpoint from time to time so that you can absorb and understand the material more readily. You are encouraged to complete each of these activities before proceeding with the next section of the module. An answer key in appendix II sets out some of the points that you might consider when completing the exercises. You will also find questions dealing with the local situation and related to practices in your jurisdiction. These are intended to help you apply the material in this module to your local circumstances. If you are working with others on this module, develop the answers through discussion and cooperative work methods. Since these responses will vary by jurisdiction, the answer key suggests where you might look for the answers.

As a result of studying the material in this module, you will be able to do the following:
1. Explain the nature of internal control and its application to insurance companies.

2. Explain each of the following objectives of internal control:
   a. The business of an insurer is conducted in a prudent manner in accordance with policies and strategies established by the board of directors
   b. Transactions are only entered into with appropriate authority
   c. Assets are safeguarded
   d. Accounting and other records provide complete, accurate and timely information
   e. Management is able to identify, assess, manage and control the risks of the business.

3. Describe the major elements of internal control.

4. Explain the roles of each of the following control functions:
   a. Actuarial
   b. External audit
   c. Internal audit
   d. Compliance.

5. Explain each of the following essential environmental conditions for internal control:
   a. Systemization
   b. Documentation
   c. Competence and integrity
   d. Resources.

6. Illustrate each of the following disciplines over basic internal accounting controls:
   a. Segregation of duties
   b. Custodial controls
   c. Supervision.

7. Given a particular control objective, illustrate effective control techniques for that objective.

8. Compare the effects of various types of control weaknesses.

9. Describe appropriate compliance tests for each category of general controls.

10. Demonstrate the necessity of application controls in computerized systems.
11. Illustrate the issues that may arise in connection with the outsourcing of functions and describe effective controls for dealing with these issues.
12. Explain the purpose of internal audits, and illustrate appropriate and inappropriate ways of organizing the internal audit function.
13. Given a particular insurance transaction in a case situation, trace that transaction through the insurance company’s accounting process.
14. Determine the adequacy of internal control procedures.
15. Explain how an evaluation of internal control facilitates supervision.
16. Explain each of the essential criteria stated in ICP 10.
ICP 10: Internal Control

Basic-level Module

A. Introduction

According to insurance core principle (ICP) 10\(^1\) of the International Association of Insurance Supervisors (IAIS),

“\text{The supervisory authority requires insurers to have in place internal controls that are adequate for the nature and scale of the business. The oversight and reporting systems allow the board and management to monitor and control the operations.}”

The same requirement is found in European Community legislation, although the European directives do not specifically define internal control:

“\text{The competent authorities of the home member state shall require every insurance undertaking to have sound administrative and accounting procedures and adequate internal control mechanisms.}”

The definitions of internal control have evolved through the years and been successively proposed by national and international associations of certified accountants or auditors. In 1977 the Order of Certified Accountants in France defined internal control as the “body of security measures aimed at managing business risks.” In 1981 the International Federation of Accountants elaborated on this concept: “An internal control

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system consists of all the policies and procedures adopted by the management of an entity to assist in achieving management’s objective of ensuring, as far as practicable, the orderly and efficient conduct of its business.” The Canadian Institute of Chartered Accountants repeated the substance of this definition in 1986 and supplemented it in 1992 by reference to “instructions issued by the senior management of a company for decisionmaking and steps to be taken.” According to these definitions, internal control applies to all activities of the company, although it is particularly relevant to accounting.

This module uses the terms internal control, internal control procedure, or simply procedure. The role of procedures is to indicate steps to be followed. Internal control is not a decision model. It does not answer the question, What should be done? but rather Who does what? When? For what purpose?

Internal control is an organizational system comprised of a series of structures, methods, and procedures implemented by a company to provide for the orderly and effective conduct of its business activities, particularly:

- Compliance with laws and regulations
- Implementation of the general policy defined by management
- Control and management of business risks
- Quality of accounting and financial information.

All employees of the company must be involved in internal control, each having his or her own duties and responsibilities.

This module discusses objectives, organization, specificities of the insurance sector, and relations with supervisory authorities, with the aim of describing internal control in an insurance company.

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2. See IFAC 2006 for the International Standards on Auditing, many of which deal with various aspects of internal control.
B. Objectives of internal control

According to the explanatory notes to ICP 10,

“The purpose of internal control is to verify that the business of an insurer is conducted in a prudent manner in accordance with policies and strategies established by the board of directors [refer to ICP 9 on corporate governance], transactions are only entered into with appropriate authority, assets are safeguarded [refer to ICP 21 on investments], accounting and other records provide complete, accurate, and timely information, and management is able to identify, assess, manage, and control the risks of the business and hold sufficient capital for these risks [refer to ICP 18 on risk assessment and management and ICP 23 on capital adequacy and solvency].”

Moreover, internal controls should verify that the various internal departments function in accordance with the prevailing laws and regulations of the jurisdictions in which the company operates (especially the rules for individual and collective protection of policyholders) as well as its own bylaws and policies.

Internal control is an essential tool of the company’s board of directors, providing key elements that help it to define, implement, and correct its policy (see COSO 1994). Management of the company’s risks is a priority for executives, and internal control provides managers with the means of identifying, assessing, managing, and controlling the risks involved in the company’s business activities.

In an insurance company, this objective is two-pronged. On the one hand, the insurer covers the risks of its customers. The board of directors defines a marketing strategy, a pricing policy, and the general criteria for risk selection. Internal control verifies whether these instructions have been followed and measures their validity after the fact. On the other hand, the insurance company is exposed to risks that threaten its financial soundness and jeopardize its profitability. These risks are analyzed elsewhere from the regulatory and prudential standpoint. They are generally classified as:

- **Technical risks.** Mispricing, underfunding, inappropriate reinsurance
- **Investment risks.** Risks relating to rating, liquidity, exchange rates, market, default of a counterparty, and risks specific to derivatives
- **Other risks.** Risks such as default of a key partner (reinsurer, broker), external pressures (membership of a financial group), and management failures.

This list is indicative, not exhaustive. These risks also include those specifically relating to certain internal departments. Risk management systems therefore include internal control procedures, one of whose main objectives is to alert managers to the
possible impact of these risks on the situation of the company (see CEIOPS 2003 and COSO 2004).

Protection of assets is a more specific objective, but it stems from the preceding one. Some would restrict internal control, however, to the series of procedures aimed at protecting the company’s assets and improving its performance. In general, protecting assets includes preventing errors, fraud, and the taking of risks disproportionate to the expected benefits. Improving performance means integrating the corresponding procedures into a qualitative approach. With regard to an insurance company, managers use internal control procedures to ensure that:

- Investments and disinvestments are justified and carried out under the best conditions
- Investments are suitable to the commitments they cover
- Investments are properly valued, and potential depreciations are identified
- Investments are protected against financial risks and also against loss (fire, flood), misappropriation, and fraudulent use.

To reduce its financial risks, an insurance company may use derivatives. These instruments, whether used to provide coverage or to modify the yield structure of an investment portfolio, are subject to specific risks: leverage effect, complex handling, default of counterparty, and others. Risk management (control) of derivatives is an internal control problem. It is important for the board of directors to participate in the development of strategies for their use, to be well informed about positions taken, and to understand their impact. This is accomplished through internal control procedures.

A basic goal of internal control is to verify that the policies and strategies defined by the board of directors and the decisions arising from the board are applied correctly (see Committee of the Conference of Insurance Supervisory Authorities of the Member States of the European Union 2002). The more complex the company’s structures and the more geographically and technically diversified its activities, the more necessary it is to have reliable information—for example, on rates, provisions, and investments. This is especially true for outsourcing and for foreign operations. Is the branch manager following the rules of the head office? Or is he using specific local circumstances to justify his deviation from the general line of conduct? Procedures should be in place to prevent or limit the extent of inappropriate initiatives.

The head of the company, who makes the decisions, may commit errors: for example, encouragement of mispricing, underfunding of certain commitments, inappropriate reinsurance, or an unsuccessful investment. The resulting losses will deplete the company’s own funds more or less heavily, depending on the managers’ ability to detect the errors, take measures to correct them, enforce these measures, and monitor their effectiveness. Internal controls should draw attention to weaknesses, thus enabling executives to improve their management skills.
Internal controls should also ensure that transactions concerning the company have been carried out by the persons assigned to negotiate and conclude them and in ways authorized by the board of directors (delegation of signatures, division of tasks, and control of procedures). The delegation of powers, which is all the more necessary if the company engages in an extended field of activity, is secured by the division of tasks, assigning the functions of decisionmaking (or authorizing decisions), protection (safeguarding) of assets, accounting, and control to different persons. Collusion between the treasurer and the accountant may thus facilitate fraudulent activities that are difficult to detect in a routine internal audit. The collapse of Barings Bank in 1995 was the result of failed speculations by a single broker in Singapore, who both made and recorded decisions, using his own computer program, to which no one else had access.

To be effective, internal controls must include:

- An organizational chart of the company, listing the persons empowered to sign for the company (that is, to engage the responsibility of the company) and the persons empowered to approve a decision
- A written manual describing the division of tasks, responsibilities (especially with regard to supervision), and powers (of signature, among others).

