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The Institute of Internal Auditors Australia

White paper

Insurable Risk Reporting

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Insurable Risk Reporting

Background

Purpose

This white paper provides a basis for internal auditors, boards, audit committees, and risk and insurance managers to evaluate the quality and completeness of insurable risk reporting for their organisation.

Background

Audit committee charters typically reflect the audit committee's responsibility to review the impact of the organisation's risk management, including its control environment and insurance arrangements.

As a consequence, effective audit committees across the public, private and not-for-profit sectors require periodic annual reporting on 'insurable risks', or more frequent reporting in some cases. Where this responsibility has not been delegated to the audit committee, the board should receive an insurable risk report periodically.

Discussion

Issue

Irrespective of which sector they are operating in, audit committees and boards need mature and consistent practices for insurable risk reporting and the foundations that support it.

There are several fundamental questions for audit committees to consider:

› Does the organisation have an appropriate corporate policy framework in place for insurances?

› Does the organisation have the right level of insurance coverage in terms of insurable risks (breadth) and the values that they are insured for?

› Is insurance cover held with insurance companies with the capacity to pay (creditworthiness) in the event of a claim?

› Are there any particular conditions of the insurance policies that need to be managed?

› Is the management of claims efficient, effective, and does it represent value-for-money?

History

In terms of professional auditing standards, the internal audit activity must evaluate the effectiveness and contribute to the improvement of risk management processes (International Professional Practices Framework IPPF, Standard 2120 – Risk Management).

The IPPF related Practice Guide *Assessing the Risk Management Process* states, "Numerous risk management frameworks are available. Each offers principles that organisations should consider when developing a comprehensive risk management process. Some frameworks focus on internal controls and their relationship to an organisation's risks. Others focus solely on IT risks, strategic risks, or insurable risks, for example. An organization may recognize that no single risk management framework encompasses all the risk areas that it needs to consider."

Exhibit 1 illustrates five common features of a risk management process.

Exhibit 1 – Common Features of a Risk Management Process

Insurable Risk Reporting

There are a variety of risk management treatment options such as:

- Avoid the risk – don't do it.
- Reduce the risk – by changing the likelihood or consequence.
- Share the risk – through partnership, joint venture, or insurance.
- Retain the risk – by accepting it.

Insurance is arranged by organisations as a common risk treatment approach, with the primary aim to reduce the financial impact of a business interruption, loss or damage to a facility or equipment.

Insurance coverage for assets and obligations such as property, motor vehicles, and workers' compensation has been a traditional risk treatment approach for many years. The nature of insurances and the coverage arranged continues to expand in keeping with business changes, and includes legal liability exposures (public and products), professional indemnity / director's and officer's liability, and cyber risks in more recent years. Organisations might also arrange insurances for miscellaneous losses such as employee dishonesty, personal accident, overseas business travel, and event cancellation. Additionally, insurances will be required for specific construction projects and programs of work.

Insurance policy exclusions eliminate coverage for some types of risk. Essentially, exclusions narrow the scope of insurance coverage by removing coverage for risks that insurers are unwilling to take. **Exhibit 2** provides examples of exclusions for several classes of insurance policies.

Exhibit 2 – Examples of Exclusions

Class of Policy	Example of Possible Exclusions
Property	Wear and tear; inherent vice; property damage arising from pollution; inventory losses due to errors, waste, or poor management / bookkeeping.
General	Illegal acts, fraud and dishonesty; fines and penalties; pollution (except sudden and accidental); motor vehicle accidents.
Cyber	Mere threats; failure of operating systems; cost of security improvements.

Public Sector-specific Protection

States and territories may find it more cost-effective to establish a single organisation to manage the state-wide insurance arrangements. For instance, NSW uses the organisation *Insurance for NSW* (known as icare) to manage the Treasury Managed Fund (TMF) on behalf of NSW Treasury to provide a comprehensive state of protection for over 200 NSW Government agencies. TMF is a self-insurance scheme created by the NSW Government to insure the NSW Government agency risk, providing a level of cover that is not available in the commercial market at an affordable cost.

