

Internal Audit Directive for Insurers, 2079 B.S.
(Approved by the Board on 2079-02-03)

Insurance Board has issued the following Directive for Insurers in exercise of the power conferred by clause (d2) of Section 8 of the Insurance Act, 2049 for the purpose of facilitating the insurers to comply with requirement of relevant Act, Rules and Regulation and to ensure quality audit.

Chapter-1
Preliminary

1. **Brief Name and Commencement:** (1) The name of this directive shall be Internal Audit Directive for Insurers, 2079.

(2) This directive shall commence from first date of the month of Shrawan, 2079 B.S. (July, 2022 A.D.)

2. **Definitions:** (1) Unless the subject or the context otherwise requires, in this Directive :-

- (a) “Audit Committee Charter” shall mean a formal written document prepared by the Board of Directors, pursuant to clause (b) of Section 11, that defines the purpose, authority and responsibility of the internal audit function and audit committee,
- (b) “Control risk” is the risk that arises out of inadequate control systems, deficiencies/gaps and /or likely failures in the existing control processes. The control risks could also be classified into low, medium and high categories.
- (c) “In charge of internal audit function” shall mean the personnel, working as the head of internal audit function, who is responsible for the internal audit function and signs the internal audit report of the insurer,
- (d) “Independence” shall mean freedom from all conditions that threaten the ability of the internal audit function to carry out its internal audit responsibilities in an unbiased manner.
- (e) “Inherent Business Risks” shall mean the intrinsic risk in a particular area/ activity of the insurer and could be grouped

into low, medium and high categories depending on the severity of risk,

- (f) “Internal Audit” shall mean an independent examination of management function, which involves a continuous and critical appraisal of the functioning of the insurer with a view to suggest improvement thereto, and add value to and strengthen the overall governance mechanism of the entity, including the entity's strategic risk management and internal control system,
- (g) “Internal Audit Function” shall mean a function of an insurer, pursuant to Section 3, that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the insurer’s governance, risk management and internal control processes,
- (h) “Risk Based Internal Audit” shall mean an audit system that focuses on significant and risky areas or activities and ensures compliance with accounting principles, laws, policies and procedures, analyses the effectiveness of the internal control system and risk management system, and independently and objectively report on material facts and figures,
- (i) “Risk Register” shall mean the main depository of key risks and respective controls identified across the insurer's departments/units or business lines,

(2) All the other words and expressions used herein and not defined in this directive but defined in the Insurance Act 2049 (December, 1992 A.D.) or in the Insurance Regulations, 2049 (March, 1993) or in any Directives made there under, shall have the same meanings respectively assigned to them in those Acts or Regulations or Directives.

Chapter-2

Internal Audit Function

3. Establishment of Internal Audit Function: (1) An insurer shall establish internal audit function.
 - (2) Internal audit function shall consist of an in-charge of internal audit function and other staffs.
 - (3) The Audit Committee shall ensure that the internal audit staffs in the internal audit function perform their duties with objectivity and impartiality.
 - (4) The in-charge of internal audit function shall report regularly to the Audit Committee.
4. Independence of Internal Audit Function: (1) Internal audit function shall be independent of the internal control process in order to avoid any conflict of interest and shall be given an appropriate support within the insurer to carry out its functions. It shall not be assigned the responsibility of performing other accounting or operational functions.
 - (2) The communication channels between the internal audit staff and management shall encourage reporting of negative and sensitive findings. All serious deficiencies shall be reported to the appropriate level of management as soon as they are identified. Significant issues posing a threat to the insurer's business shall be promptly brought to the notice of the Board of Directors, Audit Committee or top management, as appropriate.

Chapter-3

Audit committee

5. Formation of Audit Committee: The Board shall form an audit committee consisting of at least three members including an independent director, who is not involved in day to day operation of the insurer. The independent director shall be the chairperson of the audit committee.
 - (2) At least one member of the audit committee shall be a Chartered

Accountant having more than 5 years' experience on accounting or auditing or a person having more than 10 years of experience in accounting or auditing or financial field after having obtained at least bachelor's degree in accounts or commerce or finance. In charge of the audit function shall be the member secretary.

(3) Chief Executive Officer, Finance head or any person who is a close relative of the chief executive officer of a company shall not be eligible to be a member of the audit committee.

