2024 Insurance Company Audit Committee Agenda

Sections

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A rapidly changing industry demands a more active insurance company board

Today's rapidly changing insurance industry calls on insurance company boards to take a more active leadership role this year. Oversight of risk will be challenging with industry-specific and geopolitical risks to new risks from the digital world, including cybersecurity, data privacy, and generative artificial intelligence (GenAI). Insurance regulators also continue to be active with issuing changes and updates to regulatory requirements. Insurers will need to be ready for the increased demand for risk oversight by responding to regulators with compliance, audit expertise, and enlightened management.

With a myriad of risks and an uptick in regulatory activity, the board should emphasize financial reporting requirements and internal controls, reinforce audit quality to stand up to regulatory scrutiny, ensure internal audit focuses on key risks, support management as the insurer modernizes and potentially experiences talent flight, and counsel insurance executives and employees on ethics and culture. Given the scope of oversight required, 2024 should be a year the board delegates more tasks to its committees to increase the validity of the committee reports to the Board and influence on management. To aid this endeavor, a series of questions accompanies each section of the 2024 Insurance Company Board Agenda. Use the questions as thought starters and to guide discussions with insurance company leadership.

This year is filled with uncertainty about interest rates, the economy, geopolitics, and the US election. Reacting to each new crisis is not the best course of action and could put the insurer at a disadvantage. The board needs to be attentive, proactive, and forward thinking in 2024.

> As automation and digital transformation reshape every sector of the industry, new monitoring controls and policies are necessary. The board's role in overseeing management becomes even more crucial during this transformative time for insurers.

Scott Shapiro

US Sector Leader, Insurance

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Focus on financial reporting and internal controls

In any year, it is prudent for boards to prioritize attention on financial reporting requirements and internal controls for risk management. In 2024, it is imperative. Oversight of risk will be daunting given the breadth of risks that insurers face, including industry-specific, regulatory, geopolitical, climate change, cybersecurity, data privacy, generative AI, as well as risks encountered with digital technologies relied on for insurance digital transformation initiatives.

For audit or risk committees, a comprehensive risk assessment is mandatory. It is the level playing field for identifying, mitigating, and disclosing material risks. Boards should have the risk assessment under their purview, along with an eye on two standout risk concerns. One is risk concentration that occurs when the insurer has a high concentration of assets, liabilities, or activities in a particular area or sector. Risk concentration puts added risk on the insurer that the board should be aware of and understand the insurers methods and tools for quantifying, assessing and reacting to potential risk concentrations.

The second risk is elevated risk of non-compliance with new financial reporting requirements as financial reporting is also being impacted by regulatory trends intended to elevate transparency. The Financial Accounting Standards Board (FASB) has issued reporting requirements around new segment disclosures, income tax disclosures, and income statement disaggregation disclosures. Additionally, the National Association of Insurance Commissioners recently adopted changes to statutory reporting requirements designed to enhance transparency around insurer's invested assets, in light of concerns about emerging investment structures that were classified as bonds but may have risks more aligned with equity investments. Transparency, along with risk assessments and financial reporting, can help with elevated risk and instances of noncompliance.[1]

Additionally, the SEC is emphasizing the importance of quality financial reporting, with Paul Munter, Chief Accountant, issuing a statement that the cash flows statement is integral to a complete set of financial statements and should be given the same professional care, effective internal controls, and robust, high-quality audits as other financial statements. Munter went on to stress the importance of an objective analysis related to the statement of cash flows from the perspective of a reasonable investor when evaluating the materiality of both the financial statement and the internal controls over financial reporting impacts of an error in the statement of cash flows. While the statement from The Office of Chief Accountant was focused on the statement cash flows, insurers should evaluate whether the observation is applicable to other financial statements and disclosures.[2]

[1] National Association of Insurance Commissioners Web site, News release, February 13, 2024

[2] Securities and Exchange Commission (SEC) Web site, Newsroom statement, December 4, 2023

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Boards should seek answers to the following 10 questions that are designed to increase the focus on financial reporting and internal controls:

- Which executives are responsible for identifying material financial, liquidity, concentration, credit, and operating risks?
- How is management identifying and mitigating identified risks?
- Does management have an incident response plan that can be used for a wide range of incidents or crises? Have the plans been tested?
- Is concentration risk being monitored via metrics and addressed through dispositions or redirection of investments?
- Are sufficient and experienced management resources in place to proactively work through potential accounting transactions or implications from the risks identified?
- Are processes in place to monitor social media for shifts in sentiment or other negative news that could impact insurer customer behavior?
- Are processes in place to monitor digital channels for unusual or higher-volume activities, and have call center staff and artificial intelligence (AI) tools been trained to identify and report such activity?
- Are transparent disclosures of such risks and mitigation activities included in the company's SEC filings?
- What processes and controls are in place to assess the statement of cash flows conformity with US GAAP requirements?
- Has management identified any classification errors in the current year-to-date or prior-year statement of cash flow? If yes, how has management assessed whether correction in the current period as a little "r" restatement is appropriate versus a big "R" restatement?

