What do members of insurance Audit Committees need to know?

A comprehensive view from regulatory perspectives

Based on several discussions with Audit Committee members, we noted that the various regulatory perspectives from the Dutch Corporate Governance Code, EU regulations and Solvency II raised many questions. With this publication we provide a comprehensive view on the requirements for Audit Committees of Dutch insurers.

What is happening in the insurance market?

Financial crises and corporate scandals have increased worries and critics towards external supervision and regulatory bodies. In addition, these matters have raised the urgent need for reviewing and redesigning the governance system, including supervisory boards and audit committees.

For a while now, the duties and responsibilities of (Corporate) Governance bodies in insurance companies, particularly the Audit Committee, have been in the spotlight, not just in the Netherlands but also internationally.

The duties and responsibilities of Audit Committees in the Netherlands are determined by law and best practices, such as the Dutch Corporate Governance Code. New European regulations enacted by the Dutch government further strengthen the Audit Committee’s role. The enactment of the Solvency II Directive in 2016 has further strengthened the regulatory framework within which insurers need to operate.

To provide a comprehensive view on the requirements for Audit Committees of Dutch insurers, we have examined the various regulatory perspectives, such as the Dutch Corporate Governance Code, EU regulations and Solvency II.

These regulations stress to a different extent the matters to which insurance companies and their Audit Committees need to comply to. By identifying the requirements within the Dutch Corporate Governance Code, EU regulation and Solvency II, this publication offers insurers an ample approach to understand whether they are complying with current regulatory requirements with respect to their Audit Committees.
Dutch Corporate Governance Code: Impact on the Audit Committee

The requirements under the Code have been expanded in order to further strengthen the Audit Committees duties & responsibilities. The Dutch Corporate Governance Code has undergone a major update. The Code is effective as per January 2017, with changes that will have a significant impact on Audit Committee’s tasks.

What are the major changes to the role of the Audit Committee?

Risk management accountability
PRINCIPLE 1.4

1.4.1 Accountability to the Supervisory Board
The management board should discuss the effectiveness of the design and operation of the internal risk management and control systems referred to in best practice provisions 1.2.1 to 1.2.3 (Risk assessment, implementation, monitoring of effectiveness) inclusive with the Audit Committee, and render account of this to the Supervisory Board.

1.4.2 Accountability in the management report
If there is no separate department for the IAF (Internal Audit Function), the Supervisory Board will assess annually whether adequate alternative measures have been taken, partly on the basis of a recommendation issued by the Audit Committee, and will consider whether it is necessary to establish an Internal Audit department. The Supervisory Board should include the conclusions, along with any resulting recommendations and alternative measures, in the report of the Supervisory Board, such as:

i. the execution of the risk assessment, with a description of the principal risks facing the company in relation to its risk appetite. These risks may include strategic, operational, compliance and reporting risks;

ii. the design and operation of the internal risk management;

iii. any major failings in the internal risk management and control systems which have been observed in the financial year, any significant changes made to these systems and any major improvements planned, along with a confirmation that these issues have been discussed with the Audit Committee and the Supervisory Board; and

iv. the sensitivity of the results of the company to material changes in external factors.

Role of the Supervisory Board
PRINCIPLE 1.5

1.5.1 Duties and responsibilities of the Audit Committee
The Audit Committee undertakes preparatory work for the Supervisory Board’s decision-making regarding the supervision of the integrity and quality of the company’s financial reporting and the effectiveness of the company’s internal risk management and control systems. Among other things, it focuses on monitoring the management board with regard to:

i. relations and compliance with recommendations and following up on comments, the internal and external auditors;

ii. the funding of the company;

iii. the application of information and communication technology by the company, including risks relating to cybersecurity; and

iv. the company’s tax policy.

1.5.2 Audit Committee attendance: management board, Internal Audit and external auditor

Consultations
The chief financial officer, the Internal Audit and the external auditor should attend the Audit Committee meetings, unless the Audit Committee determines otherwise. The Audit Committee should decide whether and, if so, when the chairman of the management board should attend its meetings.

