

# The Status of Sarbanes-Oxley and Insurance

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## Disclaimer

The views and opinions expressed in this discussion are not necessarily those of the Casualty Actuarial Society nor the employers or clients of the speakers

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## Agenda

- Background
- Consultant Perspective
- Audit Perspective
- Company Perspective
- Questions/Discussion

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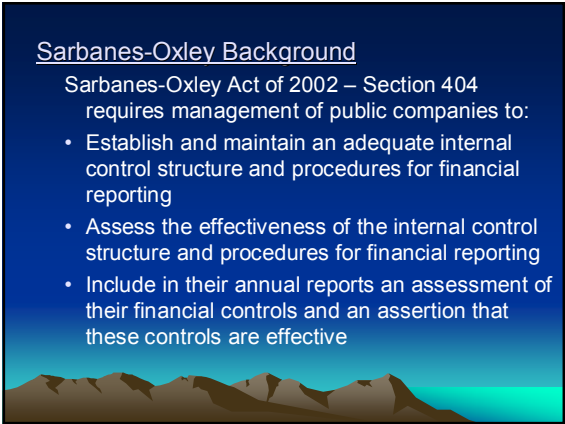
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Sarbanes-Oxley Background

Sarbanes-Oxley Act of 2002 – Section 404 requires management of public companies to:

- Establish and maintain an adequate internal control structure and procedures for financial reporting
- Assess the effectiveness of the internal control structure and procedures for financial reporting
- Include in their annual reports an assessment of their financial controls and an assertion that these controls are effective



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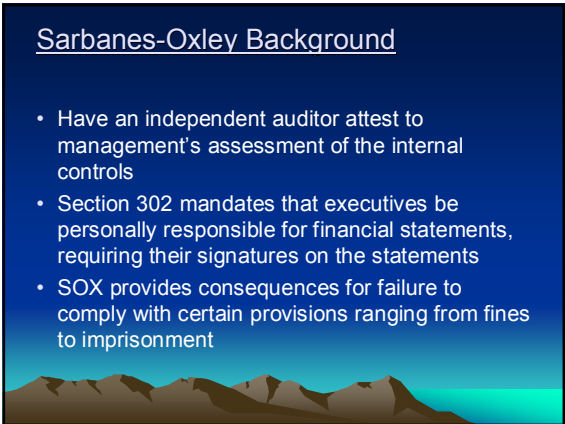
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Sarbanes-Oxley Background

- Have an independent auditor attest to management's assessment of the internal controls
- Section 302 mandates that executives be personally responsible for financial statements, requiring their signatures on the statements
- SOX provides consequences for failure to comply with certain provisions ranging from fines to imprisonment



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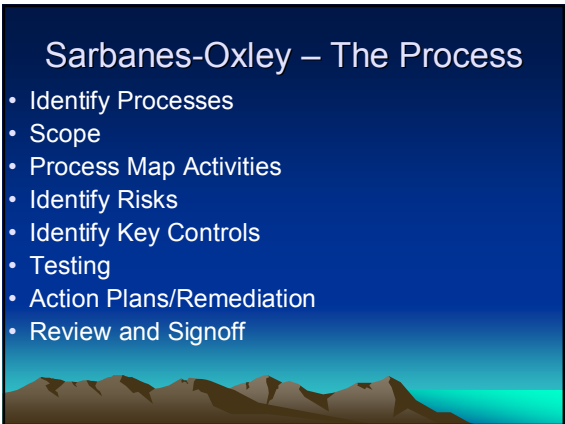
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Sarbanes-Oxley – The Process

- Identify Processes
- Scope
- Process Map Activities
- Identify Risks
- Identify Key Controls
- Testing
- Action Plans/Remediation
- Review and Signoff



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### Sarbanes-Oxley: Timing/Where Are We?

