

**ANNUAL REPORT
OF THE INTERNAL AUDIT SERVICE
ON INTERNAL AUDITING
FOR 2013**

Distribution list:

- The management board (MB) of Sava Reinsurance Company
- Sava Reinsurance Company supervisory board (SB) members
- Sava Reinsurance Company supervisory board audit committee members

Ljubljana, 28 February 2014

1. INTRODUCTION

Pursuant to Article 165 of the Slovenian Insurance Act (ZZavar), Article 25 of the Sava Re Group Internal Audit Rules and International Standards for the Professional Practice of Internal Auditing, the internal audit service (IAS) prepared this report on internal auditing for the three months to 31 December 2013.

This report includes:

- a review of the effectiveness and efficiency of internal control systems,
- a review of implementation of the 2013 annual plan and departures from the work plan;
- summary of major findings in internal audit reviews;
- monitoring the realisation of recommendations;
- other activities of the IAS (personnel and training) and
- program for improving quality assurance.

The IAS is an autonomous organisational part, functionally and organisationally separate from other parts of Sava Reinsurance Company, and reports directly to the management board of Sava Reinsurance Company. Its position in the Company ensures autonomy and independence of operation.

2. EFFECTIVENESS AND EFFICIENCY OF INTERNAL CONTROL SYSTEMS AT SAVA REINSURANCE COMPANY

As part of its audit assignments, the IAS reviewed the effectiveness and efficiency of internal control systems. IAS considers that control systems at Sava Reinsurance Company are appropriately defined and that controls, authorisations and responsibilities are largely set out in internal rules and complied with in practice. When reviewing individual areas, the IAS found minor deviations which were pointed out and recommendations were given together with actions for the elimination of irregularities and weaknesses. Weaknesses and deviations relating to operational efficiency of the internal control system have been promptly eliminated by business functions, except for those relating to improvements in the information system, which will take more time to implement.

Regular reviews have also been targeted to establishing the probability of fraud, and exposure and vulnerability to IT risks. In fields subject to internal auditing, internal control systems have been set up and are operating so as to prevent fraud. As part of audit reviews, recommendations were given to improve the Company's information system, which is currently being implemented.

3. REALISATION OF THE 2013 ANNUAL PLAN

In 2013, the IAS carried out audit reviews and other activities in accordance with the annual 2013 IA work plan. There have been 15 audit reviews planned. There were 12 internal audit reviews carried out; of these 4 were carried out at Sava Reinsurance Company and 8 in subsidiary companies in co-operation with each company's internal audit function.

At Sava Reinsurance Company, we carried out the following internal audit reviews:

- procurement process and cost management
- financial process – asset management,
- Solvency II harmonisation project,
- IT audit reviews and audit review of the Reinsurance Contract Project Application project

The following internal audit reviews have been carried out in subsidiaries:

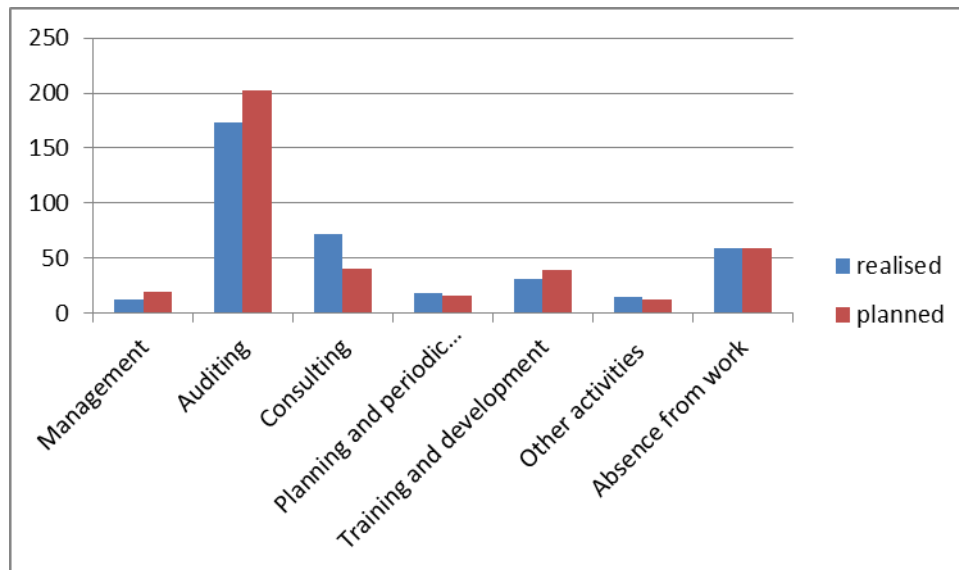
- claims liquidation process in the subsidiaries Velebit životno osiguranje and Velebit osiguranje,
- corporate governance in the subsidiary Sava osiguranje,
- claims handling and claims settlement in the subsidiary Illyria,
- financial management and cost management in the subsidiary Illyria Life,
- commission accounting process at the subsidiaries - Velebit životno osiguranje and Velebit osiguranje,
- review of reserving of provisions for outstanding claims in the subsidiary Sava Montenegro.

