A Guide to Internal Audit
Meeting the Requirements of Solvency II
Internal Audit under Solvency II

The advent of Solvency II requires insurers and reinsurers operating within the EU to have an effective internal audit function. Under the terms of Article 41 of the Solvency II Directive insurers are required to have their systems of internal governance subject to regular internal review. Article 47 requires that the internal audit function is used to perform this evaluation of the adequacy and effectiveness of the internal control system and the governance framework. Article 47 also requires that internal audit is independent from the operational functions of the business.

Solvency II Requirements

Article 41 of the Solvency II Directive contains Level 1 requirements in respect of general governance including the following elements which link to the specific internal audit requirements of Article 47:

- The systems of internal governance shall be subject to regular internal review
- The system of governance shall be proportionate to the nature, scale and complexity of the operations of the undertaking
- The undertaking shall have written policies in relation to at least risk management, internal control, internal audit and outsourcing, and those policies should be reviewed at least annually.

Article 47 of the Solvency II Directive comprises the following specific Level 1 requirements in respect of internal audit:

- Insurance and reinsurance undertakings shall provide for an effective internal audit function. The internal audit function shall include an evaluation of the adequacy and effectiveness of the internal control system and other elements of the system of governance
- The internal audit function shall be objective and independent from the operational functions
- Any findings and recommendations from internal audit shall be reported to the administrative, management or supervisory body which shall determine what actions are to be taken with respect to each of the internal audit findings and recommendations and shall ensure that those actions are carried out.

For larger insurers and reinsurers the implications of the new requirements are likely to be minimal as they already have internal audit functions embedded in their governance framework. For smaller entities the introduction of the new regulations will be more far reaching and will add to the costs of regulatory compliance.

However, internal audit is not all about cost – it is also about delivering benefits to the business, particularly around the design and operating effectiveness of systems of internal control.

One of the over-arching principles of Solvency II is that its requirements should be implemented in a manner which is proportionate to the nature, scale and complexity of the entity’s operations. The challenge for smaller insurers is to introduce internal audit in a proportionate and cost effective manner and in a way which will still enable them to take advantage of improved systems and operating processes.

The Benefits of Internal Audit

Internal audit is something wider than merely the performance of compliance checks, as is recognised by the Global Institute of Internal Auditors’ definition of internal audit:

“Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation’s operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.”
Progressive organisations have already recognised the value adding capabilities of internal audit. They are increasingly using it as an important management tool and a third line of defence in evaluating and improving the effectiveness of governance, risk management and assurance.

For insurers, internal audit is often focused on the way in which the organisation manages its commercial risks. It is also likely to be forward looking, although it confirms processes by looking at current and past activity. By contrast, external audit is usually focused upon financial reporting, primarily from an historic perspective. For example, external audit will focus on whether a premium has been correctly recorded, but may be less concerned about whether the underwriting and calculation of that premium is in accordance with appropriate procedures, which would be the focus of internal audit.

The range of reviews undertaken by internal audit is becoming ever wider as it becomes embedded as an important tool of a business and the function’s abilities and uses become recognised within the organisation. It is possible for the work of internal audit to evolve from areas such as confirming underwriting pricing principles have been applied correctly to challenging the basis on which the pricing principles are set in the first place.

To reinforce the credibility of internal audit, international standards and other guidance has evolved, although at present this is best practice rather than mandatory.

Many regulators believe internal audit can play a key role in preventing a repeat of some of the problems of the recent financial crisis. In the UK, the Chartered Institute of Internal Auditors has produced guidance on “Effective Internal Audit in the Financial Services Sector”. This sets high expectations of the way in which organisations in the financial services sector operate their internal audit functions. In the UK the regulators, the PRA and the FCA, have stated that they will consider the nature and extent of compliance with the guidance in any assessment of internal audit effectiveness within regulated firms. With increased co-operation across regulators within the EU it is likely that expectations of compliance with such guidance will spread as Solvency II becomes embedded.

