On the 2020 Insurance Audit Committee Agenda

Prioritizing a heavy audit committee agenda is never easy, and 2020 will be particularly challenging. Insurers' audit committees are operating against a backdrop of volatility and uncertainty. The industry is having to manage through increasingly frequent and highly destructive environmental risks and disasters. Cybersecurity challenges threaten the privacy of data, and the role of cyber insurance is still evolving. Underwriting, pricing, and claims modernization demands are increasing on what seems like a daily basis. Furthermore, there are several accounting-change mandates either just instituted or looming on the horizon. Each of these challenges coincides with an increase in the level of regulatory scrutiny. In short, 2020 is shaping up to be a busy and complicated year.

Drawing on insights from several KPMG surveys and our professionals' frequent interactions with insurance audit committee members and senior management, we have flagged a series of issues that we recommend audit committees keep in mind as they consider and carry out their 2020 duties:

— Maintain control of the audit committee's agenda.

— Understand the impact of technology on the finance organization's talent, efficiency, and value.

— Assess management's progress on areas for operational excellence.

— Reinforce audit quality and set clear expectations for the external auditor.

— Stay current on implementation efforts for new accounting standards.

— Redouble focus on the company's ethics, compliance, and whistle-blower programs.

— Help ensure internal auditors' focus is on risks beyond financial reporting.

Maintain control of the audit committee's agenda.

For a number of years now, KPMG has been reporting that audit committee members have concerns that their agendas—beyond their core financial reporting, internal control, and internal/external auditor oversight mandates—may be too crowded, risking overall effectiveness.

The risks that many audit committees may now be overseeing—such as those associated with financial reporting, cybersecurity and information technology; third-party arrangements, operational effectiveness; legal and regulatory compliance—have become much more complex as time passes.

We believe insurance audit committees may have been assigned certain duties that are beyond their mandate, which would tend to crowd out the functions they need to be overseeing. And, they may be overseeing other matters that are within their mandate but they may not necessarily have the expertise to address. In our view, those audit committees should deflect the former and ask for outside help with the latter. Therefore, it is important for audit committees to step back and assess whether some of the agenda items fit their members' capabilities, whether its members have the abilities and time to oversee the risks that have been assigned to them, and whether they fit with the audit committee's core oversight responsibilities. Members may need to ask: Do cyber-risk and data-governance matters require greater attention from the full board—or, perhaps a dedicated board committee? The same question could be raised about information technology and other risks. The use of more powerful and insightful technologies in the finance function (such as incorporating artificial intelligence capabilities to reduce human error possibilities) may be an area where the audit committee may need assistance. These questions and others underscore the need for even more discipline and vigilance by the audit committee in 2020.

Understand the impact of technology on the finance organization's talent, efficiency, and value.

Modernization of the finance function is increasingly critical to the overall success and effectiveness of insurance companies. Product changes and customer engagement requires better insight and analytics while it also needs a finance functional that is more nimble than what's existed in the past. There are many technology changes that present significant opportunities for the finance function to add greater value to management and to the overall organization. As audit committees monitor and help guide finance's progress in this area, we suggest three areas of focus. First, the most significant hurdle to improving finance is data challenges. The core general ledger information is typically highly aggregated, preventing seamless analysis and insight. Companies are moving to event-based accounting models where analysis occurs seamlessly across multiple business dimensions while retaining the direct linkage to the general ledger, what are finance's plans to address its data challenges and deploy new cloud technologies to automate the core finance processes? Second, how will finance become a true business partner delivering insight that can help drive profitable growth? We've seen finance technologies driving significant process and operating model changes. The traditional siloed finance processes related to financial reporting and the budgeting, planning, and forecasting processes are being eliminated, driving more advanced analytics and business insights. Driver-based performance models are becoming more common in the industry, helping insurance companies develop cost-efficient and highly effective predictive analytic solutions.

Third, the increase in automation and advances in analytics are changing the skills needed in the finance workforce. As finance functions move away from task-based operating models to providing capabilities and delivering outcomes, we see a decrease in the need for resources doing task-based activities. What is your organization doing to plan for the future? Is finance attracting, developing, and retaining the talent and skills necessary to match its evolving needs? In this environment, it is essential that the audit committee devote adequate time to understanding finance's transformation strategy. This point raises some essential areas for audit committee members to question: Is your finance organization handling the rapid digitization of the finance function in a strategic fashion? Is operational excellence something that the business is striving to achieve? Answering those questions is critical if the business is to remain competitive in the marketplace and able to service customers in the way they want to be serviced.

Reinforce audit quality and set clear expectations for the external auditor.

Audit quality is enhanced by a full and engaged audit committee that sets the tone and clear expectations for the external audit, while at the same time monitors auditor performance rigorously through frequent, quality communications and a robust performance assessment. (See the Center for Audit Quality's External Auditor Assessment Tool, released in April 2019). Pay close attention to the PCAOB's quality control initiatives, as the PCAOB staff has announced that it is developing a concept release for the board's consideration and may seek amendments to the PCAOB's quality control standard. Probe the audit firm on its quality control systems that are intended to drive sustainable, improved audit quality—including the firm's implementation and use of new technologies. A September 2019 speech by PCAOB board member Duane M. DesParte (Improving Audit Quality Through a Renewed Focus on Quality Control) highlighted key elements of a firm's quality control (QC) system to include "areas of firm governance and structure, QC system risk assessment and monitoring, continuous improvement, and transparency." In discussions with the external auditor regarding the firm's internal QC system, consider the results of PCAOB and internal inspections and efforts to address deficiencies. Remember that audit quality is a team effort, requiring the commitment and engagement of everyone involved in the process—the auditor, audit committee, and management.

