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FOR POLICY REFORM

MODULE 5C - AUDITING

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MODULE 5C - AUDITING

TECHNICAL ASSISTANCE FOR POLICY REFORM II

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BEARINGPOINT, INC.

USAID/EGYPT POLICY AND PRIVATE SECTOR OFFICE

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SO 16: AUDITING

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CONTENTS

1.0 AUDITING:	2
2.0 ACCOUNTING ASSERTIONS (AUDIT ASSERTIONS):	3
2.1 Obtaining Evidence:	5
3.0 WORKING PAPER DOCUMENTATION:	6
4.0 TICKMARKS:	7
5.0 WORKING PAPER NUMBERING:	8
6.0 ADDITIONAL AUDITING PROCEDURES:	9
7.0 WORKING PAPERS SAMPLE	10
7.1 Sample Working Papers for Receivable from Reinsurers	10
7.2 Sample Working Papers for Other Credit Balances	15

1.0 Auditing:

What is auditing?

It is the inspection of business records by an independent person. Auditing involves obtaining and evaluating evidence from independent sources such as banks, brokers, and policyholders. The inspector must obtain sufficient evidence and perform sufficient verification that he or she can draw a conclusion as to whether the account balance is correct and fairly stated.

Auditing also involves verifying accounting assertions. Accounting assertions are assertions made by management related to the financial statements.

2.0 Accounting Assertions (Audit Assertions):

When management creates financial statements, they contain certain assertions by management. The assertions contained in the financial statements come from the accounting process. Accounting paints a picture of past financial transactions and communicates this to the reader. The auditing process, on the other hand, uses generally accepted criteria to provide an objective opinion as to whether the financial statements accurately reflect the accounting assertions.

There are eight basic assertions.

- Accuracy
 - Completeness
 - Compliance
 - Cutoff
 - Existence
 - Obligation and Ownership
 - Valuation
 - Presentation and Disclosure
-
- Accuracy (AC) – Recorded transactions and account balances are mathematically accurate, are based on correct amounts and have been classified into the correct account.
 - Ensure that the totals of the claims paid register agrees to the amount recorded in the general ledger under paid claims.
 - Total the listings of investments owned and agree that total to the general ledger account.
 - Be sure that investment income is not recorded as premium income.
 - Completeness (CO) – All transactions and account balances that should be recorded in the annual financial statement were recorded.
 - The primary area of concern is that all liabilities are complete. If liabilities are understated, then Shareholder's equity will be overstated.
 - For accounts payable trace payments made after year end and verify that they are included in the accounts payable at year end if incurred during that year.
 - For unpaid claims, select a sample of open claim files and trace the claims to the listing of unpaid claims.
 - Compliance (CM) – Business transactions and affairs have been conducted in accordance with insurance laws, codes and other directives from EISA.
 - When reviewing transactions, be sure that they comply with the insurance laws.

- Cutoff (CT) – All transactions are recorded in the correct accounting period.
 - Verify that policies are recorded in the same year as being issued. If not recorded in the proper year, then premiums will be either understated or overstated.
 - Verify that claims are recorded in the period in which they occur. If not, then the mathematical reserves may be incorrect.

- Existence (EX) – recorded transactions occurred and are not fictitious and recorded assets and liabilities existed as of the balance sheet date.
 - Verify that no false transactions have been recorded.
 - You can verify that all policies that are recorded have been issued by selecting a sample of policies and then reviewing the policy and underwriting file.

- Obligation (OB) and Ownership (OW) – Recorded liabilities are obligations of the company and recorded assets are the rights of the company at the balance sheet date.
 - To test the obligation assertion, you can select a sample of the accounts payable and trace them to the invoices to ensure that they are an obligation of the company and not of someone else such as management or a related entity.
 - Be sure that the company has ownership of all of the assets reported.
 - Verify that the investments reported are actually owned by the company. This can be done by reviewing the share certificate or other documents that prove ownership.