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Reinforce audit quality and compliance oversight

Insurers are subject to a myriad of regulations and laws that result in audits and compliance. However, the Public Company Accounting Oversight Board (PCAOB) has proposed changes to auditing standards that would heighten the auditor's responsibilities for detecting instances of noncompliance with laws and regulations. These proposed changes are dependent on SEC approval.

For boards that have the responsibility to ensure the insurer complies with all applicable laws and regulations, the board should reinforce audit quality and stress compliance oversight. The added regulatory burden could have consequences. Failure to comply could have either a direct or indirect material effect on the financial statements. Auditors would be required to determine a complete population of laws and regulations that apply to the insurer, including across jurisdictions, to identify all instances of noncompliance. The PCAOB's economic analysis of the proposed changes to the standard acknowledge that new requirements would result in additional, potentially substantial costs to auditors and the companies they audit. Increased costs may arise due to the need to supplement the audit engagement team with additional resources knowledgeable about insurance laws and regulations.

Additionally, the PCAOB is priorities and standard-setting activities show that the PCAOB is working to modernize its auditing standards. As auditors use technology to inform risk assessment, obtain a deeper understanding of business processes and related transactions, and drive a consistent response to risk, auditing standards need to and are expected to evolve and adapt to increasing use of technology.[3]

Insurance audit and risk committees, with the board's oversight, should seek answers from management regarding these questions:

- What is the status of the PCAOB's proposed NOCLAR rule and the expected impacts of the final standard on the insurer's internal processes and the audit?

- Who is responsible for compiling and maintaining a complete list of relevant laws and regulations across the insurer, including across jurisdictions?
- What controls are in place over the completeness and accuracy of the list of relevant laws and regulations?
- How does management assess whether potential noncompliance has either a direct or indirect material effect on the financial statements, internal controls over financial reporting, and who is responsible for reviewing such conclusions?
- What is the nature and status of topics on the PCAOB or AICPA rulemaking agendas and how would these impact the insurers external audit?

[3] Source (summarized from): https://kpmg.com/us/en/frv/reference-library/2023/the-pcaobs-agenda-to-modernize.html

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The staff of the Public Company Accounting Oversight Board issued a spotlight on its 2024 priorities.

- Continued emphasis on inspecting audits of companies engaging in merger and acquisition activities, including business combinations
- Selection of nontraditional audit areas to inspect
- Additional scrutiny of regional public banks
- Ongoing changes in interest rates, which can have a material effect on a company's liquidity
- Allowance for loan and lease losses
- Classification of investments as available for sale or held to maturity
- Valuation of investments in hard-to-value securities
- Ability to meet margin requirements
- Ability to meet long-term debt obligations
- An entity's ability to continue as a going concern

> The PCAOB continues to evaluate the NOCLAR audit standard, including holding a roundtable in spring 2024 and re-opening the comment period. These types of roundtable conversations, along with more public meetings and discussion papers, will best serve the public interest and allow for further understanding of the costs and benefits of such significant proposed changes to insurance companies and their auditors.[4]

Kyle Ten Pas

Partner and National Audit Sector Leader for Insurance

[4] Source - derived from Christian's quote: https://kpmg.com/us/en/frv/reference-library/2024/pcaob-seeks-additional-insight-on-proposed-amendments.html

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Regulatory-driven sustainability reporting landscape highlights the importance of data quality

In March 2024, the SEC adopted its climate rule (The Enhancement and Standardization of Climate-Related Disclosures for Investors). In April, 2024, the SEC issued an Order to stay (i.e. pause) this rule due to pending litigation against the climate rule. While the outcome of the judicial review is uncertain, the rule, as written, requires nearly all SEC registrants to provide disclosures about climate-related risks. This includes three types of disclosures. First, financial statement disclosures, which will be part of the audited financial statements and therefore in the scope of the insurer's internal control over financial reporting. Second, climate-related disclosures (e.g. governance, risk management, strategy) which will be in the insurer's annual report or registration statement. Third, scopes 1 and 2 greenhouse gas (GHG) emissions disclosures will be required, if material, for certain insurers. Such GHG emissions disclosures will be subject to assurance.[5]

