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# Understanding the New Insurance Company Requirements to Adopt Corporate Governance and SOX Best Practices

## White Paper



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## Overview

The *Model Regulation Requiring Annual Audited Financial Reports* (Model Audit Rule or "MAR") has been in existence since 1980. The regulation requires insurers with \$1 million or more in written premiums or 1,000 or more policyholders or certificate holders to file audited, annual statutory financial statements with the state insurance departments.

Recently, the National Association of Insurance Commissioners (NAIC) and the American Institute of Certified Public Accountants (AI CPA) Working Group adopted changes to the MAR. The revised MAR, called the *Annual Financial Reporting Model Regulation*, incorporates best practice corporate governance standards and elements of the Sarbanes-Oxley Act of 2002 (SOX or "the Act"). The revised MAR will impact both non-public and public insurers:

- Non-public insurers will, for the first time, be required to comply with certain SOX-like provisions
- Public insurers that are SOX-compliant will be subject to additional SOX-related reporting requirements for their statutory financial statements

The revisions to the MAR will be effective December 31, 2010 pending adoption by the individual state governments.

## **MAR Revisions**

The MAR changes include many of the SOX-like requirements found in Sections 200, 300 and 400 of the Act. These areas cover audit committees, auditor independence and services, conduct of officers and directors in connection with audit reports, and internal control over financial reporting. The following is a summary of the significant MAR revisions:

### **Audit Committees**

- Requires insurers to have an audit committee
- Specifies that the entire board of directors will constitute the audit committee if the insurer does not have a designated audit committee
- Recommends that the audit committee periodically meet with the external auditor, with no management present, to discuss the strengths and weaknesses of the insurer's control environment
- Requires a percentage of the audit committee members to be independent, based on certain threshold written premium volumes
- Requires the audit committee to be responsible for the appointment, compensation and oversight of the external auditor
- Requires the external auditor to report directly to the audit committee

### **Auditor Independence and Services**

- Reduces the amount of time that a lead or coordinating audit partner may participate on the audit of an insurer from seven years to five years
- Prohibits an insurer's external auditor from providing the following non audit services: financial systems design and implementation, appraisal, broker or dealer, investment advisor, investment banking, actuarial (except for issuing an actuarial opinion on reserves if certain conditions are met), internal audit outsourcing, management/human resources and legal services
- Requires pre approval by the audit committee of all auditing and non-audit services performed by the external auditor, such as tax services
- Does not recognize an external auditor as being independent if a member of the board, the president, or other key financial officer personnel were employed by the external auditor and participated in the audit of the insurer within one year prior to the date of the most current statutory opinion
- Requires insurers to provide the state with a written communication, received from their external auditor, for any unremediated material weaknesses noted by the external auditor during the audit
- Requires insurers to make available information about significant deficiencies communicated by the external auditor for the state regulators during a financial condition exam
- Requires insurers to provide the state with a description of remedial actions taken, or proposed, to correct unremediated material weaknesses if these actions are not described in the external auditor's communication

## **Conduct of Officers and Directors in Connection with Audit Reports**

- Prohibits directors or officers from making materially false or misleading statements, or omitting material facts in statements made to external auditors in connection with an audit

## **Internal Control Over Financial Reporting**

- Requires insurers with direct written and assumed premiums equal to or exceeding \$500 million, or in "hazardous financial condition," to file a report with the insurance department on management's assessment of internal control over financial reporting for their audited statutory financial statements

## **Audit Committee and Management's Internal Control Reporting Requirements**

Two of the most important MAR changes are the audit committee requirements and management internal control reporting requirements.

### ***Audit Committees***

The revised MAR imposes new audit committee requirements on insurers. According to the revised Model Audit Rule, companies that are required to file audited statutory financial reports with the state and are not SOX compliant must designate a group of individuals constituting an audit committee "for the purpose of overseeing the accounting and financial reporting processes of an insurer". Audit committee members are also required to be members of the board of directors.

Additionally, insurers with greater than \$300 million of prior year direct written and assumed premiums will need to have a majority (50% or more) of independent audit committee members; and insurers with over \$500 million of prior year direct written and assumed premiums will need to have a supermajority (75% or more) of independent audit committee members. The effective date of the audit committee requirement is January 1, 2010 -- one year prior to the effective date for filing Management's Report of Internal Control over Financial Reporting (ICFR).