- Valuation (VA) – Assets and liabilities are valued in accordance with EISA Insurance Accounting guidelines.
 - Investments should be valued according to accounting guidelines. If the investment is available for sale, then it should be recorded at the market value and not the original cost or amortized value.

- Presentation and Disclosure (PD) – The elements of the Annual Statement are properly classified and all disclosures are accurately included in the Annual Statement.
 - Ensure that the annual statements and any disclosures are completed properly.

To help clarify the concept of an assertion, take as an example “Bank Deposits” on a balance sheet. As bank deposits is classified as an asset, the reader is entitled to assume that the cash both exists and is owned by the company. Existence and Ownership are key accounting assertions relating to the asset category of bank deposits. As another example, the assertions for “Creditors & other credit balances” would be those of completeness; that all the liabilities that should be recorded have been recorded, and valuation, that the liabilities recorded are valued correctly (i.e. they are not over or under stated). The assertions for a revenue item such as premiums earned would include: cutoff; that the policy was earned by the company; ownership; that the policy did not belong to another company; and completeness; that all the premiums earned were recorded.

2.1 Obtaining Evidence:

The inspector must obtain evidence to support the accounting assertions. Evidence can come in many forms including, but not limited to:

Evidence	Example
• Physical evidence	Bank statements, invoices, etc
• Testing of calculations to ensure accuracy	Calculating unearned premium reserve
• Internal documents	Minutes of meetings
• Accounting records and reports	General ledger and trial balance
• External documents	Confirmation of reinsurance receivables with reinsurers
• Consistency with other evidence norms	Ratios and comparisons with industry norms

The inspector will not necessarily employ all these verification techniques for every assertion. The degree in which an inspector collects evidence and applies verification techniques is based on the inspectors’ judgment and the net risk assessment. We discuss the net risk assessment later.

3.0 Working Paper Documentation:

Proper working papers demonstrate professionalism and document the work that was done for the account being audited. The degree of documentation is based on the judgment of the inspector and the adequacy and effectiveness of controls. Working papers should contain sufficient information to allow an experienced inspector having no previous connection with the inspection to ascertain from them the evidence that supports the inspectors' significant conclusions and judgments.

Working papers should include –

- Purpose of the working paper;
- Documentation of information obtained about the area being reviewed;
- Authoritative support for findings and recommendations contained in the report;
- Conclusions of the inspector; and
- A guide for subsequent inspections.

General guidelines for the preparation of working papers are:

Completeness and Accuracy – Working papers should be complete, accurate, and support observations, testing, conclusions, and recommendations. They should also show the purpose and scope of the work performed.

Clarity and Understanding – Working papers should be clear and understandable without supplementary oral explanations. With the information the working papers reveal, a reviewer should be able to readily determine their purpose, the scope of the work done and the preparer's conclusions.

Pertinence – Information contained in the working papers should be limited to matters that are important and necessary to support the objectives and scope.

Logical Arrangement – Working papers should follow a logical order.

Legibility and Neatness – Working papers should be legible and as neat as practical.

4.0 Tickmarks:

Tickmarks are used to simplify documenting work done and conditions found. A legend that defines each tickmark should be placed on the working paper. Tickmarks should be concise and should adequately explain the results of the audit procedures performed. It should be evident as to whether or not an error or weakness was noted.

Examples:

- ✓ Amount agrees to invoice examined.
- ✕ Cancelled check was examined.
- ☒ Column was totaled (footed).

These are just a few examples. You can create a tickmark for any purpose and using any type of symbol, letter or number.

One common tickmark is PBC. This means that the schedule was Prepared by the Company. It is a good idea to designate which schedules or papers were not prepared by the inspector. If the schedule was prepared by the company, then you should note on the schedule who prepared it at the company.

5.0 Working Paper Numbering:

Generally, working papers need to be numbered so that it identifies its location. The number assigned should begin with a capital letter that matches the section of the working papers where the page will be filed, followed by a dash and a number that allows the page to be filed in a logical sequence. If a working paper continues for multiple pages, or if there are exhibits supporting a working paper, subsequent pages and the exhibits should have the same letter and number followed by a lower case letter.

