CIRCULAR LETTER

TO : ALL INSURANCE/REINSURANCE COMPANIES, MUTUAL BENEFIT ASSOCIATIONS, INSURANCE/REINSURANCE BROKERS AND PRE-NEED COMPANIES AUTHORIZED TO TRANSACT BUSINESS IN THE PHILIPPINES

SUBJECT : Expectations of the Insurance Commission (IC) for an Effective External Audit Function

In order to assess the quality of governance over controls and the independent oversight conducted into the quality of audits of financial statements as well as in the evaluation of the continuing qualifications of the external auditors accredited by IC, attached is a paper containing the guiding principles for an effective external audit function. These principles clearly set out the responsibilities of the board of directors and management of every IC-covered institution, the roles of the external auditors, and the relationship between IC and the external auditors.

Please be guided accordingly.

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Insurance Commission’s Expectations for an Effective External Audit Function

I. Introduction

The mandate of the Insurance Commission (IC) is to protect the policyholders’ and planholders’ interests and maintain the stability of the insurance and pre-need industries. Hence, the IC must ensure that all its covered institutions (Cl)\(^1\) adhere to safe and sound insurance practices and command the confidence of the public and those with whom they do business. In this regard, the IC, to the extent possible, shall endeavor to uphold the principles of fairness, accuracy and transparency in all documents required to be published by Cls to empower the public to make informed decisions.

The audited financial statements (AFS) reflect important information available to the public such as the financial condition, results of operations and level of risk exposures of a CI. The AFS also disclose any material information that affects or will affect the risk exposures of a CI. The breadth and depth of information in the AFS will undoubtedly aid the decision making process of stakeholders. It is therefore important that the AFS embody the principles of fairness, accuracy and transparency to enhance confidence of the public on the entire financial system as well.

The AFS bears the opinion of the external auditor based on the audit conducted. In this regard, the external auditor is expected to conduct the audit in accordance with internationally recognized ethical and auditing standards, including those calling for independence, objectivity, professional competence, due care and adequate planning and supervision.

The public relies on the auditor’s opinion as it lends credibility to the financial statements of a CI. The regulators also depend on the assessment done by external auditors as this provides critical inputs in the evaluation of the safety and soundness of a CI. The tasks of the regulators such as the IC, and external auditors are viewed as complementary. Mutual recognition of the respective roles of IC and the external auditor, as well as how said roles complement each other, improves not only the effectiveness of the external audit function but also the quality of supervision performed by IC.

Accordingly, the IC is issuing the following guiding principles for an effective external audit function to set-out its expectations from management and external auditors and to strengthen its relationship with the latter. These principles take into account international best practices\(^2\) and shall be used by IC in assessing the effectiveness of the oversight of the Board of Directors over the Cls and the quality of the external audit function.

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1 Covered institutions (CI) include insurance and reinsurance companies, professional reinsurers, mutual benefit associations, insurance and reinsurance brokers, general agents and pre-need companies.

2 These include those cited in the papers issued by the International Association of Insurance Supervisors (IAIS) in October 2011 and the Organization for Economic Co-operation and Development (OECD) in 2004.
II. Guiding Principles

1. The Responsibility of the Cls’ Board of Directors and the Management

a. Insurers and pre-need companies must be managed prudently. The Board should therefore understand the external auditor’s approach to internal controls relevant to the audit. This includes evaluating the roles of the external auditor, the internal auditor and the actuary so as to establish the degree of assurance that the Board can draw from the external auditor’s report. Hence, the duties and responsibilities of the entity’s Board of Directors and the board level Audit Committee in relation to controls, independent oversight and checks and balances systems, include, among others, to ensure that:

Board of Directors

(i) Adequate governance structures and control processes related to the different activities of the Cls are established and complied with, including:

- Systems that accurately identify and measure all material risks and adequately monitor and control these risks;
- Adequate internal controls, organizational structures and accounting procedures leading to a suitable controlled environment aimed at meeting the Cl’s prescribed corporate strategy, performance, information system and compliance objectives;
- The evaluation of the quality of assets and their proper recognition and measurement; and
- Requirements on the gathering and disclosure of material and relevant information on financial accounts including related party transactions.