The security of the procedures requires the involvement of many participants in each operation, with internal control supervising its effectiveness.

Internal controls, finally, must ensure that the information set out in the accounts and reports prepared by the various departments of the company is complete, accurate, and delivered in a timely manner. Likewise, internal controls must verify the security of computer systems. In particular, internal controls affect accounting by limiting the mis-statements that are likely to alter the quality of information, thereby distorting the views of the decisionmaker and the external investor concerning the company's real financial situation. Thus internal controls should seek out the following misstatements:

- Recording of fictitious transactions
- Failure to record real transactions
- Unauthorized transactions, such as a rate rebate agreed by a broker that exceeds the ceilings set by the board of directors
- Allocation errors, such as the allocation of claims in one class of insurance to another class, distorting the calculation of rates
- Errors in the date of entries, leading to postponement to the following fiscal year of charges attributable to the reported financial period (unreported claims, for example)
- Errors of presentation, for example, in respect of off-balance-sheet operations.

Computer technology also incurs risks due to the concentration of data, which can weaken the security of information, and the use of complex applications, which can
result in the repetition of problems if the program contains errors. Therefore, internal controls should ensure:

- The physical and logistic security of installations and data, including the protection of files and software and the possible use of alternative installations
- The existence of an audit trail, that is, a series of written procedures allowing for chronologically reconstituting transactions, justifying any transaction by using a source text to follow an unbroken trail to and from the financial statement, and explaining the changes in balances from one statement of account to another by showing what transactions have been performed.

The list of objectives illustrates the importance of internal control. Before managers and economists recognized and elaborated on its role, companies carried out internal control without knowing it, since common sense always led them to seek appropriate means to manage and control their actions.

In 1977 the Order of Certified Accountants in France pointed out,

“Internal control is not in itself a separate system or function of the company. It is (ideally) a concern: the desire of the entrepreneur who is organizing his company to provide for “security measures” in each management procedure that will ensure, as far as possible, self-regulation and self-supervision. It is the presence of these “security measures” in systems that demonstrates the internal control of the company, both technically and administratively speaking.”

Exercises

1. What are five main purposes of internal control?
2. Summarize the internal control requirements prescribed by the company and insurance laws of your jurisdiction. Do they deal explicitly with the five main purposes of internal control?
C. Organization of internal control

The internal control procedures put in place by insurance companies are increasingly cumbersome and sophisticated. They must also be adequate. From the prudential standpoint, meeting this criterion is particularly important in certain areas of business, such as accounting or computer technology, but not only in these fields.

Internal control is widely dealt with in banking regulations and guidance (see Basel Committee on Banking Supervision 1998). In the insurance sector, the subject is addressed, depending on the jurisdiction, by laws and regulations, by directives from the supervisory authorities, or by recommendations from professional associations. The rules are more or less detailed, are often similar for all financial services, and sometimes elaborate on matters specific to insurance.

In 1992 the European Union defined an obligation in principle, nothing more: “The competent authorities of the home member state shall require every insurance undertaking to have sound administrative and accounting procedures and adequate internal control mechanisms.” ICP 10 repeats this requirement, specifying that the controls must be “adequate for the nature and scale of the business.”

Thus the organization of internal control must be adapted to the company’s sector of activity—property and liability insurance, reinsurance, or life and health insurance—its size, its hierarchical structure, its geographic diversification, its customers (individuals, companies), the distribution of its capital, and its capacity to access capital markets.

The effectiveness of internal control depends on a number of conditions: respect for basic principles and techniques for their proper application, the involvement of internal participants at all levels, and the monitoring of the implementation of procedures and follow-up on the fulfillment of target objectives.

Basic principles and their application

The company must be rationally organized, meaning that its structures must be described in an organizational chart and its procedures must be written down in the form of a manual. There is no typical organization. Each company is organized on the basis of its objectives, strategy, size, and the diversity of its business. In particular, the organizational chart should specify the persons authorized to sign for the company—that is, engage the company’s responsibility and, potentially, their own criminal liability. More generally, the organizational chart should list all persons empowered to make decisions. The manual should describe the delegation of powers, which should be unambiguously set out for the benefit of persons qualified to exercise such powers. The delegation should correspond to the actual functions of the person empowered. The procedures thus formalized should be applied systematically and continuously.
QUALITY AND AVAILABILITY OF INFORMATION

Internal control networks should gather and use information that is:

- Relevant, meaning adapted to their use
- Neutral, meaning free from manipulation
- Usable, meaning allowing each user to find the information he or she needs, such as ratios and staff tables
- Verifiable, including clear and easily understandable documentation so that transactions and other significant events are recorded promptly and itemized accurately.

Effective internal control requires good information-gathering techniques. One of the problems in large companies is that senior managers are often surrounded by people who praise rather than criticize; they may find it difficult to obtain information that has not been filtered by managers or operational and functional intermediaries. Thus the board of directors should perhaps receive some information directly. In the insurance sector, this includes claims, litigation, monitoring of off-balance-sheet operations, gaps between premiums written and collected, significant discrepancies between claims payments and provisions, and rates of recovery where recourse exists on claims, either judicially or amicably or through “subrogation”.

COMPETENCE AND HONESTY OF PERSONNEL (THE “FIT AND PROPER” TEST)

According to a statement by the Treadway Commission in 1992, “The most influential factors in determining the effectiveness of internal control are the attitude and the behavior of the senior officers and directors, who set the example for the entire company.” The competence of employees can be ensured by appropriate recruitment, ongoing training in specialized institutes and on the job, the setting of motivational targets, and incentive-driven career paths.

Honesty is a virtue, but not necessarily an eternal one: serious damage may be caused by trustworthy employees who suddenly “go off the rails” after exhibiting irreproachable behavior for many years. Individual mobility or the transfer of responsibilities at all levels of the hierarchy may offer some protection from the temptations that arise out of routine and habit.

Even in a highly computerized environment, fatigue or distraction can cause human error and undermine the effectiveness of internal control. Accordingly, whatever the level of competence and integrity of the employees, it is always advisable to supervise their operations, whether this is done by their immediate superiors or by auditors from the internal auditing department.

3. National Commission on Fraudulent Financial Reporting (United States), more commonly known under the name of its chairman; see also COSO 1994.
**AVAILABILITY OF SUFFICIENT MATERIAL AND HUMAN RESOURCES**

Internal control should be proportionate to the situation of the company and the risks to which it is exposed. This means setting up an organization with adequate personnel and tools. But the expenses incurred should be in proportion to the results obtained, according to the rule of cost-benefit relationships. If the procedures set up to detect insurance fraud in the filing and payment of claims are much more costly than the savings they bring, different and more cost-effective procedures should be developed. More generally, a kind of internal control capable of preventing every error or every fraud would obviously be effective but out of the question if its cost were prohibitive and if it increased redundancies to the detriment of speed in processing the information.

**SEGREGATION OF DUTIES**

According to ICP 10, essential criterion b,

“*The framework for internal controls within the insurer includes arrangements for delegating authority and responsibility and the segregation of duties.*”

Internal control is ineffective when the same person carries out two functions in the same operation that simultaneously involve decisionmaking, preservation of assets, recording, and control. According to a traditional approach, the decisionmaking function involves the achievement of business objectives. When the decision is delegated to a subordinate, the decisionmaking function is related to the authorization or approval function. The preservation (protection or safeguarding) of assets applies both to computer-processing units and networks and to fixed assets and securities, including cash held for safekeeping. Its proper exercise requires the use of methods, such as safes, badges, or access codes, that limit or prohibit access to funds and documents. The expansion of electronic trading requires setting up access controls for programs and files, including passwords, locks, and access software. This duty is often carried out by treasurers or persons authorized to trade stocks. The duty to preserve assets means ensuring that the assets are themselves covered by an adequate insurance policy. The task of recording or accounting includes verifying transactions before recording them, a task that is often assigned to computers via programming control procedures.

Experience has shown the absolute necessity of segregating the duties of accountant and treasurer. The accountant must never handle cash or checks, and the accountant’s signature must never be authorized with a bank. Otherwise, the accountant would be in a position, for example, to record false claims and pay them immediately, write off premiums owed and steal the checks remitted by policyholders, or record a transfer of assets for less than the actual amount and keep the difference. Even worse, if there is collusion between the accountant and the treasurer, the two are in a position to orga-
nize their misappropriations so as to foil any internal control procedure. The purpose of verification (or control) is to monitor the other duties through routine, systematic, and ongoing operations.

But this traditional approach is inappropriate to the computerized environment of the large modern companies operating in a system of integrated accounting. In traditional accounting, even with many automated tasks, each party remains responsible for a specific function, whereas in integrated accounting, the tasks depend on data processing, in which the steps automatically follow one another after the initial entry has been made. Thus there is no longer a separation between the tasks of decisionmaking, preservation, and accounting. The segregation takes place at another level, between the design function and the user function.

The computer user—accountant, treasurer, asset manager—must merely be able to carry out the operations sequence necessary to his or her mission, and does not need an exhaustive description of the processes and computerized verifications involved in these processes. The designer of a computer system should not be allowed access to operating systems.