## **Management's Report of Internal Control over Financial Reporting**

MAR Section 16, Management's Report of Internal Control over Financial Reporting, was the most debated provision of the revised MAR since many believed that this new requirement would result in undue costs for mutual insurers, companies owned by their policyholders, and smaller carriers. MAR Section 16 requires management to perform an assessment of their internal controls over financial reporting for their audited Statutory Accounting Principle (SAP) financial statements and to report on the effectiveness of those controls with their domiciliary state insurance department. Similar to SOX Section 404, MAR Section 16 prohibits management from determining that internal controls over financial reporting are effective if one or more unremediated material weaknesses exist as of the balance sheet date.

The NAIC/AICPA Working Group gave consideration to the efforts that insurers may have already made to comply with SOX. As a result, the revised MAR allows insurers that comply with SOX Section 404 for their audited Generally Accepted Accounting Principle (GAAP) financial statements to satisfy the MAR internal control assessment requirement by filing their Section 404 report with the state, and attaching a separate addendum for any material statutory reporting processes not covered in the Section 404 report.

An important difference between the revised MAR and SOX Section 404 is that the revised MAR *does not require that an insurer's external auditor* provide an attestation report on the effectiveness of internal controls over financial reporting. This significantly reduces the efforts required by external auditors and the attending costs that would be incurred had the MAR revisions mandated this Section 404 attestation requirement. This approach is also consistent with the current trend toward reducing requirements for SOX Section 404 by the Public Company Accounting Oversight Board (PCAOB). The PCAOB recently eliminated the requirement for external auditor attestation on management's self assessment of internal controls over financial reporting, but did not eliminate the external auditor's attestation report on internal control over financial reporting.

On the following page is a comparison of the key MAR Section 16 requirements and the recently revised SOX Section 404 requirements.

Model Audit Rule v. SOX Section 404 Requirements

Area	NAIC Model Audit Rule	SOX, Section 404 *
Applicability	<ul style="list-style-type: none"> <li>• Insurers with \$500 million or more in direct and assumed premiums</li> <li>• Insurers with a Risk-Based Capital (RBC) "level event" 1 or in hazardous condition 2</li> </ul>	<ul style="list-style-type: none"> <li>• Most SEC Registrants</li> <li>• N/A</li> </ul>
Management's Assessment	<ul style="list-style-type: none"> <li>• Statement that internal controls are effective over financial reporting for SAP financial statements</li> <li>• Management is not permitted to conclude that controls are effective if one or more unremediated material weaknesses exist as of the balance sheet date. Any unremediated material weaknesses must be disclosed.</li> <li>• Companies that are required to (or voluntarily) comply with SOX Section 404 can use those reports to satisfy the assessment requirement 3</li> </ul>	<ul style="list-style-type: none"> <li>• Statement that internal controls are effective over financial reporting for GAAP financial statements</li> <li>• Same</li> <li>• N/A</li> </ul>
External Auditor Attestation	<ul style="list-style-type: none"> <li>• Not required, but management's most recent report on internal controls over financial reporting needs to be considered by the external auditor in planning and performing the audit of the SAP financial statements</li> <li>• Management's Report of Internal Controls Over Financial Reporting (ICFR) will be subject to the state insurance department's financial condition examinations</li> </ul>	<ul style="list-style-type: none"> <li>• Requires external auditors to opine on a whether a company's ICFR are effective</li> <li>• N/A</li> </ul>
Filing of Reports	<ul style="list-style-type: none"> <li>• Annual report to insurer's domiciliary insurance department</li> <li>• Disclosure of any unremediated material weaknesses in ICFR</li> <li>• Filing of external auditor's communication of unremediated material weaknesses identified during the audit to the state insurance department</li> </ul>	<ul style="list-style-type: none"> <li>• Annual report to the SEC</li> <li>• Same</li> <li>• N/A</li> </ul>
Effective Date	<ul style="list-style-type: none"> <li>• 2010</li> </ul>	<ul style="list-style-type: none"> <li>• 2004</li> </ul>

<sup>1</sup> Any of the regulatory action levels described in the Risk-Based Capital requirements or the trend test. For example, Total Adjusted Capital is equal to or less than 200% of required risk-based capital

<sup>2</sup> As defined in the Corrective Action statute

<sup>3</sup> Section 404 reports that do not cover all material control processes over SAP statements must include an addendum stating that the controls over these material SAP processes are effective

\* As per the changes by the PCAOB, in May 2007, resulting in the adoption of Auditing Standard 5 (AS5)

## ***Preparing for the MAR 2010 Changes***

All insurers subject to the MAR will need to prepare for the new requirements, in particular the onerous requirements of Section 16.

### **Non-SOX Compliers**

Insurers that do not currently comply with SOX should begin preparing for the new MAR Section 16 requirements by developing a MAR Section 16 compliance program. These companies need to develop their compliance program to specifically focus on the major SAP reporting processes. Management has discretion as to the nature of the internal control framework used, and the nature and extent of documentation required to support its assertions, including allowing reference to existing documentation.

