



Insurance and the Model Audit Rule

by Stephen Gierach and
Richard Cascarino

Executive Compumetrics, Inc. (ECI)
Richard Cascarino & Associates

Company Backgrounds

Executive Compumetrics, Inc.

Executive Compumetrics, Inc. (ECI), based in Illinois, has been serving the industry for more than 20 years. During that time, ECI has provided consulting services to a wide variety of IT users, including financial institutions, a major securities exchange organization, life and health insurance companies, property/casualty insurance companies, power utilities, a "big six" public accounting firm, light and heavy manufacturing companies, food processing and distribution companies, and major telephone utilities.

Richard Cascarino & Associates

Richard Cascarino & Associates has, for the last 20 years, been providing Internal Audit, Fraud Audit, IS Audit Consultancy, Risk Management and Corporate Governance consultancy as well as Professional Development services to clients throughout the United States of America, the African region, Europe and the Middle East. These include some of the largest corporations, government departments, auditors general, professional bodies and financial institutions in their respective countries.

Company Backgrounds (cont.)

Executive Compumetrics, Inc.

The Firm has specializes in —

- Third Party Internal Audit and Compliance Management Services
- Sarbanes-Oxley Compliance Audit Readiness Services
- Model Audit Rule Compliance Audit Readiness Services
- SAS-70 Services
- Physical/Logical Security Assessments
- Application Control and ERP Reviews
- Risk Assessment
- IT and business process re-engineering
- Cost reduction analysis

Richard Cascarino & Associates

Richard Cascarino & Associates strives to serve its customers by providing high grade, international consulting services in the fields of:

- Corporate Governance
- Internal Audit
- Internal Audit Training
- IS Audit
- IS Audit Training
- Forensic Audit and Fraud Audit
- Forensic Audit Training
- Fraud Audit Training
- Risk Management
- Strategic use of IT
- Audit Committee effectiveness
- Enterprise Risk Management

Purpose of the New Model Audit Rule

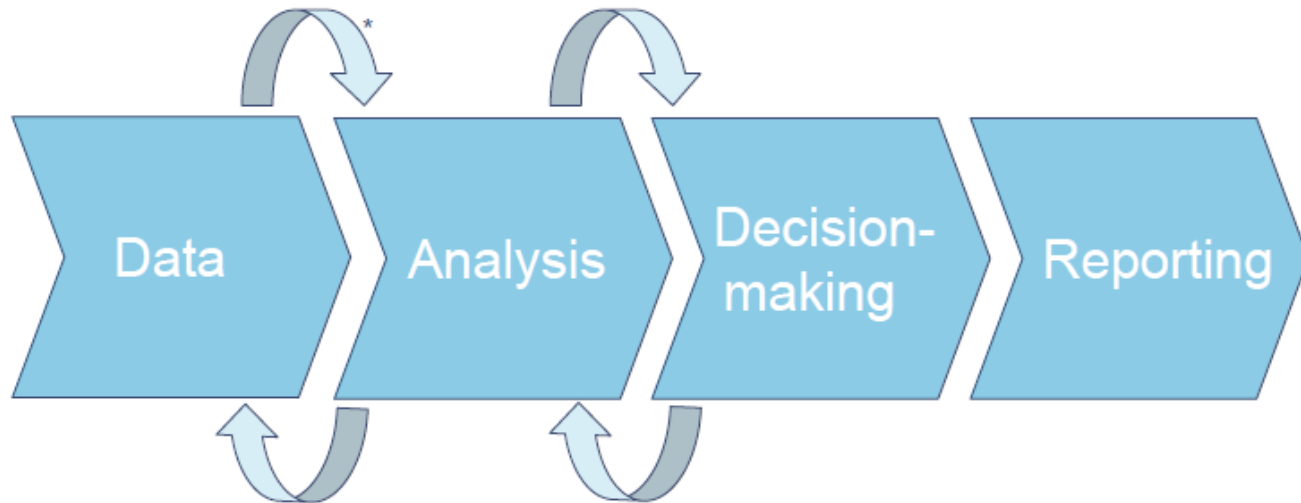
- To improve the ability of state insurance departments to oversee the financial condition of insurers.
- To achieve greater transparency, prevent fraud, and enhance public confidence in the insurance industry.