The principle of avoiding self-supervision—inseparable from the principle of segregation of duties—entails the cross-checking of data and reciprocal control. Cross-checking consists of comparing similar information contained in different documents or verifying information on the basis of different sources. Computer processing multiplies the possibilities for automatic cross-checking.

Reciprocal control consists of comparing the same data recorded by two different people. For example, the accountant records premiums, and the treasurer records checks received from the policyholder. As another illustration, the acquisition of a building is recorded both by the technical management service for property holdings (fixed assets) and by the accounting office (register of property acquisitions and sales), with reciprocal control consisting of reconciling the two amounts.

Ongoing supervision of the chain of command is also necessary in order to meet the objectives of internal control. Such supervision may be carried out through programming procedures, and managers should regularly verify that they are working properly.

**Internal control participants**

Internal control is put in place at the level of a department, a company, a group of insurance companies, or a financial conglomerate. The unit of reference for the following discussion is the company.

As an essential tool for company decisionmakers, internal control is not an isolated, distinct function, and even when it involves specialists, whether within or outside the company, it constitutes an integrated system that covers all departments and involves
the contribution of the individuals who set up the procedures, manage them, implement them, and follow up on any changes and corrections deemed necessary.

Design is the responsibility of the board of directors and possibly the committees to which it has delegated certain powers. The board should also require corrections that appear necessary based on information received. Management and implementation are the responsibility of staff on the basis of self-supervision and supervision by the chain of command. The correct design and appropriate operation of internal control are verified by teams of inspectors (auditors) or experts (risk managers, actuaries, or certified accountants), both within and outside the company. The coordination of controls, the listing of shortcomings, and the follow-up of improvements are most often assigned to a coordinator, sometimes known as a compliance officer.

**Board of directors**

According to ICP 9, on corporate governance,

“The board [of directors] is the focal point of the corporate governance system. It is ultimately accountable and responsible for the performance and conduct of the insurer. Delegating authority to board committees or management does not in any way mitigate or dissipate the discharge by the board of directors of its duties and responsibilities … The supervisory authority reviews the internal controls and checks their adequacy to the nature and the scale of the business and requires strengthening of these controls where necessary. The board of directors is ultimately responsible for establishing and maintaining an effective internal control system.”

The board of directors is thus both the designer of the internal control system in the company and its final user. As such, the board establishes principles and guidelines, defines strategic objectives and organizes the means to fulfill them, including the division of responsibilities and tasks, defines the steps to be taken to monitor and evaluate their implementation, analyzes the information gathered, requests additional information as needed, examines the recommendations received with a view to improving the operation of the company, and requires any corrections and adjustments to be made, together with providing the ways and means to follow up their implementation.

In this task, the board of directors may be assisted by committees especially created for the purpose. The larger the company, the more likely it is to have committees. But the delegation of powers to these committees, which may include administrators and senior managers among their members, does not exempt the board from its obligations and responsibilities.

According to ICP 9, advanced criterion d, “The board of directors may establish committees with specific responsibilities like a compensation committee, audit com-
mittee, or election committee.” These committees may differ considerably in composition, purpose, and powers from one company to another.

The most common is an audit committee with a wide range of responsibilities: preparation and organization of a code of conduct and an internal audit manual, establishment of an annual audit program, and follow-up of internal audit reports.

Specialized functional committees also are set up to deal with issues such as risk management, investments, computer technology, and ethics (policyholder information and protection). The risk management committee is responsible for monitoring risks that could expose the insurance company to losses, including technical risks, investment risks, or management risks. Its powers, which are related to internal control procedures, also include computer risk (losses to which the company is exposed as a result of malfunction or inappropriate use of computers, such as fraud, pirating, or sabotage), and operational risk (losses resulting from personnel errors or fraud).

Sometimes a special compliance committee is entrusted with verifying compliance of the company’s actions with prevailing laws and regulations and with its own by-laws and policies. This committee collects all available information on the adherence to statutes and to procedural or audit manuals adopted by the board of directors. On the basis of its findings, it proposes amendments to the board. Its role is more formal than operational in nature.

A compliance officer, who may be the general secretary of the compliance committee or any other person appointed for this purpose, sometimes acts as the liaison between the committees and executives charged with reviewing reports, taking an inventory of weaknesses discovered, and following up with corrective actions.

**AUDITORS**

Auditors are the agents who measure internal control. Their role is specified in ICP 10, essential criterion c:

“The internal and external audit, actuarial, and compliance functions are part of the framework for internal control and must test adherence to the internal controls as well as to applicable laws and regulations.”

The audit is a critical review of the information disseminated throughout the company (or to third persons). A financial audit certifies the faithful representation of the company’s accounts. An operational audit inspects the details of the company’s activities with a view to improving its performance: it concludes by making recommendations and sometimes proposing more effective procedures, in particular with regard to internal control.

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4. The root of the word “audit” is the Latin word “audire” (to listen); the auditor should not, however, be satisfied with merely listening: he must also be listened to!
The auditor is the natural or legal person (audit firm) carrying out an audit. It may be either external or internal.

The external auditor may be legal (statutory auditor) or contractual, having received the mandate to carry out a specific mission, such as setting up internal control procedures.

The internal auditor is usually a paid employee of the company he or she audits. According to the Institute of Internal Auditors, this is “an independent appraisal function established in an organisation to examine and evaluate its activities as a service to the organisation. The objective of internal auditing is to assist members of the organisation in the effective discharge of their responsibilities. To this end, internal auditing furnishes them with analyses, appraisals, recommendations, counsel, and information concerning the activities reviewed.”

If the establishment of an internal audit function is incompatible with the structure and size of the insurance company (in the case of small and medium-size firms), the board of directors should organize supplementary supervisory procedures or outsource this function in order to provide adequate security for the internal control system.

IAIS emphasizes the specific nature and importance of the internal audit function in ICP 10, essential criterion j:

“The supervisory authority requires that an internal audit function has unfettered access to all the insurer’s business lines and support departments, assesses outsourced functions, has appropriate independence, including reporting lines to the board of directors, has status within the insurer to ensure that senior management reacts to and acts upon its recommendations, has sufficient resources and staff that are suitably trained and have relevant experience to understand and evaluate the business they are auditing, employs a methodology that identifies the key risks run by the institution, and allocates its resources accordingly.”

Internal auditors examine the regularity and security, adequacy, and effectiveness of internal control systems prepared by each department in the company, in liaison with the audit committee (or perhaps with the board of directors through the general secretary, if he or she has been assigned the job of coordination by the board). They assess whether systems are consistent with actual operations and propose appropriate remedies to problems they detect in the internal control procedures.

To accomplish their job of analysis, internal auditors must be:

- Competent and experienced
- Sufficiently numerous and adequately equipped
- Given sufficient power to require the departments subject to their investigations to submit reports, documents, and other materials they need for their audit and to require those being audited to cooperate
• Independent, meaning that, within the scope of their mission, their powers are not limited, although they cannot disseminate the information they collect to anyone other than the parties concerned unless there are good reasons for doing so.

• Capable, more generally speaking, of carrying out their mission properly and effectively, impartially and fairly.

The internal audit function must also be universal, meaning that it must cover all of the company’s activities.

Several types of internal audits are commonly conducted: an annual audit of each department in the company, an audit on a particular topic covering several departments, and a follow-up to a previous audit to verify whether or not the corrective actions taken by department managers were adequate, effective, and implemented in a timely manner.

An annual audit program is prepared by a coordinator (audit committee, general secretary, or compliance officer) and approved by the board of directors. This program defines general company policy with regard to audits, describes the priority requirements for meeting management objectives, and inventories individual audit programs.

Programs for individual internal audits are prepared within the framework established by the coordinator, who takes into account the various types of risks and their severity, as well as the frequency, scope, and degree of depth of the work done previously. Approval of individual programs is often delegated to the general management of the company. An individual program must provide information on the proposed objectives of the audit, the methodology to be followed, the activities to be examined, the schedule, and the budget.

Other Internal Control Participants

The missions of accounting and financial audits are specific to the audit, whose purpose is to verify that the financial statements issued by the company correctly reflect its economic situation and its business. For this audit, which is characterized by regularity with respect to accounting rules and conformity with the recorded financial data, external certified accountants or auditors may be called on who are also asked to express their views on the reliability of the accounts and, more generally, on the soundness of the internal control systems taken as a whole.

Because of the specific characteristics of insurance, a special role is given to risk managers and actuaries in the organization of internal control and its qualitative evaluation. According to ICP 18, on risk assessment and management,
The supervisory authority requires and checks that insurers have in place comprehensive risk management policies and systems capable of promptly identifying, measuring, reporting, and controlling their risks (criterion a).

- The risk management policies and risk control systems are appropriate to the complexity, size, and nature of the insurer’s business (criterion b).
- The risk management system monitors and controls all material risks (criterion c).

Examples of the application of these principles to insurance companies are given in the following section with respect to various topics: protection of investments, asset management, derivative instruments, and risk tolerance, following the identification, analysis, and research of aggregations.