The SEC's climate rule is part of a broader sustainability reporting landscape – and the stay on the climate rule has no effect on insurers preparing for compliance with other rules. For example, insurers may be subject to California's climate disclosure laws, European Sustainability Reporting Standards (ESRS), and/or standards issued by the International Sustainability Standards Board (ISSB). Despite certain differences across these various sustainability reporting regimes, they all hinge on collecting and using high-quality data. While data quality is a crucial element of any reporting, it is particularly relevant to the calculation of estimates. For example, insurers may face challenges in estimating scope 3 emissions, as required by California's climate disclosures laws and required, if material, by ESRS and standards issued by the ISSB.[6]

Some of the factors that are important in considering data quality include accuracy, reliability, and consistency. The board or audit committee should be informed and understand attestation requirements for data quality since this data may be used by investors, stakeholders, and other interested parties to make informed decisions about the insurer's sustainability practices and performance. Ensuring high-quality data is essential for companies to effectively communicate their sustainability efforts and maintain stakeholder trust.

[5] Reuters, Web site, "US SEC Stays Climate Disclosure Rule Amid Legal Challenges" (April 4, 2024)

[6] The Harvard Law School Forum on Corporate Governance, Web site, February 22, 2024

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The board's insistence on data quality will be instrumental in preparing for a regulatory-driven sustainability reporting landscape. The following questions can help the board assess their company's preparedness to provide high-quality climate and other sustainability-related data.

- What steps has the insurer taken to prepare for compliance with sustainability-related disclosure laws and regulations?
- How is the insurer incorporating currently approaching the SEC's climate rule? For example, is the insurer considering incorporating compliance with the SEC's climate rule into any existing sustainability-related reporting regulation implementation programs?
- What processes has the insurer implemented for assessing, identifying, and managing emerging and material climate-related risks with effective board oversight?
- How is the insurer integrating climate-related risk information with internal reporting, monitoring, and escalation processes, as well as external and regulatory reporting capabilities?
- What measures has the insurer taken to ensure the accuracy and alignment of its climate and other sustainability-related regulatory reporting with its public statements, commitments, strategy, and products/services marketing?
- How is the insurer collecting high-quality climate and other sustainability-related data, and what criteria does it use to define data quality?

Data quality is the bedrock of regulatory-driven sustainability reporting, crucial for compliance and maintaining stakeholder trust.

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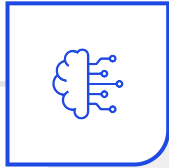

Step up oversight responsibilities of generative AI

The board is well aware of the digital transformation underway at the insurer. Digital transformation has been a multi-year initiative often referred to as insurance modernization. Now there is an emerging technology making a name for itself in financial circles—generative AI (GenAI). A 2023 fourth quarter KPMG survey found that financial executives are accelerating AI adoption with GenAI being a top priority. Among survey findings, 52 percent of financial executives said their companies are already piloting or deploying GenAI, while 37 percent are in the research and planning phase.[7] GenAI promises amazing improvements in areas that support finance, including financial analysis, compliance, scenario risk management, and internal audit.

Despite GenAI's promising future, the board should be fully aware of the risks when using this emerging technology like data privacy and hallucinations or biases that occur with GenAI output. For the board, the emphasis should be on corporate governance, internal controls, and auditing to ensure that the technology is used responsibly. Executives within the insurer may get caught up in the hype of GenAI and push for adoption and use cases. It's up to the board and the strength of its committees to exercise caution and ensure appropriate governance and accountability. Rest assured, regulation will be a fast follow. Insurance regulators will likely apply existing regulations to GenAI across its lifecycle and ascertain whether the technology can be trusted, work as claimed, and causes no harm.

The board, along with audit and risk committees, should understand how management is progressing with GenAI on a regular basis. Explore these questions:

- Are our data and systems ready for the implementation of AI/GenAI solutions?
- Have we developed clear guidance and policies around ethics, trust, and proper use of AI to ensure the impact on customers, employees, and other stakeholders is taken into consideration?
- Have we considered partnerships with fintechs or other third parties in the development of AI/GenAI solutions?
- Are we prepared to hire data scientists, machine learning engineers, and domain experts, and provide training for existing employees to ensure the workforce is ready for GenAI implementation?
- Have we considered using pilots or trial periods to test generative AI under controlled conditions?
- Have we established performance metrics to evaluate the impact AI solutions are having on efficiency, cost avoidance, innovation, and growth?

