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RESEARCH ARTICLE

INSIGHT ON AUDIT EFFICIENCY IN THE MACEDONIAN INSURANCE MARKET

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ABSTRACT

The internal and external audit functions are indispensable for maximizing the operative efficiency of insurance companies. While internal auditors look into the risk and control culture and advise on how to maximize operating efficiency, external auditors are charged with the task of obtaining reasonable assurance that the financial statements prepared by the undertaking subject to audit are free from material errors and misstatements, i.e. that the financial statements are presented fairly, in all material aspects, in accordance with generally accepted accounting principles. High quality audit helps protect the rights and interests of company clients, suppliers, associates, and solidifies the public trust and reliance upon the Macedonian financial system. In this paper, I focus on analysis of the meaning of audit in the Macedonian insurance industry where starting point for preparation of audit is the established legal frame. The Macedonian insurance industry is subject to supervision by the Insurance Supervision Agency of the Republic of Macedonia. Furthermore, I unveil the results of my field research across several Macedonian undertakings looking into internal audit function deficiencies and improperly addressed external audit findings. In the summary section, I make recommendations for the purpose of removing these shortcomings in the future.

INTRODUCTION

The internal and external audit functions are interwoven and essential for maximizing the operative efficiency of every insurance company. External auditors read and often draw on the work of the internal audit department but have a mandatory scope that goes beyond the internal audit department. But have a mandatory scope that goes beyond the internal audit department. Hence, while internal auditors look into the risk and control culture and advise on how to maximize operating efficiency, external auditors are charged with the task of obtaining reasonable assurance that the financial statements prepared by the insurance company subject to audit are free from material errors and misstatements, i.e. that the financial statements are presented fairly, in all material aspects, in accordance with generally accepted accounting principles. High quality audit helps protect the right and interests of company clients, suppliers, associates, and solidifies the public trust and reliance upon the state financial system. The absence of superior internal and external audit practice internationally leads to major omissions and belated disclosure of unprofessional operational activities within the entity subject to audit. One of the greatest scandals from the beginning of this millennium is related to the insurance industry and is due to the late discovery of a major accounting fraud in the financial statements of AIG1, American Insurance Group, in 2005. Following thorough investigation by the US Securities and Exchange Commission, motivated by an insider's lead, AIG were charged with a massive accounting fraud in amount of 3.9 billion US dollars, public bid manipulation, as well as stock price manipulation2. The fraud consisted of financial wrong doings, such as misrepresentation of loans as revenues and influencing brokers to inflate AIG's share price on the stock market. The core player was the CEO, Hank Greenberg. Following the investigation, AIG had to complete payments towards the SEC in amount of 10 million dollars in 2003 and 1.64 billion dollars in 2006, 725 million dollars towards three Ohio-based pension funds, and 115 million dollars towards a Louisiana pension fund. In consequence, Greenberg was fired but no criminal charges were pressed against him. These events raise awareness across the financial services industry about risks and possibilities insurance companies face in their everyday operations, while also raising the need to surveil and regulate the insurance segment. In consideration of the foregoing, insurance companies in the Republic of Macedonia

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[1] AIG is an internationally present insurance company founded in 1919, with average annual revenues of more than 60 billion US dollars for the past three years. The core business of AIG consists of property insurance, life insurance, pension insurance products, mortgage insurance as well as other financial services offered and sold in more than 100 countries worldwide. AIG is listed on the New York and Tokyo Stock Exchange

[2] More details at: http://www.accounting-degree.org/scandals/

face intense regulation, burdensome technology innovation, highly competitive market environment, and market consolidation as a wide-spread form of non-organic growth. Entities must be observant and focused on finding elaborate ways to generate positive margins and growe quity while executing sound risk mitigation processes.

Audit requirements in the Macedonian insurance industry

Starting point for preparation of audit in the Macedonian insurance industry is the established legal frame, especially:

- The Law on Insurance Supervision
- Law on Compulsory Traffic Insurance
- Company Law
- Obligation law
- Bylaws prepared in accordance with the above-mentioned laws.

At the same time, the Macedonian insurance industry is subject to supervision by the Insurance Supervision Agency of the Republic of Macedonia (hereinafter referred to as the Regulator), an independent body whose scope is defined by the Law on Insurance Supervision. Unlike some other jurisdictions, the Macedonian Law on Insurance Supervision establishes internal and external audit as compulsory for every insurance undertaking (www.aso.mk). The internal audit function must be established by the supervisory body, normally Supervisory Board of the entity. As stipulated by articles 123-128 of the Macedonian Law on Insurance Supervision, the internal auditor must make sure that:

- Operations are run in compliance with the Law on Insurance Supervision, and the internal acts and rulebooks
- The book-keeping and financial statements are compliant to the Law on Insurance Supervision
- The internal audit is performed in accordance with the IIA standards, Solvency II, and the Company code of conduct (Law on Insurance Supervision of the Republic of Macedonia, 2002).