6. **Functions, Rights and Duties of Audit Committee:** The audit committee shall have the following functions, rights and duties:-

- (a) To ensure fair and transparent reporting and prompt publication of financial statements,
- (b) To review the internal control system and the risk management system of the insurer,
- (c) To review the effectiveness of the compliance function of the insurer,
- (d) To supervise and review the internal auditing activity of the insurer
- (e) To recommend the names of potential auditors for the appointment of the auditor of the company, fix the remuneration and terms and conditions of appointment of the auditor to be presented by the board of directors in the general meeting for the approval thereof,
- (f) Approve the annual audit plan and all major changes to the plan,
- (g) Recommend for the appointment and removal of the internal auditor,
- (h) To review and supervise whether the auditor of the company has observed such conduct, standards and directives determined by the competent body pursuant to the prevailing law as required to be observed in the course of doing auditing work,
- (i) Based on the conduct, standard and directives determined by the competent body pursuant to the prevailing law, to formulate the

policies required to be observed by the company in respect of the appointment and selection of the auditor,

- (j) Review the scope of audit plan, budget of internal audit function, and ensure that coverage of matters of regulatory interest within the audit plan is adequate,
- (k) Review audit reports quarterly and ensure that the senior management is taking necessary and timely corrective actions to address control weakness and compliance issues. Audit committee shall be responsible for the review of status of its recommendations and actions to be taken for non-compliance of its recommendation,
- (l) To review the external auditor's management letter,
- (m) To ensure compliance with the acts, rules, directive, guidelines, circulars and the internal policies and procedures and relevant laws,
- (n) Ensure that the internal audit function has adequate resources to carry out its duties that commensurate with the internal audit plan and scope,
- (o) Ensure that internal audit function maintains open communication with the senior management, external auditors and supervisory authority,
- (p) Review the effectiveness of the internal audit function, including confirmation with independence and Code of Ethics.

7. Accountability of Audit Committee and Insurer: (1) The audit committee shall be directly accountable to the board on all matters related to the performance of its duties, and shall have sufficient independence and authority as well as structure and staffs commensurate with the size and complexity of the insurer.

(2) The Insurer shall submit to the Insurance Board, the Internal Audit Report duly signed by the internal auditor along with the management comments in separate letter within two months from the end of each quarter in every fiscal year.

8. Meeting of Audit Committee: The meeting of the committee shall be held at least eight times per year and not less than twice within three months. However, all

serious deficiencies shall be reported to board of directors as soon as they are identified.

9. Committee Effectiveness: The Audit Committee should review, at least annually, its own performance to ascertain whether members collectively and individually remain effective in discharging the respective roles and responsibilities assigned to them and identify opportunities to improve the performance of the Audit Committee as a whole.

10. Responsibilities of the Management of Insurer: The management of the insurer shall have the following responsibilities:-

- (a) Provide necessary resources needed for the effective performance of the internal audit, risk management and compliance function.
- (b) Prepare risk register that identifies inherent risk and internal control mechanism that mitigates those risks and submit the same to the internal audit, risk management and compliance department or units.
- (c) Ensures that internal audit, risk management and compliance function are fully informed of the latest development in new products and operational changes and the associated risks.
- (d) Provide full access to required data, information and explanations so as to support the internal audit work.
- (e) Prepare an action plan to implement findings and recommendations of internal audit, risk management and compliance department/units and take timely and appropriate actions.

11. Responsibilities of Board of Directors: Board of directors of the insurer shall have the following responsibilities:-

- (a) Ensure that all department/units/branches/business lines have prepared risk register, review and ensure that that management has dispatched same to internal audit, risk management and compliance functions.
- (b) Ensure periodic review of internal audit as well as audit committee charter, policies and procedures and annual risk based audit plan.
- (c) Review the performance of the internal audit, audit committee, risk management and compliance functions at least once in quarter.

Chapter-4

Internal Auditor

12. Appointment, Removal, Engagement of Internal Auditor: (1) The internal auditor of the insurer shall be appointed by its Board of Directors on recommendation of the Audit Committee. Audit committee while making recommendation to the Board of Directors shall recommend at least three Chartered Accountant firms along with the remuneration and facilities to be provided to them.

(2) The internal auditor should be compulsorily hired from a firm of Chartered Accountants in practice. Insurer shall designate at least an officer level employee to act a contact person with the internal auditor.

(3) If the insurer wishes to discontinue the service of the internal auditor or the internal auditor wishes to discontinue his/her service towards the insurer during the audit tenure, written notice with appropriate reason shall be given to Insurance Board.