Example:

All working papers supporting Bank Deposits would be assigned the letter A. The first page would be A-1; the second page A-2; and so on. If A-3 consisted of more than one page, it would be labeled A-3a, A-3b, A-3c, and so on.

6.0 Additional Auditing Procedures:

The amount of additional auditing that is required for a Significant Activity will depend on what your net risk assessment is. (As calculated in Module 4).

- If the net risk assessment is low, the Significant Activity has a lower-than-average probability of a material adverse impact on its capital and earnings (surplus) in the foreseeable future.
 - Since the risk is low, then no additional auditing needs to be performed.
- If the net risk assessment is moderate, the Significant Activity has an average probability of a material adverse impact on its capital and earnings (surplus) in the foreseeable future.
 - In order to offset the moderate risk, some additional auditing steps will need to be performed. The additional steps could include analytical review of the account balance, obtaining detail of an account, or confirmation of an account balance.
- If the net risk assessment is high, then the Significant Activity could potentially result in a higher than average probability of a material adverse impact on its capital and earnings (surplus) in the foreseeable future.
 - In order to offset this high net risk, then the inspector needs to perform additional auditing steps to reduce this risk. The amount of work to be performed will depend on the type of account involved.
 - For investment accounts, confirmation of the account balance or shares owned by an outside source (such as a bank) would help offset the risk that the investments are not owned by the insurance company.

7.0 Working Papers Sample

7.1 Sample Working Papers for Receivable from Reinsurers

W/P Reference: C - Lead

ABC Insurance Company
Receivables from Reinsurers Lead Sheet
30-Jun-08

Prepared by: Michael Dinius
Date: 29/10/2008

Account Name	Work Paper Reference	Amount at 30/6/2008	Amount at 30/6/2007
Local companies	C-1	8,345,190	3,827,392
Foreign companies	C-2	7,349,830	3,480,428
Reserves retained by reinsurers	C-3	3,999,100	8,834,923
		<u>19,694,120</u>	<u>16,142,743</u>
Less:			
Allowance for impairment loss of receivable from insurance & reinsurance	✓	(723,598)	(458,203)
Total Receivable from Reinsurers	✗	<u><u>18,970,522</u></u>	<u><u>15,684,540</u></u>

Purpose:

This work paper was prepared to detail the amounts as reported in the annual statement

Conclusion:

The amounts listed agree to the the annual statement

Tickmark Legend:

- ✗ Amounts agree to the annual statement
- ✓ Inspector has reviewed the calculation for the allowance and agrees with the calculation

ABC Insurance Company
Receivable from Reinsurers - Local Companies
30-Jun-08

Prepared by: Michael Dinius
Date: 29/10/2008

Listing of amounts receivable from reinsurers - Local Companies

Egypt Re	✓	<u>8,345,190</u> To C-Lead
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Purpose:

This work paper was prepared to list the local companies that comprise the receivable from reinsurers.

Conclusion:

The amounts reported above agree to the reports filed with the reinsurer. No exceptions were noted.

Tickmark Legend:

- ✓ Amount agrees to reports filed with Egypt Re

ABC Insurance Company
 Receivable from Reinsurers - Foreign Companies
 30-Jun-08

Prepared by: Michael Dinius
 Date: 29/10/2008

Listing of amounts receivable from reinsurers - Foreign Companies

A.C.E. Bermuda Insurance Company	✓	3,920,392
C.N.A. International Re. LTD	✓	100,293
Samsung Fire & Marine Ins. Co. LTD	✓	2,038,495
Continental Casualty Co.	☒	1,290,650
 Total		 <u>7,349,830</u>
		To C-Lead

Purpose:

This work paper was prepared to list the foreign companies that comprise the receivable from reinsurers.

Conclusion:

The amounts reported above agree materially to the reports filed with the reinsurer. One exception was noted and detailed below.

