

ANNUAL INTERNAL AUDIT REPORT FOR 2012 BY INTERNAL AUDIT DEPARTMENT OF ZAVAROVALNICA TRIGLAV

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Recipients of the report: Management Board
Audit Committee
Supervisory Board
General Meeting of Shareholders

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1 PURPOSE OF THE REPORT

Pursuant to Article 165 of the Insurance Act and Article 27 of the Internal Audit Department Rules of Zavarovalnica Triglav, the Internal Audit Department (hereinafter also: the IAD) shall prepare an Annual Internal Audit Report and submit it to the Management Board and the Supervisory Board. In turn, the Management Board shall inform the General Meeting of Shareholders on the content of the report and the opinion of the Supervisory Board on the report.

The Internal Audit Department also prepares:

- detailed reports on individual internal audits conducted which are submitted to the Management Board and the management of the insurance company;
- quarterly reports on internal audits submitted to the Management Board and the Audit Committee; and
- semi-annual reports on internal audits submitted to the Management Board, the Audit Committee and the Supervisory Board.

The purpose of drafting the Annual Internal Audit Report for 2012 is to present the Management Board, the Audit Committee, the Supervisory Board and the General Meeting of Shareholders with:

- information on the work of the IAD and the implementation of planned internal audit activities in the reporting period;
- a summary of significant findings of internal auditors resulting from internal audits conducted in the reporting period;
- an assessment of the adequacy of resources for the work of the IAD in the reporting period;
- a summary of material findings on the external quality assessment of the functioning of the IAD.

The report contains all the information required by Article 165(2) of the Insurance Act.

2 OVERVIEW OF THE WORK OF THE IAD AND THE IMPLEMENTATION OF PLANNED INTERNAL AUDIT ACTIVITIES

In 2012, the IAD carried out activities based on the adopted plan of action for the IAD, particularly the Annual Work Programme of the Internal Audit Department of Zavarovalnica Triglav for 2012 which was adopted by the Management Board on 15 December 2011 and approved by the Supervisory Board on 22 December 2011. In accordance with internal audit professional guidelines and good practice in this field, the IAD conducted regular and extraordinary internal audits and carried out other internal auditing activities which are a mandatory component of internal audit in accordance with the aforementioned guidelines.

In the reporting period, the IAD conducted:

- **29 regular internal audits** of which 27 audits were related to the business operations of the Company out of 29 audits planned by the Annual Work Programme for 2012¹, and 2 audits

¹ In 2012 the IAD failed to carry out the following two planned internal audits:

- the internal audit of international insurance programmes was not performed due to HR deficiencies (the early retirement of an internal auditor in July 2012 which could not have been foreseen when planning the IAD activities for 2012);

transferred from 2011 (20 audits were related to the business operations and 9 were carried out in other companies of the Triglav Group);

- **1 extraordinary internal audit** pertained to the audit of operating costs in 2009-2011 of subsidiary Triglav Osiguranje, Belgrade.

In the reporting period, the IAD carried out **other internal audit activities**:

- formal advisory activities in the subsidiary Lovćen Osiguranje, Podgorica, in IT system redesign, planned for October 2013;
- informal advisory activities, particularly in relation to the drafting and update of internal acts of the insurance company;
- monitoring the implementation of recommendations of both internal and external auditors;
- an annual IAD work plan for 2013 was drawn up;
- the IAD submitted quarterly or semi-annual reports to the Management Board, the Audit Committee and the Supervisory Board on its activities, on conducted internal audits and resultant findings and on the implementation of recommendations of internal and external auditors;
- quality maintenance and quality management activities within itself and within other internal audit departments of the Triglav Group:
 - drafted the recast internal audit manual defining in greater detail the methodology of work of the IAD and internal audit departments in other companies of the Triglav Group;
 - kept improving the planning and implementing procedures for internal audits and related reporting;
 - reorganised itself and updated its job classification and position descriptions;
 - performed audits of the internal audit departments in the following the subsidiaries of the Triglav Group:
 - Triglav Osiguranje, Zagreb;
 - Triglav Osiguranje, Belgrade;
 - Triglav Osiguruvanje, Skopje;
 - Triglav Osiguranje, Banja Luka;
 - Triglav Osiguranje, Sarajevo;
 - Lovćen Osiguranje, Podgorica;
 - organised a seminar for internal auditors from other companies within the Triglav Group aimed at exchanging experience and good business practices among internal auditors;
 - successfully concluded an external quality assessment of its functioning performed by an external expert (summary of the findings on the external quality assessment can be found under Chapter 5).