(4) If the internal auditor discontinues his/her office during audit tenure by whatsoever reason under sub-section (3), another internal auditor shall be appointed by the insurer and its intimation shall be to the Insurance Board within fifteen days from the date of appointment.

(5) During the course of audit if there arises any conflict/constraints between auditor and the insurer which results in non-fulfillment of audit assignment, both the parties shall either jointly or severally inform Insurance board within seven days of arisal of such conflict.

(6) Internal auditor shall propose the audit team and its composition with at least one chartered accountant before commencement of the engagement and it is the duty of the Audit Committee to approve the same. Any changes in the composition of the team shall be communicated by internal auditor to the Audit Committee.

(7) The audit engagement and audit plan may be reviewed by Insurance board if necessary.

13. Involvement in Internal Audit and Statutory Audit: A firm or a person who is appointed to act as an internal auditor or its partners or employees or any

of the persons engaged in internal audit work shall not be involved in the statutory audit of the same insurer in any way. Similarly, a firm or a person who is appointed as a statutory auditor or its partners or employees or any of the persons engaged in internal audit work shall not be involved in the internal audit of the same insurer.

14. Contents of Internal Audit Report: Internal audit report shall include summary of audit issues, detailed audit issues, prior period audit resolution, details of manpower deployed and time taken to execute the audit, and other necessary issues.

Chapter-5

Risk Based Internal Audit

15. Guide on Risk Assessment: (1) Insurers should be clear that role of risk management function/department/committee and role of risk based internal audit is different. Risk management function/department/committee focuses on risk identification and measurement, risk control and mitigation, risk monitoring and review, development of policies and procedures etc. as elaborated in Risk Management Guideline, 2076 issued by the Insurance Board. The risk-based internal audit, on the other hand, undertakes an independent risk assessment solely for the purpose of formulating the risk-based audit plan keeping in view the inherent business risks of an activity/location and the effectiveness of the control systems for monitoring the inherent risks of the business activity.

(2) Responsibilities for managing individual risks are clearly identified and assessed through the risk register maintained by various functional departments and consolidated by risk management department.

(3) Insurers shall develop a policy for risk-based internal audit and it should be approved by the Board of Directors. It shall include the risk assessment methodology for identifying the risk areas based on which the audit plan would be prepared. The policy shall also lay down the maximum time period beyond which even the low-risk business activities/locations shall not remain unaudited. However, the time period should not exceed three years.

(4) While formulating the audit plan every activity/location of the insurer, including the risk management function, shall be subjected to risk assessment by the risk-based internal audit.

(5) The risk assessment process shall include the following:-

- (a) Identification of inherent business risks in various activities undertaken by the insurer.
- (b) Evaluation of the effectiveness of the control systems for monitoring the inherent risks of the business activities i.e. Control Risk.
- (c) Drawing up a risk-matrix for taking into account both, inherent business risks and control risk factors.
- (d) Other issues deemed necessary.

(6) The risk assessment should be undertaken on a yearly basis. The assessment should also be periodically updated to take into account changes in business environment, activities and work processes, etc.

(7) Every insurer shall have an independent risk assessment system in the internal audit function for focusing on the material risk areas and prioritizing the audit work.

(8) While assessing the risk of every activity/location; internal auditor shall categorize the inherent risk and control risk into high, medium and low risk.

16. Categorization of Risk: (1) The location or the activity of the insurer shall be categorized into extreme high risk if both the inherent business risk and control risk are high.

(2) The location or the activity of the insurer shall be categorized into very high risk in the following cases:-

- (a) If inherent business risk is high and control risk medium
- (b) If inherent business risk is medium and control risk high.

(3) The location or the activity of the insurer shall be categorized into high risk in the following cases:

- (a) If inherent business risk is high and control risk low
- (b) If inherent business risk is low and control risk high.
- (c) If both the inherent business risk and control risks are medium

(4) The location or the activity of the insurer shall be categorized into medium risk in the following cases:

- (a) If inherent business risk is medium and control risk low
- (b) If inherent business risk is low and control risk medium.

(5) The location or the activity of the insurer shall be categorized into low risk if both the inherent business risk and control risk are low.

(6) The Risk Matrix shall be prepared for each business activity and location. Based on the level of risk the internal auditor shall prepare the risk matrix as set forth in Schedule.