- Between January 28 and June 30, 2005, approximately 3,000 U.S.-listed accelerated filers submitted their initial reports on the effectiveness of their internal controls
- Accelerated filer: generally, US companies with market capitalization > \$75 million
- Deadline for accelerated filers with market capitalization > \$75 million: first annual report after November 15, 2004
- Deadline for all other public companies: first fiscal year ending after July 15, 2007 (July 15, 2006 for some foreign issuers)



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### Sarbanes-Oxley: Year 1

- In year 1, insurers expended an average of 35,000 hours in complying with SOX at a cost averaging over \$6 million
- In year 1, insurers tested an average of 2,500 controls and remediated 300 deficiencies
- Approximately 8% of accelerated filers had ineffective controls reported



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### Sarbanes-Oxley: Year 2 & Beyond

- While the "crisis" of the initial filing is over for accelerated filers, others are still in the initial document/test/remediate phases
- Many mutual and private companies have completed or are going through similar processes
- All are continuing to refine controls, perform testing, remediate deficiencies and enhance documentation



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## Sarbanes-Oxley: Year 2 & Beyond

- Movement away from a “project” approach to achieving compliance towards engendering a control environment and culture

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## The Status of Sarbanes – Oxley and Insurance

Consultant Perspective

Steven Visner, FCAS, MAAA, FCA  
Principal  
Deloitte Consulting

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## Scope of a Typical 404 Readiness Engagement

### Loss Reserves

- Walkthrough of Process with Client
- Narrative of Process
- Flowchart of Process
- Typical Loss Reserve Control Set – Start with Generic then Customize to Client
  - Control Objectives
  - Control Activities
  - Process Owner
  - Gaps in Control
  - Testing Process
  - Test Findings
- Remediation if necessary

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## Example of Loss Reserve Control Set

<b>Objective:</b>	Determination of Reserves consistent with applicable actuarial and regulatory standards
<b>Expected Control Activity:</b>	Use of industry wide accepted IBNR formulae
<b>Company Control:</b>	Use of Loss Development and Bornhuetter methods depending on class reserved
<b>Test 1/Interview:</b>	Chief Actuary, Chief Reserving Actuary and member of staff to verify understanding and use of IBNR formula for different classes
<b>Test 2/Examine:</b>	Documentation of IBNR calculation for 10 reserve segments selected at random (number depends on sample size selected)

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## Difficulties Encountered

1. Understanding Differences Between Control Objective and Control Activity.

Control Objective  
The desired outcome of the control activity, that will mitigate financial risk.

Control Activity  
The process implemented that ensures the desired outcomes are met.

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## Difficulties Encountered

2. Language Difficulties

- Many people working on this besides Actuaries
- Actuaries not necessarily trained in Process Review and Sarbanes
- Actuaries need to be open and help/guide along non actuaries
- Non actuaries can understand the process that determines reserves
- Sarbanes may be a foreign language for Actuaries, but one that is very easily learned

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## Difficulties Encountered

3. IBNR does not lend itself easily to typical controls and tests
  - Easy to count sales transactions (premium invoices, payment received)
  - How do we count an actuarial transaction
    - Quarterly
    - Yearly
    - By line (Schedule P)
    - By Reserving Segment
    - By reserving method
  - How deep do we go
    - Reserving actuaries rely on pricing actuaries for ELR
      - Well how do we know pricing is doing the right thing
  - How do we test integrity

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## Common Themes

- Lack of Policies and Procedures Manuals
- Peer Review done at very high level (mostly)
- Lack of Tech Checks (validity of homegrown spreadsheets can be a big issue)
- ULAE and other Loss Sensitive Reserves
- Getting over the finish line was challenging
  - Can companies revamp processes and/or systems so quickly
  - Do you stop ongoing processes to fix gaps

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## Common Themes

- Documentation is poor
  - Not well maintained
  - Not recently updated
- Data Reconciliation Issues
- Reliance on Accounting
- Reserve Actuaries are communicating with Underwriting, Claims and Pricing
- Independent Actuaries are frequently used to corroborate managements estimates
- Many companies frequently tried to do Sarbox themselves, and ultimately outsourced all or part of this
- Timing to comply was frequently misestimated

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## Lessons Learned

- This stuff is not rocket science, but its not that easy either
- Take time to understand the client and have them understand what you are doing
- Communicating gaps to management is not easy – be prepared to defend your position
- Actuaries & Auditors need to team to get this done
  - Actuaries don't have audit backgrounds
  - Auditors may not understand nuances and details of reserving