(ii) Adequate governance structures and control processes for areas or exposures that may pose significant risk to a Cl such as fair value measurement and financial instruments. The Board’s oversight responsibilities for the Cl’s use of fair value accounting include:

- Reviewing and approving written policies related to fair valuations;
- Continuing review of significant valuation model performance for issues escalated for resolution and all significant changes to valuation policies;
- Ensuring that adequate resources are devoted to the valuation process;
- Articulating the Cl’s tolerance for exposures subject to valuation uncertainty and monitoring compliance with the Board’s overall policy settings at an aggregate firm-wide level;
o Ensuring independence in the valuation process between risk
taking and control units;
o Ensuring appropriate internal and external audit coverage of
fair valuations and related processes and controls;
o Ensuring consistent application of accounting standards and
disclosures within the applicable accounting framework;
o Ensuring the identification of significant differences, if any,
between accounting and risk management measurements
and their proper documentation and monitoring; and
o Ensuring adequate documentation of significant differences
between the valuations used for financial reporting purposes
and for regulatory purposes.

(iii) There is an effective actuarial function that periodically report to
the Board matters such as:

o Any circumstance that may have a material effect on the CI’s
operations from an actuarial perspective;
o The adequacy of the technical provisions and other liabilities;
o The prospective solvency position of the CI; and
o Any other matter as determined by the Board.

(iv) Appropriate management information systems are established;
and

(v) The interests of stakeholders are adequately protected.

Audit Committee

(i) The Audit Committee is responsible for providing oversight over
the CI’s audit functions. In addition to the duties expected of the
Audit Committee under IC Circular No. 31-2005, a CI’s Audit
Committee shall, likewise, perform the following functions:

o Appoint, dismiss and re-appoint external auditors based on
fair and transparent criteria such as (i) core values, culture and
high regard for excellence in audit quality, (ii) technical
competence and expertise of auditing staff, (iii) independence,
(iv) effectiveness of the audit process, and (v) reliability and
relevance of the external auditor’s reports;
o Regularly review and monitor the external auditor’s technical
competence, independence, objectivity and overall
effectiveness of the external audit process;
o Set compensation of the external auditor in relation to the
scope of its duties;
o Establish a system of reporting where the external auditor can
communicate directly to the Audit committee on a timely basis;
o Establish a system that addresses, in a timely and effective
manner any findings of fraud or error on the financial
statements;
- Continually engage the external auditor on matters concerning audit quality; and
- If the external auditor resigns or communicates an intention to resign, the Audit Committee should follow up on the reasons/explanations giving rise to such resignation and consider whether it needs to take any action in response to those reasons.

(ii) In assessing the effectiveness of the external auditor’s work, the Audit Committee should closely coordinate with the external auditor during all phases of the external audit engagement, as follows:

- It should discuss and agree to the terms of the engagement letter issued by the external auditor prior to the approval of the engagement. Where relevant, the engagement letter should reflect changes in circumstances relevant to the external audit;
- It should obtain an understanding of the scope and audit approach which shall be adopted by the external auditor for purposes of meeting the CI’s financial reporting requirements;
- It should ascertain and take steps to address the major areas of concern identified by the external auditor during the course of its audit. These issues may cover significant accounting estimates, valuation methodologies and accounting policies adopted;
- It should review management representation letters before these are transmitted to the external auditor to ensure that items in the letter are complete and appropriate;
- It should assess the extent of cooperation provided by the CI’s management during the conduct of the external audit; and
- It should understand and duly assess the external auditor’s opinion regarding the capability of CI management and the adequacy of accounting/information systems to comply with financial and prudential reporting responsibilities.

