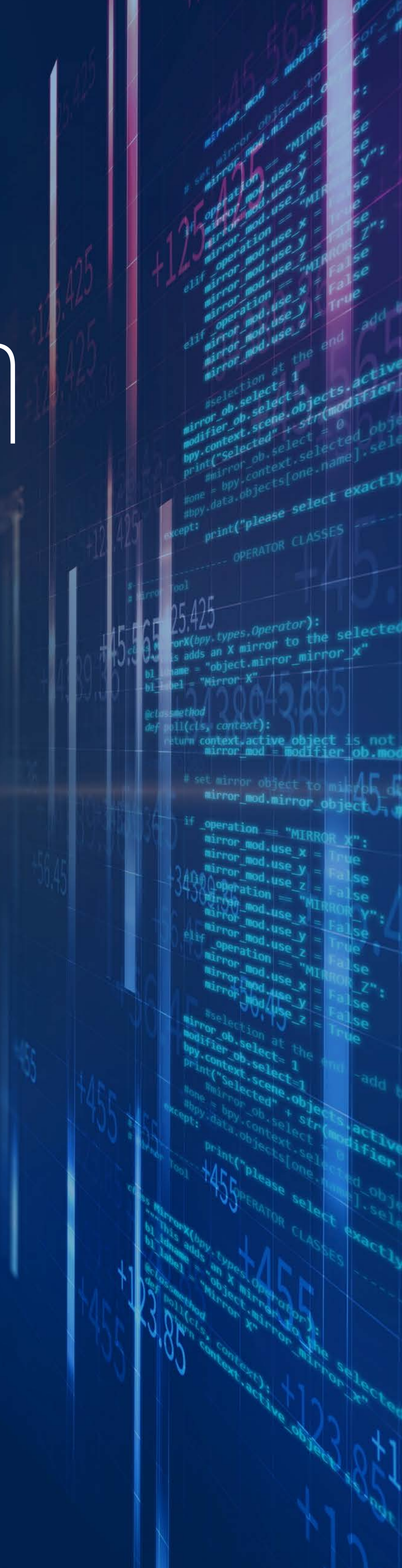
Embarking on the ICOFR journey

Trends and insight post the implementation of the Insurance Authority's Circular No. (21), 2019



July 2021

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Foreword

Unprecedented circumstances are forcing the insurance industry to dramatically evolve and rethink the way business is being conducted globally. Volatile markets, dependency on technology, enhanced compliance requirements, among other factors, are leaving organizations little choice but to adapt. Accordingly, opportunities to lead and reshape the insurance industry have never been greater.

The Insurance Authority (IA) in the United Arab Emirates (UAE) published a circular in 2019 with respect to reporting requirements. This endeavors to strengthen internal controls within insurance companies in the UAE. We believe it is an opportune time to share insight on how insurance companies are complying with the requirements, the key areas of remediation identified and the next steps in their internal controls journey.

We leverage our first-hand experience of conducting such reviews in the market as well as insights from insurance companies in the UAE to present trends and insights on the implementation of IA's circular relating to internal control over financial reporting (ICOFR). This report is designed to help an insurance company compare its ICOFR framework against its peers. On behalf of KPMG Lower Gulf, we look forward to delving deeper into the topics discussed within this publication, and exploring how your organization can make the most of opportunities that lie ahead.

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Executive summary

According to Circular No. (21) of 2019, *"As part of the year end audit exercise, external auditors are required to obtain an understanding of the internal controls relevant to the audit and to express an opinion on their operational effectiveness."*

Setting the context

Multiple instances of questionable financial practices in large companies around the world precipitated the need for regulators to reassess and strengthen governance structures and internal control requirements for companies, and set new standards for public accounting firms, corporate management, and the boards of directors.