Model Audit Rule New Requirements

- **Audit Committee composition, independence, and duties**
- **Lead audit partner rotation**
- **Requirements regarding pre-approval of audit services & prohibited non-audit services**
- **Conduct of the insurer with regard to the audit**
- **Management's report on I/Cs over fin. Reporting**
- **Communication of I/C related to matters noted in the audit**

Process, Risks and Controls in Loss Reserving


Raising the Bar on Reserving Controls



Possible Risk Areas			
Completeness / Accuracy Manual Adjustments External benchmarks Segmentation Level of Detail	Methods/ Assumptions	Actuarial value/range versus Management best-estimate	Documentation Communication

Insurance Entities

- Property & Casualty Insurance Companies
- Life & Health Insurance Companies
- HMO's
- Town Mutual Insurance Companies
- Fraternal Benefit Societies
- Limited Health Service Organizations
- Title Companies
- Warranty Plans



Executive Compumetrics, Inc. (ECI)
Richard Cascarino & Associates

Types of Financial Reporting Systems

■ Generally Accepted Accounting Principles (GAAP)

- All the rules and standards required for accounting for the AICPA, SEC, NYSE
- Required for commercial entities

■ Statutory Accounting Principles (SAP)

- Accounting and reporting rules and standards developed by the NAIC in conjunction with state regulatory authorities
- System required for insurance companies for financial statements filed with the various state insurance departments. (Annual Statement of each company due Mar 1)

■ IFRS and ICFR

Executive Compumetrics, Inc. (ECI)
Richard Cascarino & Associates

Regulation of Insurance

- **Financial analysis division**
 - Crunch numbers from your annual and quarterly statement filings (SAP)
 - Send letters asking questions
 - All licensed insurers are fair game
- **Examination division**
 - Conduct of financial and market examinations
- **Market conduct division**
 - Rates, forms and rules

Regulation of Insurance

- **National Association of Insurance Commissioners (NAIC) – www.naic.org**
 - Organized in 1871 to address the need to coordinate the regulation of interstate insurers
 - Developed uniform model for financial reporting
 - Model laws, regulations and guidelines
 - Statutory Accounting Practices (SAP)
 - Annual Statement Blank (Yellowbook)
 - Risk-based Capital
 - IRIS Ratios

Executive Compumetrics, Inc. (ECI)
Richard Cascarino & Associates

Regulation of Insurance

- Model laws (audit, investment, reinsurance, etc.)
 - ❑ Developed by the NAIC, discussed by working groups at the NAIC's quarterly meetings and sent to the states for adoption
 - ❑ Ideally this results in somewhat uniform regulation across state lines
 - ❑ State legislatures tend to tinker with the laws to suit their constituents
 - ❑ Wisconsin—currently reviewing NAIC Model Audit Rule (SOX changes) for future state legislation

Regulation of Insurance

■ NAIC financial reporting requirements

- **Annual statement (paper and electronic)**
- Insurance expense exhibit
- Investment risk interrogatories
- Management discussion and analysis
- Medicare supplement
- Supplement A to Schedule T
- SVO compliance certification
- **Audited financial statements**
- Accountants' letter of qualifications
- **Actuarial certification**
- Notice of adverse financial condition
- Premium tax return
- Holding company registration statement
- Prior notification of material transaction

Executive Compumetrics, Inc. (ECI)
Richard Cascarino & Associates

Regulation of Insurance

■ Statutory Accounting Practices (SAP)

- Accounting prescribed or permitted by an insurer's domiciliary state
- Prescribed practices hierarchy
 - Statement of Statutory Accounting Principles (SSAP)
 - Emerging Accounting Issues Working Group
 - Annual Statement Instructions
 - Purposes and Procedures Manual of the SVO
 - SAP Statement of Concepts
- Permitted – special allowances by each specific state