Audit committees in jurisdictions using these arrangements need to understand how the arrangements operate, the reasonableness of coverage, and exclusions or specific conditions.

Discussion

Treating the risk (also known as risk response planning) typically involves establishing a plan to treat or modify the highest ranked risks to achieve acceptable risk levels. This is influenced by the organisation's risk tolerance and appetite levels and, broadly, advocates responses that will reduce, accept, avoid or transfer risks.

Risk transfer is a common risk management strategy where the negative impact of a risk or type of risk is redirected to a third party. For instance, insurance (financial impact), outsourcing (supplier responsible for non-core work activities), hedging (exchange rate risk), and other financial instruments (such as leasing).

This white paper focuses on insurable risk as an often-used risk transfer strategy. Insurance is available for many types of potential losses, including property damage, business interruption, workers' compensation, general liability, and motor vehicle liability.

Audit committees require periodic reporting on 'insurable risks', and this is typically provided on at least an annual basis, or more frequently where significant changes occur to insurers or the insurance policies and their provisions. Insurable risk reporting involves several layers of information, as illustrated in **Exhibit 3.**

Insurable Risk Reporting

Exhibit 3 – Example of the Different Layers of Information in Insurable Risk Reports

Corporate Policy on Insurances **In place, current, applied, and covers minimum requirements for insurance arrangements**			
Right Level of Cover Describes assets at risk, classes of policies, breadth and depth of coverage of individual policies, and amounts insured.	**Creditworthiness of Insurers** Provides assurance on insurers' capacity and intent to pay all reasonable claims.	**Special Conditions** Provides assurance of effective compliance monitoring of exclusions, special conditions, and deductibles.	**Claims Management** Describes nature and value of claims for the period, and provides assurance on effectiveness of claims management.

Corporate Policy on Insurances

A corporate policy covering the minimum requirements for insurance arrangements (as a risk mitigation strategy) is normally set by the Board (or alternate) on advice of the Chief Executive Officer. **Exhibit 4** illustrates basic excerpts from the corporate policy.

The Board will usually seek endorsement of the corporate policy by the audit committee. The corporate policy might be a standalone insurable risk policy, or incorporated into a broader corporate policy covering related areas like corporate investments and cash reserves.

Typically, insurance monitoring arrangements are put in place, with a routine (at least annual) report on insurable risks provided to the audit committee.

Exhibit 4 – Example of a Corporate Policy for Insurable Risks (Excerpts)

The <organisation> maintains liability, commercial, business travel, and conference and exhibition insurance as a matter of policy. The insurance mitigates the need for capital to support the contingencies covered by the insurance.

At least once each year the <organisation> arranges a review of all insurance cover by a broker. This review is then considered by the audit committee who implements changes as considered necessary.

In renewing an insurance cover, for each renewal period, the insurance broker is to ensure the recommended insurer meets a minimum security (credit) rating with one of the major ratings agencies. Insurance providers for bigger exposure items must have a long-term 'high grade' credit level. This equates to AA- (Standard and Poors) or Aa3 (Moodys) or better. Where there is no insurance provider, or where premiums would be prohibitively high, then insurance providers must be at the top of the upper medium grade which equates to A+ (Standard and Poors) or A1 (Moodys).

The broker is also required to inform the <organisation> of any change (deterioration) of the insurer's rating.

A regular (annual) report is to be prepared for the audit committee's consideration. This report is to list the name of the insurer/s, the type of cover, the period and amount of cover, the security rating of the insurer, and the insurer's parent domicile. This information is to be supplied by the broker, together with any other information that the broker considers relevant.

If there are any special or specific conditions attached to the insurance policies, then these are to be communicated to the audit committee, with appropriate monitoring arrangements to be established through the audit committee.

Some of the basic features of an insurable risk report are described in this paper.

Insurable Risk Reporting

Right Level of Insurance Coverage

Insurances Needed

The specific insurance arrangements needed by the organisation will be guided by its risk appetite statement, areas of risk mitigation where insurance is required influenced by the content of the risk register, emerging risk profiling activities, the corporate policy on insurances, and for public sector organisations any Government or Ministry policy requirements.

