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LABUAN OFFSHORE FINANCIAL SERVICES AUTHORITY, MALAYSIA

LABUAN OFFSHORE FINANCIAL SERVICES AUTHORITY

Our Reference :

Circular No.: 135/40/5/LIIA/ALTC

5 September 2006

Chairman, Association of Labuan Trust Companies (ALTC)
Chairman, Labuan International Insurance Association (LIIA)

Dear Sir/Madam,

Guidelines on Minimum Audit Standards for Internal Auditors of Offshore Insurance and Insurance-Related Companies

The above matter refers.

We are pleased to inform you that LOFSA would like to introduce the "Guidelines on Minimum Audit Standards for Internal Auditors of Offshore Insurance and Insurance-Related Companies (Guidelines) in order to enhance and upgrade internal audit functions of insurance and insurance related companies in the Labuan IOFC.

The Guidelines would be effective from **1 January 2007** to allow all offshore insurance and insurance-related companies to be familiar with the requirements of the Guidelines.

We enclosed herewith the Guidelines on the above matter for your further attention and distribution to all your members. Please contact En. Mohamad Akbal Mohd Yunos at 087-591336 if you require further clarification on the matter.

Please be guided accordingly.

With kindest regards.

Yours sincerely,

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LABUAN OFFSHORE FINANCIAL SERVICES AUTHORITY, MALAYSIA

GUIDELINES ON MINIMUM AUDIT STANDARDS FOR INTERNAL AUDITORS OF OFFSHORE INSURANCE AND INSURANCE-RELATED COMPANIES

Introduction

1. These Guidelines serve as a general guide for the internal auditors of offshore insurance and insurance-related companies pursuant to section 16A (3) of the Offshore Insurance Act 1990 (OIA). They are not intended to provide comprehensive discussion of all possible matters or situations of audit significance that the internal auditors may encounter in the course of an audit. The Guidelines are also not meant to be exhaustive nor intended to provide detailed audit steps required to perform the audit of every operational area of the licensees. The internal auditors should also be guided by the authoritative pronouncements issued by the relevant professional accounting and auditing bodies.

Provision of the Law

2. Section 16A (1) of OIA states that every licensee shall conduct an internal audit of the licensee's books and operations annually and shall submit to LOFSA a report of such audit together with the internal auditor's comments, which includes comments on the licensee's accounting system and controls. Section 16A (2) of OIA further states that for the purpose of this section, an internal audit of a licensee shall be carried out -

(a) by authorized officers from the licensee's head office or holding company or any corporation which is related to the licensee; or

(b) by a qualified offshore insurance manager as may be approved by LOFSA; or

(c) in the case of a licensee who is either an individual or does not have an internal auditor, by an auditor who shall not be the same auditor appointed for the purpose of section 16.

In this regard, where an offshore insurance manager manages a licensee in accordance with section 6(1)(e)(ii) of OIA and wishes to carry out the internal audit functions for the licensee, the offshore insurance manager must have an internal audit department that is independent from the insurance management activities. All licensees are required to notify LOFSA once an internal auditor is appointed or change of existing internal auditor.

3. All internal audit functions must be reported to the Board of Directors (BOD). Internal auditors should also report to LOFSA immediately any significant audit finding uncovered in the course of audit that would adversely affect the offshore insurer's operating and financial condition. Otherwise, the Internal Audit Report must be submitted to LOFSA within three (3) months after the completion of the internal audit.

Scope

4. The scope of the internal audit should cover, among others, the following items:

4.1 **Accomplishment of Established Objectives and Goals**

A good business plan and strategies are crucial as they provide clear directions and guidelines to the Management and employees. The management audit should cover the entire operations to determine whether: -

i. Objectives and goals are clearly set and measurable;
ii. Objectives and goals have been articulated and communicated to all staff and are being met;
iii. Adequate controls are established for measuring and reporting the accomplishment of objectives and goals;
iv. An effective control mechanism is implemented to monitor actual performance against budget. Any significant variances are analysed, investigated and promptly reported to the management and the board;
v. Management has considered the strengths, weaknesses opportunities and threats of the respective operation or programme;

vi. The achievement of established objectives and goals is in compliance with policies, plans, procedures, laws and regulations;

vii. The underlying assumptions used by management in developing business plan and strategies are appropriate and reasonable; and

viii. Matters raised during previous audits, if any, are accordingly attended and rectified.

