



SOCIETY OF ACTUARIES

**Valuation Actuary Symposium  
September 24-25, 2009**

**Session 19 PD: NAIC Model Audit–  
Documentation and Best Practices**

Thomas W. Fineis, FSA, MAAA  
Alan R. Furan, FSA, MAAA

**Deloitte**

Ohio.gov | Department  
of Insurance

**Actuaries**

Risk is Opportunity.®

# NAIC MODEL AUDIT RULE

Thomas W. Fineis, FSA, MAAA  
Director  
Deloitte Consulting, LLP  
Alan R. Furan, FSA, MAAA  
Chief Life and Health Actuary  
Ohio Department of Insurance  
September 24, 2009  
Valuation Actuary Symposium  
19 PD



SOCIETY OF ACTUARIES

## **Agenda**

**Actuaries**

Risk is Opportunity.®

- Speaker and Topic Introduction
- Summary of MAR Provisions
- MAR Readiness Action Plan
  - Approaches to Implement
  - Implementation Issues
  - Lessons from Sarbanes-Oxley
- Regulatory Perspective
- Questions & Answers



SOCIETY OF ACTUARIES

## An Evolution of Change

- 1989 – Solvency Policing Agenda
- 2001 – Wave of Corporate Scandals
- 2001 – Statutory Accounting Codification
- 2002 – Introduction of Sarbanes-Oxley
- 2003 – NAIC/AICPA prohibits use of “indemnification” agreements in CPA audit agreements
- 2005 – RBC C3 Phase 2
- 2006 – Adopted Revisions to the Model Audit Rule
- 2009 – VACARVM



## Summary of MAR Provisions



## New Elements & Benefits

- Auditor Independence
- Corporate Governance
- Management Reporting Requirements

### Benefits

- Intended to strengthen auditor objectivity, focus and independence
- Intended to enhance audit committee objectivity, focus and independence
- Internal control environment is now a reportable management responsibility, not just an accounting function



## Summary of MAR Provisions

NAIC / AICPA Working Group (WG) formed Title II, III and IV subgroups consisting of the NAIC representatives and selected (by IP) insurance companies.

### Auditor (Title II Subgroup – Auditor Independence)

- Effective 1/1/2010
- Non-Audit services
- Audit Partner rotation
- Hiring former auditors

### Audit Committees (Title III Subgroup – Corporate Governance)

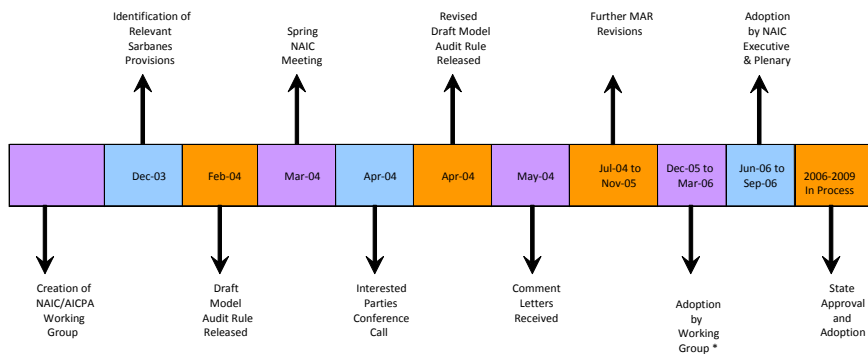
- Effective 1/1/2010
- Audit Committee composition
- Pre-approval of services by auditor

### Management (Title IV Subgroup – Management Reporting Requirements)

- Effective 12/31/2010
- Internal Control certification requirements
- Rapid and current disclosures



## Adoption Timeline



## Auditor - Non-Audit Services

- Permitted if pre-approved by audit committee and not one of the prohibited services
- 3 Principles of independence:
  - Cannot function in the role of management
  - Cannot audit own work
  - Cannot serve in an advocacy role for the insurer
- Prohibited services\*:
 

