

# **ANNUAL REPORT OF THE INTERNAL AUDIT SERVICE ON INTERNAL AUDITING FOR 2014**

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## **Distribution list:**

- management board, Pozavarovalnica Sava d.d.
- supervisory board members, Pozavarovalnica Sava d.d.
- audit committee members, Pozavarovalnica Sava d.d.

**Ljubljana, 16/03/2015**

## **1. INTRODUCTION**

The Internal Audit Service (IAS) prepared this annual report on internal auditing for 2014 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.

This report includes:

- the effectiveness and efficiency of internal control systems at Sava Reinsurance Company,
- a review of implementation of the 2014 annual plan and departures from the work plan,
- a summary of major findings established in internal audit engagements;
- monitoring the realisation of recommendations;
- other activities of the IAS (personnel and training),
- a programme for improving quality assurance.

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

## **2. EFFECTIVENESS AND EFFICIENCY OF THE INTERNAL CONTROL SYSTEM**

The assessment of the effectiveness and efficiency of the system of internal controls is given for the period from 01/01/2014 to 31/12/2014 on the basis of audit engagements. Based on all tests and methods used in individual areas of auditing, it is the opinion of the IAS that at Sava Reinsurance Company internal controls are largely adequate and that the degree of their reliability is satisfactory. Furthermore, it is of the opinion that business events are recorded in compliance with regulations. Audit engagements 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.

Regular engagements have also been targeted to establishing the probability of fraud, and exposure and vulnerability to IT risks. In the fields subject to internal audit engagements, 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. OVERVIEW OF REALISATION OF THE 2014 ANNUAL PLAN***

In 2014, the IAS carried out audit reviews and other activities in accordance with the 2014 IA work plan. There were 15 audit engagements planned (of which 4 at Sava Reinsurance Company and 11 joint audit reviews of subsidiaries). There were fully completed 7 reviews of subsidiaries, which were carried out in cooperation with the internal audit services of these companies (reasons for deviations are given below). Throughout the year, there were two audit reviews running at Sava Reinsurance Company and has been continued in 2015 due to the high risk assessment.

We carried out the following partial internal audits at Sava Reinsurance Company:

- solvency 2 alignment project (2 interim reports),
- IT audit and project audit – amending the Reinsurance Contract application (1 interim report).

In subsidiaries, the following joint internal audit operations were carried out:

- review of the profit commission calculation at Sava osiguruvanje,
- risk management audit for claims provisioning at Zavarovalnica Maribor,
- re-audit of corporate governance at Sava osiguranje,
- audit review of recording of policy acquisition costs at Sava životno osiguranje
- audit review of company information systems in accordance with the decision of the Serbian National Bank on "minimum IS management standards for financial institutions" at Sava osiguranje,
- audit of cost management at Zavarovalnica Tilia,
- audit of cost management at Zavarovalnica Maribor.

The table below shows realised time for activities compared to the 2014 plan.



Table 1: Realisation of annual plan by time of IAS staff dedicated to activities<sup>1</sup>

Audit activity	2014 plan		2014 realization	
	No. auditor days	As % of total time	No. auditor days	As % of total time
<b>1 Department management and preparing strategic documents</b>	<b>20</b>	<b>8 %</b>	<b>11</b>	<b>4 %</b>
<b>2 Audit activities</b>	<b>190</b>	<b>75 %</b>	<b>188</b>	<b>66 %</b>
2.1 Auditing	159	63 %	148	52 %
2.1.1 ordinary reviews	147	58 %	144	51 %
2.1.2 extraordinary reviews	0	0 %	0	0 %
2.1.3 monitoring of recommendations	12	5 %	4	1 %
2.2 Consulting	15	6 %	20	7 %
2.2.1 formal consulting business	0	0 %	0	0 %
2.2.2 informal consulting business	15	6 %	20	7 %
2.3 Planning and periodic reporting	13	5 %	14	5 %
2.4 Ongoing monitoring of all activities	3	1 %	6	2 %
<b>3 Training and development</b>	<b>12</b>	<b>5 %</b>	<b>27</b>	<b>10 %</b>
3.1 External training	7	3 %	7	2 %
3.2 In-house training and self-study	0	0 %	1	0 %
3.3 IAS development	5	2 %	19	7 %
<b>4 Other activities (co-ordination with external auditor, ISA, etc.)</b>	<b>3</b>	<b>1 %</b>	<b>7</b>	<b>2 %</b>
<b>5 TOTAL (1+2+3+4)</b>	<b>225</b>	<b>89 %</b>	<b>233</b>	<b>82 %</b>
<b>6 Absence from work</b>	<b>27</b>	<b>11 %</b>	<b>50</b>	<b>18 %</b>
6.1 % Annual leave	27	11 %	27	10 %
6.2 Absence due to illness	0	0 %	23	8 %
	<b>252</b>	<b>100 %</b>	<b>283</b>	<b>100 %</b>