(iii) In order to reinforce the Audit Committee’s effectiveness in performing its key role in strengthening corporate governance, the Audit Committee shall maintain effective communication channels with the external auditor through regular and structured dialogues in the course of the external audit. Such communications should focus on the key accounting or auditing issues that, in the external auditor’s judgment, give rise to a greater risk of material misstatement of the financial reports, as well as other external audit concerns of the Audit Committee. Internal and external auditors should be allowed and encouraged to attend the meetings of the Audit Committee. During regular meetings of the Audit Committee, matters that may be raised include audit findings that would impact on the CI’s compliance with regulatory requirements, disclosures and other accounting concerns.
Management

Management, in general, is responsible for the implementation and consistent adherence by all personnel to the policies approved by the board of directors in relation to controls, independent oversight and checks and balances systems, ensuring, among others, that:

(i) Financial statements are prepared in accordance with accounting standards on the prescribed financial reporting framework. Documentation sufficient to support the financial statements is maintained. This responsibility includes ensuring that the external auditor who audits and reports on the financial statements has complete and unhindered access to, and is provided with, all necessary information that can materially affect them and, consequently, the auditor’s report on them, to the extent allowed by law. Management also has the responsibility to provide all information to regulatory agencies that are entitled to such information by law or regulation;

(ii) Management is responsible for maintaining, monitoring and evaluating the adequacy and effectiveness of the internal control system on an ongoing basis, and for reporting on the effectiveness of internal controls on a periodic basis. This function shall include an assessment of the adequacy of, and compliance with, the CI’s established policies and procedures and assurance as to the adequacy, effectiveness and sustainability of the CI’s risk management and control procedures and infrastructure. In fulfilling its duties and responsibilities, management should take all necessary measures to ensure that there is a continuous, adequate and effective internal audit process.

b. Given that transparency is an essential element for sound corporate governance, the board of directors and management should have an effective oversight on the CI’s disclosure practices. Disclosures should be accurate, clear and presented in a manner that shareholders, depositors, other relevant stakeholders and market participants can understand easily.

c. The responsibilities of the board of directors and management are in no way diminished by the existence of a system for the supervision of CIs by IC or by a requirement for the CI’s financial statements to be audited by an external auditor.

2. The Role of the CI’s External Auditor

a. The objectives of the external auditor are to: (i) Form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework based on an evaluation of the conclusions drawn from the
audit evidence obtained; and (ii) Express that opinion clearly through a written report that also describes the basis for the opinion.

b. In forming this opinion, the external auditor shall identify and assess the risks of material misstatement in the CI's financial statements, taking into consideration its operations, control environment and its components as well as the CI's financial reporting systems. The assessment shall also take into account qualitative aspects of the CI's accounting practices, including indicators of possible biases in management's judgments. The external auditor should, likewise, assess and communicate to the Audit Committee the results of its assessment on the capability of CI management, the strength of the CI's control environment, and the adequacy of its accounting/information systems to comply with financial and prudential reporting responsibilities.

c. The external auditor shall conclude whether it has obtained reasonable assurance that the financial statements, as a whole, are free from material misstatement, whether due to fraud or error. That conclusion shall include an evaluation of the following:

(i) Whether sufficient appropriate audit evidence has been obtained
(ii) Whether uncorrected misstatements are material, individually or in aggregate; and
(iii) Compliance with the applicable framework.

If material error or fraud is discovered, the external auditor shall immediately bring such information to the attention of the Audit Committee. Moreover, the external auditor shall report to the IC such material error or fraud and other matters prescribed under existing regulations.

d. In particular, the external auditor shall evaluate whether, in view of the requirements of the applicable financial reporting framework:

(i) The financial statements adequately disclose the significant accounting policies selected and applied;
(ii) The accounting policies selected and applied are appropriate and consistent with the applicable financial reporting framework;
(iii) The accounting estimates made by management are reasonable;
(iv) The methodologies, assumptions and valuation practices including technical provisioning for losses and other liabilities are adequate and consistent with the applicable financial reporting framework;
(v) The information presented in the financial statements are relevant, reliable, comparable and understandable;
(vi) The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and
(vii) The terminologies used in the financial statements, including the title of each financial statement, are appropriate.

e. The external auditor recognizes that in carrying out the audit of financial statements, insurance entities and pre-need companies have the following characteristics that generally distinguish them from most other enterprises, and which the external auditor takes into account in assessing the level of inherent risk:

(i) An insurance company offers in return for the insurance premium already received the mere promise to perform its services of indemnifying the policyholder should the insured event occurs. Therefore, the policyholder must be able to trust the insurer to be able to fulfill its obligation.

(ii) Insurance companies assume risks on behalf of policyholders. They mitigate these risks by acquiring insurance with reinsurers. Through the use of reinsurance, an insurer can reduce risks, stabilize its solvency, use available capital more efficiently and expand underwriting capacity.