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1 The numbering has been adopted from the latest Dutch Corporate Governance code (2016). The principles refer exactly to those mentioned in the Code.
1.5.3 Audit Committee report
The Audit Committee should report to the Supervisory Board on its deliberations and findings. This report must, at least, include the following information:

i. the methods used to assess the effectiveness of the design and operation of the internal risk management and control systems referred to in best practice provisions 1.2.1 to 1.2.3 (Risk assessment, implementation, monitoring of effectiveness), inclusive;

ii. the methods used to assess the effectiveness of the internal and external audit processes;

iii. material considerations regarding financial reporting;

iv. the way material risks and uncertainties referred to in best practice provision 1.4.3 (statement by the management board) have been analysed and discussed, along with a description of the most important findings of the Audit Committee.

1.5.4 Supervisory Board
The Supervisory Board should discuss the items reported on by the Audit Committee as per of best practice provision 1.5.3 (Audit Committee report).

Explanatory notes to the code

1.5.1 Duties and responsibilities of the Audit Committee
The majority of the Audit Committee’s duties already arise out of the relevant legislation, and are not repeated in the Code. Specific reference is made to Article 39 of the EU Statutory Audits Directive (Directive 2006/43/EC). This article will be implemented in Dutch legislation: Article 2:2 of the Decree of 26 July 2008. The requirements for the composition and available expertise in relation to the preparation and auditing of this degree.

In some cases, especially for companies operating in the financial sector, a risk committee is established in addition to the Audit Committee. Article 39, paragraph 4 of the above-mentioned Directive stipulates that, if another body has been designated to perform the functions of the Audit Committee, the management report must state which body carries out those functions and how that body is composed.

Relevant topics to the Dutch Corporate Governance Code

a. Culture: Attention has been raised to Corporate culture. The question arises as to what opinion the Audit Committee will have on the current and desired culture of the insurer.

b. Long-term value creation: Within the latest Dutch Corporate Governance Code awareness towards long-term value creation has been raised. For the future the opinion of the Audit Committee on long-term value creation will play an increasing role.

Who can be on an Audit Committee?

Effective management and supervision on the Audit Committee

PRINCIPLE 2.3 | Organisation of the Supervisory Board and reports

2.3.2 Establishment of committees
If the Supervisory Board consists of more than four members, it should appoint from among its members an Audit Committee, a remuneration committee and a selection and appointment committee. Without prejudice to the collegiate responsibility of the Supervisory Board, the duty of these committees is to prepare the decision-making of the Supervisory Board. If the Supervisory Board decides not to establish an Audit Committee, a remuneration committee or a selection and appointment committee, the best practice provisions applicable to such committee(s) should apply to the entire Supervisory Board.

2.3.3 Committees’ terms of reference
The Supervisory Board should draw up terms of reference for the Audit Committee, the remuneration committee and the selection and appointment committee. The terms of reference should indicate the role and responsibility of the committee concerned, its composition and the manner in which it discharges its duties. The terms of reference should be posted on the company’s website.
2.3.4 Composition of the committee
The Audit Committee or the remuneration committee should not be chaired by the chairman of the Supervisory Board or by a former member of the management board of the company. More than half of the members of the committee should be independent within the meaning of best practice provision 2.1.8 (independence of Supervisory Board members).

2.3.5 Committee reports
The Supervisory Board should receive from each of the committees a report of their deliberations and findings. In the report of the Supervisory Board it should comment on how the duties of the committees were carried out in the financial year. In this report, the composition of the committees, the number of committee meetings and the main items discussed at the meetings should be mentioned.

2.1.4 Expertise
It is important that sufficient expertise is available within the management board and the Supervisory Board to identify opportunities and risks that may be associated with innovations in business models and technologies in a timely manner.

The requirement for financial expertise within the Supervisory Board is provided for in law. Pursuant to the EU Statutory Audits Directive (Directive 2006/43/EC), at least one member of the Audit Committee must have competence in the preparation and auditing of the financial statements.

1.3.3 A plan
The IAF should draw up an audit plan, involving the management board, the Audit Committee and the external auditor in this process. The audit plan should be submitted to the management board, and then to the Supervisory Board, for approval. In this plan, attention should be paid to the interaction with the external auditor.

1.3.4 Performance of work
The IAF should have sufficient resources to execute the Internal Audit plan and have access to information that is important for the performance of its work. The IAF should have direct access to the Audit Committee and the external auditor. Records should be kept of how the Audit Committee is informed by the IAF.

What is the Audit Committee’s relationship with the internal and external auditor?