Chapter-6

Scope of Internal Audit

17. Scope: (1) The scope of the risk-based internal audit must be determined by each insurer for low, medium, high, very high and extremely high risk areas. While determining the scope of internal audit and extent of transaction testing internal auditor should consider the assessed risk, its frequency, magnitude and direction.

(2) In any case, the internal auditor shall cover, at least, the area of Compliance, Risk Management System, Economical, Effective and Efficient Utilization of Resources, Underwriting, Reinsurance, Accounting and Finance, Claims, Management Information System (MIS), Procurement, Human Resource Management, Investments, and Follow-up of previous internal audit report.

18. Compliance: While covering the area of compliance, pursuant to Sub-section (2) of Section 15, the internal auditor shall address the following areas of audit concern:-

- (a) The internal auditor must review operational, financial and legal compliance including Insurance Act, 2049, Insurance regulation, 2049, Directives and Circulars issued by Insurance Board and compliance with other prevailing Acts, Rules and Regulations.
- (b) Compliance of the policies, procedures and guidelines issued by insurer's board of directors.
- (c) Internal auditor should also assess the effectiveness of the compliance function.

(d) Internal auditor should report on the non-compliance of AML/CFT related Acts, Regulations and Direction.

19. Risk Management System: While covering the area of risk management system, pursuant to Sub-section (2) of Section 15, the internal auditor shall address the following areas of audit concern:-

- (a) Review whether the risk management guideline issued by Insurance Board has been complied or not.
- (b) Effective management supervision is practiced by the board of insurers and its delegated authorities;
- (c) Procedures that identify and quantify the level of risk on a timely basis are in place;
- (d) Limits or other controls are in place to manage the risk;
- (e) Reports to the management accurately present the nature and level of risk taken and any non-compliance with approved policies and limits;
- (f) Procedures to assess the controls over the possibility and impact of various risks.

20. Economical, Effective and Efficient Utilization of Resources: (1) The internal audit shall encompass safeguard of assets and economic use of its resources from propriety aspect and extend role of compliance audit to cover management auditing and budgetary process.

(2) While covering the area of economical, effective and efficient utilization of resources, pursuant to Sub-section (2) of Section 15, the internal auditor shall address the following areas of audit concern:-

- (a) Established system for planning, appraising, authorizing and controlling the use of resources are operational and effective;
- (b) Operating standards have been established for measuring the economy, efficiency and effectiveness of resources employed have been met;
- (c) Deviations from operating standards are promptly identified, analyzed and communicated to those responsible for taking

remedial measures; and

(d) Remedial or corrective actions have been taken.

21. Underwriting: (1) While covering the area of underwriting, pursuant to Sub-section (2) of Section 15, the internal auditors shall address the following areas of audit concern:-

(a) Review mechanism used to identify and manage the risks associated with underwriting and underwriting process.

(b) Policies and procedures

(2) The internal auditor shall consider the following matters about policies and procedures pursuant to clause (b) of sub-section (1):-

(a) Adequacy of policies and procedures;

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

(c) Accumulation of risks (general) / multiple policies 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; and

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

22. Reinsurance: While covering the area of reinsurance, pursuant to Sub-section (2) of Section 15, the internal auditor shall address the following areas of audit concern:-

(a) Policies and procedures for evaluation and fixing of risks retention limits, and the evaluation of the quality reinsurers are

set;

- (b) Reinsurance program is reviewed regularly to ensure reinsurance needs are properly and adequately met;
- (c) Important reinsurance documentations are properly handled; and
- (d) Other necessary issues.

23. Accounting and finance: While covering the area of accounting and finance, pursuant to Sub-section (2) of Section 15, the internal auditor shall address the following areas of audit concern:-

- (a) Reporting system provides accurate statistical records of the insurer's underwriting data;
- (b) The premium recording system 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.
- (g) Other necessary issues.