From January to the end of April 2014, my employment was split between Sava Reinsurance Company and Tilia, where I headed the department. More time was spent on Tilia was than planned, which is why I did not carry out one audit: the audit of the accounting process and of preparing financial statements. We also estimated that the risk was lower than initially assessed and that the closing of financial statements was adequately covered by the external auditor.

The audit review of recording of acquisition costs at Velebit osiguranje and Velebit životno osiguranje was not carried out following an agreement with the subsidiary. After the annual work plan had been adopted by Sava Reinsurance Company, the companies Velebit osiguranje and Velebit životno osiguranje received the decision of the local regulator

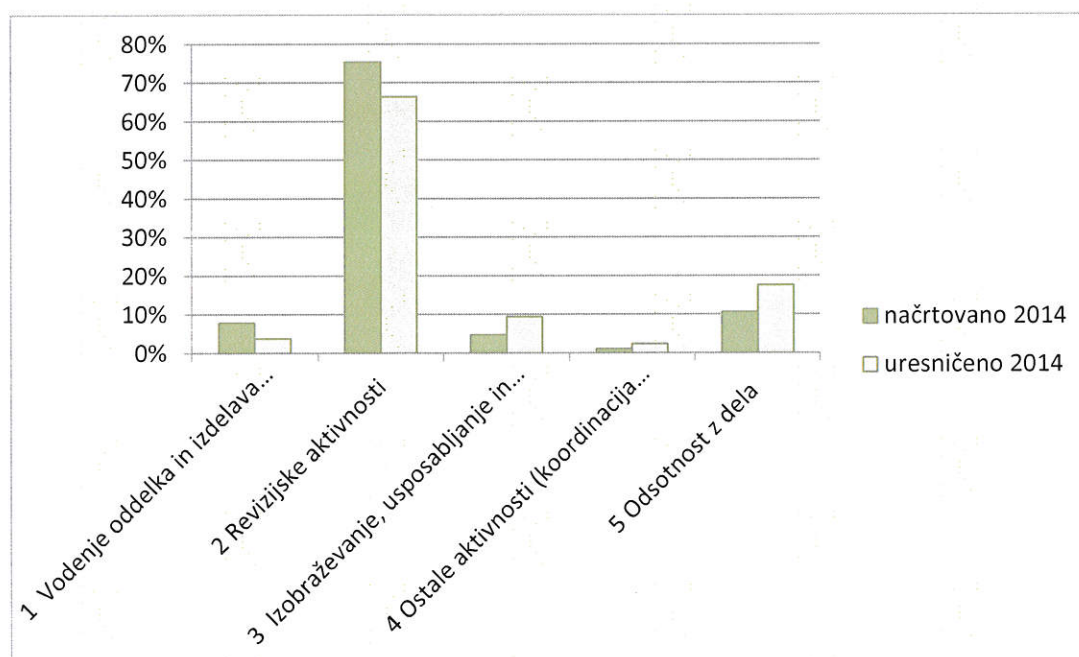
<sup>1</sup> In the table under point 2.1.1. the service hours of a contractor have been included (31 days), which had not been considered in the 2014 plan.

requesting that additional audits be carried out, which is why the IAS of the subsidiaries had to adjust their annual plans. We assessed with regard to estimated risks that the said audit review could also be performed at a later stage.