Tickmark Legend:

- ✓ Amount agrees to reports filed with the reinsurer
- ☒ Amount per the reports filed total 1,425,500. This is a difference of 134,850. Since this is an asset account and the company has understated the asset and the amount is immaterial, no further procedures will be necessary

ABC Insurance Company
Reserves retained by reinsurers
30-Jun-08

Prepared by: Michael Dinius
Date: 30/10/2008

Listing of reserves retained by reinsurers

A.C.E. Bermuda Insurance Company	C-3a	200,987
Samsung Fire & Marine Ins. Co. LTD	✓	2,987,077
Continental Casualty Co.	✓	811,036
Total		<hr/> <hr/> 3,999,100
		To C-Lead

Purpose:

This work paper was prepared to list the companies that have retained reserves.

Conclusion:

The amounts reported above agree to the reports filed with the reinsurer. No exceptions were noted.

Tickmark Legend:

- ✓ Amount agrees to reports filed with the reinsurer

ABC Insurance Company
Reserves retained by Samsung Fire & Marine Ins. Co. LTD
30-Jun-08

Prepared by: Michael Dinius
Date: 30/10/2008

Listing of reserves retained by Samsung Fire & Marine Ins. Co. LTD

Reserves retained for Treaty Year 31/03/2008	✓	1,234,099
Reserves retained for Treaty Year 31/03/2007	✓	343,088
Reserves retained for Treaty Year 31/03/2006	✓	1,409,890
Total		<u>2,987,077</u>
		To C-3

Purpose:

This work paper was prepared to detail the reserves retained by Samsung Fire & Marine

Conclusion:

The amounts reported above agree to the reports filed with the reinsurer. No exceptions were noted.

Tickmark Legend:

- ✓ Amount agrees to reports filed with the reinsurer

7.2 Sample Working Papers for Other Credit Balances

W/P Reference: K - Lead

ABC Insurance Company
Creditors and Other Credit Balances Lead Sheet
30-Jun-08

Prepared by: Michael Dinius
Date: 29/10/2008

Account Name	Work Paper Reference	Amount at 30/6/2008	Amount at 30/6/2007
Accrued expenses	✓	469,620	328,774
Accrued commissions	K-1	5,544,441	6,432,935
Tax Authority (salaries tax)	✓	318,714	193,947
Claims payable	K-2	17,761,809	1,750,377
Tax Authority (withholding tax)	✓	235,898	193,775
Sundry creditors		8,209,145	12,024,960
Total Creditors and other credit balances	✘	32,539,627	20,924,768

Purpose:

This work paper was prepared to detail the amounts as reported in the annual statement

Conclusion:

The amounts listed agree to the the annual statement

Tickmark Legend:

- ✘ Amounts agree to the annual statement
- ✓ Amounts are immaterial. Inspector passes further audit procedures

PBC

ABC Insurance Company
Accrued Commissions
30-Jun-08

Prepared by: Michael Dinius
Date: 29/10/2008

Accrued Commissions Listing

Accrued commissions - Agent A	✓	xxxx
Accrued commissions - Agent B		xxxx
		xxxx
Accrued commissions - Agent Z	✓	xxxx
Total Accrued Expenses		<hr/> <u>5,544,441</u> <hr/>
		To K-Lead

Purpose:

This work paper tests the accuracy of accrued commissions

Conclusion:

Accrued commissions as reported are correct

Tickmark Legend:

- ✓ Amount agrees to commissions due to agent

PBC

ABC Insurance Company
Claims Payable
30-Jun-08

Prepared by: Michael Dinius
Date: 29/10/2008

Unpaid Claims Register

Claim 10293	✓	xxxx
Claim 38392		xxxx
Claim 12938	✓	xxxx
Claim 32812		xxxx
Total		<hr/> <u>17,761,809</u> To K-Lead

Purpose:

This work paper tests the accuracy of the claims payable

Conclusion:

Claims payable are accurate

Tickmark Legend:

- ✓ Amount agrees to claim file

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