Creating an Internal Audit Function that Meets Solvency II Requirements

Step One: Creating an Internal Audit Framework

The first step is putting together a framework that identifies how the internal audit function will operate, including ensuring how it will maintain its independence. This typically includes the creation of policy that details internal audit’s scope, access and resources as well as confirming its independence and reporting lines. There should also be a charter created that provides a brief summary that can be shared around the organisation explaining the: status, scope, expectations and responsibilities of internal audit.

A reporting framework should set out what will be reported, in what style, to whom and how frequently. It should also identify the steps to be taken when there is a need for escalation in respect of urgent issues.

It is important to ensure that the internal audit framework meets the necessary regulatory requirements as well as creating a practical structure within which to deliver the required internal audit function, including key performance indicators. In building this framework it will be necessary to decide not only how the internal audit function will operate but also how management will interact with internal audit, such as whether an audit committee will be in place. There will also need to be consideration of any professional guidance that is to be followed such as international standards on internal audit.
Step Two: Develop the Internal Audit Plan

Internal Audit, in conjunction with management, will need to develop a plan that is risk-based and linked to the risk management system of the business. Article 44 of the Solvency II Directive requires that the risk management system at least addresses the following areas: underwriting, reserving, asset-liability management, investments, liquidity & concentration risks, operational risks, reinsurance and other risk mitigation as well as any internal modelling.

The frequency and depth of testing of different areas will depend on the nature and complexity of the organisation and its systems and the resultant risks and the level of comfort required over those risks. The level of risk may be influenced by other controls in place; for example, work by an external actuary or external auditor may reduce reserving risk. Underlying compliance, Sarbanes-Oxley and other regular testing may also reduce risk and therefore the frequency of internal audit reviews. However, the plan must ensure that all key risk areas are covered at least once over a cycle of internal audit activity, usually three years. Some risks may be so significant that they need annual review.

As the internal audit function evolves many businesses expand the areas into which reviews are conducted, often with an increased focus on identifying ways in which the business can operate more effectively rather than just testing risk controls. In the insurance sector businesses are increasingly using internal audit as a resource to test compliance with Solvency II requirements such as governance, documentation, data accuracy, modelling and reporting.

The three year plan will form part of an ongoing rolling plan. A detailed annual plan will set out the reviews to be conducted in the next year, the timing of those reviews and the staffing required. It may include an allowance for special reviews in addition to those within the main review cycle.

### Solvency II Requirements

**Level 2 Implementing Measures – Systems of Governance**

The Level 2 Implementing Measures on Systems of Governance at Section 3.5 provide details of the requirements that will apply from January 2016 when Solvency II comes into force. Insurers should therefore be preparing now so that they will be compliant by 2016. In summary the measures are as follows:

**Independence (Appropriate operating framework and policy)**
- Independence of operations and oversight
- Independent and free to carry out work, obtain information and report (terms and conditions)
- Access and communication – unrestricted
- All activities and units within scope
- Sufficient resources.

**Internal Audit Charter**
- Internal Audit Charter – define status, objective and scope, competence, tasks, responsibilities. (In practice this usually includes details of the expected behaviour of auditors and auditees)
- Documenting of work to allow review of work and findings
- All units to notify weaknesses to internal audit.

**Preparatory Guidelines applicable in 2014 -15**

**Guideline 35: Ensure internal audit independence**
- To perform and report without impairment

**Guideline 36: Establish Internal Audit Policy**
- Terms and conditions to carry out tasks
- Rules for procedures before notifying regulator
- Criteria for rotation of assignments or staff
- Co-ordination across groups.
Once the annual plan is approved, contact will be made with the operating functions to plan individual reviews in more detail and agree a timetable.

Detailed plans for each review will then be drawn up and agreed with senior management and the function to be reviewed ahead of any work being undertaken. This will ensure the review is based on the relevant risks and controls relating to that area and any specific concerns of management.