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## Lessons Learned

- Get expectations of external auditors early and throughout the process
- Senior Managements buy in and communication downward makes this process go much smoother (tone at the top is important)
- Use this as an opportunity to improve process & operations, not just comply with law
- Actuaries can help out on underwriting, claims, reinsurance Sarbox segments
- This is a great learning experience for junior actuaries

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## The Status of Sarbanes-Oxley and Insurance

Audit Perspective

Ann Griffith, FCAS, MAAA, CPCU  
Ernst & Young LLP

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### Audit of Internal Controls over Financial Reporting

- PCAOB Auditing Standard No. 2 provides the objectives, responsibilities, scope, etc. of audit of internal controls over financial reporting - - implements the Section 404 audit process
- AS 2 states that the objective of such an audit is to “express an opinion on *management’s* assessment of the effectiveness of the internal controls” and “obtain *reasonable assurance* that no *material weakness* exists as of the date specified in management’s assessment”

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### PCAOB AS 2

In order for the auditor to complete an audit of internal controls, management must:

- Accept responsibility for the effectiveness of the controls
- Evaluate the effectiveness of the controls
- Support it’s evaluation with sufficient evidence/documentation
- Present a written assessment of the effectiveness of the controls

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### PCAOB AS 2

Auditor responsibilities include:

- Planning the engagement
- Evaluating management’s assessment process
- Obtaining an understanding of internal controls
- Testing and evaluating the design effectiveness of the internal controls
- Testing and evaluating the operating effectiveness of the internal controls
- Forming an opinion on the effectiveness of the internal controls

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## Year 1 Challenges

- Year 1 was challenging in terms of the demands on resources for the audit firms as well as for the issuers and their consultants
- Communications between clients and some audit firms was stifled somewhat by:
  - Hesitance of issuers to reveal potential control deficiencies to their auditor
  - Heightened emphasis on independence

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## Year 1 Challenges

- Clients varied significantly in terms of level and quality of documentation of processes, controls and testing - - what level is acceptable will only be clear after some PCAOB reviews are complete

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## PCAOB: Year 1

- PCAOB observes that the objectives of 404 are generally supported, but compliance costs are seen as too high and unsustainable
- In May 2005, PCAOB issued guidance designed to improve the efficiency and effectiveness of audit of internal controls

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## PCAOB Guidance – May 2005

Auditors should:

- Integrate their internal control and financial statement audits
- Tailor audit plans to the risks facing individual issuers
- Use a top-down approach / risk-based assessment
- Utilize the work of others to improve efficiency
- Engage in direct and timely communication with audit clients

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## PCAOB Guidance – May 2005

- Drew attention to “reasonable assurance”
  - Degree of assurance as would satisfy prudent officials in the conduct of their own affairs
  - not an absolute level of exactitude
  - Recognize that there is a zone of reasonable conduct that should be acceptable

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## PCAOB Guidance – May 2005

- Focus should be on controls related to those processes and transactions for financial statement accounts and disclosures that are most likely to have a material impact on the financial statements
- Focus should be top-down: focus first on company-level controls, then on significant accounts, then on significant processes impacting those accounts, and then on individual controls at the process, transaction or application level

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## PCAOB Guidance – May 2005

- Discussions and exchanges between management and auditor do not in themselves violate independence
- As long as management, and not the auditor, makes the final determination as to accounting and the auditor does not design or implement accounting policy, auditor involvement is appropriate and is not indicative of a deficiency

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## Year 2 Expectations

As a result of the experience gained in year 1 and the guidance provided by PCAOB, year 2 is expected to show

- Better and more timely communication between clients and auditors
- Reduction in the cost and resource commitment
  - More reliance on others' work
  - Less need for remediation
  - Fewer controls tested – focus on *key* controls

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## On-Going Challenges

- Non-accelerated filers still to make initial filing
- Transition from initial documentation / test / remediate phase to an on-going process of tracking changes in controls and monitoring the processes
- Move to better use of technology for on-going monitoring of processes and controls
- Shortened financial statement reporting deadlines for large companies

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## On-Going Actuarial Process Issues