The table below shows realised time for activities compared to the 2013 plan.

Table 1: Realisation of the annual work plan by IAS time allocation

Business activity	Realised 2013		Planned 2013	
	Audit days	%	Audit days	%
1 Department management and preparing strategic documents	13	3,3	20	5,0
2 Audit activities	279	70,3	266	67,0
2.1 Revidiranje	173	43,6	202	50,9
Regular reviews	155	39,0	179	45,1
Extraordinary reviews	0	0,0	8	2,0
Monitoring implementation of recommendations	18	4,5	15	3,8
2.2. Consulting	72	18,1	40	10,1
Informal consulting	72	18,1	40	10,1
Formal consulting	0	0,0	0	0,0
2.3. Planning and periodic reporting	18	4,5	16	4,0
2.4. Ongoing monitoring of all activities	16	4,0	8	2,0
3. Training and development	31	7,8	39	9,8
Training	7	1,8	21	5,3
Development of professional bases	24	6,0	18	4,5
4 Other IA activities	15	3,8	13	3,3
5 TOTAL activities	338	85,1	338	85,1
6 Absence from work	59	14,9	59	14,9
TOTAL	397	100,0	397	100,0

Figure 1: Planned and implemented time allocation



Three internal audit reviews were not realised in 2013. The reviews of the accounting process and of the preparing of financial statements for Sava Reinsurance Company and of the process of accounting for and paying of commissions in the subsidiary Sava osiguruvanje, which had been planned for 2013, will be implemented in 2014. The IAS also did not carry out audit reviews of the integration of ZM, into the Sava Re Group but through informal counselling, it contributed to the integration of ZM into the group. There were no extraordinary audits carried out in 2013.

Counselling

In 2013 the IAS conducted a number of informal counselling for Sava Reinsurance Company with the aim of improving the control environment and risk management. In 2013, there were 72 days spent on informal counselling, which is 32 days more than planned, mainly due to co-operating in the due diligence activities in ZM and co-operating in the Radar Project – the ZM integration project.

The IAS has been informally counselled on the following:

- review of accounting processes in Zavarovalnica Maribor,
- project group participation (adjustment to amended IFRSs, risk management and integration of Zavarovalnica Maribor into the Sava Re Group, co-operation with the liquidity and the ALM committees);
- participation in policy formulation regarding receivables management and review of other rules of Sava Reinsurance Company that have been amended in the period.

4. SUMMARY OF KEY FINDINGS OF AUDIT REVIEWS CARRIED OUT

4.1 SAVA REINSURANCE COMPANY

Solvency II harmonisation project

The internal audit review will be in progress throughout the process of alignment to the Solvency II Directive, on which the IAS will regularly prepare (generally quarterly) interim reports. The objective is to monitor business activities relating to alignment to the operating requirements of the Solvency II Directive. It was found that Sava Reinsurance Company was actively preparing for the requirements of the Directive. A special working group was set up. A steering committee of management board members is regularly briefed on progress and costs (also anticipated). Key milestones are also regularly reported to the audit committee and the supervisory board of Sava Reinsurance Company. All recommendations made have been implemented.