In the fourth quarter, we started 4 engagements (reinsurance process and combined loss ratios, follow-up audit of claim handling and settling at Illyria, follow-up audit of financial management at Illyria Life and audit of compliance with the law and internal rules at Illyria Life), which will be completed in the first quarter of 2015 because of my prolonged hospital stay.

In 2014, we spent more days for the IAS development than planned (19 auditor days instead of 5 days) due to the external audit carried out in September and October 2015.

*Graph 1: Graphical presentation of planned and realized use of time*



### Consulting engagement

The IAS conducted informal consulting at Sava Reinsurance Company in 2014 with the aim of improving both the control environment and risk management. In 2014 there were 20 auditor days spent for informal consulting.

The IAS was primarily involved in the following informal consulting:

- participation and collaboration in project groups (risk management for the Sava Re Group, liquidity committee, ALM committee, Solvency 2 harmonization),
- participation in the preparation and review of policies that were being amended at the time.



## ***4. SUMMARY OF MAJOR FINDINGS ESTABLISHED IN INTERNAL AUDIT ENGAGEMENTS***

### **1.1 SAVA REINSURANCE COMPANY**

Revision of the project of adapting to the Solvency 2 Directive and the IT audit and amending of the Reinsurance Contract application (Revolve) are running throughout the year and due to the high risk assessment continue in 2015. Based on engagements carried out, we issued interim reports.

#### **Solvency 2 harmonisation project**

The internal audit engagement ran throughout the duration of the project of alignment to the Solvency 2 Directive, on which the IAS prepared periodic progress reports (in 2014 two interim reports). The objective of this engagement was to control the business activities related to the alignment to the Solvency II Directive by means of checking the action plan, including any changes thereto.

It was found that Sava Reinsurance Company was actively preparing for the requirements of the Directive, although there were delays with some subprojects. A working group was set up, including staff from EU companies (ZM; ZT, Velebit, Sava Re). The project status, costs and timelines adjustments were reported to the steering committee. Certain activities in the QRT project (quantitative report template), which is designed to automate SCR calculations (solvency capital requirement and generating QRTs) should be verified and tested by the IT auditor as this tool will enable a unified process of calculating the solvency capital requirement and preparation of statutory reports; we therefore proposed that the IT auditor be included in the audit mainly due to reviewing the security and protection of data transfer between different systems and companies, review of controls put in place based on requirements and specifications and review of work instructions.

#### **IT audit and change in Reinsurance Contract application (Revolve)**

The internal audit engagement ran throughout the duration of the project, on which the IAS prepared periodic progress reports (in 2014 one partial report was issued). The aim of the internal audit review was prompt monitoring of the adequacy of requests for modifications to the application, monitoring and verifying the adequacy of the action plan of the project, potential changes, implementation of the plan and reporting.

As early as in the 1st and 2nd quarter, the project team reported overlapping with other projects and hence difficulties in providing human resources, we therefore recommended that the management board – to ensure smooth progress – ensure sufficient resources so that additional inputs can be carried out and modules tested. The IAS proposed that due dates be amended because of delays in the implementation of activities. Delays and

deviations in the implementation of the project were promptly reported to the management board on a monthly basis in writing.

## 1.2 JOINT AUDIT REVIEWS IN SUBSIDIARIES

In accordance with the Sava Re Group Control and Supervision Policies, the IAS conducted seven (7) internal audit engagements within the Sava Re Group, as part of "additional monitoring". Audit reviews were carried out in cooperation with the internal auditors of subsidiaries in the form of joint reviews.

### Review of the profit commission calculation in the subsidiary Sava osiguranje

The aim of the audit was to review the existence and efficiency of the internal control system in the commission calculation and settlement process. We reviewed the compliance of commission calculation with internal rules, 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 calculation process, the adequacy of parameters for calculating underwriting commissions, and accuracy and timeliness of records and adequacy of IT support.

It was found that the system of internal controls in the commission calculation and settlement was good<sup>2</sup>. In the internal audit engagement, we found some deviations assessed as low risk and issued some recommendations.