Stay current on implementation efforts for new accounting standards

Insurance company audit committees will need to focus on how management is handling two accounting issues that are expected to have significant impact on insurers: Accounting for long-duration contracts and the current expected credit loss (CECL) model.

CECL

Now that the FASB's standard on CECL is in effect (January 1, 2020), audit committees will need to understand how management is following the standard that affects the timing of the recognition, measurement, presentation, and disclosure requirements for insurers' assets valued at an amortized cost. We recommend two broad areas of focus: First, the question needs to be asked about whether the audit committee is being fully briefed on whether management and the firm's auditor understand—and are appropriately dealing with—the transition impact of the standard's implementation. Finding answers to that question requires reflection on a few issues: Has the audit committee reviewed the company's required disclosure document, and is the committee satisfied with the company's external auditor's evaluation of the transition impact? Second, there must be an evaluation of readiness that would require that the audit committee have detailed discussions on the impact of internal control over financial reporting; new disclosure requirements regarding assumptions, models, and methods for estimating allowances for credit losses; and the impact on disclosure controls and procedures. The committee would need to obtain views of the external auditor regarding the company's readiness, as the auditor is in a unique position to provide insights on the company's reporting processes and internal controls.

Long-Term Contracts

Although the Financial Accounting Standard Board has issued a two-year delay in the implementation of a new standard regarding long-term contracts, audit committees of life insurance companies and other insurers holding long-duration contracts would be well served to remain vigilant about management's progress toward plans for compliance with the pending new standard. The standard would have impacts on long-term policies such as annuities and life insurance. If finalized, publicly traded insurers would have until 2022 to follow the rules, while private companies would have until 2024. Given that this standard represents a fundamental change to the accounting for these products, audit committees should ensure that companies take the opportunity to optimize their accounting processes and implement automation while they are making the changes.

Redouble focus on the company's ethics, compliance, and whistle-blower programs.

The reputational costs of an ethics or compliance failure are higher than ever. Fundamental to an effective compliance program is the proper tone at the top and a focus on a culture throughout the organization of doing the right thing at all times. The culture must support the company's strategy, including its commitment to its stated values, ethics, and legal/regulatory compliance. These mandates are particularly true in a complex business environment, as companies move quickly to innovate and capitalize on opportunities in new markets, leverage new technologies and new sources of data, and engage with more vendors and third parties. Coupled with a challenging global regulatory environment (the array of new data privacy, environmental, healthcare, financial services, and consumer protection regulations, as well as the Foreign Corruption Practices Act and the United Kingdom's Privacy Act), compliance risks and vulnerabilities will require vigilance. Closely monitor the tone at the top and culture throughout the organization with a sharp focus on behaviors (not just results) and red flags. Does the company's culture make it safe for people to do the right thing? Help ensure that the company's regulatory compliance and monitoring programs are up to date, cover all vendors, and clearly communicate the company's expectations for high ethical standards. Focus on the effectiveness of the company's whistle-blower reporting channels and investigation processes through a #MeToo lens. Does the audit committee see all whistle-blower complaints? If not, what is the process to filter complaints that are ultimately reported to the audit committee? As a result of the radical transparency enabled by social media, the company's culture and values, commitment to integrity and legal compliance, are brand reputation are on full display.

Help ensure internal auditors' focus is on risks beyond financial reporting.

Aside from financial reporting risk issues, and issues that can damage a company's reputation due to cultural and compliance failures, internal audit's mandate is changing. Audit committees must be vigilant on these additional issues. The audit committee should work with the chief audit executive and chief risk officer to help identify whether the audit plan is risk based and flexible—and whether it can adjust to changing business and risk conditions. What's changed in the operating environment? What are the risks posed by the company's digital transformation and by the company's extended organization—sourcing, outsourcing, sales, and distribution channels? What role should internal audit play in auditing the culture of the company? Set clear expectations and help ensure that internal audit has the resources, skills, and experience to succeed. What work is management doing to promote agility and build the workforce of the future? Help the chief audit executive think through the impact of such possibilities of the financial impact of disasters on the insurer's growth, profitability, and strategy. The impact of the increase in frequency and intensity of storms offers an example of how audit committees may leverage internal audit's help in understanding management's plan to cope with a rapidly developing challenge. Ask internal auditors to understand the extent to which the insurance company has a high risk of insuring properties owners in certain regions where wildfires and flooding are likely. Insured losses from wildfire globally have skyrocketed. In 1970, according to data Guy Carpenter & Co. LLC,[1] losses were $0.48 billion. By 2000, losses reached $8.56 billion. In 2018 the losses were $16.12 billion. Insurers may decide not to write coverage in certain areas. Is management considering such a move? Some home insurers have decided not renew tens of thousands of home-insurance policies in areas with high wildfire risk in the past two years. Is internal audit involved in discussions about helping management identify regions where offering property protection policies is not economically viable? Is the issue of climate risk even a topic of discussion? KPMG recently reported that the CEOs at three of the largest insurers in the world say they are not debating the political issue accompanying the topic; they simply have increased prices already because their insured losses have been significant from events such as storms and wildfires.

[1] "More Californians Could Lose Home Insurance After Wildfires," The Wall Street Journal, November 1, 2019

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KPMG recognizes that insurers are rethinking the way they conduct business. Volatile markets, disruptive technologies, laser focus on the customer, and a new regulations and compliance issues have brought financial services companies to a crossroads.

KPMG's Insurance professionals know how to transform today's uncertainty into opportunity for our clients. We view our insurance clients' current challenges as possible breakthroughs that can transform their operations and create a sustainable advantage. We work with leading insurers to help them redirect these changes—with the goal of creating answers to their most pressing business questions. Learn more at kpmg.com/us/insurance

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