Regulation of Insurance

■ Objectives of SAP

- Measurement of the company's ability to pay claims in the future (Statutory Surplus)
 - Assets not available to pay claims are "non-admitted" in terms of computing "statutory surplus"
 - Furniture and fixtures, certain receivables
 - Very Conservative

■ Objectives of GAAP

- Measurement of earnings from period to period (Net income/EPS)
 - Matching costs with recognized revenues
 - Some conservatism

Regulation of Insurance

- **A.M. Best Company – www.ambest.com**
 - ❑ Most well known rating agency for the insurance industry
 - ❑ Best's Rating – their opinion of the company's balance sheet strength, operating performance and business profile
- **Other rating agencies**
 - ❑ Weiss Research
 - ❑ Standard & Poor's
 - ❑ Duff & Phelps
 - ❑ Moody's

Executive Compumetrics, Inc. (ECI)
Richard Cascarino & Associates

AM Best Ratings

Secure	A++, A+	Superior
	A, A-	Excellent
Vulnerable	B++, B+	Very good
	B, B-	Fair
	C++, C+	Marginal
	D	Weak
	E	Poor
	F	Under regulatory supervision
Not rated	NR-1	Insufficient data
	NR-2	Insufficient size
	NR-3	Rating criteria inapplicable
	NR-4	Company request
	NR-5	Not formally followed

Regulation of Insurance

■ Annual Independent audits

□ NAIC Model Audit Rule

- Auditor awareness of domiciliary state insurance laws and regulations
- Auditor must be qualified to audit insurance companies
- Auditor must provide notice of all material weaknesses
- Statutory accounting practices for regulatory purposes
- Similar accounts and groupings as the annual statement
- Reconciliation to annual statement, if any
- Due date generally June 1.

Model Audit Rule: New for 2010

- *Implementation Guide for the Annual Financial Reporting Model Regulation*
 - New requirements for 2010 related to financial reporting:
 - Auditor (external) independence
 - Corporate governance
 - Internal controls

Auditor Independence

- **Independent Certified Public Accountant**
 - **Lead Audit Partner Rotation Requirements**
 - The lead audit partner (having primary responsibility for the audit) may not act in that capacity for more than five (5) consecutive years; and
 - The person shall be disqualified from acting in that or a similar capacity for the same company or its insurance subsidiaries or affiliates for a period of five (5) consecutive years.

Audit Committee Independence

□ Requirements for Audit Committees:

■ *Independence*

- A policyholder
- A person who serves on the Board of Directors of a contracting entity
- An otherwise non-independent member of the Board of Directors is considered independent if state law requires participation on the Board as long as the member is not an officer or employee of the insurer or one of its affiliates.

Internal Control

- Management's ***Report of Internal Controls over Financial Reporting***
 - Management must ***annually provide their*** domiciliary insurance department with a ***report on internal controls over the statutory*** financial statement process.

Internal Control

- Management must make an assertion regarding the effectiveness of the insurer's internal controls over financial reporting to the best of its knowledge and belief after ***diligent inquiry***.
 - ***Diligent inquiry*** – ***Conducting a search and thorough review of*** relevant documents which are reasonably likely to contain significant information with regards to Internal control over financial reporting and making reasonable inquiries of current employees and agents whose duties include responsibility for Internal control over financial reporting.

Internal Control

- The report must disclose any ***unremediated material weaknesses*** with internal controls over financial reporting that exist as of the balance sheet date.
 - Not permitted to conclude that its Internal control over financial reporting is effective; and
 - Must include a description of the nature of any unremediated material weakness in the report.