### Audit review of risk management for claims provisioning at Zavarovalnica Maribor

The objective of the internal audit was an examination and assessment of the adequacy of internal controls and risk management in the process of establishing claims provisions. In the context of reviewing the process for establishing claims provisions, we examined the organization (hereinafter department), system of powers, and the distribution of duties among employees within the department. We examined the internal rules relating to claims settlement procedures with a focus on provisioning procedures. We also reviewed the process of establishing provisions for claims outstanding claims – RBNS and IBNR.

<sup>2</sup> In accordance with standard 2410. A1 and the methodology, the IAS assessed the **effectiveness and efficiency of the internal control system** in relation to the risks as follows:

**VERY GOOD:** The control system of the audited business unit / organizational unit is in every respect very good; internal controls established are strong; all key controls are operating and there are no deviations. Supervision is optimal. The risk is very low. There are no findings assessed as medium or high risk.

**GOOD:** The control system is generally good; minor weaknesses may be addressed by the head of any business function / organisational unit in the course of the business process. The management is in good control of management; authorizations and powers are observed in practice. In case of departures, immediate action follows and processes are improved continuously. Monitoring is carried out regularly. The risk is low. 1–2 findings assessed as medium risk, there are no findings assessed as high risk.

**ADEQUATE:** Combination of weaknesses in the control system requires immediate corrective action by head of business function / organisational unit. Management is aware of required monitoring and supervision; procedures and responsibilities are roughly defined. Supervision is irregular. Risks are medium-high. Most findings are medium risk.

**INADEQUATE:** Major weaknesses in the control system affecting operations and which must be immediately addressed by the head of business functions / organisational unit. Supervision is not conducted according to defined processes but left to individuals. Risks are high. There are findings assessed as high risk.

**UNSATISFACTORY:** High degree of major weaknesses (non-compliance, complete lack of controls), requiring complete reorganisation of business function / organisational unit. Supervision is not conducted. Risks are very high.

We reviewed procedures for provisioning, subsequent changing of provisions, basis for establishing of and criteria used for assessing the adequacy of claims provisions and setting up and functioning of internal controls.

It was found that the system of internal controls in the claims provisioning process was good. Internal audit estimates that the company set up good internal controls in the provisioning process. Internal rules are set up that are followed in practice, there is regular control and review of compliance with internal rules. Reporting and communication is well organized, as the amount and revision of claims provisions is verified.

#### **Follow up audit – Corporate governance at Sava osiguranje**

The objective of the internal audit engagement was to examine the implementation of the recommendations made after the 2013 audit review, relating corporate governance, in which we also reviewed the implementation of policies and strategies, set by the parent.

Based on the audit, we found that the internal control system in the area of corporate governance at Sava osiguranje was good and that policies adopted (taken over from the parent) were being implemented. Records were well-ordered and archived, especially supervisory board meeting materials and minutes.

#### **Audit review of recording of policy acquisition expenses at Sava životno osiguranje**

The objective of the internal audit engagement was to examine and assess the adequacy of internal controls in the process of recording policy acquisition expenses based on rules applicable in the subsidiary as well as the system of internal controls in relation to the costs of insurance operations.

Based on our audit, we found that the system of internal controls in the field of recording of expenses was good, that the rules adopted were complied with and that records were well-organized and filed.

#### **Audit review of company information systems in accordance with the decision of the Serbian National Bank on "minimum IS management standards for financial institutions" at subsidiary Sava osiguranje**

The objective of the review of information technology (IT) was a general overview of the IT environment – organization of IT, hardware and software, management and data protection, as well as existing internal controls in the process of data access.

We found that the system of internal controls was adequate. We proposed that certain recommendations be addressed at the Group level, whereby the person responsible was to prepare proposals for modifying the system: We also suggested that the company pay more attention to security and protection of information system and data; it is necessary to ensure adequate physical security of premises where central computer equipment is set up, to modernize the process for managing user access to systems and the process for managing change for key applications.