Long-term value creation
PRINCIPLE 1.3 | IAF

3.1 Appointment and dismissal
The management board both appoints and dismisses the senior Internal Audit. Both the appointment and the dismissal of the senior Internal Audit should be submitted to the Supervisory Board for approval, along with the recommendation issued by the Audit Committee.

1.3.2 Assessment of the IAF
The management board should assess the way in which the IAF fulfils its responsibility annually, taking into account Audit Committee’s opinion.
Performance of the external auditor's work

PRINCIPLE 1.7

The Audit Committee and the external auditor should discuss the audit plan and the findings of the external auditor based on the work the external auditor has undertaken. The management board and the Supervisory Board should maintain regular contact with the external auditor.

1.7.2 Audit plan and external auditor's findings
The external auditor should discuss the draft audit plan with the management board before presenting it to the Audit Committee. The Audit Committee should annually discuss with the external auditor:

i. the scope and materiality of the audit plan and the principal risks of the annual reporting identified by the external auditor in the audit plan; and

ii. based also on the documents from which the audit plan was developed, the findings and outcomes of the audit work on the financial statements and the management letter.

1.7.3 Publication of financial reports
The Audit Committee should determine whether and, if so, how the external auditor should be involved in the content and publication of financial reports other than the financial statements.

1.7.4 Consultations with the external auditor outside the management board's presence
The Audit Committee should meet with the external auditor as often as it considers necessary, but at least once per year, outside the presence of the management board.

Misconduct and irregularities

PRINCIPLE 2.6

2.6.3 Notification by the external auditor
The external auditor should inform the chairman of the Audit Committee without delay if, during the performance of his duties, he discovers or suspects an instance of misconduct or irregularity. If the actual or suspected misconduct or irregularity pertains to the functioning of a management board member, the external auditor should report this directly to the chairman of the Supervisory Board.

From the explanatory notes to the code

1.3.6 Absence of an Internal Audit department
The basic principle is that insurance companies should establish their own Internal Audit department to undertake the IAF. In the event of a deviation from this principle, for example if the size of the company is not suited to this, outsourcing may be an appropriate alternative. In case of outsourcing, the Supervisory Board and the Audit Committee will remain involved in the execution of the IAF, as stipulated in best practice provisions 1.3.1 to 1.3.5 (appointment and dismissal, assessment of the IAF, Internal Audit plan, performance of work, reports of findings).
The EU Audit legislation, in the form of a Directive and a Regulation, introduces additional requirements specific to the role and responsibilities of audit committees; as well as changes to auditor oversight.

What are the major changes to the role of the Audit Committee?

Provisions affecting Audit Committees are contained in both the Directive and Regulation. The Directive states that 'Member States shall ensure that each public-interest entity (PIE) has an Audit Committee. The Audit Committee shall be either a stand-alone committee or a committee of the administrative body or supervisory body of the audited entity.' However, the functions assigned to the Audit Committee may be performed by the administrative or supervisory body as a whole.

In reality, most of the requirements for Audit Committees emphasized in legislation do not require a change of the Dutch system for public interest entities (PIEs), which means: listed companies, banks and insurance companies are in principle required to set up an audit committee, but can choose to designate a different body to perform the duties of the Audit Committee. So the only change of substance is the fact that these requirements are now being enshrined in law.

The following table outlines the requirements of all EU Audit Committees.

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Article 39.6 of the Directive states that the audit committee shall:

- inform the administrative or supervisory body of the audited entity of the outcome of the statutory audit and explain the role of the Audit Committee in that process;
- monitor the financial reporting process and submit recommendations or proposals to ensure its integrity;
- monitor the effectiveness of the undertaking’s internal quality control, risk management systems and internal audit (where applicable), regarding the financial reporting of the audited entity, without breaching its independence;
- monitor the performance of audits – taking into account the findings and conclusions of the audit reviews carried out by the competent authorities;
- review and monitor the independence of the statutory auditors; and
- be responsible for the procedure for the selection of the statutory auditor.

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3 The use of the word ‘auditors(s)’ in this document refers to auditor(s) and/or audit firms.
Who can be on an Audit Committee?

The Audit Committee should be composed of independent non-executive members of either the administrative body or the supervisory body.

Audit Committee members can be directly appointed at the annual general meeting. However, a majority of the members of the Audit Committee have to be independent of the audited entity.

