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Sarbanes Oxley – The BANE of Small Insurers?

by Norm Hill

Background

In 2002, the Sarbanes Oxley legislation (SOX) was passed by Congress to deal with bankruptcies and revelations of gigantic frauds perpetrated by Enron, WorldCom and others. The Act requires that, under criminal penalties, both public company management and their auditors must attest to the adequacy of the company's internal controls. Also, it established a new federal organization, the Public Company Accounting Oversight Board (PCAOB), with broad powers to regulate audit functions of accounting firms that audit public companies.

Sarbanes Oxley wording was not exact as to what was meant by "internal controls," much less by how internal controls could be judged to be adequate. The criminal indictment and resulting demise of Arthur Andersen was due to alleged participation in the above Enron fraud. Many people, including this author, believe that the remaining big four audit firms, all other public firms and all public company auditors, were terrified of similar fates if they or their clients ran afoul of the requirements for internal control attestation.

Audit fees have skyrocketed from initial engagements designed to test and strengthen internal controls. Other firms have developed lucrative specialties as SOX consultants. Their stated expertise would test these controls before the auditor looked at them, and supposedly make it easier and less expensive to obtain the required attestation.

Application to Insurers

One of the trickiest areas in which to define and test controls is that of intangible assets and liabilities. The situation is worsened if these accounting items are established or finally established outside of the company's mainframe computer system. This includes output from PCs or from spreadsheets. Unfortunately, calculations like these are almost universally applied for insurer policy reserves, claim liabilities and deferred acquisition costs. Therefore, when internal controls are critically examined, these items receive unusual amounts of attention and unprecedented scrutiny. This means that, among various insurer departments, the actuarial department will bear a heavy brunt of SOX procedural review.

The phrase "internal controls" has long been subject to different interpretations. Originally, internal controls meant systems that would preclude company fraud, unless committed by at least two employees. Now, it seems to mean that insurers' records of reserve factors, of mainframe reserve factor applications or even of offline spreadsheet formulas and results (i.e., as used by actuarial departments) must be rigidly protected and controlled. Anyone attempting to change these key records must be a member of management and document in writing his changes and reasons for changes.

Application to Small Insurers

Investor interests that were ruined in the Enron and WorldCom scandals typically are not present with small-capitalized stocks. Large companies are different from smaller ones in more than just size. Large organizations often have complex business models that lead to complex accounting practices. Smaller companies generally have less complicated financial statements requiring less rigid internal controls.

The key problem confronting smaller companies is Section 404 of the Act. It requires designing, documentation and auditing of financial controls. Section 404 has also led to demands on companies to erect rigid separation between certain types of internal duties. Historically, small insurers have given multiple duties to each employee. Now, SOX has forced companies to increase their personnel count by preventing individuals from acting in multiple capacities.

The problems just mentioned are even more acute for small insurers in defining controls for financial items computed by spreadsheets. They are more likely than large insurers to rely on spreadsheets or even manual calculations.

SOX forces both small and large insurers into the same regulatory mold when it comes to internal controls and external auditing. Its regulatory measures are not tailored to a company's size, nor were they designed to require as little additional cost as possible. Unfortunately, this uniform regulatory doctrine also applies to insurers in the formative stages of growth.

Development-stage companies with little or no revenue cannot afford burdensome compliance costs. According to a study by Financial Executive International, SOX implementation cost averages around $800,000 for companies with annual revenues under $100 million. This compares with $1.25 million for companies with sales of $100-500 million. For companies with annual revenues of about $50 million, compliance costs would thus consume nearly 1.5 percent of revenues, severely squeezing or eliminating operating margins. Funds available for reinvestment would also be depleted. In other words, small companies that create jobs and drive economic growth bear the relative brunt of SOX cost.

Statutory Implications

It has been said that whenever scandals give way to some kind of new federal legislation, the NAIC wants to show diligence and "get on the bandwagon" for appropriate expansion to the statutory arena. They have held several hearings and meetings on how to apply SOX requirements to statutory accounting statements of insurers and their audit reports.