The insurance company must employ at least one certified auditor to perform the internal audit function with clear segregation of duties. The internal auditor prepares an annual program, approved by the supervisory body, which must encompass all areas that will be analyzed and description of the content of the planned operational assessments. The annual Internal audit report accompanied by the Regulator statement of opinion is to be revised at the annual Shareholders meeting, along with the external Audit report. Should the internal auditor detect risk of insolvency or illiquidity as a result of poor risk management, the Supervisory Board must be duly briefed. On the other hand, (statutory) external audit represents compulsory external investigation of the financial statements and other financial information and is being performed based on specific legal requirements and in compliance with the International Audit Standards of the International Financial Audit Committee (IFAC), translated and published in the Official Gazette of the Republic of Macedonia. The purpose of external audit is to express opinion on the financial statements/financial data accuracy, fairness and compliance with the adopted IAS and IFRS reporting standards (article 4, Audit Law of the Republic of Macedonia). Apart from articles 478-480 and 506 of the Macedonian Company Law (Company Law, 2004), the Law on Insurance Supervision defines the need for and implementation of audit across the insurance industry with articles 117-122 and 129-132. Namely, the Law on Insurance Supervision stipulates that all Macedonia-based insurance companies are legally due to submit their (consolidated) financial statements to external audit, which are then submitted to the Regulator in a revised format 15 days past the adoption of the Certified audit report, or four months after the completion of the relevant business year.

The Regulator approves the chosen audit company 15 days following the election date provided that the audit firm complies with the proscribed criteria: minimum three years of audit experience, independence from the organization subject to audit, no consulting services to the audited firm in the previous three years, no more than five consecutive audits of the (consolidated) financial statements, and no sanctions/fines in the last three years from the Macedonian Institute of certified auditors. The auditor has to inform the Regulator if the insurance company or physical entities related to the insurance company do not follow the risk management guidelines and expose the insurance company to insolvency or illiquidity risk, or impact the clients negatively. The following domains must be encompassed when performing statutory audit to an insurance company in Macedonia:

- Balance sheet
- Income statement
- Cash flow statement and Statement of changes in stockholders' equity
- Balance and changes to technical provisions
- Balance and investment structure of assets that offset the technical provisions
- Balance and investment structure of assets that offset the mathematical reserves
- Balance and structure of stockholders' equity investments
- Implementation of Risk management policies
- Internal audit implementation
- General ledger maintenance
- IT system quality
- Accuracy and completeness of reports towards the Regulator
- Evaluation of balance, off-balance sheet items, and accounting policies
- Net income distribution

The audit report is to be published in at least one daily newspaper, accompanied by the Auditor's opinion, within 15 days of adoption by the Shareholders' Assembly, but not later than six months following the reporting year subject to audit.

Internal audit focuses its attention on the key business risks and the effectiveness in managing those risks. The incapacity to detect painful areas, issue and follow recommendations for improvement across operating segments will affect negatively the accuracy and fairness of the financial accounts, an area assessed by external auditors. Hence, the need for deep dive into the malfunctioning areas identified with external audit on the Macedonian insurance market that could not or were not detected and managed at the internal audit level, thus resulting with financial misstatements and qualified audit opinion.

Field research: Internal audit shortcomings in the Macedonian insurance industry

The field research took place in 2016 and looked into the 2013-2015 reporting period, encompassing six (out of total of eleven) insurance undertakings with headquarters in the Republic of Macedonia. The research looks into external audit findings on Macedonian insurance enterprises that were not properly addressed by the internal audit department. In the summary section, recommendations are made for the purpose of removing these shortcomings in the future. The research was conducted in the form of a survey asking internal auditors in insurance companies to reflect on insurance company organizational structure, internal auditor independence and objectivity, and Management letter notes as disclosed by external auditors. Several aspects were covered: risk management, revenue recognition, bad debt calculation, segregation of duties.

Limitations to research results: the survey did not encompass five of the eleven insurance undertakings operating in the Republic of Macedonia, so there may be expections to the research conclusions reached.

