

Insurance audit as a factor for the effective environmental pollution liability insurance of enterprises with hazardous production

Irena Misheva

Abstract—The current report aims to focus on the specifics and significance of audit when insuring against environmental pollution liability in the case of enterprises with hazardous production.¹

Keywords—environmental pollution liability insurance, internal control, insurance audit, insurance supervision, quality management of the insurance service, auditing the insurance company.

Over the last decade, insurance companies have been facing newer and newer challenges. The globalisation and concentration processes, as well as the liberalisation and deregulation of the insurance markets have been placing increasingly higher demands on insurers. Those demands are related to the changes in the insurance legislation and the unification of the national regulatory acts of individual EU member states.

The change in the economic and legal environment is necessitated by the ever growing need of effective quality management in terms of the insurance service. What is specific about insurance as a business activity is that it is, on the one hand, aiming at achieving a high level of customer satisfaction and, on the other, at achieving set targets and catering for shareholder interests. Applying a standardised approach to quality management of the insurance service therefore redefines the role of control and audit in an insurance company.

In this respect, the current report aims to focus on the specifics and significance of audit when insuring against environmental pollution liability in the case of enterprises with hazardous production. The author aims at reviewing the following **topics**:

firstly, an overview of the specifics of insurance audit in the context of internal control within the insurance company;

secondly, an outline of the rights and obligations, as well as of the requirements towards the expertise and skills of the internal auditors within the insurance company;

thirdly, an overview of auditing practices in the process of environmental pollution liability insurance;

next, an analysis of the sequence of actions to be taken for each audit performed by the internal auditors when insuring against environmental pollution liability;

last but not least, recommendations on improving the mechanisms of control, subject to evaluation when auditing the insurance company.

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The insurance audit when insuring against environmental pollution liability is to be defined as *an activity of the internal auditors by which they provide an independent evaluation of the efficiency of the management system and the various activities of the insurance company relating to the transfer of risk from the enterprise with hazardous production onto the insurer*.

Under the Bulgarian legislation, the internal audit is defined as a function of internal control within the insurance company, which in turn constitutes a continuous and uninterrupted process implemented within the activity of the insurer or reinsurer whose organisation and activity should comply with the **principles** of lawfulness, economic use, efficiency, effectiveness and transparency.²

An internal audit in insurance law **is defined as** an independent and objective consultancy activity aiming at providing assurance and improving the organisation and activity of the insurer or reinsurer. The internal audit shall contribute to achieving the targets of the insurer or reinsurer by applying a systematic and structured approach to evaluation and improvement of the effectiveness of the management and control processes.³

In insurance literature, internal audit is defined as “an independent and objective activity aimed at providing guarantee and consultancy for the purpose of improving the organisation and activity of the insurer and reinsurer”. The

² ORDINANCE No. 32 of 13.09.2006 on the requirements to the organization and activity of the internal control unit of the insurer and of the persons included in an insurance group. Adopted by Decision No 64-H of 13.09.2006 of the Financial Supervision Commission, promulgated in the State Gazette, No 81 of 6.10.2006, article 2 (2), article 3 (2), article 3 (3).

³ Same, article 4 (1).

¹ About author: Irena Misheva is associate professor, Ph.D in the University of National and World Economy – Sofia, Bulgaria, Faculty: General Economics, Department: Human Resources and Social Protection,

internal audit “shall contribute to achieving the goals of the insurer and the reinsurer through applying a systematic and disciplined approach to the evaluation and improvement of the efficiency of the management and control processes”.⁴

The main **instrument** of the insurance audit is the concept of insurer's risk

The aim of the insurance audit in the case of environmental insurance is to determine the level of efficiency of the insurance operations at all stages of insurance protection of the insured sites with higher environmental pollution risk. The main **stages** when performing an insurance audit within enterprises with hazardous production are three, namely:

- audit preparation;
- audit execution (including eliminating discrepancies by means of corrective or preventive measures);
- audit conclusion.

When performing their activity the head of the internal control unit and the internal auditor within the insurance company have the right to:⁵

- an unlimited access to:
 - a) office premises and the assets of the insurer or the reinsurer;
 - b) the decisions of the management bodies and other officials;
 - c) accounting and information systems;
- perform supervision, require information, gather evidence and data, reports and any other documents relating to the performance of their duties.

● in addition to the above-mentioned rights, the head of the internal control unit also has the right to:⁶

- a) report to the management body and the general assembly on all matters relating to the performance of the internal audit;
- b) suggest individuals to be hired who possess the necessary expertise and skill to perform internal audit activities;
- c) have access to the chairman and member of the auditing committee and to attend their meetings;
- d) define the goals, scope, frequency, auditing methods and resources necessary for executing each audit commitment.