**Solvency II Requirements**

**Level 2 Implementing Measures – Systems of Governance**

Internal Audit Plan (In addition to the overall plan, detailed plans for each review will also need to be drawn up)

- Plan for a number of years, based on risk analysis, across complete activities, governance & developments
- Audit cycle to ensure all activities are reviewed in a reasonable timescale
- Realistic plan with necessary resources and budget, and submitted to senior management for approval

**Preparatory Guidelines applicable in 2014 -15.**

Guideline 37: Establish internal audit function tasks including:

- Internal Audit Plan covering:
  - All areas of activities and governance for upcoming years

**Example three year plans might be as follows:**

### EXAMPLE 1: A small mono-line insurer with basic systems

<table>
<thead>
<tr>
<th>Review Areas</th>
<th>Year 1 2015</th>
<th>Year 2 2016</th>
<th>Year 3 2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Governance &amp; planning</td>
<td>Y</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Underwriting - including pricing &amp; coverholders</td>
<td>Y</td>
<td></td>
<td></td>
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<tr>
<td>Claims &amp; reinsurance</td>
<td></td>
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<tr>
<td>Reserving</td>
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<tr>
<td>Finance &amp; investment</td>
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<td></td>
<td></td>
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<tr>
<td>IT</td>
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<td>Y</td>
<td></td>
</tr>
<tr>
<td>Total reviews</td>
<td>2</td>
<td>2</td>
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</tbody>
</table>

### EXAMPLE 2 Moderate:

**A larger insurer writing different types of business with more complex systems**

<table>
<thead>
<tr>
<th>Review Areas</th>
<th>Year 1 2015</th>
<th>Year 2 2016</th>
<th>Year 3 2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Governance</td>
<td>Y</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Underwriting – approval, recording &amp; exposure</td>
<td>Y</td>
<td>Y</td>
<td></td>
</tr>
<tr>
<td>Underwriting - pricing</td>
<td></td>
<td>Y</td>
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<tr>
<td>Reinsurance &amp; recoveries</td>
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<tr>
<td>Claims</td>
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<tr>
<td>Reserving</td>
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<tr>
<td>Coverholders</td>
<td></td>
<td></td>
<td>Y</td>
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<tr>
<td>Reporting &amp; finance</td>
<td></td>
<td></td>
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<tr>
<td>Treasury &amp; investments</td>
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<tr>
<td>Planning &amp; modelling</td>
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<tr>
<td>Conduct &amp; compliance</td>
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<tr>
<td>Taxation - direct &amp; indirect</td>
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<tr>
<td>Total reviews</td>
<td>5</td>
<td>5</td>
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</tbody>
</table>
Step Three: Reporting and Monitoring of Internal Audit

The style of individual review reporting will be agreed with management and will include a rating system against which findings will be measured, and the level of detail and background information required. Some organisations prefer exception reporting of important issues; others, particularly those whose systems are evolving, may benefit from more detail of how the function operates. The reporting requirements will also specify the level of documentation of testing to be retained.

Individual reports should be issued in draft and final form within an agreed timetable shortly after the work has been completed. They will include recommendations with individual responsibilities and timescales allocated to them.

There will also be an annual report summarising the reviews conducted, findings and recommendations. This will seek to put the individual findings into the wider context of controls within the organisation. The report will also document performance of the internal audit function against agreed key performance indicators regarding timetables, resources and budgets.

There should also be ongoing reporting on the implementation of recommendations, conducted either by internal audit or another function such as compliance.

Solency II Requirements

Level 2 Implementing Measures – Systems of Governance

Reporting (typically there will be detailed reports on individual reviews as well as annual overview reporting)

- Report to audit committee in larger organisations
- Track and follow up implementation of recommendations
- Prompt written reporting, even if no findings, to management of audited area and senior management if significant
- Written report at least annually commenting upon suitability and efficiency of controls, any shortcomings, recommendations to remedy inadequacies, follow up on past points
- Report to senior management on achievement of internal audit objectives; discuss plan, resources, activity, recommendations and implementation.