Actuaries have a separate place in the operation and control of insurance companies (see IAIS 2003c). As internal control participants in a life insurance company (and even non-life companies in some jurisdictions), they are logically cited by ICP 10, essential criterion l:

“The supervisory authority requires actuarial reporting to the board and management where the appointment of an actuary is called for by applicable legislation or by the nature of the insurer’s operations.”

The actuary is a specialized professional who should have direct access to the board of directors.

The large international auditing firms may have actuaries on staff, or call on independent actuaries, to assess an insurer’s technical provisions, rates, and profit-sharing with policyholders.

In a number of countries, the law requires insurance companies to choose an appointed actuary. This actuary must guarantee that the premiums and technical provisions of life insurance are calculated in accordance with generally accepted actuarial regulations and principles. The actuary must therefore have access to all the information that may be useful. The actuary reports his or her observations to the board of directors, and is therefore an important internal control agent.

**Reporting and follow-up**

Upon completion of their engagement, the internal auditors draft a report, which should:

- Assemble the information that has been gathered and the analyses resulting from it
• Evaluate the work done to make it more easily usable by others
• Contain a list of audited activities, a description of how easily the mission was accomplished, and a list of interviews, observations, conclusions, opinions, and recommendations.

Interviews and reports, coordinator's comments, and notification of those being audited are the stages of a dialogue that should elicit actions and reactions from company directors and department managers, ultimately resulting in steps to correct the errors detected and improve internal control procedures in accordance with the auditor's recommendations.

The coordinator transmits to the head of the department being audited the findings of the audit, annotated with the coordinator's own comments, opinions, instructions, and suggestions. The head of department is invited to submit a plan for taking corrective measures. The auditor's report may be communicated to other persons in the company, at the request of the department head, proposal of the coordinator, and authorization of the director. The coordinator prepares a complete report for the board of directors. It must be strictly confidential, addressed to heads of departments, and open to the external auditors. It lists the items studied, problems to be solved, observations, and recommendations.

With the coordinator's help, the head of the department in question must take immediate steps to remedy the problems uncovered by the auditor or even by senior management. In a report to the coordinator, the department head details the actions taken, indicates the results obtained, and announces any new initiatives planned, while providing evidence that instructions have been followed. The coordinator then formalizes the monitoring of corrective actions in a new regular audit, whose purpose is to affirm that the audit has been conducted and to evaluate its effectiveness.

### Exercises

3. Explain the relevance of an organization chart to internal control.

4. Provide three examples of duties that should be segregated from one another within an insurer and explain the problems that could arise if such segregation is absent.

5. List at least four parties that might participate in the internal control process of an insurer. Which of these are commonly in place for the insurers that operate in your jurisdiction?
D. Internal control and procedures specific to insurance

In general, an insurance company's approach to internal control—its objectives, principles, participants, and some of its procedures—is no different from that of other companies in the financial sector. Nevertheless, it must take specific characteristics of the insurance business into account:

- **The special nature of insurance operations.** These include pricing based on assumed future experience (risk of mispricing), risk selection, long-term underwriting (risk of underfunding), correlation between life insurance contracts and investments (rates, depreciation, or counterparty risks), reinsurance (specific risks), intermediation (risk of default by a partner), and outsourcing.

- **The need for stronger protection of insurance consumers.** Internal control should seek to measure the quality of services rendered to the insured, for example, on the basis of transactional information, such as the payment of surrender value (life insurance) and settlement of claims (non-life insurance).

Examples of important functions in an insurance company for which internal controls are required are as follows:

- Risk assessment (life insurance)
- Claims provisions (non-life insurance)
- Safeguarding of investments
- Asset-liability management
- Derivative instruments
- Computer systems
- The use of intermediaries
- Outsourcing
- Anti-money laundering.

For each of these procedures, this section describes the risks specific to the activity in question, the consequent objectives of internal control, and the main internal control procedures implemented.

**Risk assessment (life insurance)**

The purpose of an insurance contract is to guarantee against risk. In life insurance, the risk is linked to life expectancy: the insured may die too soon (death benefit) or too late (life annuity). The insurer must calculate the risk in order to decide whether to accept it and to determine the amount of the corresponding premium.
In this context, the internal control procedures put in place by the life insurer deal with:

- **The insurance application.** Is it designed to allow for an accurate assessment? Is it properly filled out?
- **Assessment of risk accumulation.** Do any other existing contracts in the company cover the same insured party?
- **Medical selection (death benefit).** Do the medical questionnaire and, where applicable, supplementary examinations constitute effective protection against adverse selection?
- **Reinsurance of guarantee capital for an amount exceeding the insurer's capacity.** Is it adapted to the insurer’s means? Is it applied?

The contract file containing the information needed for managing risks, premiums, and technical provisions should be user-friendly.

Problems of follow-up of premiums and technical provisions call for various actions, including, among others, the following:

- **Writing of premiums.** Internal control procedures should provide assurance that the applied rate conforms to the assessed risk at the time the policy is written. Computerization of premium calculation generally alleviates this problem.
- **Collection of premiums.** Procedures to protect against misappropriation or loss of payment and the risk of misallocation of the payment are organizational in nature, and internal controls should see that such payments are properly applied, including direct deposit, the segregation of duties between the receipt of funds, the allocation of funds, and the monitoring of bank accounts.
- **Matching of each premium to the technical provision.** For example, if the risk is that a premium recorded as revenue has no counterpart in the technical provision set forth in the policy, the role of internal control is to make a systematic analysis of unearned premiums and verify that the premium files are consistent with the technical provision files.

With respect to non-life insurance, except in reference to medical selection and technical provisions, emphasis should be placed on rates. How is the applicable rate determined? Is there a procedure for verifying the rates applied? If so, what is it? In the case of rating exceptions, is there a particular procedure for authorization through channels depending on the size of the exceptions? If so, what is it? Generally, it is the responsibility of internal control to maintain a fair balance between the company’s business objectives (to earn a profit) and technical imperatives (sufficient premium payments).
The technical provisions must be adequate to meet all of the insurance company’s commitments to its policyholders. In a non-life company, the outstanding claims provision is intended to cover the full settlement of all claims (and management and related expenses) arising before the date of reporting and not paid by that date. This includes reported claims and late claims (claims incurred but not reported).

The claims provision is the most important item in the liability column of a non-life insurance company, but it is only an estimate. Misestimation is always possible, distorting the picture of the company’s financial position as stated in its balance sheet. The control of claims provisions is thus a priority for assessing the risks incurred by an insurance company, particularly underfunding, which distorts the balance sheet; mispricing, which is concealed by miscalculation of costs; mismanagement of claims; and fraud or the unjustified payment of real or fictitious claims.

Internal control procedures should measure the quality of claims management (see OECD 2004) and the appropriateness of the amounts of provisions held. By the very nature of their duties, internal auditors appear to be the most suitable persons to examine the provisions in detail, and they sometimes devote considerable time to this task, if necessary.

An internal audit of the claims provisions fulfills two main objectives: to verify the amounts at a given date (for example, in the balance sheet) and to verify the company’s procedures and methods of assessment. The first type of verification deals with the level of provisions. Are they legally correct? Are they sufficient? The auditor should indicate the amount that appears to be adequate. The second type of verification concerns methods and procedures. Are they acceptable under the regulations? Are they reasonable? Are they properly implemented? Are the provisions free of fraud? Is the division of duties with regard to assessing the files organized in such a manner as to ensure satisfactory control of the assessments themselves?

The internal audit report should also confirm that the accounting procedures applied are accurate, indicate the influence of these procedures on claims statistics and the analysis of provisions, and suggest improvements. Is there a connection between payments recorded in the claims files and payments on account? Is there a stricter procedure for payments exceeding a set limit? The report should also evaluate the computer technology system used for claims in light of the analysis of provisions, indicate the impact on provisions of flaws in the system, and make recommendations. Finally, it should provide a general assessment of the management of provisions in the claims department (initial assessment of the file and systematic review for each new event), evaluate the tools available to managers (risk assessment and management manual) and the regular updating of these tools, indicate the impact on provisions of flaws detected in management or tools, and suggest improvements, based on specific analyses of insufficient provisions ascertained.
An audit of provisions therefore exposes problems that go beyond the auditor’s strict mission of assessing claims provisions. These include reappraisal of pricing and the company’s business strategy, dysfunctional accounting practices, and malfunctioning data-processing chains. As these problems emerge, additional audits are needed. Then the auditors analyze the responses of those being audited to the report’s recommendations and follow up the audit, checking the reactions elicited by each recommendation.

It could happen that claims provisions are estimated correctly, but the procedures and methods used by the company are unsatisfactory. For example, in a small company, the general manager, by his business knowledge and experience, may be particularly skillful in assessing claims provisions prudently and conscientiously and entering a reliable and sufficient amount on the balance sheet. Even if his results are correct, however, such a procedure is unacceptable under the principles of internal control and, in particular, the rule of segregation of duties.

**Safeguarding of investments**

An insurance company’s investments back its commitments to its policyholders. They must offer security and yield. In most countries, they are regulated. ICP 21, on investments, essential criterion e, sets the standards and stresses the importance of internal control in this regard:

“The supervisory authority checks that insurers have in place adequate internal controls to ensure that assets are managed in accordance with the overall investment policy, as well as in compliance with legal, accounting, and regulatory requirements. These controls should ensure that investment procedures are documented and properly overseen. Normally the functions responsible for measuring, monitoring, settling, and controlling asset transactions are separate from the front office functions.”