As members of the internal control unit, auditors are expected to comply with the standards of the ethical code and the best practices for ethical behaviour. Auditors are to be honest, objective, diligent, loyal and be able to communicate and work with people as well as be able to work in a team and should have an open attitude. When practising their profession, internal auditors within the company need to have the relevant expertise, specialised knowledge and skill. These are as follows:

1. professional skills in applying professional practice standards for internal audits, procedures and audit methods;

2. knowledge and experience in applying accounting standards;

3. knowledge of the principles of corporate management, risk management and good insurance practice.

The main audited activities when insuring against environmental pollution liability can be reduced to the following:

- Underrating of the insurance company;
- Signing the insurance contract;
- Maintenance of the insurance contract;
- Evaluation of the losses and determining the amount of the insurance payment;
- Payment of the insurance amount and indemnification of injured third parties;
- Reinsurance activities.

When auditing the underrating activity, the internal audit aims to identify appropriate risk selection based on the risk assessment and while taking into consideration the relevant risk insurability criteria and requirements. In this respect, the internal audit has to serve the following **purposes**:

- inspection as to whether the company has all the relevant permits for performing its activity and an assessment of its compliance with the environmental protection legislation;
- an inspection and accurate identification of the harmful substances which are used or stored within the company and which constitute a hazard for the environment or the population;
- an inspection of the relevant technical, technological and environmental conditions under which the company performs its activities;
- an inspection of the documents relating to safety briefings, tests, drills and personnel trainings on how to react in the event of an industrial accident or crisis;
- an inspection of the information on the risk situation within the enterprises with hazardous production and higher environmental pollution risk;
- an analysis of the forecasts for the potential amount of the losses which may be incurred on third parties as the result of environmental pollution from a breakdown or a technogenic accident;
- An inspection of the reliability of the information when determining the recipients who are potentially at risk in the event of an environmental pollution outbreak as a result of the company activity;
- an inspection of the evaluation of the potential impact of environmental factors on the audited site;
- an inspection of the evaluation of the nature of the potential environmental impact, including but not limited to the scale and duration of the impact, the type of harmful impact of the environmental pollution risk;
- an inspection of the evaluation of the qualitative characteristics of the environmental risk, respectively of the likelihood of an industrial accident occurring and the potential damage inflicted on the environment and the population;

⁴ Same, article. 4 (1).

⁵ Same, article 4 (3).

⁶ Same.

- an inspection of the cost effectiveness as relates to the chosen criteria for environmental risk evaluation;
- an analysis of the results obtained from the environmental audits performed within the company which provide information on the condition of the site with high environmental pollution risk to be insured. When performing an environmental audit, one can use data obtained from various types of environmental audit research, namely: inspection of the faithfulness of the presented reports on the environmental impact; evaluation of the compliance of the technical production process with environmental requirements; an evaluation of the compliance of the monitoring and control system with environmental requirements; an evaluation of the level of competence of the personnel.⁷

When auditing the *signing of the insurance contract* the internal audit aims to provide solutions to the following **issues**:

- An inspection of whether the elements of the insurance policy have been filled correctly.
- An inspection of whether the insurer providing the environmental insurance has complied with the requirement to specify in the insurance policy the contacts of the emergency commissioner responsible for evaluating damages.
- An inspection of whether the amount of the tariff rate has been determined correctly and specified in the insurance contract.
- An inspection of whether the amount of the insurance premium has been calculated correctly in compliance with the chosen insurance amount within the limited liability under the environmental pollution liability insurance.
- An inspection of whether internal company regulations regarding insurance contracts have been complied with.
- An inspection of the accountability of the insurance policies, if they have been signed by insurance brokers and an inspection of the agreed commission rate for the broker as specified in the approved technical insurance plan.

When auditing the *evaluation of losses and the determining of the amount of the insurance payment*, insurance auditors are to perform inspections of the correct execution of the following **tasks**:

- Establishing the direct material damages resulting from the realization of the environmental risk;
- Establishing the indirect losses resulting from the negative impact of the environmental pollution within the scope and limits of the insurer's liability;
- Establishing non-pecuniary damages, including but not limited to disability and moral damages;
- A forecast of the social and economic damage on the state;

- Defining the measures for reducing the harmful impact resultant from the pollution. Audit inspections are performed in compliance with Directive 2004/35/EC which stipulates that the prevention and remedying of environmental damages should be based on the polluter pays principle and the principle of sustainable growth. This means that operators should be made to take measures and develop practices for minimising the risk of environmental damage so as to reduce their exposure to financial liability;
- Suggesting environmental risk management activities;
- An inspection of whether the emergency certificate issued by the emergency commissioner has been filled correctly.⁸ The emergency certificate is in essence a document certifying the need for environmental insurance which must contain information on the size and causes for the damage as well as other evidence relevant to the circumstances concerning the realization of the environmental event. The data in the certificate provide the insurer with the opportunity to establish whether there is an insurance case and serve as grounds for the indemnification of third parties as specified in the terms and conditions of the insurance contract;
- An inspection of the decisions under claims brought to court;
- An inspection of processed claims relating to environmental insurance.