**Risk management audit in cost management at Zavarovalnica Tilia**

The aim of the internal audit engagement was to assess the functioning of the internal control system of the audited area and formulation of recommendations to reduce the identified risks to an acceptable level. We found that the system of internal controls in purchasing was adequate. We found that the company's awareness of the importance of systematic risk management of fraud and compliance risks was not yet present, and that employees did not have sufficient knowledge and opportunities to point to risks (internal control environment). Rules, procedures and instructions were in place for purchasing, recording and reporting, however, their communication, observance and annual review of adequacy as well as updating is not up-to-date. The company does not have a succession policy for key personnel (purchasing, IT, accounting), which may directly affect the achievement of objectives.

That in turn affected the risk inherent in controls, recording and reporting on business events of purchasing and partly on transparency and the value of calculated indicators.

The areas reviewed have shortcomings, but this did not directly affect the achievement of business objectives, but impacted efficiency and effectiveness of purchasing procedures and reporting (both for internal and external users).

A positive step is that the company, in line with the guidelines of the parent company, started standardizing and centralizing procurement process.

**Risk management audit in cost management at Zavarovalnica Maribor**

The aim of the internal audit engagement was to assess the functioning of the internal control system of the audited area and formulation of recommendations to reduce the identified risks to an acceptable level.

We found that the system of internal controls in purchasing was adequate. We believe that the company's awareness of the importance of systematic risk management of fraud and compliance risks was not yet present, and that employees did not have sufficient knowledge and opportunities to point to risks (internal control environment).

Rules, procedures and instructions were in place for purchasing, recording and reporting, however, their communication, observance and annual review of adequacy as well as updating was not sufficiently smooth.

That in turn affected the risk inherent in controls, recording and reporting on business events of purchasing and partly on transparency and the value of calculated indicators.

The examined area had some weaknesses and irregularities that affected the efficiency and effectiveness of procurement procedures, the correctness of reporting and disclosures in the audited period.

## ***5. IMPLEMENTATION OF RECOMMENDATIONS FOR ELIMINATION OF WEAKNESSES AND IRREGULARITIES***

The IAS is required to report periodically on the implementation of recommendations made and proposals given based on irregularities and weaknesses identified. At 31/12/2013 there were 46 recommendations outstanding; from 01/01/2014 to 31/12/2014 we made 68

recommendations; at 31/12/2014 there have been 84 recommendations implemented. Of these, at 31/12/2014 there were 30 recommendations outstanding; of these 20 recommendations were partially implemented, 3 remained unimplemented, 7 recommendation were not yet past due. The share of implemented recommendations was 79 % for the Group.

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 recommendation status*

Seq. no.	Realised reviews	Recommendations outstanding at 31/12/2013	Recommendations made from 1/1 to 31/12/2014	Recommendations realised by 31/12/2014	Recommendations outstanding at 31/12/2014 (3+4-5)	Recommendations outstanding at 31/12/2014, of which			Realised as % of past due recommendations (5/(5+8+9))
						not past due rec.	past due partly realised rec.	past due unrealised rec.	
1	2	3	4	5	6	7	8	9	10
1.	Total Sava Reinsurance Company	8	14	17	5	2	3	0	85 %
2.	Total subsidiaries	38	54	67	25	5	17	3	77 %
3.	Total	46	68	84	30	7	20	3	79 %

## 6. OTHER ACTIVITIES

In accordance with the presented bases and criteria, the IAS prepared the annual work plan for 2014, a report of the IAS for 2013 and quarterly reports on internal auditing. All reports have been prepared in compliance with statutory regulations and internal rules of the IAS.

In the period, the IAS coordinated activities for the preparation of contracts with external auditors, cooperated with the external auditor relating to the audit of 2013 financial statements and relating to the 2014 financial statements in pre-audit, participated in meetings of the management board, supervisory board and audit committee, and monitored the implementation of recommendations of the IAS, the external auditor and regulator (ISA).

As part of the development of internal auditing, we prepared a translation of the IAS methodology for subsidiaries and conducted a workshop on quality assurance in the IAS. In the third quarter, an external quality assessment was carried out; time spent on coordination with external assessors was recorded as development.