Taking into consideration the personnel issues described in Chapter 4 of this report, the IAD is of the opinion that the planned internal audit activities in 2012 were implemented adequately.

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- the internal audit of business operations of Triglav nepremičnine, Ljubljana, was not conducted due to substantial changes in the company's operation and its consequent reorganisation that will, as foreseen, be concluded by the end of March 2013.

Both unperformed audits were included to the Annual Work Programme of the IAD for 2013.

3 SUMMARY OF SIGNIFICANT FINDINGS BASED ON CONDUCTED INTERNAL AUDITS

When conducting internal audits, the IAD focuses on the verification and evaluation of the adequacy and effectiveness of the internal audit systems of the Company, which must ensure that:

- risks are adequately identified and controlled;
- accounting information and information required for decision-making and day-to-day operation is correct, reliable and timely;
- employees act in accordance with the law and other regulations, standards and guidelines and in accordance with internal regulations governing the business operations of the Company;
- resources are used economically and efficiently and that they are protected appropriately;
- programmes and plans are implemented and targets achieved;
- the Company continuously improves the quality of its operation.

Based on the internal audits conducted in 2012, the IAD is of the opinion that **the functioning of the internal audit systems of the Company** as a whole is **adequate**², but there are nevertheless a number of possibilities to improve the functioning of these systems in individual areas of activity of the Company.

The following section contains a summary of significant findings in individual areas of activity of the Company.

In **development, underwriting and claim settlement** it is necessary to recast the internal acts to reflect the implemented reorganisation of business fields; thoroughly examine the scheme of property and pecuniary interests insurance premiums as well as the individual tariffs of premiums; record and examine any possible deficiencies, discrepancies and proposals for changes as well as apply the useful audit findings to update or modernise the system and tariffs of premiums; facilitate the activities for designing a competitive corporate package; complement the criteria for providing commercial discounts and improve the procedures for monitoring provided commercial discounts; integrate additional software controls to underwriting applications for providing discounts in accordance with the systems and tariffs of premiums as well as decisions on the scope of powers; re-examine the correctness of data in the registers of insurance agencies – companies and insurance

² The adequacy and efficiency of the functioning of internal audit systems is evaluated in view of adherence to relevant legislation and other regulations and internal acts, provision of an efficient work organisation and an appropriate division of powers and responsibilities of employees, the adequacy of procedures and the design and operation of audits in individual areas of activity of the insurance company, the adequacy and efficiency of information provision and communication with employees etc. The following criteria were used when evaluating the adequacy and efficiency of internal audit systems:

- **very good** – The audit system is very good in every respect. Robust internal controls are established, all key controls are functional and there are no derogations. There is optimum supervision. The risk level is very low.
- **good** – The audit system is good in general. The management controls business operations well and promptly recognises and eliminates deficiencies. Responsibilities, powers and procedures are well defined and are only rarely exercised contrary to expectation. There is regular supervision. The risk level is low.
- **adequate** – There are certain deficiencies in the audit system which do not significantly undermine the business operations of the insurance company, but they nevertheless require immediate action by the management. For the most part, responsibilities, powers and procedures are adequately defined, but are on occasion not exercised according to expectation. There is occasional supervision. The level of risk is medium.
- **poor** (but still conditionally acceptable) – There are serious deficiencies in the audit system that (may) significantly undermine the business operations of the insurance company and must be eliminated by the management immediately. Responsibilities, powers and procedures are not adequately defined and are often exercised contrary to expectation. Supervision is rare and is left to individuals. The level of risk is high.
- **insufficient** – There are very serious deficiencies in the audit system (significant non-compliance with external regulations, complete lack of control) that jeopardise the business operations of the insurance company and require a complete re-organisation of the company. There is no supervision. The level of risk is very high.

agents – sole proprietors, as well as appropriately update and complete such registers; improve the cooperation of mentors when initiating new insurance agents and introduce appropriate activities for improving the quality of underwriting at contractual points of sale; adequately recast the insurance agency and brokerage contracts; improve the control over commissions paid to contractual points of sale and brokers as well as examine the possibility of simplifying and automating the calculation of commissions; improve the procedure of recovering open claims relating to contractual points of sale and the control over the deliveries of means of payment; devote more attention in the procedures of claim handling and loss adjustment to the eligibility of claims and the volume of loss; improve the organisation of claim documentation; improve the procedures for providing information to benefit assignees; improve the procedures for reminders of subrogation receivables; recast the agreements and contracts relating to personal data processing concluded with car service stations as well as improve the control of services provided by such stations.