<ul style="list-style-type: none"> <li>– Bookkeeping or related services</li> <li>– Financial information systems design and implementation</li> <li>– Appraisal or valuation services</li> <li>– Actuarially-oriented advisory services involving determination of amounts recorded in the financial statements</li> </ul>	<ul style="list-style-type: none"> <li>– Internal audit outsourcing</li> <li>– Management functions or HR</li> <li>– Broker dealer, or investment banking</li> <li>– Legal services and expert services</li> <li>– Other – specified by commissioner</li> </ul>
---	---

\* Exemption can be requested if small insurer



## Audit Partner Rotation

- Currently rotation required after 7 years with a 2 year cooling off period.
- As of 1/1/2010 rotation required after 5 years with a 5 year cooling off period.
- Application for relief on the basis of unusual circumstances:
  - Small accounting firms
  - Premium volume of insurer
  - Number of jurisdictions in which the insurer transacts business



## Hiring Former Auditors

- A 12 month cooling-off period is required (i.e., can not have worked on the audit within a one-year period preceding the date the most current statutory opinion is due)
- Applies to partners and senior managers who participated in any capacity in the audit of the insurer during the preceding year.
- Restricted positions include:
  - President
  - CEO
  - CFO
  - Controller
  - Chief Accounting Officer
  - Any equivalent position



## Governance - Audit Committees

- Established by the board of directors to oversee the accounting and financial reporting processes and audits of financial statements.
- Holding company audit committee may act for subsidiary, if so designated and commissioner is notified.
- If no audit committee designated, entire board shall constitute the audit committee.
- Directly responsible for appointment, compensation, and oversight of the accountant for purpose of preparing or issuing audit report or related work.



## Composition of Audit Committees

- Each member must be part of the Board.
- Depending on premium volume, some members must be independent of the insurer
- Independence defined:
  - May not accept any consulting, advisory or compensatory fee from the insurer (other than as a board or sub-committee member)
  - May not be an affiliated person of the insurer or subsidiary.
  - Exception where domiciliary law requires participation by otherwise non-independent member.



## Composition of Audit Committees

The proportion of independent audit committee members for ***non-SOX Compliant*** entities subject to this regulation shall meet or exceed the following criteria. (Companies that are ***SOX Compliant*** are deemed to be in compliance with the Subsection if they are in compliance with the related SEC requirements):

Prior Calendar Year Direct & Assumed Premiums (from non-affiliates)			
Filing Status	\$0-\$300 million	\$300-\$500 million	Over \$500 million
All reporting entities not included above	No minimum requirements. <i>Also See Notes A &amp; B.</i>	Majority (50% or more ) of members shall be independent. <i>Also See Notes A &amp; B.</i>	Supermajority of members (75% or more) shall be independent. <i>Also See Notes A &amp; B.</i>

**Note A:** *The commissioner has discretionary authority to require the entity's board to enact improvements to the independence of the audit committee membership if the insurer is in a RBC action level event, meets any one or more of the standards of an insurer deemed to be in hazardous financial condition, or otherwise exhibits qualities of a troubled insurer.*

**Note B:** *All entities with less than \$500 million in prior year direct and assumed premiums are encouraged to structure their audit committees with at least a supermajority of truly independent audit committee members.*



## Pre-approval of Services by Auditor

- All audit and non-audit services shall be preapproved by the audit committee.
- Audit committee can delegate authority to one or more members of the committee.
  - Decisions of delegate are to be presented to full audit committee at each scheduled meeting.
- Pre-approval exception for non-audit services:
  - Aggregate amount less than 5% of total fees paid to auditor, and
  - Services not recognized by insurer to be non-audit services, and
  - Promptly brought to the audit committee (or delegate) & approved.