As part of cooperation with the IAS of subsidiaries, we performed peer reviews in Sava osiguruvanje, Illyria and Velebit osiguranje and živотно osiguranje. The bulk of activities, including giving instructions and professional assistance in the adoption of the methodology,



was conducted in the form of written or telephonic communication with auditors of subsidiaries.

### **Personnel, training**

In 2014 the IAS was staffed by two persons: the director (professional designation: certified internal audit) and internal auditor – senior auditor with split employment (1 hour Sava Re, 7 hours Zavarovalnica Maribor – professional designation: certified internal auditor).

IAS staff attended training events organized by the Slovenian Institute of Auditors, 3rd International IIA Conference, the annual conference of internal auditors and seminars organized by the Slovenian Institute of Auditors, the Slovenian Insurance Days and monthly training organized by the IIA –Slovenian Institute of Auditors. The IAS contributes to activities of the Slovenian Insurance Association, Internal Audit Section.

We planned €1,810 for training and spent €1,550 euros (reduced conferences costs). Investments and other costs were planned at €96,976. We spent €91,712 (lower travel costs for the purpose of conducting audits).

## ***7. IAS QUALITY ASSURANCE AND IMPROVEMENT PROGRAMME***

In accordance with the requirements of the Standards, the IAS conducted a quality assessment of the IAS. The assessment was carried out on the basis of a programme for quality assurance and improvement, covering all aspects of the IAS in every respect and continually monitoring its effectiveness.

### **Internal quality assessment of the IAS**

Pursuant to the Standards, the IAS conducted a self-assessment in 2014. The results showed that the operations of the IAS complied with the definition of internal auditing, the standards and the code of ethics. However, in individual substandards where operations were not fully compliant, the IAS prepared an action plan for improvement and follows it in its day-to-day dealings.

### **External quality assessment of the IAS**

In September and October 2014, the IAS was subject to an external assessment of the quality of internal audit activities implemented by the company Vezjak Svetovanje d.o.o.

The objective of the external quality assessment was to assess the compliance of its operations with the definition of internal auditing, directly adopted International Standards for the Professional Practice of Internal Auditing, the Code of Ethics, Code of Internal Audit Principles and the Professional Code of Ethics of Internal Auditors. The assessment was of the IAS, particularly in the period from August 2013 to September 2014.



It was established that there was general compliance with the standards. Based on the recommendations of the external assessment, we prepared an action plan for implementing the recommendations. .

Director of IAS  
Danijela Pavlič



**OPINION OF THE SUPERVISORY BOARD  
TO THE ANNUAL REPORT OF THE  
INTERNAL AUDIT SERVICE  
ON INTERNAL AUDITING FOR 2014**

In 2014, the Internal Audit Service of the Sava Re Group (IAS) carried out audits in the areas set out in the annual plan, which had been adopted by the management board of Pozavarovalnica Sava d.d. in its session dated 27/01/2014 (hereinafter: Sava Reinsurance Company) and had been approved by the supervisory board in its meeting on 06/02/2014.

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 9 internal audit reviews carried out in 2014; of these, 2 were carried out at Sava Reinsurance Company and 7 in subsidiary companies in cooperation with each company's internal audit function.

Based on all tests and methods used in individual areas of auditing, it is the opinion of the IAS that at Sava Reinsurance Company internal controls are largely adequate and that the degree of their reliability is satisfactory. Furthermore, it is of the 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 annual report of the IAS. The Supervisory Board was informed of the self-assessment carried out by the IAS. The self-assessment results showed that the activities of IAS were compliant with the definition of internal auditing, with the professional practice of internal auditing, code of ethics, code of internal audit principles and with the Slovenian Insurance Act. The supervisory board also took note of the results of external quality assessment of internal audit conducted by an independent assessment team. It was established that there was general compliance with the standards.

Based on the above, the supervisory board hereby gives its unqualified opinion to the annual report of the IAS on internal auditing in 2014.

Ljubljana, 17 March 2015

Supervisory Board  
of Sava Reinsurance Company  
Chairman  
Branko Tomažič