A broker will often be used who understands the organisation's risks and its risk management arrangements, and who is able to introduce reputable insurers at an affordable price.

Further analysis might be appropriate on other areas, such as:

- The types of insurances other similar organisations hold.
- Excesses – possibility to increase these to save on premiums.
- Any significant changes, for example low likelihood events and consideration of need for coverage or not.

Insurances Held

A periodic schedule of insurances will typically list all policies held. An example of such a schedule is included in **Exhibit 5**. The insurable risk report accompanying the schedule will identify any gaps in coverage utilising the organisation's corporate policy on insurances, and list any exclusions and special provisions.

Exhibit 5 – Example Format of an Insurances Schedule

Corporate Wide Insurances					
Class of Policy Description	Insurance Coverage Level	Insured Parties and Insurance Coverage details	Exclusions and Special Provisions	Insurance Excess	Insurer and Credit Rating

Insurance Companies have the Capacity to Pay

There is little point in having insurance with an insurer that does not have the capacity or intent to meet its obligations (claims) when called upon to do so.

While insurance is often seen as a 'risk transfer' approach, it does not eliminate the organisation's risks (the management of particular conditions of insurance policies is discussed in the next section); monitoring the creditworthiness of insurers is also a critical control.

The Corporate Policy for Insurable Risks (see **Exhibit 4**) should state the organisation's minimum security (credit) rating for insurers, and this will often reflect a long-term 'high grade' credit level of the major ratings agencies for example Moodys, and Standard and Poors.

Throughout the year the continued creditworthiness of all insurers should be monitored to ensure their security rating does not fall below the level required by the organisation. Monitoring will usually be undertaken by the broker, and monitoring and reporting arrangements should be formally and unambiguously established with the broker. The audit committee should be alerted to any adverse trends as they occur, and at least once a year should be provided with an insurable risk report.

Many policyholders were adversely affected by the crash of HIH Insurance in 2001. At the time, HIH Insurance was Australia's second largest insurance company and its demise is considered to be the largest corporate collapse in Australia's history, with losses totalling about AUD 5.3 billion.

Particular Conditions of Insurance Policies that need to be Managed

An important role for audit committees is to understand any significant 'exclusions' from the insurance policy, and any special conditions. That is, what is not covered by the policy or where the cover is conditional on the organisation satisfying specific requirements.

The audit committee will be interested in the compliance arrangements established to ensure the organisation's obligations under the exclusions and special provisions are being met, and further action is taken by the organisation where required.

For instance, an audit committee reviewed an insurance policy for fraud for a not-for-profit organisation and noted an exclusion in the event that segregation of duties was not maintained. The audit committee took steps to assure itself more frequently there were controls in place and operating effectively to ensure segregation of duties was not breached; this included where key staff were on leave. Insurance policy requirements regarding the fraud condition (segregation controls) were added to the chief executive officer's quarterly compliance report to the audit committee.

Audit committees should also be made aware of any potentially significant impacts arising from deductibles and how they are managed. The deductible clause in an insurance policy reflects the threshold amount to be paid out-of-pocket by the organisation as policyholder before the insurer will pay any expenses. Deductibles could be stated as a dollar amount, a percentage of the total amount, or a split which is a hybrid of the first two.

Exhibit 6 – Illustrative Example – Understanding the Conditions of Insurance Policies

The case of Kerry Packer's missing gold bullion is an interesting high-profile case study on the need to understand and monitor the conditions of insurance.

In April 1995 about $5.8 million of gold bullion was stolen from a private safe inside the Sydney office of Australia's then wealthiest man, Kerry Packer. The gold was covered under the company's global property policy with per occurrence limits of $5 million for bullion, with a deductible of $1 million, some of which had been exhausted by other claims.

A dispute over the deductable arose with the eight insurers after they paid $4.02 million. Mr Packer's company sued for an additional $742,049 which Mr Packer claimed he was entitled to because the policy was worded in such a way that the deductible should have been subtracted from the value of the gold, not the actual sum insured.