In **finance and accounting** it is necessary to formalise the Insurance Company's strategy of liquidity risk management; draft an investment policy statement relating to the long-term business fund for the »PDPZ-Renta« individual voluntary supplemental pension insurance as well as improve the record-keeping of implemented adequacy checks of individual investment policies and investment policy statements; improve the software support for the liquidity management process as well as establish additional functionalities and controls within the software support to the process of financial investment management; formalize the rules on breaking down the costs of depreciation of fixed assets and examine the possibility of improving the existing method of analysing the adequacy of breaking down and allocating operating costs per cost centres, insurance classes and functional groups.

In **IT and IT systems** it is necessary to formalise the guidelines for managing IT authorisations and design a concept for standardising the system of IT authorisations management for target IT systems; improve the implementation of testing processes during the development phase of IT systems; define the procedures for terminating the existing databases that will enable a safe transition to the IT-Build database, and adopt appropriate measures for improving the stability of operation of the IT-Build system; formalise the strategy of the applicative and technical solution for business reporting as well as complete the architecture plan and data protection strategy for the data warehouse.

In **human resource management and management of intangible and tangible fixed assets** it is necessary to improve the procedures of concluding and accounting for payments of authorship and specific task contracts; examine the adequacy of strategic guidelines in the area of real-estate management as well as, if necessary, amend these guidelines and ensure their implementation; improve the procedures for real-estate management and define in greater detail the rules for adopting decisions on real-estate appraisals; improve the procedures for listing the intangible and tangible fixed assets; produce the methodology for purchasing and maintaining the intangible and tangible fixed assets as well as improve the procedures for monitoring the implementation of plans.

In **organisation and business processes** it is necessary to improve the applicative support for managing professional powers; formalise the responsibility for data management; establish an adequate system for managing code tables/registers; improve the process of liquidation of received invoices.

In **project implementation** it is necessary to improve the processes of project planning, project implementation monitoring and reporting on the development of projects; improve the system of safekeeping and accessibility of project documentation; formalise the method of recording and monitoring project costs to ensure correct and timely information on project costs; establish an automated transfer of project cost data from other applications to the project management application.

In **management of subsidiaries** it is necessary to clearly define the powers and responsibilities of individual stakeholders in the process of managing subsidiaries; produce a comprehensive and in-depth analysis of the current system of managing individual subsidiaries; renew the planning procedures for the insurance activities in subsidiaries and related reporting procedures; formalise the criteria for appointing members to management and supervisory bodies of subsidiaries; standardise the system of information and data collection as well as formalise the procedures for charging costs to subsidiaries. The implementation of all relevant activities for the elimination of violations, irregularities and deficiencies detected in internal audits in subsidiaries concerned must be ensured in cooperation with the management of the respective subsidiaries. The following section summarises the possible improvements to the functioning of the internal audit system in the subsidiaries of the Triglav Group where the IAD conducted audits either independently or in cooperation with internal auditors employed by the subsidiaries (some of the possible improvements are only related to individual companies and not to all audited companies):

- in development, underwriting and claim settlement, stricter adherence to the internal acts of individual companies and an appropriate division of powers is required; the control of insurance policies should be improved; improvements are also needed in relation to the resolution of complaints; the calculation of commissions shall be better controlled, the cost analysis of underwriting shall be produced and appropriate measures shall be adopted to contain those cost at an appropriate level; in the processes of claim appraisal and settlement more attention should be paid to eligibility and the extent of damage and more orderly claims documentation and more efficient claim settlement and subrogation should be ensured;
- in finance and accounting it is necessary to improve the procedures for monitoring payments and recovering claims, formalise the criteria for value corrections and write-off of claims, improve the procedures of petty book transactions, as well as improve the record-keeping of business events to ensure correct and timely information on operations;
- in IT and IT systems it is necessary to de-couple incompatible functions, improve the motivation for modernising the existent or introducing new IT systems, formalise the responsibility for managing IT systems, improve the procedures for change management of IT systems, improve control procedures during the transfer of data from the old to new IT systems, ensure monitoring of access to production bases and adequately limit the administration powers, establish procedures for periodical reviews and formal confirmations of the rights to access IT systems, improve data preservation procedures, ensure a uniform version of basic functionalities of the AdInsure IT system in all subsidiary insurance companies as well as appropriately register the differences in local functionalities and produce a plan to standardise the hardware elements in all subsidiary insurance companies;
- in human resource management it is necessary to ensure strict compliance with the rules covering employee remuneration and use of official payment cards, recover the resources in the case of overdrafting the approved limits as well as improve the procedures of issuing, completing and approving business trip orders and travel cost calculations;