At least one member of the Audit Committee has to have competence in accounting and/or auditing.

The committee members as a whole should have competence relevant to the sector in which the company has its business.

The Chair of the Audit Committee is appointed by its members or by the supervisory body of the audited entity.

Note – Member States can opt to require the Chairman be elected annually by the shareholders general meeting.

What is the Audit Committee’s relationship with the internal and external auditor?

Audit Committees are responsible for submitting a recommendation to the administrative or supervisory body of the audited entity for the appointment of the auditor. The recommendation should include at least two possible choices for the audit engagement and a justified preference for one of them.

Tender documents should contain transparent and non-discriminatory selection criteria to be used for the evaluation of proposals. The audited entity has to prepare a report on the conclusions of the selection procedure, which is validated by the Audit Committee, to demonstrate that the selection procedure was conducted in a fair manner.

The Audit Committee has to monitor the effectiveness of the undertaking’s internal quality control, risk management systems and internal audit (where applicable), regarding the financial reporting of the audited entity, without breaching its independence.

The initiation of Solvency II serves insurers as a regulatory framework with regards to the role of the supervisory body, emphasizing on the application of an efficient governance system.

In Member States the formation of an independent reporting body becomes inevitable. According to the Directive, the responsibilities and duties for the different bodies should be seen with regard to different national laws. The development of an Audit Committee is advised under Solvency II for large organizations or organizations with a high risk profile, which should establish an Audit Committee.

Solvency II Directive (2009/138/EC) states the following requirements for Audit Committees:

a. The internal audit plan needs to be communicated and approved by the Supervisory Body;

b. Organizations with high risk profile or of large size shall establish an Audit Committee;

c. Solvency II is likely to result in more detailed Board and committee minutes being required. Similarly, internal consents and the views expressed by the Supervisory Body may need to be recorded more formally.

d. overseeing the financial statements, financial reporting, and disclosure processes;

e. The Supervisory Body needs to demonstrate its independence from other organizational functions and its authority to acquire all necessary information.

f. Internal Audit should report its results and remediation plans to the Audit Committee, which shall be fully understood by the Supervisory Body.
Who can be on an Audit Committee?

Solvency II focuses on the fact that members of the Supervisory Board need to demonstrate the necessary expertise within the industry as well as have experience in communicating with the responsible functions: actuarial, compliance, internal audit and risk management functions.

- The audit committee should be composed of knowledgeable members with the right expertise.
- The supervisory authorities should have appropriate power to verify the governance structure.
- The chairperson of the Board or the insurer’s controlling company may not be appointed as a member of the Audit Committee.

What is the Audit Committee’s relationship with the internal and external auditor?

The advent of Solvency II requires insurers operating within the EU to have an effective internal audit function. Under the terms of Article 41 of the Solvency II Directive insurers’ governance system is subject to regular internal review. The internal audit function performs an evaluation of the adequacy and effectiveness of the internal control system and the governance framework, while being independent from other operational functions of the business.

For larger insurers the effects of Solvency II are minimal as they already have an internal audit function in place. For smaller corporations the introduction of Solvency probably has a more far reaching impact as it will add to the costs of regulatory compliance. Introducing an internal audit function in an cost effective manner and in a way which still offers the advantage of improved governance systems and operating processes is a challenge for small insurers.

In larger organizations the Internal Audit function reports to the Audit Committee (otherwise to the supervisory body) on audit findings, efficiency of controls, recommendations to remedy inadequacies and follow up of past issues.

The Audit Committee should ensure the internal and external auditor’s adequacy and independence. Reporting of results is required to the supervisory body. The Audit Committee shall be responsible for the oversight of supervisor statutory reporting requirements, as well as other financial reporting requirements, professional accounting requirements, internal and external audit, and the appointment of the insurer’s external auditor.

The external auditor’s engagement should be evaluated at least annually by the Audit Committee. In addition, reviewing the internal and external audit plans, ensuring that they cover all material risks and financial reporting requirements of the insurer, and regularly review the findings of audits, ensuring that issues are being managed and rectified in an appropriate and timely manner shall be undertaken by the Audit Committee.
We would welcome any questions you may have and are available to assist you in putting in place any dilemmas that concern you as member of an Audit Committee. Please find the contact information for our subject matter experts below.

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