Preparatory Guidelines applicable in 2014-15

- Internal Audit Charter – define status, objective and scope, competence, tasks, responsibilities. (In practice this usually includes details of the expected behaviour of auditors and auditees)
- Documenting of work to allow review of work and findings
- All units to notify weaknesses to internal audit.

Preparatory Guidelines applicable in 2014-15

Guideline 37: Establish internal audit function tasks including

- Establish internal audit reporting to senior management including:
  - Presentation of plan for approval
  - Issuing of reports at least annually which: identify findings, recommendations, timelines, person responsible, and confirmation of implementation
  - Verify compliance with senior management’s decisions and recommendations.
4 Options for Delivering an Internal Audit Function

When considering how to set up an internal audit function there are three broad options:

- Recruiting an in-house team to be responsible for the internal audit of the whole group or a single company
- Outsourcing internal audit to a firm of consultants
- A combination of the above, generally referred to as co-sourcing

Independence from normal operations and technical skills are key requirements for internal audit and can present particular challenges especially for in-house functions that are operating at the smaller end of the scale.

There are therefore a number of advantages and disadvantages which need to be evaluated when selecting how to resource an internal audit function.

In-house Internal Audit function

**Advantages**
- The organisation has its own dedicated internal audit resource who will have regular first hand contact with the business and will develop an understanding of its culture. Consequently, recommendations may be more in tune with the needs of the organisation.
- The in-house internal auditor will be readily available to undertake ad hoc projects. This, depending on the skills of the individual, may save on external consultancy costs.
- It provides the opportunity for the organisation to train someone in the ways of the organisation to prepare them for future ‘line management’ responsibility.

**Disadvantages**
- The cost of a suitably skilled team could be higher than that incurred through an outsourced/co-sourced relationship. For smaller organisations in particular it may be difficult to employ the exact resource skill level and number of resource days required.
- Internal audit within the insurance sector is becoming an increasingly detailed proposition and there is a need for a variety of specialist skills, such as IT and actuarial. Building a team with this skill set is likely to be very difficult.
- The loss of an internal auditor can be disruptive especially if they are senior and part of a small team.
- The in-house resource may find it more difficult to present an independent view and benchmark the organisation’s systems and processes against practice elsewhere.

Outsourced/Co-Sourced internal audit function

**Advantages**
- The organisation will be able to call on its external provider’s technical skills and and other resources, ensuring it receives a first class internal audit service.
- If necessary, through the selection of an external provider with appropriate international reach, the organisation will be able to effectively carry out reviews of its international operations.
- The responsibility for providing suitably qualified internal auditors falls on the external provider.
- Arrangements are very flexible and can be tailored to meet the requirements and budgets of the organisation. Additional resources for special projects can be readily accessed.
- The external provider incurs the cost of setting up the internal audit infrastructure (i.e. the cost of developing a methodology, ongoing training of the team, etc).

**Disadvantages**
- As the external provider is not usually at the organisation throughout the year, there will need to be close liaison to coordinate the work and to keep the internal audit team aware of developments.
- The external provider is unlikely to be as embedded within the operations and management of the company as an in-house resource.
- Internal audit expertise will reside in the external provider and there will be limited opportunity to build up skills in the organisation.
- To contain costs it will be necessary to prevent ‘scope creep’ in what is requested from internal audit, particularly in relation to ad hoc projects.
About PKF Littlejohn

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PKF Littlejohn is the sixth largest provider of external audit services to the UK insurance sector. We also provide internal audit services to a number of major insurance companies and brokers and our clients range from small companies to large multinational groups.

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For further information, please contact:

Philip Alexander
palexander@pkf-littlejohn.com
+44 (0)20 7516 2444

Neil Coulson
ncoulson@pkf-littlejohn.com
+44 (0)20 7516 2270

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