An appeals court ruled in favour of Mr Packer, overturning a NSW Supreme Court decision in favour of the insurers. In handing down the ruling, the judge said the policyholder was correct in that the deductible should be subtracted from the value of the gold and then the monetary cap should be applied. The judge reflected that the policy showed the claim "is not the maximum amount which the insurer is obliged to pay under the policy, but the true value of the loss suffered."

Source: *Prepared from media reports. Intended to be an educational and illustrative example.*

Claims Management

Medium and large organisations with a higher proportion of claims, for example workers' compensation, property damage, and motor vehicle claims, might outsource management of these claims to a third party with specialist expertise. Audit committees will be interested to know whether the claims management service is efficient, effective, timely and represents value-for-money. For longstanding relationships, they might consider when the arrangement was last 'market tested'.

An insurable risk report will also typically include a section that summarises the history of insurance claims, and the lessons learned to avoid reoccurrences of incidents that led to the claims.

Five Action Steps

Undertake the following steps using insurable risk reporting where it is available.

1. Assess whether there is a current corporate policy covering the minimum requirements for insurance arrangements, then assess its completeness and whether it is applied in practice.
2. Determine the reasonableness of insurance coverage of 'at risk' assets, including the classes of policies, the breadth and depth of coverage of individual policies, and the amounts insured (against the values).
3. Determine whether there is reasonable and effective monitoring of the continued creditworthiness (by considering each insurer's minimum-security rating in line with the corporate policy on insurances – action step 1) to ensure they have the capacity and intent to pay all reasonable claims.
4. Determine whether effective compliance arrangements have been established to ensure the organisation's obligations under the exclusions and special provisions are being met. In particular, consider whether deductibles are understood and actively managed.
5. Periodically assess the efficiency, effectiveness and value-for-money of the organisation's claims management service, whether in-house or managed by a third party, and consider when the arrangement was last 'market tested'.

Insurable Risk Reporting

Conclusion

Audit committees and boards rely on management to establish and maintain mature and consistent practices for insurable risk reporting and the foundations that support it.

Insurable risk reporting should align with the organisation's corporate policy framework for risk management insurances, and provide assurance the organisation has the right level of insurance coverage, is managing particular conditions of insurance policies like exclusions and deductibles, insurers have the capacity to pay, and claims management is efficient, effective and represents value-for-money.

Bibliography and References

International Professional Practices Framework (IPPF), Standard 2120 – Risk Management.

IPPF Practice Guide - Assessing the Risk Management Process.

Purpose of White Papers

A White Paper is an authoritative report or guide that informs readers concisely about a complex issue and presents the issuing body's philosophy on the matter. It is meant to help readers understand an issue, solve a problem, or make a decision.

Author's Biography

Written by: Bruce Turner AM
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Bruce remains active as an audit and risk committee chair, company director, executive coach, mentor, and white ribbon ambassador. He has held board and independent audit committee roles over the last decade in thirty diverse organisations, including six years on the IIA-Australia Board to mid-2018.

His forty years of practitioner and leadership experience in internal auditing across the globe traverses the energy, financial services (commercial, merchant and central banking), government, manufacturing, and transport sectors. Prior to his retirement in 2012, he held Chief Audit Executive roles at the State Rail Authority of NSW, Integral Energy Australia, and ultimately the Australian Taxation Office.

As an audit committee chairman, Bruce recognises the importance of meaningful reporting of insurable risks.

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As the chief advocate of the Internal Audit profession, the IIA serves as the profession's international standard-setter, sole provider of globally accepted internal auditing certifications, and principal researcher and educator.

The IIA sets the bar for Internal Audit integrity and professionalism around the world with its 'International Professional Practices Framework' (IPPF), a collection of guidance that includes the 'International Standards for the Professional Practice of Internal Auditing' and the 'Code of Ethics'.

IIA-Australia ensures its members and the profession as a whole are well-represented with decision-makers and influencers, and is extensively represented on a number of global committees and prominent working groups in Australia and internationally.

The IIA was established in 1941 and now has more than 200,000 members from 190 countries with hundreds of local area Chapters. Generally, members work in internal auditing, risk management, governance, internal control, information technology audit, education, and security.

Insurable Risk Reporting