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REPORT OF THE AUDIT BODY

Note by the Audit Body

1 Introduction

1.1 At a joint session held in October 2002, the 1992 Fund Assembly and the 1971 Fund Administrative Council elected the following as members of the Audit Body for a period of three years:

Professor Eugenio Conte (Italy)
Mr Charles Coppolani (France) (Chairman)
Mr Maurice Jaques (Canada)
Mr Heikki Muttilainen (Finland)
Dr Reinhard Renger (Germany)
Professor Hisashi Tanikawa (Japan)

1.2 Mr Nigel Macdonald was elected as the member of the Audit Body not related to the Organisations ('outsider').

1.3 The Audit Body has met three times since the October 2003 sessions of the Funds' governing bodies, viz 12 December 2003, 16 April 2004 and 28 June 2004. The representatives of the External Auditor have attended these meetings and have made a significant contribution to the Audit Body's deliberations.

1.4 At the request of the governing bodies, the Audit Body has had a meeting with the members of the Investment Advisory Bodies in order to look at the question of Dual Currency Deposits.

1.5 At the invitation of the governing bodies, the Audit Body has also considered the procedures to be followed in the recruitment of future Directors. The outcome of the Audit Body's consideration of this issue is presented in documents 92FUND/A.9/15 and 71FUND/AC.15/12.

1.6 In its report to the governing bodies at their October 2003 session, the Audit Body indicated that it planned to expand its activities from the area of financial risk to cover also that of non-financial risk. This has taken place over the last year as can be seen from the main issues considered by the Audit Body.

2 External Audit of the Funds' Financial Statements

- 2.1 The Audit Body is very appreciative of the excellent relationship which has been developed with the External Auditor. This relationship has allowed the Audit Body to follow the different stages of the audit of the Funds' Financial Statements.

2002 Financial Statements

- 2.2 At the December 2003 meeting the External Auditor presented the Audit Body with the Audit Memorandum and End-of-Audit Report to Management, which was provided to the Secretariat in respect of the 2002 Financial Statements (approved by the governing bodies at their October 2003 sessions). This Memorandum brings to the attention of the Secretariat less significant issues which do not need to be brought to the attention of the governing bodies. Three minor points were raised by the External Auditor in respect to the audit of the 2002 Financial Statements and the Audit Body was satisfied with the Director's response to the issues raised.

2003 Financial Statements

- 2.3 In December 2003 the Audit Body had the opportunity to discuss with the External Auditor the Audit Strategy document relating to the audit of the 2003 Financial Statements, which covered the timing and scope of the audit. In respect of claims-related expenditure, the Audit Body asked to what extent the External Auditor looked at claims to establish if they had been correctly assessed and to what extent the decisions which had been made by the Funds were considered by the Auditor and whether settlements had been made in conformity with the criteria established by the governing bodies. The representative of the External Auditor confirmed that checks had been made that the criteria laid down in the Claims Manual had been followed. In addition the External Auditor's representatives stated that discussions were always held with the relevant Claims Managers dealing with the particular incident and with the Head of the Claims Department and the Deputy Director/Technical Advisor as required.
- 2.4 At the April 2004 meeting the External Auditor presented an interim audit report on the audit of the 2003 Financial Statements, which had been carried out in January 2004. An explanation was given of the controls procedure on claims expenditure used by the External Auditor. All items of expenditure over £500 000 had been examined. Staff costs and administrative expenditure had also been examined on a test basis as well as cash at bank and in hand, the staff Provident Fund and other assets and liabilities. In respect of claims and claims-related expenditure, the Audit Body expressed the view that the final audit should concentrate on smaller claims (ie those under £500 000) and therefore the number of tests on such claims should be proportionately higher. The larger claims were subject to tighter controls (needing more senior approval), more because of their size and significance than because they were seen as being more risky. The representative of the External Auditor agreed that a wide spread of claims (including smaller claims) would be tested.
- 2.5 The Audit Body raised a question regarding the frequency of bogus claims. The Director informed the Body that over the years very few such claims had been discovered and that in this respect it was very useful to have local Claims Handling Offices whose staff knew the local circumstances.
- 2.6 The annual accounts of each of the two Funds comprise essentially an Income and Expenditure account (which is further analysed to show separately General Fund transactions and Major Claims Fund transactions), and the Balance Sheets, accompanied by Cash Flow Statements and supporting notes to the accounts.
- 2.7 The representatives of the Funds' External Auditor have explained to the Audit Body in some detail the work they have done in examining these financial statements. It is not necessary in this