The purposes of internal control are clear:

- To ensure that asset management complies with laws and regulations
- To ensure that the investment strategy defined in writing by the board of directors (or the investment committee or other authority delegated for this purpose) is correctly applied. According to ICP 21, essential criterion c, this strategy should determine, among others, the asset mix over the main categories of investment, investment limits by type of asset, counterparty, outsourced manager, market, currency, and geographic area, and profitability objectives adjusted to
yields required to meet commitments (quest for matching rates and time periods).

- To evaluate protection mechanisms against risks associated with investment activities that might affect the coverage of technical provisions or solvency margins. According to ICP 21, essential criterion d, these risks include market risks (such as stock market depreciation), interest rate risk, liquidity risk, counterparty failure, material destruction, misappropriation, and fraud.
- To control the integrity and reliability of information processed and produced. Are investments, together with any acquisitions and transfers relating to them and the corresponding income, properly recorded and allocated?
- To ensure the segregation of duties. Are acquisitions and transfers justified? Have they been carried out under the best possible conditions? Is the valuation of investments on the balance sheet correct?
- To suggest qualitative improvements in management.

In short, internal controls should provide the decisionmaker with the necessary tools to take strategic positions (see IAIS 2004 for more information on investment risk management).

A report on investment policy should be submitted at least once a year to the board of directors. It provides details on, among others, the methods used to evaluate and control investments—in particular, to evaluate the quality of assets, the internal investment control mechanism, the division of responsibilities, delegation of power, internal control procedures, structure of the investment portfolio, and results by type of investment.

Internal control procedures include:

- Verification that investments entered on the balance sheet tally with existing investments, based on monitoring of transactions and analysis of information provided to the accountant
- Justification of operations and inventories, including control of documents certifying ownership or sale of fixed assets
- Monitoring of counterparties by an internal or external assessment system (rating agency)
- Establishment of a special investment file, including balance sheet, income statement, published brochures, and press clippings
- Establishment of a management control mechanism to monitor the profitability of investments based on performance indicators, time-series analyses, and consistency ratios.

According to ICP 21, essential criterion h, regular audits should also identify weaknesses in internal control and deficiencies in management. In other words, the internal control function is first of all preventive; if this is not possible, it should allow for the
timely detection of risks that could be detrimental to the company’s financial situation.

**Asset-liability management**

For a life insurance company, the purpose of asset-liability management (ALM) is to build up sufficient appropriate assets to match the commitments that constitute its liabilities. ALM consists of influencing the composition of investments to optimize results, while at the same time controlling the financial risks involved. It is applied at two levels: to a product (for example, a unit-linked contract) and to the entire balance sheet.

At the second level, ALM is an analysis and overall planning tool. Asset-liability management attempts to reach an optimal compromise between the nature of liabilities and assets, seeking the product that will be most attractive to the client (liability) or choosing assets on the basis of security (risk) and profitability criteria. Asset-liability management should be based on available competencies in the various departments of the company, including technicians, product managers, and asset managers.

The building of an asset-liability management function must, therefore, be done in the context of the internal control system. An audit should inventory the specific asset-liability risks, which are in addition to the financial risks discussed elsewhere. These may include:

- **Funding risk on traditional contracts.** These contracts carry two risks: reinvestment risk (risk that the rate of return on future investments will be lower than the rates guaranteed in the insurance contracts) and liquidation risk (risk that the company will be forced to transfer depreciated liabilities without reimbursement).

- **Unit-linked contracts.** These contracts carry the risk of illiquidity of a unit-linked contract when payment of a benefit is owed to the policyholder, the risk of asset-liability inadequacy, when the insurer delays in acquiring (or selling) units of account corresponding to variations in the volume of commitments, and floor guarantee risk.\(^5\)

An asset-liability committee (or, failing that, the investment committee) is the decisionmaking body that identifies the risks specific to the insurance company, defines the company objectives (for example, to respect statutory ratios or protect annuity investments against long-term inflation), and draws up a financial strategy. The allocation of assets, which should reflect regulatory, accounting, or fiscal constraints, is oriented differently depending on the relative priority attached to yield and security.

The committee should also adopt terms of reference containing written objectives and strategy, listing authorized financial transactions and acceptable types of invest-

\(^5\) The floor guarantee risk may be considered as the risk that the return on the invested assets is less than the rate guaranteed as the minimum return to the policyholder under the terms of the contract.
ments, and describing an exception procedure (to avoid any delays that might result from excessively rigid financial management).

The asset-liability manager should be free to make decisions within prescribed limits. The manager should submit a report on activities to the asset-liability committee periodically (at least once a year). Management may be assigned to a special internal unit combining representatives of the company’s liabilities and assets. It may also be delegated to a third party, with the inclusion of terms of reference in the management mandate.

Internal control procedures are aimed, first of all, at compliance with the terms of reference or the instructions given to the manager. Control of compliance with the terms of reference or instructions may be carried out at several levels: by the asset-liability committee, on the basis of the manager's report, by internal audit, and by a specific financial control procedure, onsite and based on documentary evidence. The controller may also make substantive comments on the asset-liability policy or even conduct a complete audit of asset-liability risks.

To monitor the level of risks incurred and their evolution, the controller may use model balance sheets, making future projections of the company's results and financial situation on the basis of predetermined scenarios (see IAIS 2003b for more information on stress testing by insurers). These scenarios, or hypotheses, including the economic and financial climate, the company's production process, and client behavior, make it possible to build risk indicators, containing warning thresholds.

**Derivative instruments**

If it enters the derivatives market, an insurance company is exposed to specific risks, including the following:

- *The fluid nature of derivatives*, in which transactions may be made very rapidly based on verbal orders (promises) and in volumes that are sometimes considerable, making them quite hard to track
- *Considerable leverage effect*, in which losses and gains may be heavy compared with the initial investment
- *Complex management*, in which the staff who manage derivatives must be particularly well qualified, as should policymakers in this area
- *Liquidity problem*
- *Counterparty risk.*

Derivatives require supervision, monitoring of positions, and strict internal control.

According to ICP 22, on derivatives and similar commitments,
“The supervisory authority requires insurers to comply with standards on the use of derivatives and similar commitments. These standards address restrictions in their use and disclosure requirements as well as internal controls and monitoring of the related positions.”

Specifically, in essential criterion e,

“The supervisory authority requires that insurers have in place risk management systems, covering the risks from derivatives activities, to ensure that the risks arising from all derivatives transactions undertaken by the insurer can be analyzed and monitored individually and in aggregate [and] monitored and managed in an integrated manner with similar risks arising from nonderivatives activities so that exposures can be regularly assessed on a consolidated basis.”

According to the French Commission on Stock Market Operations, “The management of risks arising from derivatives is a problem of internal control” of various kinds. The first subject of internal control is a detailed description of strategies. The board of directors, general management, and other senior staff should have a clear understanding of the strategies used by traders and should evaluate each objective pursued and each method of implementation. Internal control reports should provide enough detail to enable management to draw up a list of authorized strategies and to approve or veto any new strategy.

The second subject concerns resources. The company must have adequate computer, communications, and management resources to allow traders to act appropriately and quickly. The system’s effectiveness may be subjected to certain tests, such as the measurement of a given position or the building of a stress test.

The third subject is the monitoring of liquid assets. In an investment strategy, the company should have the necessary liquid assets for the future purchase of contract assets. Where does the notion of liquid assets stop? At available assets in the bank alone? Or is it a broader concept, including time deposits and future cash flows, such as accrued interest, amortized securities, or premiums to be collected? Are liquid assets used more than once for different purposes?

Internal control policies and procedures should answer these questions. Other procedures should seek to ensure compliance with limits on the use of derivatives set by the board of directors—limits by type of strategy, product, market, and counterparty (transaction by mutual agreement).
Computer systems

Computer technology has transformed the structures of insurance companies by allowing them, among other things, to process quickly large volumes of data on contracts, premiums, claims, technical provisions, commissions, and investments. At the same time, the computer has become a new source of risks that fall within the scope of internal control.

The specific risks connected with the technical aspects of each type of information system, whether or not it is centralized or involves independent or networked personal computers, are not discussed here. But all systems entail shared risks, which are inherent in the use of computer technology:

- **Error risk.** The use of complex computer processes involves a repetitive and voluminous number of operations, and hence anomalies occur if the software contains an error. Each error has a systematic character: if it has already occurred, it is probably due to a design fault in the system and will reoccur each time the same conditions are repeated.

- **Risk of malicious intent or fraud.** The user-friendliness of software (unlike traditional accounting tools) allows any malicious person to make an erroneous entry. The concentration of information weakens its protection.

- **Risk of negligence.** The greater the sophistication of the hardware being used, the greater the need for strict control. However, the sometimes blind confidence of operators in these resources dampens their critical spirit and creates a psychological climate of optimism and relaxation that is especially conducive to errors and fraud. The history of computer technology is full of events that illustrate this fact.