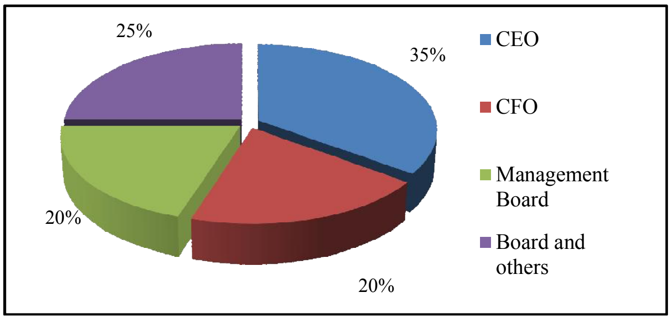
Research Hypothesis

Organization status of the internal audit department is key to the ability of internal auditors to exercise their function. The International Standards for the Professional Practice of Internal Auditing (IIA, 2004) stipulates that the chief audit executive (CAE) should Report to a level within the organization that allows the internal audit function to Accomplish its activities.
Standard 1110 of the International Standards for the Professional Practice of Internal Auditing establishes that the internal auditor should be positioned and report to a level within the organization in a manner that allows them to accomplish their core activities and audit function (The Institute of Internal Auditors, 2012. In their 2004 study, Leung et al. look into the role of internal auditors in management and corporate governance of Australian companies by investigating the reporting responsibilities of internal auditors within the organization (Leung et al., 2004). The study indicated that more that 22% reported either to CFO or CEO.

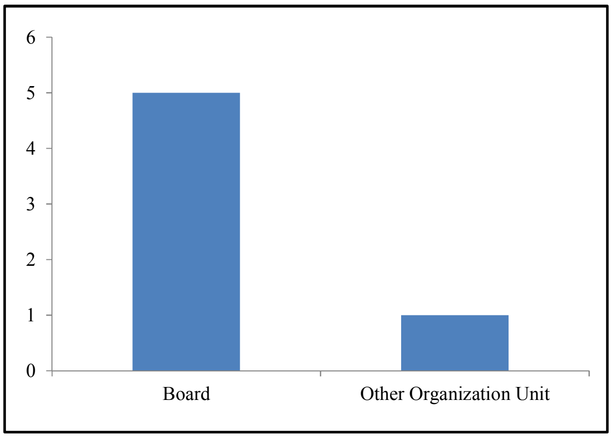
Organizational set-up

As confirmed with my field work, audit committee is not an established practice in the Macedonian insurance sector. Therefore, Supervisory Board (where present: only one from the six surveyed undertakings) or independent/non-executive Board members take over the role of overseeing the performance of the internal audit department. However, when asked about their line of reporting within the organization, the majority of respondents -internal auditors engaged in the Macedonian insurance sector - stated that they report only to management. Their answers can be presented as follows:

Namely, although all the respondents had reporting responsibilities to the Board, i.e. audit committee, 20% actually follow through this set-up in reality (see Graph 1). The vast majority report to management where 35% stated that they report mostly to the CEO and 20% to the CFO. Only 20% report to both, Board and management. As regards to the company organigram, only one of the six insurance undertakings taking part in my field research stated that their Internal Audit department is positioned within the Finance organizational unit, directly under the organization's Chief finance officer (see Graph 2).



Graph 1. Line of reporting responsibility



Graph 2. Organization positioning of the Internal Audit Department

The remaining five explained that they were positioned independently of the organization's units, directly under the Management Board/Supervisory Board where applicable. When asked if they had adequate access to the audit committee/non-executive Management board members, the vast majority (more than 70%) provided a positive opinion. However, in the comment section of the questionnaire most of the respondents noted that they felt that the board did not have appropriate knowledge on internal audit or accounting, or were not truly in charge of hiring and evaluating the work of internal auditors. Organization-wise, when needed to discuss plan, work or findings, internal auditors meet more frequently with managing directors, CEO or CFO, than with non-executive board members or internal audit committee where present. In fact, 2/3 of the respondents stated that not only do they meet regularly with the CEO/CFO, the latter are usually present at their meetings with the non-executive board members or audit committee. This approach can have considerable impact on communication, integrity of conclusions reached, objectivity and independence. To be more precise, the IIA Standards Glossary defines independence and objectivity as follows (The Institute of Internal Auditors, 2012):

- "**Independence –** The freedom from conditions that threaten objectivity or the appearance of objectivity. Such threats to objectivity must be managed at the individual auditor, engagement, functional and organizational levels."
- "**Objectivity –** An unbiased mental attitude that allows internal auditors to perform engagements in such a manner that they have an honest belief in their work product and that no significant quality compromises are made. Objectivity requires internal auditors not to subordinate their judgment on audit matters to that of others."