When auditing the *maintenance of the insurance contract* the audit inspection is to certify whether:

- all changes in the risk situation within the enterprise with increased risk of environmental pollution have been duly reported;
- whether all preventive measures for the reduction of the environmental risk and the likelihood of its realisation have been taken;
- whether the preventive actions taken by the audited enterprise have been effective.

When auditing payment of the insurance amount and the *indemnification of injured third parties*, auditors have to assess whether:

- The insurance amount has been calculated correctly;
- the insurer has indemnified all damages within the terms and conditions specified in the insurance contract.

When auditing reinsurance policy, the scope of inspection of the auditing team must encompass the content and elements of the reinsurance contract entered into by the insurer and reinsurer in the field of environmental pollution liability insurance.

⁸ According to Russian legislation, the environmental insurance audit must be performed by the Environmental insurance emergency commission whose main responsibility is to set out a list of activities, insurers and insurance events in the relevant sector on the premises of the enterprise, the organisation or institution. The emergency commissioner is responsible for training the auditors and keeping records of attested auditors in the field of environmental insurance.

⁷ <http://www.unesco.kz/cgi-bin/library>.

The auditing teams of the internal audit service can perform auditing inspections of **other audited activities** of the insurance company such as accounting, marketing, information systems and others.

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In conclusion, performing auditing inspections and a successful internal control within enterprises is a prerequisite for the provision of efficient environmental insurance in the context of the national environmental protection policy.

Under the current Bulgarian legislation there is no requirement for the mandatory implementation of a quality management system within the insurance company. The Financial Supervision Commission does not require that the insurers be certified by external auditors in order to receive a certificate guaranteeing the proper functioning of the management system of the companies.⁹

In the context of ever more severe competition on the national insurance market however, there is a constant increase of the consumer's criteria regarding the quality of the insurance service. Therefore, the insurance companies need to adjust the supply to better suit the demands of the insurance market. In view of the above said, several recommendations to the insurers can be made and the following conclusions can be drawn:

Firstly, there is an increased demand for an insurance service, which is adequate for the respective insurance needs and interests. Thus, the insurance protection needs to be adjusted to the individual demands of the consumer. In other words, the insurance service needs to be provided in accordance with the expectations of the insured parties. This means, however, that thorough control needs to be executed over the process of managing the relationship with the consumers of the insurance service.

Secondly, there is need to implement a system of managing the insurance company which standardises the processes and activities thus guaranteeing their compliance with the requirements of the consumers and other interested parties as well as with the requirements under the insurance legislation and the internal regulations of the insurer.

Thirdly, when choosing to establish a new management system within the insurance company, it must be taken into consideration that such system needs to be designed, documented, implemented, maintained and constantly improved in view of all activities and processes in the insurance company which relate to the insurance service.

Next, the design and implementation of a management system are based on the process approach and are a key factor for achieving the desired results when providing

insurance services. This approach guarantees identification, proper interaction and management of the processes in the insurance company, as well as the correlations and interactions between them and is this a prerequisite for an effective insurance activity.

Also, the internal audit of the insurance company is to be improved continuously in view of achieving maximum compliance with international standards. Insurers who specialise in environmental insurance may draw on the extensive experience of companies in the developed countries as regards the implementation of next generation control systems.

Moreover, the role of internal auditors involves providing an expert assessment and constructive advice on ways to improve control and risk management as well as to help solve issues relating to the insurance business.

In addition, state insurance surveillance, such as the Financial Supervision Commission should play an increasingly important role as the regulatory authority monitoring the activity in insurance companies by executing supervision and imposing sanctions on the one and on the other - by improving on the interaction between insurance audit, internal control and insurance supervision.

Last but not least, the insurance audit for the purposes of environmental insurance must be performed based on the data provided by the environmental audit by the enterprises with increased environmental pollution risk. This is of key importance as the environmental audit is seen as one of the branches of environmental protection.¹⁰ It is in essence “an independent evaluation of the environmental factors of the enterprise and their compliance with the requirements stipulated in the environmental legislation, in order to prevent possible sanctions for non-compliance with the environmental legislation - the so-called. compliance audit”.¹¹ A standard component of this audit is the evaluation of potential risks as regards health and safety protection.

Over the last few years it can be observed that the most significant achievements in successfully solving ecological issues are due to the application of a systematic approach to ecological management in a number of European countries and to the implementation of the international standard ISO 14 001, the British standard BS 7750 and the EMAS standard (EU Eco-management and Audit System). For instance, nowadays the number of enterprises which have adopted the practice of environmental audit in the USA has reached a staggering 95%.¹²

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⁹ In Russia, for instance, polluting enterprises are subject to mandatory insurance audit, if they are registered in the MNR register. This is also applicable for industrial sites which are obliged to declare the operational safety of the industrial sites (ordinance of the Russian Federation Government of 11.07.95, No 675).

¹⁰ <http://www.ceppi.ru/uslugi?id=38>.

¹¹ Ecological auditing. <http://www.dekonta.cz/en/services-and-products/consultancy-services/ecological-auditing.html>.

¹² Same.

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