24. Claims: (1) While covering the area of claims, pursuant to Sub-section (2) of Section 15, the internal auditor shall address the following areas of audit concern:

- (a) Adequacy of policies and procedures;
- (b) Claims process complies with the approved policies and procedures;
- (c) Segregation of duties and responsibilities relating to

claims processing/ approval and payment is practiced;

- (d) Register of claims is maintained by the insurer. All claims or known losses should be promptly registered with reasonable provision;
- (e) Claims data are accurately recorded to ensure the following:-
 - (1) Prompt in processing and paying claims and no 'delay tactics';
 - (2) Disbursement of claims are properly approved and supported by appropriate documentation; and
 - (3) Preventive measures are in place to deter fraud.
- (f) Estimates of preliminary loss reserves are reasonable, regularly reviewed and updated upon receipt of fresh and relevant information;
- (g) Claims settled through compromise or ex-gratia basis are reasonable, justifiable and not subject to abuse;
- (h) All recoveries in respect of salvage, subrogation or from reinsurers are properly recorded and collected on a timely basis;
- (i) Outstanding loss reserves are adequate at any point of time;
- (j) Proper monitoring system is in place to record accumulation of claims arising from a particular event or within a particular period;
- (k) A system is in place to identify maturing life policies to enable payments to be made promptly;
- (l) A system is in place to identify surrenders and lapses; and
- (m) Other necessary issues.

(2) The internal auditors shall prioritize the following in the financial reporting system of insurance claims:-

- (a) Whether financial reporting system provides accurate statistical records of the insurer's outstanding claims.
- (b) Whether reports are relevant, accurate, adequate and timely;

- (c) Whether reserves for outstanding loss are adequate and correctly recorded;
- (d) Whether payments of claims are accurately recorded and provision for claims is reduced or eliminated immediately; and
- (e) Whether balances of outstanding claims listing agree with the general ledger.

25. Management Information System (MIS): (1) While covering the area of management information system (MIS), pursuant to sub-section (2) of Section 15, the internal auditor shall address the following areas of audit concern:-

- (a) Whether MIS strategic plan is consistent with the insurer's business objectives and goals;
- (b) Whether participation from the internal audit department is included if an MIS steering committee is established;
- (c) Whether standards and procedures on the various MIS activities such as systems development and programming, computer operations and security, teleprocessing and computerized applications including data integrity and Electronic Fund Transfer are adequate and in compliance with the regulated policy;
- (d) Whether the organizational structure of the IS department provides proper reporting line;
- (e) Whether the management reports on the MIS activities are adequate and effective in monitoring MIS performance and in assisting management to make business decisions;
- (f) Whether MIS staff and users are adequately trained; and
- (g) Whether MIS activities have complied with relevant guidelines issued by statutory bodies if applicable from time to time.
- (h) Other necessary issues

(2) 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 programs. 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.

(3) 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.

26. Procurement: (1) While covering the area of procurement, pursuant to sub-section (2) of Section 15, the internal auditors should address, among others, the following areas of audit concern:

- (a) Whether procurement system is consistent with the insurer's business objectives and goals;
- (b) Whether procurement process complies with approved purchase manual and guidelines of the company. if company does not have purchase manual same should be made and submitted to Insurance Board within 90 days from the issue of this directives.
- (c) Whether procurement of fixed assets is within the limit as prescribed by insurance board from time to time, and
- (d) Other necessary issues.

27. Human Resource Management: (1) While covering the area of human resource management, pursuant to sub-section (2) of Section 15, the internal auditors should address, among others, the following areas of audit concern:

- (a) Adequacy of and compliance with HR policies and Manuals;

- (b) Recruitment, promotion and development of HR in line with insurer HR policy.
- (c) Compliance of Labour Act, Bonus Act, Contribution-based Social Security Act and other relevant acts are duly complied.
- (d) Other necessary issues.

28. Investments: While covering the area of investments, pursuant to Sub-section (2) of Section 15, the internal auditor shall address the following areas of audit concern:-

- (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 practiced;
- (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 Securities borrowed or lent out are properly accounted; and
- (i) Other necessary issues.

Chapter-6


Miscellaneous

- 29. Interpretation:** If there arises any ambiguities or disputes while implementation of this directive, the Insurance Board reserves the right to clarify the confusion or disputes. The clarification or decision of the Insurance Board in relation to any ambiguities or dispute shall be final and binding.
- 30. Repeal and saving:** (1) The Internal Audit Directive for Insurers, 2072 (August 2015) is hereby repealed.
- (2) All acts performed or action taken under the Internal Audit Directive for Insurers, 2072 (August 2015) shall deem to have been performed or taken under this directive.

Schedule

(Relating to Sub-section (6) of Section 16)

Risk Matrix

Risk Matrix				
Inherent Business Risk 	High	High Risk	Very High Risk	Extreme High Risk
	Medium	Medium Risk	High Risk	Very High Risk
	Low	Low Risk	Medium Risk	High Risk
		Low	Medium	High
	Control Risks 