(statutory) audit completion, aside from the Audit report, it is standard audit practice in Macedonia to issue Management letter to the Board of directors. This document contains all the notes/remarks that were detected in the course of the audit that may have significant impact to the insurance entity's operations. Furthermore, the Letter identifies issues regarding the policies, procedures and internal controls in place while setting out recommendations for improvement. In the survey, the respondents indicated the major audit findings (presented in Table 1) that were not adequately disclosed or attended to by the internal audit function. Most of the financial reporting issues and risk areas are concerned with financial reporting compliance, disclosures, transparency of earnings measurement, risk management and internal controls. Given the above summary, one can easily grasp that external auditors encountered several financial reporting issues. In fact, these problems were summarized based on feedback received from five out of the six surveyed insurance undertakings. Amongst the most frequent matters are: revenue recognition and earning measurement, lack of risk management, insufficient internal controls in cash collection processes, underestimation of expenses, capital write-offs. Financial reporting issues are the result of deficient governance mechanisms such as poor legal compliance, low information flow integrity and disrespect of timelines, inappropriateness of management and risk assessment procedures, deployment of resources, communication processes within the insurance undertaking, in effective financial reporting. Auditors are faced with numerous risks and internal control checks across many operational segments of the insurance undertakings in Macedonia. These risks may be grouped and analyzed primarily according to their nature:

Table 1. Most common findings upon auditing insurance companies in the Republic of Macedonia

Finding	*Description*	*Potential effect*
Risk management	Absence of written procedures/policies on risk underwriting Improperly defined responsibilities/segregation of duties	Incompliance with the legal framework. Making inadequate decisions
Money laundering prevention	Absence of written policy. No employee in charge of money laundering prevention and financing of terrorism	Incompliance with the Law on insurance supervision
Rulebook on damage claims	Damage claims not cashed out within 14 days of damage claim liquidation, according to the Rulebook on damage claims	Risking incompliance with the entity's Rulebook on damage claim payment
Generating insurance policies – completeness of documentation	Incomplete/unsigned documents by the company clients	Risk of incomplete premiums. Poor detection of errors/fraud upon issuing policies
Revenue recognition – alignment to official price lists	Generating policy revenues below the company price list	Risk of error/fraud upon revenue recognition and booking of lower premium revenues
Discounts and bonuses	Issuing discounts and bonuses higher than the Rulebook	Risk of error/fraud upon revenue recognition and booking of lower premium revenues
Internal controls -Collection of policies	Absence of internal controls on revenue collection; difference between daily turnover and premiums collected	Risk of error/fraud upon generating Treasury report and alignment to premiums collected for the period. Fraud risk – embezzlement by employees in branch offices
Cancellation of policies	Improper documentation of cancelled premium entries	Disregard of the written procedure. Risk of errors upon cancelling premiums
Calculation of technical provisions	Understated technical provisions	Risk of overstated net income. Risk of capital write-offs. Risk of going concern unless minimum capital requirements are fulfilled
Calculation of allowance for doubtful receivables	Inconsistency between the accounts receivable in the accounting books and the accounts receivable information used for calculation of aging of receivables	Risk of inaccurate calculation of aging structure of receivables and underestimating bad debt for the period

Given their close relationship to executive management, we can conclude that internal auditors in the Macedonian insurance industry may be subject to decision pressure from the CEO/CFO. The supervisory body (non-executive management or audit committee) must step in to regulate and supervise the formal communications between internal audit department and executive management. The Institute of Internal Auditors (the IIA) describes internal auditing in the following fashion: "Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes" (The Institute of Internal Auditors, 2012). Ergo, independence and objectivity should be applied in both assurance and consulting function of internal auditing. The IIA Standards specify that independence is related to both organizational settings and auditor, whereas objectivity stems from to personal attitude and is as such a state of mind.

External audit findings

Apart from non-financial, financial measures are associated with the effectiveness of internal audit and ability of external auditors to indicate and assess problem areas. Upon external

- **Strategic risks:** changes in legal requirements as to the amount that needs to be set aside in the form of technical provision/mathematical reserve; insolvency of core policyholders or vendors; impairment of goodwill, exchange rate fluctuations, limited possibilities for price increase due to legal limitations or likely adverse client relationship; increased promotional activity expenses; brand devaluation and loss of market share (thereof, goodwill impairment), intensified competition on the local insurance market

- **Operative risks:** employee security, natural disasters, political instability, military conflicts, epidemics, brand and reputation protection, non-compliance with policy contract provisions, information system security/unauthorized access to data, adverse media and social media reputation.
- **Reporting risks:** unauthorized access to accounting systems, inadequate segregation of duties, inadequate/non-existing accounting processes controls
- **Compliance risks:** non-adherence to the Regulator requirements, local tax requirements, the Law on protection of competition, IAS and IFRS standards, the company Code of conduct.