KPMG Says: Regulators have been very clear that existing regulations apply to the span of "automated systems"—including AI and GenAI.

[7] "AI and Financial Reporting Survey – what are companies doing and where do you stand?," KPMG LLP. October 2023

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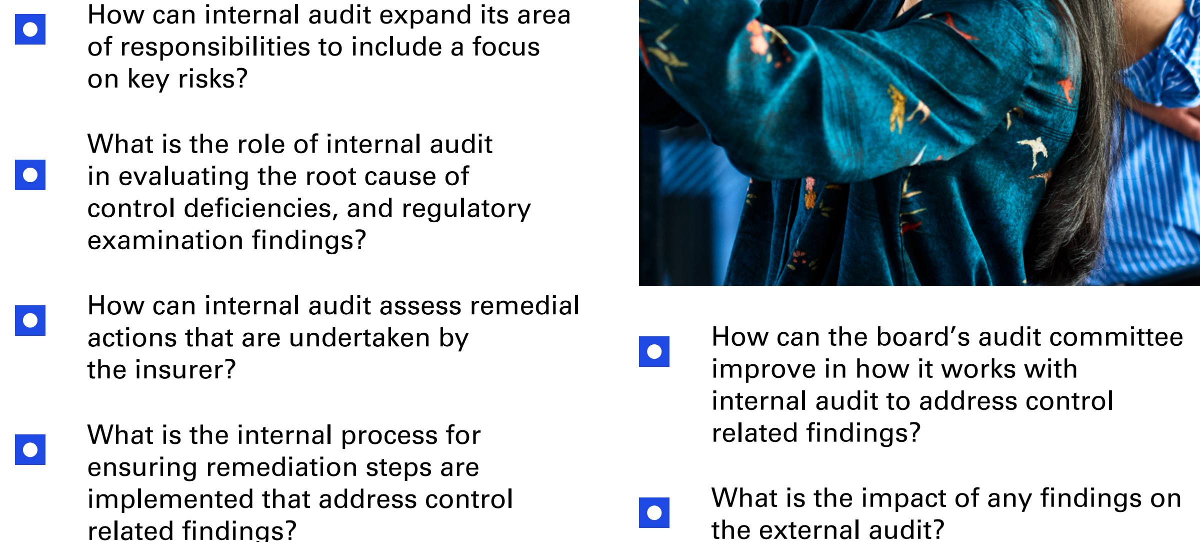
Ensure internal audit focuses on key risks

Insurance regulators may look to internal audit to assess actions taken by insurers to address control deficiencies or regulatory examination findings. Therefore, for internal audit to be a valued resource to the board's audit committee, they need to go beyond financial reporting and compliance tasks and direct their attention on the company's key risks—the fertile ground for root cause analyses and remedial actions.

In some instances, control deficiencies or regulator findings are directed at the insurer's board or committees of the board. The board is suddenly in the spotlight. As such, it is critical to have internal audit tapped to evaluate and obtain a thorough understanding of the root cause of the findings. The investigation into the root cause analysis using COSO Principles is an important and iterative process. Findings could suggest weaknesses in tone at the top or a lack of governance, which might also impact entity-level controls, as well as reporting on internal controls over financial reporting. It is why internal audit needs to focus on insurance risks. Investigations into findings could impact different areas of the insurer.

Ultimately, it is management and the board that bears responsibility for ensuring remediation steps are implemented and, in certain cases, address regulatory findings. The board's audit committee needs to be in lockstep with internal audit and, if necessary, engage independent auditors to understand the impact of the findings on the external audit. Explore these questions:

- How can internal audit expand its area of responsibilities to include a focus on key risks?
- What is the role of internal audit in evaluating the root cause of control deficiencies, and regulatory examination findings?
- How can internal audit assess remedial actions that are undertaken by the insurer?
- What is the internal process for ensuring remediation steps are implemented that address control related findings?



- How can the board's audit committee improve in how it works with internal audit to address control related findings?
- What is the impact of any findings on the external audit?