- **The risk of chance mishaps.** These include the crashing of a software program from an accidental interruption caused by encoding that exceeds a file's capacity—for example, when an addition contains more digits than the storage medium can accept or the use of a nine-digit storage medium to add up risk provisions, evaluated file by file, cuts off the end of all amounts exceeding 1 million.

Internal control should monitor the reliability of hardware, data entered on computers, data processing, data protection, and description of processes. Moreover, to prevent destruction of hardware and data, and possibly to repair them, internal control processes should follow a number of elementary rules with regard to security mechanisms (locks, passwords) and the safeguarding of files and programs.

Information must be protected against cyberpredation, both internal (unauthorized use, loss of data) and external (competitors, pirates), and equipment must be protected against natural phenomena (storms, electrical failures, dust) and, in the case of outages, operations relayed to external computer installations. Internal control verifies
that the company is capable of overcoming the effects of a computer technology crisis (risk of overdependence on information technologies).

**The use of intermediaries**

Agents and brokers play a major role in the insurance business, for which they constitute its primary sales force. Also, the following operational tasks are sometimes delegated to them: issuance of policies, collection of premiums, and settlement of claims. Specific risks result from such delegation:

- Underwriting risk, in which the intermediary may accept a poor risk or even commit the insurer beyond its limits
- Risk of fraud through the sale of fictitious policies or the payment of undeserved benefits
- Risk of embezzlement of funds received from policyholders or insurers
- Financial risk relating to late remittance of funds collected.

To guard against these risks, insurance companies set up internal control procedures to accomplish the following:

- Control the integrity of intermediaries
- Segregate duties between intermediaries and departments in charge of pricing and issuing policies
- Monitor the position of intermediaries regularly on the basis of balance sheet ratios
- Conduct internal audits, with a view to ensuring that the intermediary does not pay out undeserved benefits, regularly remits to the company all premiums collected, and does not commit the company beyond the authorized ceilings.

**Outsourcing**

Insurance companies are increasingly resorting to outsourcing, that is, contracting out some of their essential functions to third parties. Several of the ICPs refer to outsourcing, including:

- ICP 6, on licensing, essential criterion b: “Clear, objective, and public licensing criteria require … information on contracts with affiliates and outsourcing arrangements.”
ICP 13, on onsite inspection, essential criterion f: “The supervisory authority can extend onsite inspection to obtain information from intermediaries and companies that have accepted functions outsourced by the supervised insurer.”

ICP 10, on internal control, essential criteria h and j: “The supervisory authority requires oversight and clear accountability for all outsourced functions as if these functions were performed internally and subject to the normal standards of internal controls.”

ICP 10, essential criterion j: “The supervisory authority requires that an internal audit function … assesses outsourced functions.”

The range of functions that insurers have outsourced is very wide. It includes policy issuance, settlement of claims, calculation of technical provisions, establishment of rates, actuarial tasks, computer management, management of asset portfolios, prudential reporting, internal audits, and more.

Outsourcing can have certain advantages. It can reduce costs, owing to economies of scale in the provision of services, and derive benefits from the expertise of an outside specialist. However, it also entails risks that must be managed by the insurer, including:

- **Legal risk.** Noncompliance by providers with legal requirements (especially when they are not insurers themselves)
- **Operational risks.** Risk of loss of control over outsourced activities, risk of loss of the insurance company’s competence to manage the outsourced activities, risk of dependence on the provider, and risk of conflict of interest if the provider works for several insurance companies
- **General risks.** Risk of incompetence of the provider, deterioration of the quality of service provided, and excessive cost, resulting in higher premiums paid by the insured.

Internal control aims to prevent risks and potentially limit their effects. The purposes of the controls on outsourcing include verifying that: outsourcing does not undermine the interests of policyholders; the company’s board of directors feels that it is still responsible for all outsourced activities and behaves accordingly in defining and monitoring these activities; guidelines prepared by the board are clearly described in the outsourcing contract and complied with by the provider; the company’s resources for analyzing risks associated with outsourcing are adequate and effective; alternate solutions exist if operational problems should arise in respect of service providers; and the insurance company is empowered to terminate the outsourcing contract at any time if difficulties arise that are harmful to its reputation, business policy, or financial situation.
**Anti-money laundering**

In many countries, laws require financial institutions to know their customers, including the true beneficiaries of any contracts in which the representatives are not acting on their own behalf. The obligation of special vigilance applies to large transactions that are unusually complex and do not appear to have any economic justification or lawful purpose. Life insurance is especially affected, but other classes of insurance do not escape this risk, which is liable to harm the company’s reputation, to the ultimate detriment of its financial soundness.

IAIS has issued a recommendation basically addressed to supervisory authorities but also illustrating the role of internal control. According to ICP 28, on anti-money laundering,

“The supervisory authority requires insurers and intermediaries to take effective measures to deter, detect, and report money laundering and the financing of terrorism.”

Essential criterion f deals specifically with monitoring and reporting of suspicious transactions:

“The supervisory authority requires that insurers and intermediaries cooperate with the competent authorities, ensure transparency of money flows, in particular monitor for complex, unusual large transactions, or unusual patterns of transactions, that have no apparent or visible economic or lawful purpose, promptly report to the competent authority suspicious transactions, such as a transaction where the proceeds could either stem from a criminal activity or be linked or related to, or are to be used to, finance terrorism, be alert to significant, unexpected, and unexplained changes in the behavior of policyholder accounts, check reinsurance or retrocession arrangements to ensure the monies are paid to bona fide reinsurance entities, [and] should suspicion of money laundering or financing of terrorism arise, refrain from warning (“ tipping off ”) their customers when information relating to them is reported to competent authorities.”

Insurance companies should therefore put in place internal control procedures in order to raise the awareness of personnel as well as intermediaries in charge of underwriting or collection of funds, identify the underwriter of a contract, and retain a record of the transaction as long as legally required.

In case of doubt, the insurance company should draw up a “suspicious transaction report” and submit it to the authorities in charge of detecting money laundering and to the insurance regulatory authority, where necessary.
Exercise

6. This section of the module presented the following examples of important functions of an insurer for which strong internal controls are needed: risk assessment (life insurance); claims provisions (non-life insurance); safeguarding of investments; asset-liability management; derivative instruments; computer systems; the use of intermediaries; outsourcing; and anti-money laundering. Provide an example of an insurer in your jurisdiction for which internal control weaknesses in one or more of these functions contributed to the need for supervisory intervention. Describe the nature of the weaknesses and the steps that were taken to deal with them.
E. Internal control and the supervisory authority

Internal control meets a prudential need. It is therefore subject, on the one hand, to the scrutiny of external (or statutory) auditors and, on the other, to surveillance by insurance supervisors, especially concerning the financial soundness and operating conditions of companies. The external auditor must express an opinion on the legality, honesty, and accuracy of the annual statements of the company being audited.

The external auditor also describes, in a special report to the board of directors, the accounting documents to which changes should be made, adding any useful comments concerning the methods used in preparing these documents, any irregularities and misstatements identified, and any conclusions regarding the company’s accounts. This description includes weaknesses of internal control uncovered by the external auditor, risks resulting from them, and recommendations for rectifying them.

For its part, the supervisory authority monitors the reliability and effectiveness of internal control and uses the findings of internal control in assessing the company’s financial soundness and operating conditions.

This section discusses the powers and responsibilities of the supervisory authority and the supervisor’s assessment and use of internal control.

Powers and responsibilities of the supervisory authority

These powers and responsibilities are precisely described in some of the insurance core principles: ICP 10 deals specifically with internal control, while ICPs 9, 13, 17, 18, 21, and 22 refer to it. These ICPs set forth principles and assessment criteria applicable to various essential functions of an insurance company.

According to ICP 10,

“The supervisory authority requires insurers to have in place internal controls. The responsibility for the establishment, monitoring, and effective operation of these controls lies with the board of directors, which should put in place systems to organize the sharing of reliable information among the various levels of management and, in particular, to verify the effectiveness of such systems.”

The supervisor requires the insurance company, and in particular its board of directors, to comply with all applicable corporate governance standards recommended by ICP 9. Insurers must put in place a permanent audit function (ICP 10, essential criteria h, i, and j). Onsite inspections must include assessment of the internal control system (ICP 13, explanatory note 13.3).

According to ICP 17, essential criterion d, “At a minimum, group-wide supervision of insurers which are part of insurance groups or financial conglomerates includes, as
a supplement to solo supervision, at a group level, and intermediate level as appropriate, adequate policies on and supervisory oversight of … internal control mechanisms and risk management processes, including reporting lines and fit and proper testing of senior management."

Risk management policies and systems must be capable of quickly identifying, measuring, describing, and controlling the risks faced by insurance companies (ICP 18, essential criterion a), the management and safeguarding of assets (ICP 21, essential criterion e), and the use of derivatives (ICP 22). In other words, the objectives and responsibilities of the supervisory authority are as follows:

- To impose on insurance company administrators and senior managers the setting up of standards and internal controls covering all aspects of company management and to verify that the duties and responsibilities of each are clearly defined, with a segregation and separation of key functions
- To verify that the audit function is provided with the necessary means to carry out its responsibilities effectively, including access to all departments and sectors of the company, independence from senior managers and administrators, sufficient material and human resources (skills and experience), and appropriate methodology
- To verify that information from the board of directors is properly organized and that the recommendations from the audit are taken seriously
- To require, if necessary, the strengthening of internal controls.