Conclusively, we can reflect on how these field study findings highlight some vital implications that need to be addressed by the internal audit profession in the Macedonian insurance segment.

Conclusion

The theoretical and practical research attest that the internal audit function has essential contribution when it comes to assessing risk governance and controls within the Macedonian insurance undertakings. Unfortunately, controls and risk governance processes are adequately evaluated in bad times when risks do come to life. Such challenges on the Macedonian market intensify as legislation becomes more rigid, financial crisis tears down the established supply chain and harms key client liquidity and payment ability, and financial markets become less and less predictable. The proper answer to these events necessitates autonomous valuation of risk management and control systems, adding value to the internal audit function. In July 2013, the IIA published The Financial services code, with the help of an independent IIA committee and the inputs of experts and regulators from the financial services industry. The guidance explains that “The primary role of Internal Audit should be to help the Board and Executive Management to protect the assets, reputation and sustainability of the organization” (Chartered Institute of Internal Auditors, 2013). However, in order to realize this goal, the IIA emphasize that the tone of acceptance of the internal audit function should be set at the top of the organization by the Board of directors and the Committees. Aside from the role of internal audit, the Code defines the internal audit scope and priorities, reporting results, interaction with risk management, compliance and finance, independence and authority of internal audit, resources, quality assessment, relationships with regulators, wrapping up with wider considerations section. The Code recommends that internal audit should challenge vital business decisions made by upper management in order to reduce risk of operating and financial difficulties. The Code suggests that eight areas should comprise the Internal Audit scope:

- Internal governance, i.e. design and operating effectiveness of governance structures and processes
- Information presented to the Board for strategic and management decisions
- Assessing the appetite to risk
- Assessing the company risk and control culture
- Assessing integrity in dealings with customers, reputational risk
- Capital and liquidity risks.
- Key corporate events.
- Outcomes of policies and processes.

When evaluating these areas, internal auditors need to face executive management and demonstrate proper authority to materialize professional challenge. Given the research questions and findings, one can certainly draw multiple recommendations that will help promote the internal audit function efficiency in the Macedonian insurance industry. To begin with, it is essential to select the right manager of internal audit department. Non-executive Board members in charge of this selection process should ensure that the preferred person is skilled enough to make an authoritative challenge of vital business decisions and processes. Also, internal auditors must carefully select their scope of work and go beyond quantitative methodology measured by number of individual tasks completed and not by focus on issues that affect value delivered to customers and owners. Hence, larger emphasis is placed on the control environment behind commercial operations. The field research results indicated that most internal auditors report to executive management, i.e. CEO and/or CFO. But, in order to accomplish its efforts, internal audit should be independent of executive management and report to non-executive Board directors or Audit Committee where applicable. CEO should be involved in most meetings to gain his/her confidence on the topics discussed.

However, core oversight and operative support on finance and risk areas should come from the Board and the Audit Committee (in undertakings where Audit Committee exists). Insurance undertakings must develop an effective organizational structure in order to enable the insurance audit department to successfully deliver and interrelate with employees, board, external auditors, Audit Committee members, and other stakeholders. However, the research depicted that there are numerous challenges facing internal auditors in the insurance undertakings, one being organization positioning. To enable independence and objectivity in the internal audit approach, the internal audit function must be positioned in the most independent manner, distinguishing them from other operational units and executive management. Conclusively, internal auditors should be placed right under the Supervisory Board, or as a separate organizational unit. Furthermore, Macedonian insurance companies must ensure that internal auditors are provided adequate support by all managers. Internal auditors must be actively involved in all business operations in order to be able to respond to changing surroundings and to prepare and align the audit plan. Finally, auditors must work on their professional development, attend trainings on regular basis and promote their technical and soft skills. This recommendation is equally applicable to non-executive Board members and Audit Committee to enable them to listen, follow, and be proactively involved in the internal audit function of the Company. Companies should also reconsider their internal audit outsourcing contracts given the need for internal audit to challenge essential business operations. Given the dynamic market and legal environment, Macedonian insurers are facing a challenging period, which is when the audit function can make a valuable contribution. Challenging management opinion, assessing the risk management, and putting emphasis on controls, are beneficial for the insurance undertaking to function and progress in an ever-changing milieu.

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