report to go into detail but it has been considered appropriate to give an outline of the approach adopted. The auditors explained that their audit was risk based, that is they look for and check those accounting areas and items which they consider have a higher risk of potential error, or where error would have a significant impact on the correctness and fairness of the accounts.

- 2.8 With regard to their examination of the Income and Expenditure accounts, the auditors have tested the accounting controls over transactions during both their interim and final audits by checking the way a number of large and small transactions have been dealt with. The items selected for testing were chosen to be representative of the different types of transaction, of different incidents and of different times during the year. Staff and administration costs were reviewed and analysed. Having found those results satisfactory the auditors have then relied on those controls, supplemented by analytical testing and review, to provide assurance that transactions are processed and analysed correctly. The auditors have also reviewed the accounting policies which determine the way in which income and expenditure, and capital and revenue are allocated.
- 2.9 With regard to their examination of the Balance Sheets, the auditors have not just relied on the controls operating over the accounting systems to produce accurate results. They have also looked at the underlying figures that make up the amounts under each main heading and have checked them back against the underlying accounting records, and enquired into significant variances from the previous year. They have also reviewed the financial statements as a whole and have considered what contingent liabilities the Funds may have.
- 2.10 The Cash Flow Statements and the notes to the accounts have also been examined and checked.
- 2.11 The Audit Body has been involved at all stages of the audit process and expresses its thanks to the External Auditor for having facilitated such a comprehensive dialogue.
- 2.12 The Audit Body is satisfied that the audit which has been undertaken has covered all areas of the Funds' activities and recommends that the governing bodies approve the accounts of the 1971 and 1992 Funds for the financial year ending 31 December 2003.

3 Other main issues considered

3.1 IOPC Funds' Annual Report

- 3.1.1 In 2003 the Audit Body considered the Annual Report in view of its very wide distribution and the financial information contained therein. The Annual Report is an important publication. For this reason the Audit Body sought assurances from the Director that procedures were in place to ensure the accuracy as far as practicably possible of the financial information and other information on the full range of the Funds' activities contained in the Annual Report. The Director replied that every effort was made to ensure the correctness of the information given in the Annual Report.
- 3.1.2 The Audit Body had indicated that the inclusion of unaudited key financial information relating to the year of the Annual Report would enhance its value and such information was included for the first time in the Annual Report 2003. The lists of incidents in the Report (Annexes XVIII and XIX) had also been made clearer.

3.2 Visits to Claims Handling Offices

- 3.2.1 The 1992 Fund established Claims Handling Offices in La Coruña in December 2002 and Bordeaux in March 2003 to handle *Prestige* claims arising in Spain and France respectively. During 2003 visits were made by two members of the Audit Body to each of these Offices. The purpose of the visits was to give the Audit Body a better understanding of how such Claims

Handling Offices operate and an overview of the procedures applied in claims handling at these Offices. The visits were in no way duplicating the work of the External Auditor.