To assess the internal control system put in place by an insurance company, the supervisor works in stages. The procedure described here is an example, not a unique model. The first task is to understand the system. To gain an understanding of information-management networks, from the beginning of a transaction to its entry on a company’s accounts, the supervisor talks with officials of the departments and participants, studies the internal control manual, and reviews the internal auditors’ reports (see IAIS 1998).

This is followed by preparation of a description of the system to keep written track of the information collected. This description is not limited to an accounting approach; it also covers supplementary information processed by the company, such as new business statistics, shared risks in homogeneous groups, and claims by cost bracket.

Next it is important to verify the existence of a system to validate (or invalidate) the relevance of the description prepared and to review the processes and checks implemented by the company, in order to ensure that systems are designed to eliminate (or at least significantly reduce) the risks of errors and losses. Accordingly, the supervisor may use preestablished questionnaires for each function in the company and each internal control objective. How can evidence be found on the basis of accounting entries? By what procedures do persons empowered to sign checks verify that a transaction—for
example, the payment of a claim or the clearance of a reinsurance balance—is justified?

The next task is to verify the effective functioning of the described procedures. Are they actually used? Are they used all the time? To answer these questions, the supervisor may repeat the processing or control carried out by the staff or computer of the company. The test thus consists of entering data prepared by the supervisor into the computer programs used by the company in order to verify that the processing and controls envisioned by the company are implemented effectively.

A final assessment follows in which the supervisor determines the extent of his or her confidence in the internal control system of the company by assessing the design of procedures and the results of tests carried out to measure their functioning.

Assessing internal control has a dual purpose. The supervisor who is convinced of the reliability of the procedures will carry out only a few tests, but the number of validation tests will increase if unreliable procedures are discovered. If the procedures are found to be ineffective, the supervisor will suggest improvements.

The supervisor's conclusions are revalidated by reviewing the internal audit reports: the supervisor has access to all of the internal auditors' reports, and by reviewing them can revalidate supervisory findings. In turn, the supervisor assesses the quality of the audit reports by checking the accuracy of the data and the relevance of the analyses. This task is frequently difficult in the absence of any real standardization of the form and content of audit reports, which often are too full of detailed information, are intended for purely internal use, or are not certified. Faced with this situation, the supervisor may recommend that the company set up a control framework for audit reports in order to rationalize their structure and highlight the important information they contain.

Finally, the supervisor analyzes the shortcomings and weaknesses identified by the auditors and has the departments and senior management of the company follow up on the auditors' comments. The supervisor is a kind of “super” external auditor, whose powers, objectives, and actions are considerably different from those of the internal auditors. First, the supervisor's scope of activity is universal, enabling the supervisor to gain a consolidated picture of internal control in the company. The engagement of the internal auditor is generally restricted to one department. Second, supervisory actions are carried out with discretion, selectively, with their degree of depth adjusted on the basis of the supervisor's understanding of the company. The internal auditor, in contrast, is assigned to prepare the most complete inventory of issues possible to answer the questions asked by senior management, the compliance officer, or the board of directors. Third, supervisory conclusions are addressed to the board of directors and recommendations are binding on the company, which must take the corrective steps required. The internal auditor's comments are only the first step in a dialogue that may produce further feedback.
Use of internal control by the supervisor

The observations and findings on internal control are more or less fully used by the supervisor, depending on the supervisor’s judgment concerning the reliability and effectiveness of the procedures implemented by the company. But whatever the extent of its confidence in the internal control system, the supervisory authority cannot give up its own investigations, especially onsite inspections, which are the only kind capable of confirming that the quality of internal control is enduring and gathering information on the company’s operating conditions and financial soundness (generally, the primary area of concern) necessary to form an external, independent judgment. Some supervisory authorities have established detailed criteria for the assessment of internal control functions (for example, see OSFI 2002).

The supervisor uses the findings of internal control most often to assess operations such as the use of derivatives, underwriting policy, reinsurance strategy, and investment decisions, with particular emphasis on outsourcing, and sometimes to make a forward projection of trends in the company’s financial situation. The supervisor is more likely to request the internal control findings in order to assess the quality of services rendered to the insured, the effectiveness of risk management, the compliance of the company’s transactions with prevailing laws and regulations, and the adequacy of the internal audit function. A few examples are given here.

Protection of the insured and quality of services rendered (life insurance)

The supervisor uses the analyses and findings of internal control to assess the management of the company on very precise key points:

- Participation of the insureds in profits, their distribution among the various types of contracts, and justification of their amounts in comparison with models of the company’s future cash flows
- Processing of canceled contracts, delays in payment of surrender values, calculation of provisions relating to reduced premium policies
- Information prepared for policyholders, quality of brochures sent to them, and reliability of call centers
- Follow-up of complaints filed by policyholders who claim they were misinformed about the features of their contracts (unit linked, surrender values).

Sometimes the information provided by internal control procedures is not specific enough to help the supervisor make a reliable judgment on the level of technical provisions. The supervisor may reasonably ask the company’s actuary for a prospective appraisal of the company’s commitments on the basis of the most recent economic data (life expectancy table, interest rate, management fees).
RISK MANAGEMENT SYSTEM

The supervisor analyzes the risk management system set up by the company, which, if relevant, helps the supervisor to judge the financial soundness of the company. The supervisor may thus adapt the prudential ratios to specific situations brought to light by the risk inventory. Crucial questions include the following:

- Are the data collected by the company for calculating technical provisions sufficient, relevant, and well utilized?
- Do reinsurance contracts effectively protect the company against catastrophic events and an abnormal frequency of claims? Have the quality and solvency of reinsurance partners been accurately appraised?
- Are the loan files sufficiently well documented to warn the company of risks of borrower default?
- Has a prospective analysis of liquidity risk, including a cash-flow analysis, been carried out, and, if so, is it based on appropriate assumptions?

COMPLIANCE WITH LAWS AND REGULATIONS

Compliance concerns not only legal regulations applicable to all the companies in the same jurisdiction but also the internal regulations adopted by each company. Companies should have controls in place to ensure their compliance with both legal and internal regulations. The supervisor must assess whether these controls are effective in maintaining compliance with laws and legal regulations, for example, to determine whether the prudential ratios are adhered to and the administrative structures are adequate. The supervisor also examines whether the internal regulations are relevant and well enforced:

- Is the board of directors duly informed, especially about the signing of important contracts, payment of large claims, or steps taken by departments in response to the findings of the internal audit?
- Are the functions and working methods (roles, tasks, responsibilities) of the committees to which powers have been delegated clearly defined?
- Is the compliance officer’s role merely nominal, owing to vaguely defined tasks, responsibilities, and powers?
- Is a review of the internal regulations and audit manual regularly scheduled in order periodically to correct inconsistencies and shortcomings?

In turn, the internal auditors must inform the board of directors of all the shortcomings identified during the course of their reviews. It is equally important for them
to build models of the trends in prudential ratios, particularly of the company’s capacity to absorb potential losses.

ADEQUACY OF INTERNAL AUDIT

The supervisor should point out the shortcomings of internal audit capabilities and processes, including:

- Lack of know-how for the auditing of certain technical functions
- Inaccurate identification of certain risks
- Imprecise criteria for reporting to the board of directors
- Insufficient follow-up, by the departments concerned, of points dealt with in the auditors’ observations and recommendations.

In brief, internal control helps the supervisor to assess the financial situation, operating conditions, and administrative and commercial organization of an insurance company.

In some countries, the regulations mandate sanctions in the case of absence, shortcomings, or weakness of internal control. Internal control reports may also serve as a basis for sanctions if they reveal any infractions of the regulations. In some jurisdictions, including France, a report following up an onsite inspection must confirm the reality of these infractions.

Exercises

7. Describe three ways in which a supervisory authority’s assessment of the internal controls of an insurer differs from that of the insurer’s internal auditor.

8. List the off-site and on-site inspection activities performed by your supervisory authority to assess the adequacy of an insurer’s internal controls.
F. Conclusions

A company, including an insurance company, cannot be considered in good financial health over the long term if it does not have an adequate and effective system of internal control in place. These days, supervisors are so convinced of this fact that they tend to put this requirement on the same level as compliance with prudential ratios. This has not always been true, although well-managed companies do not wait for expert recommendations and regulations in order to establish effective procedures that enable their managers to control the principal risks to which they are exposed.

The large number of contracts managed, great volume of investments, wide geographic and technical diversification of activities, and growing sophistication of data processing have contributed to a widespread awareness among managers and accountants, within and outside the companies, of the importance of strong internal control to the proper functioning of firms and the success of their operations.

In the insurance sector, internal control should cover all the activities of the company, not only those related to accounting, although it is particularly relevant in certain operational domains such as acceptance of insurance risks, asset-liability management, derivatives, and outsourcing.