- Need to continue to enhance evidencing of controls – sign-offs, peer reviews, tech reviews
- Need better documentation in areas of judgment and reasons for selections
- Because of heavy reliance on spreadsheets, typically need stronger control on access, tracking changes, documentation of tech reviews

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## The Status of Sarbanes-Oxley and Insurance

Company Perspective

Michael Kooken, FCAS, MAAA

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## The Zurich Experience

- Technically *not* subject to Sarbanes-Oxley
- Implemented an Internal Control Framework
- Why Did We Bother?
  - It Is The Right Thing To Do
  - Our Customers and Stakeholders Expect It

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### Internal Control Framework

- Implemented Across the Organization
- This Discussion is Specific to an Actuarial Reserving Area



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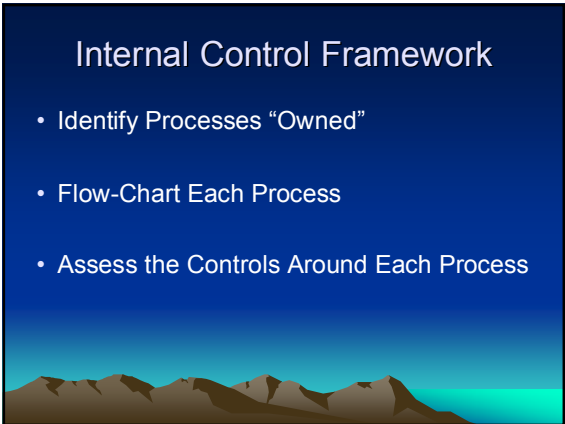
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### Internal Control Framework

- Identify Processes “Owned”
- Flow-Chart Each Process
- Assess the Controls Around Each Process



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### Internal Control Framework

- Rate the Controls
  - Satisfactory
  - Needs Improvement
  - Unsatisfactory
- Provide Evidence for “Satisfactory” Controls



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### Internal Control Framework

- For “Needs Improvement” and “Unsatisfactory,” Identify Issues that Need Remediation
- Rank Each Issue
  - Low
  - Medium
  - High



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### Internal Control Framework

- Provide an Action Plan for “Needs Improvement” or “Unsatisfactory” Controls (“Low,” “Medium,” or “High” Priority Issues)
- Remediate (Close) the Open Issues and Mark the Control as “Satisfactory”



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### Sample Processes

- IBNR Reserve
- Premium Reserve
  - Earned But Unbilled
  - Retrospectively-Rated
- ULAE Reserve
- Workers Comp Discount
- Salvage and Subrogation for Schedule P
- Asbestos and Environmental Note



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## Sample Issues – IBNR Reserve

- Policies and Procedures Inadequately Documented
- Adequate Management Review But No Formal Sign-off (“Evidence”)
- Analysis Data Maintained on a Shared Server (Access Control)
- When Data and/or Factors Are Transferred from One Application to Another

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## Sample Remedies – IBNR Reserve

- Create a Centrally Housed “Policies and Procedures” Document
- Create Sign-off Checklists and Memos that are Integral to Each Analysis

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## Sample Remedies – IBNR Reserve

- Store Data and Analyses in “Read-Only” Directories
- Analyst and Manager Review and Initial Where Factors from One Application Have Been Keyed In to Another (Automate Where Possible)

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## Sign-Off

- Quarterly Review by Control Evaluators (Senior Management):
  - Review/Update Documentation
  - Verify/Discuss Execution of Controls
  - Document Evidence for “Satisfactory” Controls
  - Document and Communicate Issue and Action Plan for “Needs Improvement” and “Unsatisfactory” Controls

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## Summary

- Processes
- Controls Around These Processes
- Satisfactory

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## Summary

- Needs Improvement or Unsatisfactory:
  - Issue Identified and Documented
  - Rank High, Medium, or Low
  - Monitored Monthly Until Closed
  - Control Moved to “Satisfactory”
- Quarterly Monitoring of Processes

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## Conclusion

- Internal Control Framework Is About
  - Controls: A Policies and Procedures Document
  - Evidence: What Proves That There Is Compliance With the Policies and Procedures Document?
  - Ongoing: It is a **Process**, not an **Event**

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## Questions? Discussion

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