Internal Control



■ **Significant Deficiency:**

- A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

■ **Material Weakness:**

- A material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

Required

- ***Risk Assessments of the following:***
 - Investments (including capital expenditures)
 - Policy and claim reserves
 - Benefit payments
 - Premiums / agent's balances
 - Reinsurance
 - Related party (affiliate) transactions
 - Operating expenses/taxes

Control Activities may include:

- Daily or monthly controls
- System and manual controls
- SAS 70 reporting controls

Example: Steps to Evaluating Controls Around the Reserving Process

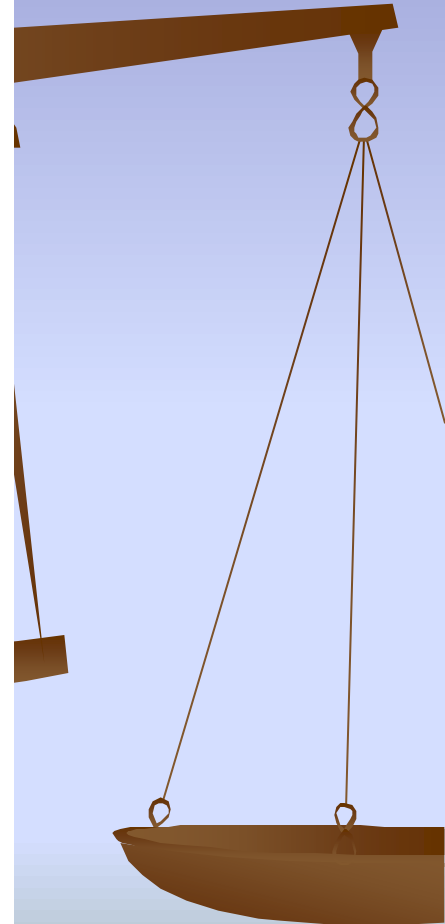
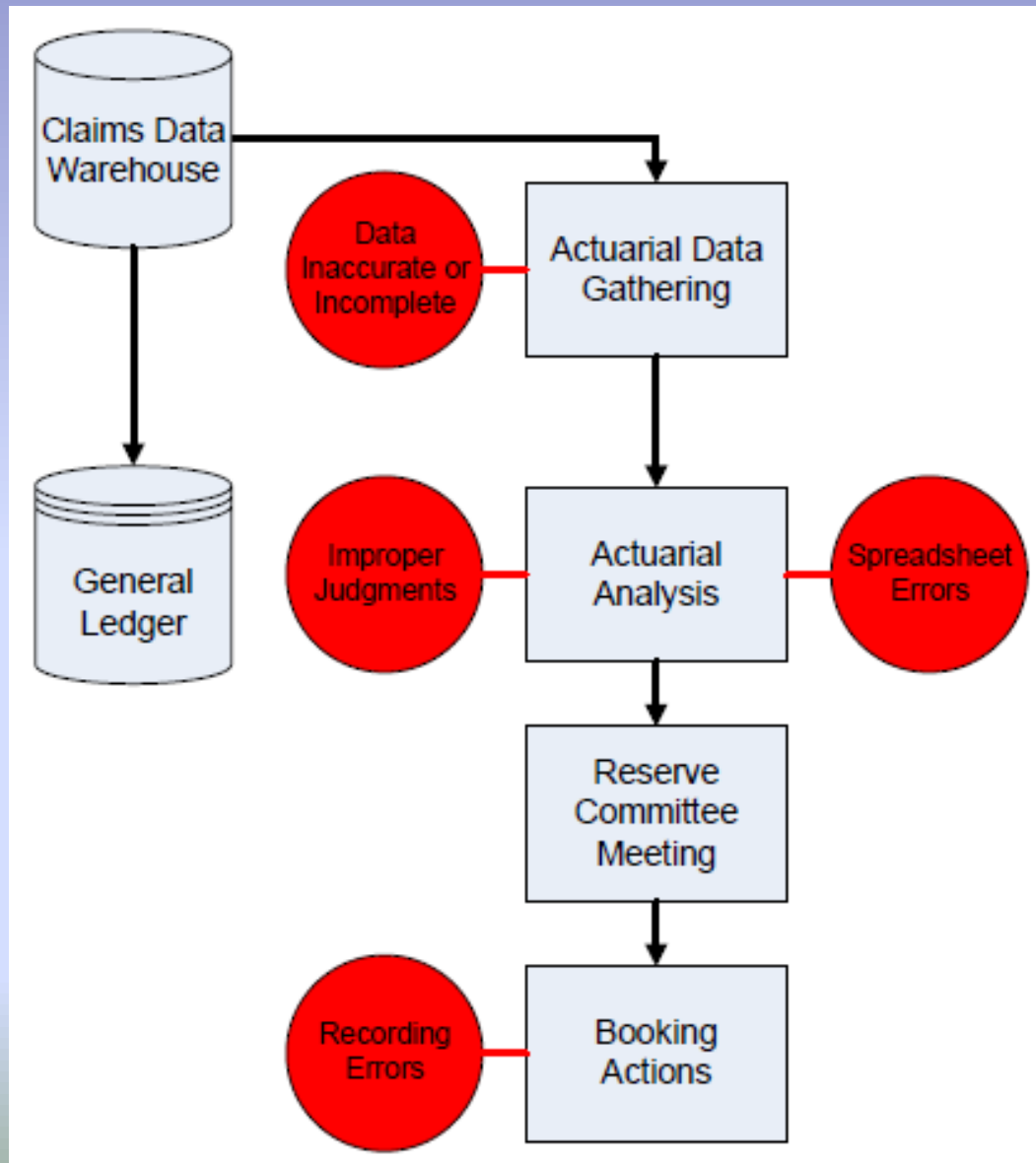
Key steps:

1. Document the reserving process
2. Identify risks that could result in a misstatement
3. Identify or create controls that mitigate the risk of misstatement
4. Test *key controls* for operating effectiveness

Identifying Risks of Misstatement

- Evaluate flowchart to identify risks that could lead to a misstatement of loss reserves
- Common risks include:
 - Data may be inaccurate or incomplete
 - Mathematical errors in actuarial analysis (including spreadsheet errors)
 - Improper judgments in analysis
 - Errors when amounts are recorded
- Handoffs between groups, reliance on manual processes and system limitations tend to increase risk of misstatement

Identifying Risks of Misstatement



Identify, Assess, and Mitigate the Controls

Where existing controls are inadequate to mitigate the risk of misstatement –

- Improve the design & operating effectiveness of existing controls or create and implement new controls
- Assign ownership to appropriate personnel / company officers
- Examples of how controls might be improved:
 - -Reserving data reconciliations
 - -Spreadsheet controls
 - -Actuarial peer review process
 - -Reconcile approved booking actions

SOX vs MAR

SOX

- Applies to all public companies
- Fiscal year
- External Audit attestation reqd.
- COSO framework prescribed
- Section 404 report

MAR

- Applies to all Insurance Cos. Domiciled in US with direct and assured premiums > \$500m
- Reporting period 12/31/2010
- COSO Framework not prescribed
- Can file SOX 404 but must include addendum with a positive statement that there were no material processes related to the preparation of the audited financial statements if not included in the 404 report or must file MAR ICFR Report if Internal Control deficiencies

CROSS CORRELATION OF SOX vs. MAR REGULATORY REQUIREMENTS

Category of Regulations	SOX	MAR
Prohibited Non-Audit Services while concurrently performing an audit required by the SEC	§201	Section 7(G)(1)
Prohibition of all partners who perform continuous audit services for more than 5 years at a specific company.	§203	Section 7(D)(1)
Pre-Approval of any audit or permitted non-audit service by the Audit Committee, when performed by an auditing firm.	§202	Section 7(J)
Prohibition on the employment of senior management who were members of the Independent firm's audit engagement within the previous year.	§206	Section 7(L)(1)
Requirement that a Management Report on Internal Control over Financial Reporting must be submitted to the <i>State Insurance Commissioner</i> , documenting the management assessment of the insurer's compliance, with Section 16 of the MAR (like §404). All unremediated material weaknesses must be disclosed.	§404	Section 16

Laying Plans for MAR Compliance

Phase 1: Learn, Educate, and Communicate

Phase 2: Commit, Scope, and Plan

- Establish a steering committee — They will be the decision makers who guide the project.
- Develop protocols — These should address involvement of internal and external auditors and provide a process for resolving issues as they arise.
- Communicate — Create a formal communication and training program for key management and employees.
- Develop a high level project plan — Determine a timeline and identify the project team roles and responsibilities. Determine whether there are enough resources to manage the project, with a consideration to the administrative effort required.