In 2019, the Insurance Authority (IA) issued Circular No. (21) of 2019, and subsequently a clarification circular in October 2020 requiring the following key activities to be performed by all insurance companies in the UAE:

- **Establish an ICOFR framework and review the design and operating effectiveness of ICOFR for the year 2020;**
- **Provide a report to the Insurance Authority including the results of the ICOFR assessment by 30 April 2021;**
- **Remediate control gaps/failures and test the operating effectiveness of implemented ICOFR during 2021; and**
- **Obtain a separate opinion from external auditors on operating effectiveness of ICOFR from 2021 onwards.**

The introduction of this circular by IA, along with its subsequent circulars, has been a significant change for insurance companies. This requirement is similar to ADAA Resolution No. (1) of 2017 implemented for Abu Dhabi Government entities. The trend amongst key regulators in the UAE is to encourage management to implement robust internal control frameworks.

Leading the change

Currently the resolution covers internal controls over financial reporting (ICOFR); hence, finance functions have played a major role in driving the ICOFR implementation and a co-sourced model with external service providers was the prevalent option for insurance companies in the UAE. The internal audit, risk and compliance teams were also key stakeholders in the ICOFR implementation across multiple insurance companies.

In implementing ICOFR, insurance companies have derived great value beyond compliance such as more efficient financial reporting processes, automation of controls, better monitoring of operational goals and objectives, enhanced governance culture, greater awareness of entity level and process level controls.

Implementing the change

Consistent with global leading practices, the ICOFR implementation journey of most UAE insurance companies was set in motion with an assessment to define materiality thresholds, after discussion and agreement with management and stakeholders to identify key processes to be included in the scope. A wide range of quantitative and qualitative parameters (such as susceptibility to fraud, level of automation, accounting complexities, period end adjustments. Were used to determine materiality thresholds.

Whilst the Insurance Authority has not mandated a specific internal control framework to be implemented, we observed that majority of the insurance companies in the UAE adopted the Committee of Sponsoring Organizations 2013 (COSO) framework.

The vast majority of insurance companies covered entity level controls, process level controls and Information Technology (IT) general controls, while a select few companies only covered process level controls as part of this ICOFR exercise.

Insight on ICOFR scope

Coverage of ICOFR review

Based on our experience working with insurance companies in the UAE as well as our discussions with key executives and key control functions, we noted that UAE insurance companies primarily covered the following areas in response to the IA Circular No. (21) of 2019.

Entity level controls

Code of conduct, conflict of interest and related party transactions	Enterprise risk management
Whistleblower mechanism	Compliance management
Board and board committee operations	Internal audit
Budgeting and Management Information Systems (MIS)	Policies and procedures
Delegation of authority	Organization structure

Process level controls

Core

Underwriting	Claims
Reinsurance	

Support

Reserve calculations	Investments
Payroll management	Cash and bank management
Period end closing and reporting process	Credit controls and payables

IT general controls

Logical access controls – network and applications	Data center controls
Change management	Information security incident response and reporting process
Backup procedures	Implementation process of disaster recovery strategies

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Common themes of control deficiencies

During our reviews and insights obtained from UAE insurance companies, a greater percentage of control failures were observed amongst Entity Level Controls (ELCs) which have pervasive influence on internal controls over financial reporting. Material Process Level Controls (PLCs) and Information Technology General Controls (ITGCs) deficiencies were highlighted in some organizations. It is evident that a higher focus has been placed by insurance companies on building strong controls around ITGC and to automate more controls.

Depicted below are themes of common control deficiencies identified by insurance companies during ICOFR implementation:

Entity Level Controls

Code of conduct and related areas:

— Absence of whistleblowing monitoring framework

— Informal process to present ethics and compliance matters to the board

— Absence of defined conflict of interest process

Compliance and enterprise risk management:

— Inadequate compliance framework

— Absence of a fraud risk management framework

— Absence of an enterprise risk management framework

Human resources:

— Absence of formal succession planning

Business continuity management:

— Absence of IT disaster recovery plan

— Absence of business continuity management plan

Board and board committee operations:

— Outdated terms of reference

— Audit Committee composition not in compliance with IA regulations

Governance documents:

— Absence of formalized strategic and operational delegations of authority matrices

— Outdated policies and procedures

Process Level Controls

Underwriting and claims:

— Absence of integration between core insurance systems and financial systems leading to manual intervention during transfer of data

— Absence of review and approval of medical claims received prior to settlement approval, including Third Party Administrators (TPAs) for medical insurance

Payroll:

— Absence of integration between HR systems and payroll systems leading to manual intervention during transfer of data

Finance related areas:

— Absence of embedded controls within the system for review and posting of journal entries

— Inadequate checks and balances on data used for reserve calculations

— Absence of review and monitoring of financial statement closing checklist activities

IT General Controls

User access management:

— Absence of an access control matrix and periodic review of users

— Absence of monitoring mechanism for privileged users and super users

Back up and restoration testing: :

— Absence of dedicated disaster recovery data center

Evolving perception

As depicted below, the way forward for insurance companies entails remediating weaknesses reported to IA by end of 2021 and obtaining an opinion on effectiveness company's internal controls by statutory auditors. Thereafter, on a periodic basis, management shall assess and review the controls to assess the control design and operating effectiveness. Post management review and at year end, the statutory auditors would review the testing performed by the management to provide their opinion on the effectiveness of the internal control systems.

While the requirements of IA emphasize the need to establish internal controls over financial reporting, some insurance companies have capitalized this opportunity to improve business processes. Globally, organizations are now focusing on structuring their ICOFR programs to better align with their strategic direction, and to support growth, reduce risk, reduce costs or drive value. Management also includes key operational controls as part of their internal control assessment program and strives for process excellence. Organizations are increasingly looking at opportunities to derive value from a mature and evolved ICOFR framework, shifting their agenda from compliance requirements to value enhancement.

	Key activity	Activities performed and the way forward
Submission to IA	**Issuance of Circular No. (21) of 2019 and clarification circular of October 2020, by IA**	— Discussed the implementation plan to comply with the IA circular's requirements within their respective governance bodies (e.g. board/audit committee)
Submission to IA	**Establish and implement the ICOFR framework.**	— Established ICOFR Framework — Conducted ICOFR Review in line with the ICOFR Framework
Submission to IA	**Provide a report to IA with management's ICOFR review results by April 30, 2021.**	— Completed the review of ICOFR for the year ended 31December, 2020 and identified improvement areas in their respective processes — Submitted gap analysis report to IA enlisting the remediation plans
Current state	**Remediate control gaps/failures and test operating effectiveness of implemented ICOFR during 2021.**	— Assist with completing remediation action plans are completed by December 31, 2021 — Test the operating effectiveness of the remediated controls — Present the results of operating effectiveness of the remediated controls to the governing bodies — Provide awareness sessions to management, internal controls teams and the governing bodies
The way forward	**Obtain external auditors' opinion on ICOFR for year 2021.**	— Review of ICOFR by external auditors as at December 31, 2021, and annually thereafter
The way forward	**Increase level of maturity of internal controls environment**	— Develop a three to five year journey to achieve an optimized internal control program and expand the scope to include operational and compliance controls (in line with COSO framework) — Leverage technology to automate manual controls — Consider implementing a control optimization project — Establish control self-assessment mechanism across the company — Synergies with the second and third line of defense to complement internal controls efforts — Proactive engagement with business functions to have leaner processes and improved reporting — Become a center of excellence for process and controls including policy determination — Leveraging Governance Risk and Compliance (GRC) tools, conducting data analytics (including predictive analytics) to identify trends and improvement opportunities

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Integrity: We do what is right.

Excellence: We never stop learning and improving.

Courage: We think and act boldly.

Together: We respect each other and draw strength from our differences.

For Better: We do what matters.

To meet the changing needs of our clients, we have adopted an approach aligned with our global purpose: Inspiring Confidence, Empowering Change. Our three pillars – exceptional quality of service, an unwavering commitment to the public interest, and building empowered teams – are the foundation of our firm.

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Designed by the Creative Team in KPMG Lower Gulf

Publication name: Embarking on the ICOFR journey

Publication number: 3563

Publication date: July 2021