IT audit review and the upgrading of the Reinsurance Contract application

The internal audit review will be in progress throughout the project period; the IAS will prepare periodical interim reports thereon. The objective of the audit review was the continuous review of appropriateness of requests for upgrading the Reinsurance Contract application. As part of the audit review of the project of upgrading the Reinsurance Contract application, the IAS proposed some potential improvements in the organisation of the project. All recommendations and proposals for improvements were taken into account. The IAS notes that so far activities have been carried out in accordance with the agreed project plan and that no noteworthy deviations have been identified.

Finance function – asset management process

The objective of the internal audit review was to evaluate the existence and effectiveness of the system of internal controls and risk management in the asset management process. In the review, we found no irregularities or deficiencies which should be noted. The rules set are fully complied with.

Procurement process and cost management

As part of the internal audit of the procurement process, we examined the appropriateness of controls and procedures in procurement of materials, fixed assets and services and the information flow in placing orders. With regard to the payment of invoices for materials or services ordered, we reviewed the adequacy of the segregation of duties among employees, taking into account liquidation rules and the adequacy of authorisations granted. It was found that the system of internal controls in procurement is good. In the internal audit review, we found some departures assessed as low risk; the time limit of recommendations has not expired yet..

4.2 JOINT AUDIT REVIEWS IN SUBSIDIARIES

In accordance with the Sava Re Group Governance and Supervision Policy, the IAS conducted eight internal audit reviews in Sava Re Group members as a means of additional supervision. Audits were carried out in co-operation with the internal auditors of subsidiaries

and as joint audit reviews. The planned joint audit reviews were realized in all companies, except in Sava osiguranje.

Claims liquidation process in the companies Velebit osiguranje and Velebit životno osiguranje

As part of the internal audit review, we reviewed the compliance of claims liquidation and claims reserving with internal rules, adequacy of separation of duties among employees, adequacy of authorisations granted, adequacy of software support, adequacy of claims handling and liquidation processes, timeliness of claims settlement and completeness of risk types considered in the claims process. The internal audit was assisted by an external claims adjuster specialised in technical claims. The review identified a number of weaknesses and irregularities that do not relate directly to the claims handling process, but to underwriting and control procedures prior to insurance underwriting. We proposed that the companies implement these recommendations as part of on-going improvement and implement as soon as possible the recommendations made by the internal audit service of the subsidiary company. We proposed that the claims department start monitoring the claims handling process on a regular basis and reports to the management board accordingly. Regarding the IT support for claims handling, we found that current controls were generally good and mostly functioning. Based on the above findings, we proposed that the management consider the option that Velebit osiguranje start using the IT support already in use in other Sava Re Group subsidiaries, which is planned for 2014. Most of the recommendations were realised.

Corporate governance at Sava osiguranje

In the four basic pillars of corporate governance (management board, supervisory board, internal and external audit), we reviewed the approval system for resolutions, internal documents, their recording and reporting to the parent, the system of monitoring the realisation of resolutions, regulatory reporting and information-flow within the company. We also verified the company's compliance with adopted policies, standards and procedures and reviewed the implementation of policies and strategies of Sava osiguranje. Based on the audit, we found that corporate governance in Sava osiguranje is good and that policies adopted and taken over from the parent are being implemented. We also proposed the adoption of the rules of procedure of the management board, the implementation of the good practice of monitoring the recommendations of the external auditor and the consistent use of the four-eyes principle. All the recommendations made were realised.

Claims handling and claims settlement in the subsidiary Illyria

As part of the internal audit review, we reviewed the compliance of claims liquidation and claims reserving with internal rules, adequacy of separation of duties among employees, adequacy of authorisations granted, adequacy of software support, adequacy of claims handling and liquidation processes, timeliness of claims settlement and completeness of risk types considered in the claims process. The internal audit was assisted by an external claims adjuster specialised in technical claims. During the audit review, the Company was also informed of certain underwriting risks as the review identified a number of weaknesses and irregularities that did not relate directly to the claims handling process, but to underwriting and control procedures prior to risk assumption. We proposed that in order to improve efficiency, activities regarding the implementation of and the upgrading of the ASP claims applications should be expedited. We recommended regular professional training of claims adjusters. We suggested that the company make a detailed cross-check of subsidiary and control records and reconcile any differences. Most recommendations were realised.