3.2.2 The results of the visits and reviews were satisfactory. The main findings were as follows:

- (a) In view of the nature and extent of the claims being handled by these two Offices, the Audit Body endorsed fully the decision of the Director to establish these Claims Handling Offices, rather than trying to handle the claims arising from the *Prestige* incident from the Fund Secretariat in London. The small number of claims emanating from Portugal (estimated at circa € million) is being handled directly by the 1992 Fund in London.
- (b) It is clear that the lessons learned from handling claims arising in earlier incidents had been applied well. Written guidance already exists and training was provided to the new staff of the Claims Handling Offices to ensure that the benefit of experience and expertise gained from the Office set up in Lorient to deal with claims arising from the *Erika* incident was learned and applied. The Funds' database for claims management had been introduced and applied at both locations.
- (c) The detailed procedures under which the two separate Offices operate are similar, but some differences exist and the Audit Body has recommended to the Secretariat that the opportunity be taken to review existing guidance so as to establish procedures and local IT systems which are as standardised and consistent as possible, so that future incidents may be handled in the same way. The Audit Body is nevertheless aware that the operations of a Claims Handling Office will have to be adapted to the circumstances of the country in which it is established. It should be emphasised that in a small office it is important to take into account the skills and experience of the individuals engaged to manage the office because the effectiveness and efficiency of operations are so dependent upon them, and hence the selection of those individuals is of great importance.
- (d) Claims are recorded in the database as soon as they are received, and scanned and copied immediately onto computer files. All subsequent correspondence relating to those claims is also recorded and scanned. In this way the Fund always has a record of what has occurred, which is additional to the physical documentation, and can be accessed remotely by the Secretariat from London.
- (e) The Claims Handling Office manages but does not assess claims; this is done by claims assessors retained by the Fund as experts, who do not act for any third parties in relation to the *Prestige* incident. These external assessors are selected for their expertise and to the extent possible the Fund uses experts in the affected country. Clearly a wider range of economic and commercial expertise is needed for assessing large tourism claims and very complex mariculture claims, for example, than is needed for assessing claims of individual fishermen or shellfish collectors. Once the necessary documentation has been received from the claimant, the Claims Handling Office sends the claims to the relevant assessor. Further information may be sought from the assessor, who may also consider that the claim justifies an inspection visit or a meeting.
- (f) Once the assessor has finalised his recommendation, the assessor also prepares a summary overview showing the rationale adopted in reviewing the claim and explaining whatever amount has been recommended for approval and, if the claim has been assessed at a lower amount than that claimed, the reasons for this. The Claims Handling Office forwards all this documentation to the insurer and the Fund for approval by both. Only after these steps have been completed is a claim approved

and the pro-rated payment is authorised, subject to the claimant agreeing formally to the approved assessment. Thus all claims are considered by the assessor, the Fund and by the P&I Club before being approved. During the assessment process the assessors may raise issues with the Claims Handling Office or with London and the inspection visits by the Audit Body showed that such communication does indeed take place regularly.

- (g) The Audit Body's inspection visits included an examination of a sample of every category of claim at each location, the sample being selected by the Audit Body members and designed to ensure that every assessor being used by the Fund had at least one claim for which he/she was responsible looked at. In every case the claims files were made available immediately, and allowed a full understanding to be gained of the history and nature of the claim.
- (h) Whilst the Claims Handling Offices are not responsible for claims assessment, the Audit Body members saw instances where Office staff had used their own initiative to assist in identifying issues or contributing to consistency of approach, and welcomed that initiative.
- (i) The wide impact of the *Prestige* incident had significant economic and social consequences. Also it quickly became clear that the scale of the incident was so large that the 1992 Fund would not be able to provide full payment of approved claims. Against this background the Spanish Government introduced a procedure whereby those individuals affected could obtain relief direct from the Government but would subrogate their own claims on the Fund. The Spanish Government has lodged a very large claim for clean-up costs. The French Government has recently submitted its claim for clean-up costs. As a result there is a considerable amount of work to be done in the coming months on assessment of claims in respect of Spain and France.
- (j) The recommendations made as a result of these visits have been discussed with the Secretariat and the Audit Body is satisfied that proper consideration has been given as to how best to give effect to them.

3.3 Relationship with Investment Advisory Bodies (IABs)

- 3.3.1 The Audit Body and the IABs are independent bodies which report directly to the governing bodies. Nevertheless, it is important that they hold discussions with each other so as to share information in respect of financial risk.
- 3.3.2 In April 2004 the IABs briefed the Audit Body on recent developments and also presented a paper on Dual Currency Deposits (DCDs) to the Audit Body which the IABs intended to submit to the governing bodies. Information on DCDs will be given in the IABs' report to the governing bodies. The Audit Body was grateful for the opportunity to consider this investment instrument in more detail.
- 3.3.3 The Audit Body is of the view that DCDs, which is an investment instrument widely used in the private sector, is appropriate to the needs of the IOPC Funds. DCDs are both an investment instrument and, if need be, a currency conversion instrument. Its use does not present any major risks and does not constitute a breach of the principles which govern the Funds' investment policy.