(iii) The insurers should maintain an up-to-date list of reinsurers taking into account the financial strength of the reinsurers. They should maintain adequate reinsurance cover at all times. Insurance by nature is a global business. Therefore, insurance companies need to have an effective and efficient connection with foreign insurers and reinsurers.

(iv) The insurers may invest and trade in complex financial instruments, hence the need to establish appropriate valuation and risk management procedures. The effectiveness of these procedures depends on the appropriateness of the methodologies and mathematical models selected, access to reliable current and historical market information, and the maintenance of data integrity.

(v) A pre-need company, on the other hand, offers in return for the amount received, the performance of future services, payment of monetary considerations or delivery of other benefits at the time of actual need or agreed maturity date specified in the contract. Hence, every pre-need company is expected to perform its obligation to its planholders.

(vi) Both insurance companies and pre-need companies have assets that should properly match against the amount of reserves and liabilities.

(vii) They have fiduciary duties in respect of the assets that were entrusted to them. Both entities therefore need to establish operating procedures and internal controls designed to ensure that they deal with such assets only in accordance with the terms and conditions set in the code.
(viii) There are regulatory requirements which in certain instances influence the accounting principles that a CI shall follow. Non-compliance with regulatory requirements, for example, risk based capital requirements, minimum paid-up capital and networth required of insurance companies and insurance/reinsurance brokers as well as the trust fund reserve requirements for pre-need companies could have implications on the financial statements of CI's concerned or the disclosures therein.

- The external auditors are required to assess CI's compliance with certain IC rules and regulations as prescribed under existing regulations. In this respect, external auditors are required to directly report to IC material breaches in said rules and regulations. In addition, external auditors should also look into the adequacy and propriety of documentation of significant differences between the valuations used for financial reporting purposes and for regulatory purposes.

- External auditors should also assess the adequacy and propriety of disclosures on related party transactions. The external auditors should exercise sound judgment on whether mere compliance with disclosure requirements prescribed under the applicable financial reporting framework already provide sufficient information to make a conclusion on whether the transactions are done at arm's length terms.

f. While the external auditor has the sole responsibility for the audit report and for determining the nature, timing and extent of audit procedures, much of the work of internal auditing can be useful to the external auditor in the audit of the financial statements. The external auditor, therefore, as part of the audit assesses the internal audit function insofar as the external auditor believes that it will be relevant in determining the nature, timing and extent of the external audit procedures.

g. Judgment permeates the external auditor's work. The auditor uses professional judgment in areas such as:

(i) Assessing inherent and control risk and the risk of material misstatement due to fraud or error;
(ii) Deciding upon the nature, timing and extent of the audit procedures;
(iii) Evaluating the results of those procedures; and
(iv) Assessing the reasonableness of the judgments and estimates made by management in preparing the financial statements.

While many areas of financial reporting require significant judgments (i.e., by management when implementing the standards and auditors when interpreting the standards during the audit process), the IC
expects that similar transactions will be accounted for in a manner that is consistent with the accounting standards and consistent across CIs.

h. External audits performed in accordance with auditing and ethics standards are an important element in enhancing market confidence. This is particularly the case with respect to valuations of financial instruments, including disclosures about the valuation methodologies, and the extent of off-balance sheet risks to which CIs are exposed. Auditors play an important role in encouraging consistent and meaningful disclosures about valuation processes.

i. The external auditor should maintain an attitude of professional skepticism throughout the planning and performance of the audit, recognizing that circumstances may exist that cause the financial statements to be materially misstated. Specific areas where professional skepticism is particularly important include, among others, fair value measurements, related party relationships and transactions, going concern assessments, and in auditing significant unusual or highly complex transactions.