Phase 3: Document, Assess, and Remediate

Phase 4: Sustain, Monitor, and Assert

Possible MAR Implementation Issues

- 
- Key areas of concern in business controls address areas including –
 - Investments
 - Policy and claim reserves
 - Benefit payments
 - Premiums
 - Reinsurance
 - Related party transactions
 - Operating expenses
 - Income taxes
 - Contingent liability reserves (litigation, malpractice, and provider disputes)

Possible MAR Implementation Issues

■ Key areas of concern in IT controls address areas such as –

- Corporate IT policies and standards
- Change management
- User access control, including “segregation of duties” and “super user access”
- Incident management and escalation
- Physical and logical security, including data transmission between systems
- Data backup and restoration
- System and application controls

Possible MAR Implementation Issues (cont.)

■ Key areas of concern in IT controls address areas such as –

- Vendor Evaluation, Selection, and Service Level Metrics
- Network Management Practices
- Internet Access and E-Mail Usage
- Internal System Performance Metrics Definition, Monitoring, and Reporting
- Application System Internal Security Controls and Cross-Checks
- Spreadsheet documentation, testing, and controls

Possible MAR Implementation Issues (cont.)

- Some controls put in place may not be realistically achievable
- There is a tendency to define too many controls, which makes it difficult to maintain, enforce, test and remediate.
- Heavy focus on some specific areas can result in oversight of other critical areas.
- The inspectors took exception with external CPA firm auditing of some fine points related to goodwill impairment, revenue recognition, a business combination, and amortization of intangible assets.

Possible MAR Implementation Issues (cont.)

- Inspectors also flagged audit situations where the CPA firm determined a higher level of risk related to some aging accounts receivable, but failed to track down the receivables or check their valuation.
- If your company holds responsibility to gather and provide supporting audit data to the audit team, it is important obtain a sufficient quantity of competent evidential matter to support the audit report.
- The audit team should have tested data provided to actuaries for use in reporting on benefit plans.
- They should also have scrutinized management's assumptions in calculating a general reserve in the allowance for doubtful accounts.

We are Here to Help!

- 1. Conduct a situation assessment of progress and gaps identified & weighted. Identify areas of project high risk.**
- 2. Review/assess and modify/enhance/refocus the current MAR program/process and project plan, directing committee, team organization, and resource requirements to meet the deadline.**
- 3. Develop a response/action plan, as needed, to prioritize, and coordinate each functional phase with suitable resources, milestones, and deliverables.**

We are Here to Help!

4. Provide remediation Quality Assurance & Oversight support to ensure all control gaps are adequately fixed.
5. Provide independent testing of modifications/changes made in terms of –
 - A. Effectiveness of Design
 - B. Effectiveness of Operation
6. Provide Project Management and technical assistance for UCF/ERM system design, development, & implementation.

Thank You for Listening!

We can help your organization to maintain its competitive advantage by assuring its effective compliance with the **Model Audit Rule** and moving it to a continuous monitoring and Unified Compliance Framework paradigm.

Please feel free to contact us at:

Executive Compumetrics, Inc.

P. O. Box 95

Tinley Park, IL 60477

(708) 633-1190

www.ExeCompInc.com

[Email: steve@ExeCompInc.com](mailto:steve@ExeCompInc.com)


Executive Compumetrics, Inc. (ECI)
Richard Cascarino & Associates

Forthcoming Webinars!

June 28 - VFM Auditing of IT

June 30 – Auditing Enterprise Resilience

See www.rcascarino.com/webinars



Executive Compumetrics, Inc. (ECI)
Richard Cascarino & Associates