Financial management and cost control in Illyria Life

As part of the internal audit of financial operations and cost control, we examined the adequacy of the organisation of the finance and accounting department, adequacy of segregation of duties among employees and the adequacy of authorisations granted. We reviewed the system of recording liabilities arising out of claims, the management of long- and short-term investments and receivables, the liquidity planning process and method of providing resources, monitoring of premium receivables and the efficiency of collecting overdue receivables. Based on a sample of selected invoices, we verified the implementation of key internal controls in the process of liquidating invoices. We proposed that the operational tasks that are now the responsibility of the executive director be delegated to the department heads and to the assistant executive director. We also proposed that in the finance and accounting operations, both companies (Illyria Life and Illyria) establish closer and regular cooperation to take advantage of potential synergies in the form of transfer of best practices and greater bargaining power with regard to external financial institutions. We pointed out the increased exposure to individual banks. We also suggested that the company should start using the claims module of the AdInsure application as soon as possible. Most of the recommendations were realised.

Commission accounting and payout process at the subsidiaries Velebit životno osiguranje and Velebit osiguranje

As part of the internal audit review, we examined the compliance of the commission accounting process, the organisation, the adequacy of segregation of duties between employees and the adequacy of authorisations granted, the adequacy of internal controls in compliance with the rules and internal procedures in the commission accounting process, the adequacy of parameters for calculating insurance commissions, and accuracy and timeliness of records and adequacy of IT support. In the audit review of commission accounting, it was found that a number of procedures carried out before or after the automatic commission calculation is being carried out manually, and entered into the system and controlled by only one person. The IAS proposed that the possibility of expanding the existing IT solution in the company to include commission accounting is considered in a way so that individual important parts of the process are assessed and controls that are currently carried out manually. We also proposed that the internal rules are supplemented to include resolutions adopted and that precise rules, criteria, authorisation and codings are set out for all sales channels. Completion dates for these recommendations have not yet become due.

The claims reserving process in Sava Montenegro

As part of the claims reserving audit review, we examined the organisation of the department for underwriting, claims settlement and development, the system of authorisations, and the segregation of duties among employees within the department. We examined the internal rules relating to claims handling, with a focus on reserving practices. Internal audit has assessed that the company, in the reserving process, established a very good internal controls. Internal rules had been set that are complied with in practice, there is regular supervision and control of compliance with internal rules. We believe that the system of internal controls for the reserving process is good in all cases and we recommended it as a good example to other companies in the Sava Re Group.

5. IMPLEMENTATION OF RECOMMENDATIONS FOR ELIMINATION OF WEAKNESSES AND IRREGULARITIES

IAS is required to report periodically on the implementation of recommendations made and proposals given based on irregularities and weaknesses identified. By 31 December 2013, 63 recommendations have been made, 9 relating to Sava Reinsurance Company, 54 relating to subsidiaries in which joint audit reviews were carried out. Of these, 22 have been implemented, 21 have been partly implemented and 20 recommendations are not past due for implementation. The share of implemented recommendations is 51%.

The table below gives an overview of recommendations given and implemented, separately for Sava Reinsurance Company and its subsidiaries. A detailed overview of recommendations implemented is contained in the IAS quarterly reports.

Table 2: Overview of recommendations

Realised reviews	Not past due recommendations at 31 Dec 2013	No. of recommendations given from 1.1.-31.12.2013	Status of recommendations at 31 Dec 2013	No. of implemented recommendations	Number of unrealized/ partially implemented recommendations	No. of not past due recommendations	Share of implemented past-due recommendations
Year 2011	4		4		4		0%
Year 2013		5	5	3		2	100%
Total Sava Reinsurance Company	4	5	9	3	4	2	43%
Total subsidiaries	27	27	54	19	17	18	53%
Total	31	32	63	22	21	20	51%

The proportion of realised recommendations has decreased because most unrealised relate to improvement of IT, which requires more time.

6. OTHER ACTIVITIES

In accordance with the presented bases and criteria, the IAS prepared an annual work plan for 2013, a report on the activities of the IAS for 2012 and quarterly internal audit reports. All reports have been prepared in compliance with statutory regulations and internal rules of the IAS.

In the period, the IAS co-ordinated the work between the external auditor and employees during the 2012 audit and for the preaudit of the 2013 financial statements, participated in the meetings of the management board, of the supervisory board and the audit committee and monitored the implementation of recommendations made by the IAS, the external auditor and the regulator (ISA).