3.4 Risk management

- 3.4.1 The Audit Body continued to look at risk management. Although the responsibility for risk management lies with the Secretariat, the Audit Body's aim was to help the Secretariat in its

consideration of this issue and to satisfy itself that procedures are in place to manage the different areas of risk.

- 3.4.2 The Secretariat with the assistance of the Funds' security consultants and the External Auditor have identified five areas of risk, in no particular order of priority, namely: reputation risk, claims handling process, financial risk, human resource management and business continuity. Under these five areas the sub-risks are to be mapped and assessed and the process and procedures to be documented to show how the risks are managed.
- 3.4.3 The Audit Body noted with satisfaction that the Secretariat had already taken a number of steps in the field of business continuity risks and that further work on risk management in various areas was being carried out.
- 3.4.4 The Audit Body will continue to assist the Secretariat in its examination of risk management. The Audit Body considers that it is necessary to manage risks but is aware that risk management is costly and takes considerable management time and resources. For this reason, a balance should be struck to arrive at the right level of risk management in the light of the activities of the Funds.

3.5 Renewal of the mandate of the Audit Body

- 3.5.1 The mandate of all the members of the Audit Body is three years and will expire in October 2005.
- 3.5.2 It was decided by the governing bodies that of the first Audit Body to be elected the mandate of three of the six members of the Audit Body from Member States should not be renewable after three years. The governing bodies decided that this matter should be considered by the Audit Body, that the Body's Chairman should report on this issue to the governing bodies no later than at their autumn sessions in 2004 and that if agreement on this point could not be reached between the members of the Audit Body, the governing bodies would decide (documents 92FUND/A.7/29, paragraph 12.15 and 71FUND/AC.9/20, paragraph 8.15).
- 3.5.3 The Chairman of the Audit Body has had discussions with the individual members of the Audit Body. Except for Mr H. Mutttilainen who, for personal reasons, does not wish to present his candidature for renewal, the other five members from Member States have declared that they would be willing to continue to serve on the Audit Body for a further term.

3.6 Winding up of the 1971 Fund

- 3.6.1 The Audit Body noted the progress that had been made since October 2003 towards the winding up of the 1971 Fund.
- 3.6.2 A number of 1971 Fund incidents have been finalised during 2003. Seven Major Claims Funds will be closed by the end of 2004 - namely the *Aegean Sea*, *Braer*, *Sea Prince*, *Yeo Myung*, *Yuil N°1*, *Sea Empress* and *Nakhodka* Major Claims Funds, and the surplus on these Major Claims Funds was repaid to contributors on 1 March 2004. The *Keumdong N°5* Major Claims Fund will be closed in 2005 when the surplus on this Major Claims Fund will be repaid to contributors.
- 3.6.3 Two major incidents, the *Nissos Amorgos* and *Pontoon 300*, still remain outstanding.
- 3.6.4 The Audit Body noted that, although a number of major incidents had been finalised, there were still several incidents outstanding which could take several years to terminate.
- 3.6.5 The Audit Body also noted the significant reduction which has taken place recently in the amounts of outstanding contributions to the 1971 Fund. However, it is clear that some of the amounts still outstanding could be difficult to recover, and the Administrative Council will therefore have to consider at some stage how to deal with these amounts in arrears.

4 **Periodicity of meetings**

4.1.1 The Audit Body considers that a frequency of three meetings per year is appropriate.

4.1.2 It is also considered that the members of the Audit Body should attend – at least for the first years - the October sessions of the governing bodies to enable them to follow the discussions of the financial issues and the operations of the Funds in general.

5 **Future work**

The Audit Body intends to continue its work on the subjects referred to above. In addition, it intends to improve its understanding of the costs incurred in claims handling.

A handwritten signature in black ink, appearing to read 'Coppolani', written over a horizontal line.

Charles Coppolani
Chairman