Furthermore, the external auditor should consider the supervisory issues raised by the IC especially in its assessment of the going concern assumption, particularly in the evaluation of the liquidity and solvency of the CI.

j. The external auditor should promote a two-way communication with those charged with the governance of the CI. The subject of the communication may include the following:

(i) The responsibilities of the external auditor in relation to the financial statement audit, and an overview of the planned scope and timing of the audit;
(ii) Information relevant to the external audit; and
(iii) Timely observations arising from the external audit that are significant and relevant to the CI’s financial reporting process, including inappropriate accounting treatment that may result in tax violation.

k. The external auditor should document its discussion with the CI’s Board of Directors and the Audit Committee. Where there are differences between IC regulations and the applicable financial reporting framework, as when there is more than one option allowed, discussions on the treatment adopted in the financial statements should be duly minuted. The external auditors are nonetheless, expected to recommend compliance with IC-prescribed accounting treatment particularly when such is likewise acceptable under the applicable financial reporting framework.
l. The external auditor is expected to charge only reasonable audit fees. In determining reasonable fees the following may be considered:

(i) Expected hours needed to complete the scope of work envisioned in the audit plan;
(ii) Complexity of the activities and structure of the company;
(iii) Level of internal audit assistance;
(iv) Level of fees being charged by other audit firms; and
(v) Quality of audit services

In this respect, the external auditor is expected to ensure that the audit fees will be set at an amount that will not in any way compromise the quality of the audit.

m. The external audit team is expected to be composed of members whose collective skills and competence are commensurate with the size and complexity of operations of the CI.

3. The Relationship between IC and the External Auditor

a. The external auditors reporting on adverse findings is useful to the ongoing monitoring of IC on the financial condition and risk profile of CIs. The external auditor’s report enables IC to become aware of emerging problems and work with the CIs and other supervisors, as appropriate, to take necessary and timely steps to address the issues.

b. The IC also engages external auditors in discussion involving accounting issues, to arrive at a consensus regarding the treatment of certain insurance and pre-need transactions. IC looks forward to the development of this forum for resolving accounting issues.

c. In many respects, the IC and the external auditor have complementary concerns regarding the same matters, though the focus of their concerns is different.

(i) The IC is primarily concerned with maintaining the stability of the insurance system and fostering the safety and soundness of individual CI in order to protect the interests of the policyholders/planholders. Therefore, the IC monitors the present and future viability of CIs and uses their financial statements in assessing their condition and performance. The external auditor, on the other hand, is primarily concerned with reporting on the CI’s financial statements to its shareholders, board of directors and other stakeholders. In doing so, the external auditor evaluates the appropriateness of management’s use of the going concern assumption.

(ii) The IC is concerned with the maintenance of a sound system of internal control as a basis for safe and prudent management of the CI’s business. The external auditor, in most situations, is
concerned with the assessment of internal control to determine
the degree of reliance to be placed on the system in planning
and performing the audit.

(iii) The IC must be satisfied that each CI maintains adequate
records prepared consistently in accordance with applicable
international accounting standards and practices to enable it to
appraise its financial condition and the profitability of its
business, and that the CI publishes or makes available on a
regular basis financial statements that fairly reflect its condition.
The external auditor is concerned with whether accounting
records are adequately and sufficiently reliable to enable the
entity to prepare financial statements that do not contain material
misstatements and thus enable the external auditor to express
an opinion on those statements.

(iv) Although the IC and the external auditor have different concerns,
there are areas where the work of the IC and the external auditor
can be useful to each other. IC increasingly utilizes audits to
complement the supervisory process, including its use as an
early warning system for emerging supervisory issues. Moreover, audited financial information is among the sources of
information used in the risk-focused supervision process, which
contributes to increased efficiency in insurance supervision. For
instance, the IC makes use of the following information gleaned
from an external auditor's work product:

1. External auditor's assessment of the CI's performance and
   risk management,
2. Material internal control weaknesses identified, and
3. Views and judgments on significant transactions, valuation
   and impairment methodologies, accounting policies.

d. Similarly, the external auditor can benefit from the work of the IC such
as when determining the extent of its audit procedures in ascertaining
the carrying value of the assets and identification and adequate
disclosure in the financial statements of all material commitments and
liabilities, and the corresponding capital position of CIs. Significant
supervisory issues raised by the IC will also aid on the external
auditor's assessment of the financial condition. For this purpose,
copies of the IC Reports of Examination can be provided by the CI to
the external auditor. External auditors, on the other hand, shall
include a provision in their audit engagement letters that contents of
the IC Reports of Examination shall be treated appropriately, an
confidentially.