4.2 Evaluation and Appraisal of System of Internal Control

i. Effectiveness of System of Internal Control

The overall system of internal control is effective, adequate and functioning as planned: key control procedures exist and are adhered to; sufficient segregation of incompatible functions is practised at all times.

ii. Reliability and Integrity of Information

In order to ensure reliability and integrity of information of the insurer, internal auditors should perform the following:

a. Ascertain and verify that financial and operating records and reports contain accurate, reliable, timely, complete and relevant information and are prepared in compliance with approved accounting standards;

b. Determine that control procedures over record keeping and reporting are adequate and effective and;

c. Evaluate the process in which information is captured, recorded and protected.

iii. Safeguarding of Assets

Adequate controls are in place to safeguard the insurer's assets against losses such as from theft, fire and unauthorised use.

iv. ***Detection of Frauds, Errors, Omissions and Other Irregularities***

The audit scope should be widened to cover at least the following areas of concern: -

a. System of internal control is effective such that errors, omissions and conflict of interest are prevented or detected promptly;

b. Situations exist whereby errors, omissions or defalcations can be concealed;

c. Major deviations from established policies, practices and procedures are investigated;

d. Propriety of management's claims is ascertained and the claims incurred are in line with internal policies and procedures; and

e. Indicators exist whereby records can be manipulated.

An investigation is warranted if there is sufficient evidence or indication that fraud or material irregularities are likely to occur. A police report should be lodged where criminal wrongdoing is suspected.

4.3. Compliance with Laws, Rules and Regulations, Policies and Procedures, Guidelines and Directives

The audit scope should cover the insurer's compliance with:

i. Offshore Companies Act 1990, OIA, Labuan Offshore Business Activity Tax Act 1990, Anti-Money Laundering Act 2001 and other relevant legislation;

ii. Guidelines, directives and circular issued by LOFSA and pronouncements or rules issued by the relevant associations; and

iii. Internally approved policies and operational procedures.

4.4 Adequacy and Effectiveness of Risk Management System

The following are some of the audit concerns with respect to the overall risk management system:

i. Effective management supervision is practised by the board and its delegated authorities;

ii. Procedures that identify and quantify the level of risk on a timely basis are in place;

iii. Limits or other controls are in place to manage the risk;

iv. Reports to the management accurately present the nature and level of risk taken and any non-compliance with approved policies and limits;

v. Responsibilities for managing individual risks are clearly identified;

vi. Procedures relating to the calculation and allocation of capital to risks are in place; and

vii. Procedures to assess the controls over the possibility and impact of various risks.

4.5 **Economical, Effective and Efficient Utilisation of Resources**

The internal auditors should extend its traditional role of compliance audit to cover management auditing and budgetary process. The internal auditors should review whether:

i. Established system for planning, appraising, authorising and controlling the use of resources are operational and effective;

ii. Operating standards have been established for measuring the economy, efficiency and effectiveness of resources employed have been met;

iii. Deviations from operating standards are promptly identified, analysed and communicated to those responsible for taking remedial measures; and

iv. Remedial or corrective actions have been taken.

4.6 **Insurance Underwriting**

i. Review mechanism used to identify and manage the risks associated with underwriting and underwriting process, including but not limited to timing, investment return, credit, expenses and loss occurrence risks.

ii. Policies and procedures

a. Adequacy of policies and procedures;

b. Compliance with the insurer's underwriting policies and procedures and adequacy of the its internal controls;

c. Accumulation of risks (general)/multiple policies (life) are checked by underwriters prior to acceptance of risk;

d. Controls exist over the acceptance and change of risks and the subsequent Issuance of policy and endorsement documents;

e. Controls exist over the collection of premium monies from direct clients and insurance brokers;

f. Procedures governing the issuance of renewal notices are in place;

g. Adequate controls are instituted over the safeguarding and issuance of cover notes for general insurance.

iii. Reinsurance

a. Policies and procedures for evaluation and fixing of risks retention limits, and the evaluation of the quality reinsurers are set;

b. Reinsurance programme is reviewed regularly to ensure reinsurance needs are properly and adequately met; and

c. Important reinsurance documentations are properly handled.

iv. Accounting and financial reporting

a. Reporting system provides accurate statistical records of the insurer's underwriting data;

b. The premium recording system for life business is adequate and reliable;

c. Reports to management and the board are relevant, accurate, adequate and timely;

d. Premiums, reinsurance premiums ceded, return premiums and commissions expenses are correctly stated and properly accounted for in the insurer's records;

e. Commissions payable and receivables are accurately and completely accounted for; and

f. Adequate provision is made for amounts due which have been outstanding.