## Management - Internal Control Reports

- Required for each insurer with direct written and assumed premiums in excess of \$500 million  
OR
- As required by commissioner when:
  - Insurer has an RBC action level event, or
  - Deemed to be in hazardous financial condition.
- May file report for Group of Insurers if common systems and controls:
  - Disclose specific insurers covered by report.
  - Disclose which systems and controls are applicable to insurer.
- SEC registrants or subsidiary of SEC registrant:
  - Must file Section 404 report with additional report on material Statutory Accounting process.



## Management's Report on IC

- Management's report should include:
  - Statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting
  - Statement that management has established internal control over financial reporting (ICFR) and an assertion that to the best of management's knowledge and belief, after diligent inquiry, its ICFR is effective to provide reasonable assurance regarding the reliability of financial statements in accordance with SAP.
  - Statement that briefly describes the approach or processes by which management evaluated the effectiveness of its ICFR.
  - Disclosures of any material change in the insurer's internal control over financial reporting as of December 31.
  - Management shall document and make available upon exam.
  - Signature of CEO and CFO (or equivalent).
- Cannot conclude ICs are effective if one or more un-remediated material weaknesses exist



## Accountant's Report on IC

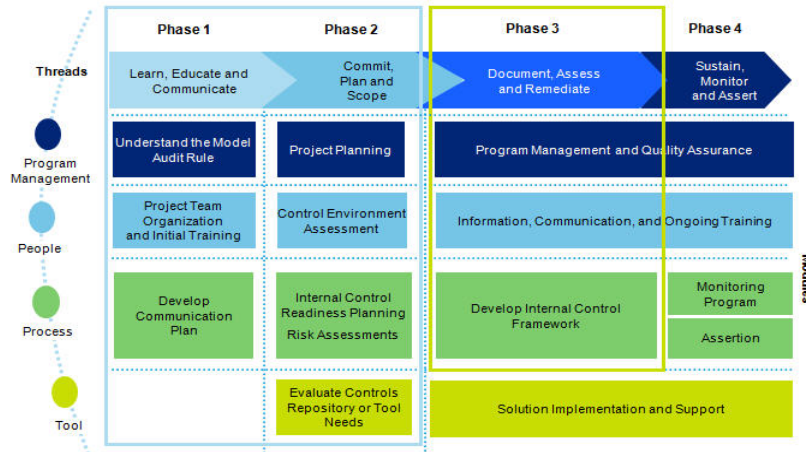
- No separate auditor attestation report is required.
- Auditor's responsibility under SAS 60 (*Communication of Internal Control Related Matters Noted in an Audit*, or its replacement) will still exist.
- The reporting requirement threshold to the Insurance Department is "un-remediated material weaknesses" existing at year end.
- If no un-remediated material weaknesses were noted, report should so state.
- Discussions regarding confidentiality issues of reports from auditor/management are ongoing.



## MAR Readiness Action Plan



# MAR Readiness Action Plan



# Company Perspectives: Potential Implementation Approaches

The following represent some potential approaches that companies may consider.

- **Compliant Now**
  - Full implementation of the Model Audit Rule, including internal control certification requirements (documentation and testing).
- **Staged Implementation**
  - Focus efforts on planning & scoping to help obtain management buy-in and then implement the requirements in stages focusing on the high-risk processes first.
- **Wait and See**
  - Do nothing in the short-term and address compliance during 2010 reporting period for ICFR report (due in early 2011).