Additionally, the NAIC's recent MAR implementation guidance states that insurers have flexibility to determine the frequency and scope of testing activities and suggests the following internal control areas for consideration when developing a MAR Section 16 compliance program:

- Internal control environment
- Risk assessment process and typical risk areas:
  - Investments (including capital expenses)
  - Policy and claim reserves
  - Benefit payments
  - Premiums/agent's balances
  - Reinsurance
  - Related party (affiliate) transactions
  - Operating expenses/taxes
  - Control activities
  - Monitoring and testing processes Information and communication processes

Non-SOX compliers should also consider the lessons learned that can be applied from the past three years of SOX compliance to capitalize on opportunities to enhance corporate governance and improve operating performance, while meeting MAR Section 16 compliance challenges. On the following page there are several examples.

Opportunities	Challenges
<ul style="list-style-type: none"> <li>• Cost savings, including coordination/integration of Internal Audit activities with SOX efforts</li> </ul>	<ul style="list-style-type: none"> <li>• Identifying and testing ONLY the KEY controls to support the SIGNIFICANT financial statement items and assertions</li> </ul> <p>Response: Effective scoping and planning process and utilization of a top down, risk based approach</p>
<ul style="list-style-type: none"> <li>• Additional operational efficiencies</li> </ul>	<ul style="list-style-type: none"> <li>• Coordinating activities that span the entire enterprise</li> </ul> <p>Response: Strong project management</p>
<ul style="list-style-type: none"> <li>• Improved corporate governance</li> </ul>	<ul style="list-style-type: none"> <li>• Getting employees to "buy in" and take responsibility for ensuring that the key controls are effective</li> </ul> <p>Response: Educating employees, effective working relationships and transferring knowledge</p>
<ul style="list-style-type: none"> <li>• Increased company - wide appreciation and awareness of strong internal controls</li> </ul>	<ul style="list-style-type: none"> <li>• Making sure the project is successful</li> </ul> <p>Response: Top senior management support and knowledgeable SOX program facilitators</p>
<ul style="list-style-type: none"> <li>• Reduced possibility of restatements</li> </ul>	
<ul style="list-style-type: none"> <li>• Further streamlining of SOX compliance program through automation</li> </ul>	
<ul style="list-style-type: none"> <li>• Ongoing improvements</li> </ul>	

## **SOX Compliers**

Insurers that currently comply with the Sarbanes-Oxley Act should prepare for MAR Section 16 requirements by performing a gap analysis to determine those materially significant statutory reporting processes that are not included in their SOX Section 404 GAAP assessment. This requires a comparison of their internal controls over financial reporting for GAAP reporting processes against SAP reporting processes. The material SAP reporting process controls that are not included in their GAAP SOX 404 assessment should be documented and evaluated for effectiveness to comply with Section 16. Some of the SAP items that typically are not included in the GAAP reporting processes and warrant consideration include, non-admitted assets, the Asset Valuation Reserve (AVR) and the Interest Maintenance Reserve (IMR).

### ***The Impact on the Regulator's Financial Condition Examinations***

Although the new MAR revisions will, in effect, level the playing field between publicly traded and non-publicly traded insurers, the purpose of the MAR, as stated in the regulation, is "to improve the state insurance departments' surveillance of the financial condition of insurers". To advance this objective, states will have access to insurers' financial reporting documentation and supporting communications. MAR regulations require that state insurance departments not only receive management's report on internal controls over financial reporting, including disclosure of any material weaknesses, but also that the states receive the external auditor's communication of material weaknesses provided to the insurer. Insurers are expected to maintain information about significant deficiencies communicated by their external auditor for review by state regulators conducting a financial condition examination. Going forward, the basis for Management's Report of Internal Control over Financial Reporting, and any supporting documentation, will be subject to the states' financial condition examinations.

### ***Final Thoughts***

As the states move toward adopting the revised Model Audit Rule, and as the impending 2010 deadline approaches, insurers should be preparing for the changes that lie ahead. For those insurers that have successfully met the SOX requirements, the changes should be minimal, assuming they have similar processes in place for accumulating, summarizing, and reporting information for SAP and GAAP financial statements. These insurers will need to determine the incremental changes to their current compliance programs, and carefully plan their MAR compliance activities, to best leverage the SOX documented processes and controls already in place.

For those insurers that have not previously met the SOX requirements, the changes will be more significant. If properly managed, however, the MAR compliance program can result in substantial improvements in corporate governance, internal controls and risk management, and have permeating benefits on operating performance, corporate culture, and financial returns.

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