4.7 Insurance Claims

The internal auditors should address, among others, the following areas of audit concern:

i. Adequacy of policies and procedures;

ii. Claims process complies with the approved policies and procedures;

iii. Segregation of duties and responsibilities relating to claims processing/ approval and payment is practised;

iv. Register of claims is maintained by the insurer. All claims or known losses should be promptly registered with reasonable provision;

v. Claims data are accurately recorded;

   a. Prompt in processing and paying claims and no 'delay tactics';

   b. Disbursement of claims are properly approved and supported by appropriate documentation; and

   c. Preventive measures are in place to deter fraud.

vi. Estimates of preliminary loss reserves are reasonable, regularly reviewed and updated upon receipt of fresh and relevant information;

vii. Claims settled through compromise or ex-gratia basis are reasonable, justifiable and not subject to abuse;

viii. All recoveries in respect of salvage, subrogation or from reinsurers are properly recorded and collected on a timely basis;

ix. Outstanding loss reserves are adequate at any point of time;

x. Proper monitoring system is in place to record accumulation of claims arising from a particular event or within a particular period; and

xi. A system is in place to identify maturing life policies to enable payments to be made promptly.

The internal auditors should pay particular attention to the following in the financial reporting system of insurance claims:

   a. Provides accurate statistical records of the insurer's outstanding claims.

   b. Reports are relevant, accurate, adequate and timely;

c. Reserves for outstanding loss are adequate and correctly recorded;

d. Payments of claims are accurately recorded and provision for claims is reduced or eliminated immediately; and

e. Balances of outstanding claims listing agree with the general ledger.

4.8 Investments

The internal auditors should focus on the following significant areas:

a. Adequacy of and compliance with policies and procedures;

b. Investment operations are in line with investment strategy;

c. Segregation of duties for trading, processing, custody, payment and receipt, and maintenance of subsidiary records and accounting functions is practised;

d. No over-concentration of investment in a particular counter;

e. Trading and exposure limits imposed by the board are not breached;

f. Reconciliation of the trading transactions against the accounts;

g. Regular revaluation exercise is carried out on the investment portfolio;

h. Adequate provision for permanent diminution in value has been made for securities of inferior quality; and

i. Securities borrowed or lent out are properly accounted for.

4.9. Information System (IS)

In reviewing the IS management function, the internal auditors should pay particular attention to the following:

i. IS strategic plan is consistent with the insurer's business objectives and goals;

ii. Participation from the internal audit department is included if an IS steering committee is established;

iii. Standards and procedures on the various IS activities such as systems development and programming, computer operations and security, teleprocessing and computerised applications including data integrity and

Electronic Fund Transfer are adequate and in compliance with the IS security policy;

iv. The organisational structure of the IS department provides proper reporting line;

v. Management reports on the IS activities are adequate and effective in monitoring IS performance and in assisting management to make business decisions;

vi. IS staff and users are adequately trained; and

vii. IS activities have complied with relevant guidelines issued by LOFSA from time to time.

In reviewing systems development and programming function, the main areas of concern should include availability and comprehensiveness of standards and procedures, compliance of development of application system with standards and documentation and effectiveness of maintenance of application system and programmes. In term of computer operations and security, internal audit should include adequacy and effectiveness of computer operation procedures and physical control of computer equipments as well as competency of staff handling security functions and adequacy of procedures on security administration.

Internal auditor should also review the adequacy and compliance of procedures on teleprocessing activities and security system implemented. The areas of concern for data integrity include adequacy and effectiveness in controls over input of data, programmed controls (e.g. edit checks, reasonable checks) and controls over output distribution.

Reporting and Documentation

5. In order to communicate the audit results effectively, the structure of the Internal Audit Report should include the following:

i. An executive summary;

ii. Date of report and period covered by the internal audit;

iii. The scope and objectives of the internal audit;

iv. The significance and magnitude of the problems or issues;

v. The causes of the problems or issues;

vi. Recommended solutions or preventive actions;

vii. Auditee's comments on the issues and recommendations, and remedial measures taken;

viii. Management's achievements noted during the internal audit;

ix. Follow-up reports of previous audits; and

x. Overall conclusion.

6. Due to no underwriting and claim functions, insurance-related companies namely insurance managers and underwriting managers are not required to audit insurance underwriting and insurance claims as stated in scope 4.6 and 4.7 above, respectively. However, they must carry out internal audit functions of other scopes, where applicable, as stipulated in these Guidelines. Insurance brokers and captives, due to the nature of their businesses, are only required to provide a letter of compliance from the Head Office, insurance manager or external auditor. This is also applicable to licensees that have not carried out any business.

Implementation Date

7. All offshore insurance and offshore insurance-related companies are required to comply with the minimum audit standards described in these Guidelines effective 1 January 2007. The licensees that have adopted more stringent audit standards should continue with their existing practices.

Labuan Offshore Financial Services Authority
10 August 2006