## Company Perspectives: Potential Approaches

Actuaries

Risk is Opportunity.®

### #1 – COMPLIANT NOW

#### PROS

- Demonstrates commitment of internal controls to stakeholders and regulators
- Helps jump-start efforts and address any issues early

#### CONS

- Requires significant resources upfront
- More external resources may be required
- Higher up-front cost
- May not allow taking advantage of additional NAIC guidance and peer company experiences as effectively

### #2 – STAGED IMPLEMENT

#### PROS

- Allows putting the right resources, tools and training in place over time and build internal competencies you don't have today
- Allows focus on high risk areas first where more time and resources are required

- Less strenuous on internal resources and helps manage costs better

#### CONS

- Could be distracted by other priorities which could ultimately lead to high costs

### #3 – WAIT & SEE

#### PROS

- No cost – business as usual
- Allow the NAIC to come out with an implementation guide (incorporated in March 2007 Accounting and Procedures Manual)

#### CONS

- High cost when you decide to implement in 2010 reporting period
- Behind peer companies which could demonstrate a lack of commitment to internal controls to stakeholders and regulators



SOCIETY OF ACTUARIES

21

## Company Perspectives: Potential Implementation Approaches

Actuaries

Risk is Opportunity.®

- Consider a top-down / risk-focused process, not a ground-up identification of all controls in existence. Consider documentation and testing of all material controls.
- Leverage existing Sarbanes-Oxley documentation and controls, where possible
  - Business Process Documentation can be expanded to include Statutory requirements
  - Adapt controls adapted to include Statutory items
    - Need to perform controls / reconciliations at the legal entity level
    - Additional controls for Statutory only items
  - May need to consider some of the tax elements such as the Net Deferred Tax Assets and Liabilities



SOCIETY OF ACTUARIES

22

## Company Perspectives: Implementation Issues

- STAT vs. GAAP considerations
- Entire Annual Statement vs. Financial Statements
- Materiality issues (holding company vs. legal entity)
- Lack of defined Internal Controls framework
  - Inconsistency in management’s assertions
- Diligent Inquiry vs. testing
- Resources needed – budget, internal availability, software repository
- Reporting Lines / Responsibilities
- Use of consultants or internal implementation
- Training and qualification of internal resources
- For companies without an AC or independent Board, they need to start looking for qualified, eligible board members now



## Other Implementation Issues

- How will it affect financial examination process?
- Inconsistency in state adoption
- Confidentiality issues
- Dilution of the CEO, CFO responsibility for Internal Controls over Financial Reporting as the changes place onus on management rather than CEO/CFO specifically.



## Key Lessons from Sarbanes-Oxley

- Implementation of the NAIC's changes to the Model Audit Rule will impact each company differently.
- The NAIC's changes to the Model Audit Rule, similar to SOX, is less rule-based than most other standards and require significant judgment. There is a lack of detailed guidance in many areas.
- Judgment is required, for example, in:
  - Scoping and planning of the project, such as with determining materiality
  - Determining what framework to use
  - Testing
  - Developing remediation plans
  - Determination of whether or not a testing exception or design flaw is a deficiency, significant deficiency, or material weakness
- Management will need to identify competent individuals who will assist with and be responsible for decision making.



## Regulatory Perspective



## Regulatory Review Process of Management's Report

- What DOI staff will perform the review? Chief Analyst? Chief Examiner? Other?
- What are regulators looking for in the report?
- How will the review of a group of insurers' management report differ from the review of a single entity?
- How could regulators handle reported material weaknesses?
- Could regulators decide to perform on-site reviews if there is not an exam going on?
- What if company documentation isn't sufficient? Surveillance Letter? Exam Report?
- What could be the consequences if company controls are not adequate?



## Links

- NAIC/AICPA Working Group
- [http://www.naic.org/committees\\_e\\_naic\\_aicpa\\_wg.htm#](http://www.naic.org/committees_e_naic_aicpa_wg.htm#)
- Section 11 Guidance
- [http://www.naic.org/committees\\_e\\_model\\_audit\\_rule.htm](http://www.naic.org/committees_e_model_audit_rule.htm)
- Compliance Guide
- [http://www.naic.org/documents/committees\\_e\\_naic\\_aicpa\\_implementation\\_guide\\_exposed-Final\\_0314.pdf](http://www.naic.org/documents/committees_e_naic_aicpa_implementation_guide_exposed-Final_0314.pdf)