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Target fallout from leadership/ talent vacuum

As insurers look to optimize costs structures while also modernizing insurance operations, there could be a loss of leadership and talent. Optimizing cost structures can lead to a reduction in workforce or executives taking advantage of early retirement programs. The board in its capacity of overseeing management, should probe the management team about potential impacts to the control environment. The departure of long-tenured employees can call into question whether policies, processes, and controls are well documented. The loss of an executive can leave a department rudderless.

In periods of change, the potential impact to the control environment requires evaluation by the insurer. For example, the accelerated utilization of data, analytics, and AI demands a new set of controls. And if employee tasks are replaced by automation as many predict with AI/GenAI, monitoring controls need to be added to ensure automated tasks perform as advertised. AI/GenAI may also require using a third-party like a fintech or specific skillsets like data scientists that demands new policies, processes, and controls. The same is true with climate and sustainability reporting requirements. It is new for the insurer and requires governance and accountability. For the board, responsible for ensuring the insurer is operating in a safe and sound manner, the leadership/ talent vacuum intersecting with digital transformation is challenging but also board confirming. It is a transforming time for the Insurer, and the board's views and being a sounding board for management is needed now more than ever.

As insurer's experience a fallout from leaders and employees departing, here are questions to ask of management:

- Are the policies, processes and controls well documented in areas where key positions are vacated by long-tenured employees such that a smooth transition of such responsibilities can occur?
- Where employee tasks are replaced by automation, what monitoring controls are in place to ensure that such tasks continue to occur as intended?
- How is the insurer preparing for the implementation of new controls required by the accelerated utilization of data, analytics, and AI?
- How is the insurer addressing the need for new policies, processes, and controls related to climate and other sustainability reporting requirements?

> In a rapidly changing insurance industry, boards must take an active leadership role, prioritize risk oversight, reinforce audit quality, and embrace proactive decision-making in 2024
>
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Sharpen insurer's focus on ethics, compliance, and culture

Insurance regulators are giving heightened attention to ethics, compliance, and culture. Regulators are looking to insurers to conduct risk and ethical business practices and view conduct risk as connected to risk culture and to the integrity and reliability of reporting, marketing/advertising, and customer interactions. Regulators also expect management to develop a culture of compliance and "individual accountability," including incentives for ethical behavior and culture commitment, disincentives for misconduct, and business practices that place the interests of customers first.

The board should pay attention to regulator moves. Issues related to tone at the top and governance while not having a direct impact on the financial statements may indicate weaknesses in entity level controls and reporting on internal controls over financial reporting that require evaluation by management and the audit committee. For public entities, the SEC's new clawback rule requires a recovery analysis be performed for either a big "R" or little "r" restatement to correct an error to previously issued financial statements to determine whether incentive-based compensation needs to be recovered from executive officers.

For management and the board, what is important is knowing that regulators may emphasize ethics, compliance, and culture. When that occurs, having policies in place and documentation can go a long way to satisfying regulators. or the board, the audit committee's oversight of culture extends to the external audit firm. The SEC and PCAOB recently emphasized the importance of an audit firm's culture, indicating that the auditor's gate keeper function is rooted in its integrity and culture and is the foundation of high-quality audits. A firm with a strong culture is key to exercising the proper professional skepticism. Boards' audit committees should inquire of the independent auditor to understand the training on ethics and integrity provided

to its professionals; also ascertain how the firm promotes a raise your hand culture and measures taken to hold professionals accountable for their conduct.

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The board's role is counseling management on ethics and culture, like leading the charge on ethics training and recommending a program for creating a speak-up culture that can help stop wrongdoing. These questions can help drive discussions and actions.

- How is the insurer currently addressing the heightened attention from regulators on ethics, compliance, and culture?
- What specific measures is management taking to ensure that the insurer conducts risk and ethical business practices?
- How is the insurer incentivizing ethical behavior and culture commitment, and what measures are in place to disincentivize misconduct?
- What policies and documentation does the insurer have in place to satisfy regulators' emphasis on ethics, compliance, and culture?

- How is the insurer addressing tone at the top and governance issues, and what measures are in place to evaluate entity level controls and reporting on internal controls over financial reporting?
- What steps is management taking to create a speak-up culture that can help stop wrongdoing, and how can the board support these efforts?

2024 KPMG U.S. CEO Outlook: 88% of CEOs say their organization's financial success, including profitability and growth, depends on their company having a strong ethical culture.[8]

[8] "KPMG 2023 U.S. CEO Outlook, Talent and Culture," page 8

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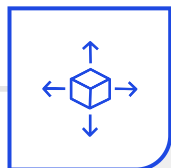

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