As part of the development of internal auditing, we revised the charter and the internal audit rules and prepared a translation of the methodology for subsidiaries (point H of the Manual - Implementation of the Audit Review).

HR and training

In 2013 the IAS employed two people, the director (professional designation: Certified Internal Auditor) and one internal auditor – a senior internal auditor employed on a part-time basis (professional designation: Certified Internal Auditor).

Employees of the IAS attended training organised by the Slovenian Institute of Auditors, the second IIA international conference, the annual conference of internal auditors, the Congress of the Slovenian Institute of Auditors and seminars organised by the Slovenian Institute of Auditors, the Slovenian Insurance Days and monthly seminars organised by the IIA – the Slovenian Institute of Internal Auditors.

An amount of € 2.715 was earmarked for education and training while only € 1.209 was used (smaller conference fees). We planned € 21.421 for investments and other expenses and used € 15.791 (lower fees of external professional, lower travel expenses for 2013 and a tool for IT support of auditing has not been bought).

We studied articles of current concern on internal auditing on the website of the IIA and the amendments to standards. We actively participate in the internal audit section of the Slovenian Insurance Association.

7. QUALITY ASSURANCE PROGRAM

In accordance with the requirements of the Standards, the IAS carried out an assessment of its work. The assessment is carried out on the basis of a quality assurance program, covering all aspects of the IAS and continuously monitoring its performance.


Quality assessment of the IAS

Pursuant to the Standards, IAS conducted a self-assessment in 2013. The results showed that the operations of the IAS comply with the definition of internal auditing, the Standards and the Code of Ethics. However, in individual substandards where operations are not fully compliant, IAS prepared an action plan for improvement and follows it in its day-to-day dealings.

Assessment of auditee satisfaction

In 2013, the IAS assessed auditee satisfaction with regard to its activities. The purpose of the questionnaires was to identify areas to be potentially improved. The results showed a high degree of satisfaction (average grade of 4,7 on a 5-grade scale, 1 meaning not satisfied and in 5 meaning very satisfied).

Director of IAS
Danijela Pavlič



OPINION OF THE SUPERVISORY BOARD ON THE IAS ANNUAL REPORT 2013

In 2013, the internal audit service of the Sava Re Group (IAS¹) carried out audits in the areas set out in the annual plan, which had been adopted by the management board of Sava Reinsurance Company in its session dated 21 January 2013 and had been approved by the supervisory board in its meeting on 31 January 2013.

The audit goals pursued by the IAS were geared towards establishing whether risk management procedures were adequate and efficient and whether the system of internal controls in the most important business and control segments were effective and efficient. Furthermore, the IAS (i) reviewed whether business events were recorded and other records maintained in compliance with the law, internal and other regulations, and (ii) assessed the adequacy of internal controls for the prevention of fraud and potential threats to information technology supporting operations.

There were 12 internal audit reviews carried out; of these 4 were carried out at Sava Reinsurance Company and 8 in subsidiary companies in co-operation with each company's internal audit function.

Based on all tests and methods used in individual areas of auditing, it is the IAS's opinion that at Sava Reinsurance Company internal controls are largely adequate and that the degree of their reliability is satisfactory. Furthermore, it is our opinion that business events are recorded in compliance with regulations. Audit reviews identified individual irregularities and weaknesses, which were eliminated within set time frames, except for those relating to improvements in the information system, which will take more time to implement. The above is to result in greater efficiency of internal controls and regularity of operations.

supervisory board members monitored the effectiveness and efficiency of the IAS through quarterly reports and the internal audit annual report. The supervisory board was informed of the self-assessment carried out by the IAS. The self-assessment results showed that the activities of the IAS comply with the definition of internal auditing, with the professional practice of internal auditing, code of ethics for internal auditors and with the Insurance Act.

Based on the above, the supervisory board hereby gives its positive opinion to the annual report of the IAS on internal auditing in 2013.

Ljubljana, 10 March 2014

The Supervisory Board of
Pozavarovalnica Sava, d.d.
Chairman
Branko Tomažič



¹ According to the reorganisation effective on 1 January 2014, the Group Internal Audit was renamed Internal Audit Service.