Understandably, the most contentious area is the so called "404" requirement, calling for auditor attestation of internal controls. One major problem of applicability is that the signoff for federal (GAAP) purposes is on consolidated financials presented in Form 10Ks. Many insurance organizations are comprised of several insurers and, even more, of non-insurer affiliated companies (agencies, TPAs, etc.). A literal SOX application to statutory accounting would require audit attestation for each of these entities.

In reference to this activity of the NAIC/AICPA Working Group, one large insurer noted its concern that any decision to modify the Model Audit Rule should be accompanied by changes in the examinations process. In the discussion of Internal/External Auditors Work, a sentence should be added, recommending that if a company has an independent opinion about internal controls, e.g., as required for public companies, that it would serve as sufficient evidence for regulators, minimizing or eliminating balance sheet verification.

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At the time of this article, the final outcome of this statutory question is uncertain.

Any Relief in Sight?

Recently, in a July 2005 article in *Financial Times*, Congressman Oxley has stated that Congress "overdid it," i.e., overreacted to the Enron debacles. He hoped that the internal controls requirement would be interpreted "sensibly." Of course, neither the Congressman nor anyone else has defined what "sensibly" means.

In London last month, Oxley was quoted as telling the International Corporate Governance Network that the 2002 SOX Act, passed to reform public company corporate accounting and governance practices, was "excessive" due to the "hothouse atmosphere" that prevailed when the law was enacted. He described SOX as a "mismatch of public policy and desired objectives." The article also reported that the Congressman reaffirmed that the Act's purpose was to enhance "the strength of the U.S. capital markets," but said that he would do things differently if he could re-write the law knowing what he knows now.

At a recent meeting of the National Association of Mutual Insurers (NAMIC),Oxley was also quoted as saying that the original bill was intended to restore confidence in capital markets, while solvency regulation exists to protect insurance policyholders. One other speaker reiterated findings from a NAMIC study that showed that for every dollar of maximum possible benefit from SOX, it would cost insurance companies $8 to comply with the Act's Section 404.

Similar public statements have come from the SEC Chairman and others. The SEC has taken steps to address

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these issues by creating an advisory committee to examine the impact of SOX and other laws on smaller companies.

Some who have struggled through the first round of SOX compliance say that companies can "live with it." The main, overall requirement is compliance with checklists that govern management review and signoff on all phases of financial statements.

This attitude, on the surface, seems sound. However, it may conflict somewhat with several public statements of federal regulators that SOX compliance should not "deteriorate" into mechanical signoffs on checklists.

At the same time, the chief accountant of the Securities and Exchange Commission, Donald T. Nicolaisen, issued a staff report that set forth the S.E.C's views on the law. His report encouraged auditors to use their judgment to reduce checks they perform. In some cases where companies applied the new law, "The assessment became a mechanistic check-the-box exercise," Nicolaisen said. "This was not the goal of the Section 404 rules, and a better way to view the exercise emphasizes the particular risks of individual companies."

"The desired approach," the report added, "should devote resources to the areas of greatest risk, and avoid giving all significant accounts and related controls equal attention without regard to risk."

One professor recently wrote a letter to the *Wall Street Journal*, defending SOX. He said that most frauds in financial statement filings have been committed by small companies. However, he seemed to overlook the fact that, by far, the greatest monetary harm to investors has arisen from large company financial frauds.

Some commentators have stated that companies can only look to the SEC for SOX relief, not Congress. Others have stated the opposite, that it is fruitless to lobby any organization but Congress for relief.

Conclusion

ERISA in 1974 was once referred to as the "greatest piece of legislative overkill" in U.S. history. Now, possibly, the same criticism could be leveled at the SOX legislation. Hopefully, just like ERISA, initial SOX costs may reduce drastically in a few years, once initial satisfactory controls are in place. However, the outcome for small insurers is still in doubt. ●

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