Internal control procedures are reflected in commentaries and recommendations in reports intended primarily for company decisionmakers, principally the board of directors but also senior managers, the audit committee, and other committees. At the same time, these reports are made available to external (or statutory) auditors and supervisors—systematically, at their request, or during onsite inspections.

External auditors must make a written judgment on the reliability of the internal control system. The supervisor has the following responsibilities within the framework of the supervisory evaluation of a company:

- To assess regularly its internal control procedures
- To ensure that internal auditors are independent of company management and, in particular, to verify that their observations are followed up and any shortcomings remedied as soon as possible.

But internal control, even if it is excellent, cannot relieve the supervisory authority of its responsibility to carry out investigations, including onsite inspections, which are the only way to:

- Confirm the permanence of this excellence
- Make a consolidated, external, and independent assessment of the company.

In its work, IAIS has stressed the need for and importance of internal control. ICP 10 is devoted to it. Several other core principles give it a significant place in the list of essential criteria that describe the challenges, propose solutions, and recommend actions.
to be taken by the supervisor. This module has shown the relevance of these principles and criteria, which cannot be rigid but must evolve through time, taking into account the needs of each company.
G. References


Appendix I. ICP 10

ICP 10 Internal control
The supervisory authority requires insurers to have in place internal controls that are adequate for the nature and scale of the business. The oversight and reporting systems allow the board and management to monitor and control the operations.

Explanatory note

10.1. The purpose of internal control is to verify that:

- the business of an insurer is conducted in a prudent manner in accordance with policies and strategies established by the board of directors (refer to ICP 9)
- transactions are only entered into with appropriate authority
- assets are safeguarded (refer to ICP 21)
- accounting and other records provide complete, accurate, verifiable and timely information
- management is able to identify, assess, manage and control the risks of the business and hold
- sufficient capital for these risks (refer to ICP 18 and 23).

10.2. A system of internal control is critical to effective risk management and a foundation for the safe and sound operation of an insurer. It provides a systematic and disciplined approach to evaluating and improving the effectiveness of the operation and assuring compliance with laws and regulations. It is the responsibility of the board of directors to develop a strong internal control culture within its organisation, a central feature of which is the establishment of systems for adequate communication of information between levels of management.

10.3. It is an essential element of an internal control system that the board of directors receive regular reporting on the effectiveness of the internal control. Any identified weakness should be reported to the board of directors as soon as possible so appropriate action can be taken.

Essential criteria

a. The supervisory authority reviews the internal controls and checks their adequacy to the nature and the scale of the business and requires strengthening of
these controls where necessary. The board of directors is ultimately responsible for establishing and maintaining an effective internal control system.

b. The framework for internal controls within the insurer includes arrangements for delegating authority and responsibility, and the segregation of duties. The internal controls address checks and balances; e.g. cross-checking, dual control of assets, double signatures (refer to ICP 9 EC b).

c. The internal and external audit, actuarial and compliance functions are part of the framework for internal control, and must test adherence to the internal controls as well as to applicable laws and regulations.

d. The board of directors must provide suitable prudential oversight and establish a risk management system that includes setting and monitoring policies so that all major risks are identified, measured, monitored and controlled on an on-going basis. The risk management systems, strategies and policies are approved and periodically reviewed by the board of directors (refer to ICP 18).

e. The board of directors provides suitable oversight of market conduct activities.

f. The board of directors should receive regular reporting on the effectiveness of the internal controls. Internal control deficiencies, either identified by management, staff, internal audit or other control personnel, are reported in a timely manner and addressed promptly.

g. The supervisory authority requires that internal controls address accounting procedures, reconciliation of accounts, control lists and information for management.

h. The supervisory authority requires oversight and clear accountability for all outsourced functions as if these functions were performed internally and subject to the normal standards of internal controls.

i. The supervisory authority requires the insurer to have an on-going internal audit function of a nature and scope appropriate to the business. This includes ensuring compliance with all applicable policies and procedures and reviewing whether the insurer’s policies, practices and controls remain sufficient and appropriate for its business.

j. The supervisory authority requires that an internal audit function:

- has unfettered access to all the insurer’s business lines and support departments
- assesses outsourced functions
- has appropriate independence, including reporting lines to the board of directors
- has status within the insurer to ensure that senior management reacts to and acts upon its recommendations
- has sufficient resources and staff that are suitably trained and have relevant experience to understand and evaluate the business they are auditing
ICP 10: Internal Control

- employs a methodology that identifies the key risks run by the institution and allocates its resources accordingly (refer to ICP 18).

k. The supervisory authority has access to reports of the internal audit function.
l. Where the appointment of an actuary is called for by applicable legislation or by the nature of the insurer's operations, the supervisory authority requires that actuarial reports be made to the board and to management.
Appendix II. Answer key

1. What are five main purposes of internal control?

The five main purposes of internal control, as described in the explanatory notes to ICP 10, are to verify that: (a) business is conducted in a prudent manner in accordance with policies and strategies established by the board of directors; (b) transactions are only entered into with appropriate authority; (c) assets are safeguarded; (d) accounting and other records provide complete, accurate, verifiable, and timely information; and (e) management is able to identify, assess, manage, and control the risks of the business and hold sufficient capital for these risks.

2. Summarize the internal control requirements prescribed by the company and insurance laws of your jurisdiction. Do they deal explicitly with the five main purposes of internal control?

Review the company and insurance laws of your jurisdiction. Some requirements may be broadly formulated, for example, “the company must maintain adequate internal controls”, while others may be deal with specific aspects of internal control, such as the safeguarding of assets. It may be useful to complete the following table as part of your analysis.

<table>
<thead>
<tr>
<th>Internal Control Purpose</th>
<th>Company Act Requirement</th>
<th>Insurance Act Requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>General requirement</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Prudent operation in accordance with board policies</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Appropriate authority for transactions</td>
<td></td>
<td></td>
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<tr>
<td>Safeguarding of assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Adequate accounting and other records</td>
<td></td>
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<tr>
<td>Risk management</td>
<td></td>
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</tbody>
</table>

3. Explain the relevance of an organization chart to internal control.

A company must be rationally organized, in a manner appropriate to its objectives, strategy, size, and the diversity of its business. An organization chart provides information needed to understand a company's organization. It should identify all persons empowered to make significant decisions.
4. Provide three examples of duties that should be segregated from one another within an insurer and explain the problems that could arise in the absence of such segregation.

A few examples follow, but many others could also be valid:

- Accountant and treasurer – the embezzlement of cash could be hidden by fraudulent accounting entries
- Sales and underwriting – inappropriate risks could be accepted to meet sales targets
- Systems designer and systems user – automated controls could be disabled to hide fraudulent transactions
- Actuary and chief executive officer – technical provisions could be understated to meet profit targets
- Internal auditor and chief financial officer – internal audit could be pressured to minimize its reporting of weaknesses in financial controls.

5. List at least four parties that might participate in the internal control process of an insurer. Which of these are commonly in place for the insurers that operate in your jurisdiction?

Internal control participants could include the following: board of directors, audit committee of the board, internal audit, risk management, compliance, and actuary. Review legislation to determine which of these participants are required. Consult with colleagues, as necessary, to determine which of these are commonly in place in your jurisdiction.

6. This section of the module presented the following examples of important functions of an insurer for which strong internal controls are needed: risk assessment (life insurance); claims provisions (non-life insurance); safeguarding of investments; asset-liability management; derivative instruments; computer systems; the use of intermediaries; outsourcing; and anti-money laundering. Provide an example of an insurer in your jurisdiction for which internal control weaknesses in one or more of these functions contributed to the need for supervisory intervention. Describe the nature of the weaknesses and the steps that were taken to deal with them.

Consult with colleagues, as necessary, to identify an example and summarize the weaknesses that existed and the steps that were taken—by both the supervisory authority and the insurer—to deal with them.
7. Describe three ways in which a supervisory authority’s assessment of the internal controls of an insurer differs from that of the insurer’s internal auditor.

First, the supervisor’s scope of activity is universal, enabling the supervisor to gain a consolidated picture of internal control in the company, while the engagement of the internal auditor is generally restricted to one department. Second, supervisory actions are carried out with discretion, selectively, with their degree of depth adjusted on the basis of the supervisor’s understanding of the company. The internal auditor, in contrast, is assigned to prepare the most complete inventory of issues possible to answer the questions asked by senior management, the compliance officer, or the board of directors. Third, supervisory conclusions are addressed to the board of directors and recommendations are binding on the company, which must take the corrective steps required. The internal auditor’s comments are only the first step in a dialogue that may produce further feedback.

8. List the off-site and on-site inspection activities performed by your supervisory authority to assess the adequacy of an insurer’s internal controls.

Review supervisory manuals, inspection plans, and inspection criteria, and consult with colleagues to identify the activities performed by your supervisory authority to assess the adequacy of internal controls. For example, off-site activities may include reviewing organization charts, board minutes, company policies, procedure manuals, internal audit plans, internal audit reports, and actuarial reports, conducting cross-sector studies of specific aspects of internal control, and requiring insurers to complete questionnaires on their risks and related controls. Examples of on-site activities include substantive tests of transactions, tests of controls, and interviews with various internal control participants.