- in marketing communication, rules should be drafted for awarding sponsorship funds, donations and funds for prevention activities as well as an appropriate system for improving the efficiency of supplying marketing materials and services should be set up;
- it is also necessary to improve the procedures for monitoring advance payments given for different purposes and their liquidation as well as the procedures of liquidation of received invoices, and to adopt measures to improve physical and fire safety.

In order to establish efficient internal audit systems in the subsidiaries of the Triglav Group, the Company continued its activities pertaining to the introduction of unified minimum standards for internal audits in all subsidiaries of the Triglav Group throughout 2012.

In 2012, the IAD submitted regular reports to the Management Board on all internal audits conducted. The Management Board discussed the reports and instructed the heads of the audited departments and the addressees of recommendations to follow the recommendations of the IAD, to eliminate the detected violations, irregularities and deficiencies within the agreed time period and to report to the IAD on their progress. Based on these reports, the IAD regularly monitors the implementation of given recommendations and reports to the Management Board, the Audit Committee and the Supervisory Board. The same monitoring and reporting process also applies to the recommendations of external auditors.

Based on its monitoring of the implementation of recommendations, the IAD is of the opinion that the Management Board and the management of the Company are aware of possible repercussions of the detected violations, irregularities and deficiencies on the Company's attainment of key targets and that they have taken measures and initiated activities for their elimination.

4 ASSESSMENT OF THE ADEQUACY OF RESOURCES FOR THE WORK OF THE IAD

The Management Board is providing the IAD with appropriate work conditions. The number and structure of employees of the IAD and their qualification level generally enable the IAD to implement the planned internal audit activities in a given year, provided that the IAD is not faced with unforeseen lengthy absences due to sick leave, maternity/parental leave or other unexpected reasons.

As at 1 January 2012, there were 10 persons employed in the IAD, of which one person was on maternity/parental leave, so that 9 persons were working actively. As at 31 December 2012, 9 persons were employed and working actively. The decrease in the number of employees in 2012 results from the early retirement of 1 person in July 2012 that could not have been foreseen by the IAD when planning its activities for 2012.

Of all the employees of the IAD, 6 persons have at least one of the professional titles awarded to persons having successfully completed training in the field of auditing and related fields by the Slovenian Institute of Auditors:

- 1 person has the professional titles »verified internal auditor« and »certified auditor«;
- 4 persons have the professional title »verified internal auditor«;
- 1 person has the professional title »verified information system auditor«.

The IAD provides all employees with an adequate level of professional training and education. In 2012, the employees participated in formal in-house and external training courses, while a part of their activities consisted of informal education in the form of reading relevant technical literature.

5 SUMMARY OF SIGNIFICANT FINDINGS ON THE EXTERNAL QUALITY ASSESSMENT OF THE FUNCTIONING OF THE IAD

The Internal Audit Department of Zavarovalnica Triglav operates in accordance with the International Standards for the Professional Practice of Internal Auditing (hereinafter also: the Standards). According to the Standards, at least once in every five years an external assessment of the conformity of IAD's functioning with the Standards shall be carried out by a qualified independent expert. Since the first conformity assessment of IAD's operation with the Standards was conducted in 2007, the conformity assessment was included to the IAD's Annual Work Programme for 2012.

Vežjak svetovanje, d.o.o. (hereinafter the external auditor) was selected to carry out the external audit, covered the period from 8 October to 22 October 2012, focusing mainly on the functioning of the IAD from January 2011 to September 2012.

The report on the performed external assessment, also presented to the Management Board and the Audit Committee, shows that **the IAD operates in compliance with the Standards in all important aspects** so that in the future special attention will above all have to be devoted to increasing the efficiency of the IAD's operation, with special stress laid on the procedures for drafting reports.

The measures for bringing about the recommendations arising from the external assessment have already been included to the *Quality Management and Improvement Programme of IAD Functioning in Zavarovalnica Triglav for 2013 and guidelines for 2014–2015*, that were already presented to the Management Board and the Audit Committee at the beginning of 2013. The reports on implementing the recommendations will be presented in periodical reports on functioning of the IAD used for providing information to the Management Board and the Audit Committee or Supervisory Board.