

Monday, September 28, 2009

Volume 3, No. 187

ISSN 1935-9721

Featured Articles

Corporate Governance

Private Insurers Prepare for Taste of Sarbanes-Oxley

Topic(s): SEC, Audit Engagements, External Auditing, Financial Reporting, Disclosure, Internal Auditing, Sarbanes-Oxley, Governance, PCAOB

by Tom Harlan

Summary: *Insurers are expecting increased scrutiny from state insurance departments as they implement changes to their 2010 statutory financial reports under the NAIC's revised model audit rule. One of the amendments will require private insurers that have more than \$500 million in premium volume to provide an annual management report of internal control over statutory financial reporting.*

Insurers are preparing for increased scrutiny from state insurance departments, as they make changes to their 2010 statutory financial reporting under the National Association of Insurance Commissioners' Model Regulation.

The regulation, also known as the model audit rule, currently 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 state insurance departments. The NAIC, an organization of insurance regulators from all 50 states, amended the rule in 2006, saying insurance departments needed regulation like the Sarbanes-Oxley Act of 2002 to improve the monitoring of the condition of insurers.

However, the NAIC, which meets quarterly, delayed implementation of the rule until 2010 so the 50 states, which have different regulatory models, could enact legislation or adopt regulations. At a June 13, 2009, meeting, the NAIC's financial regulation standards and accreditation committee voted to adopt the 2006 revisions, saying that states that do not make the changes by the end of 2009 might hurt their accreditation standing.

Only 32 state insurance departments completed the process as of September 11 to adopt the rule, but the NAIC said that all 50 states are expected to make the changes by the end of the year.

One of the amendments will require private insurers that have more than \$500 million in premium volume to provide an annual management report of internal control over statutory financial reporting to their state insurance commission when they file reports for the 2010 reporting year. Similarly, Section 404 of the Sarbanes-Oxley Act of 2002 requires every public company to prepare a management report assessing the effectiveness of its internal controls over financial reporting and have that assessment affirmed by the external auditor.

Under the model audit rule, publicly traded insurers must file a report stating that internal controls that have a material impact on the preparation of the statutory financial statements were included in the scope of the Section 404 reports. The NAIC said an independent certified public accountants (CPA) should consider the public and private insurers' reports during the annual audit, and, as required by the rule, the insurers must file with the state insurance department the CPA's communication regarding any unremediated material weaknesses found during the audit.

Amendments to the model audit rule will also require insurers to:

- Set limits on the number of consecutive years an audit partner may participate on the audit of an insurer and on other non-audit services; and
- Form independent audit committees with set percentages of independent members, after they reach premium thresholds of \$300 million and \$500 million.

The NAIC said the amendments will provide insurance policyholders with protection similar to securities investors under Sarbanes-Oxley, which was created after corporate and accounting scandals at companies like Adelphia and Worldcom cost investors billions of dollars.

"This is a little bit of damage control in advance for regulators, who are among those that will be second guessed why they didn't have rules in place, or have oversight if there is another Enron, Adelphia, or WorldCom," said Harry W.R. Chamberlain, a shareholder in law firm Buchalter Nemer's litigation, insurance, and appellate practice groups. "Public regulators don't want to be on the hook next time this happens."

Insurers that procrastinate will not receive leniency, insurance lawyers and consultants say, because the NAIC gave insurers four years to become compliant with the revised rule, after Sarbanes-Oxley proved to be costly and burdensome for large public companies.

"Companies saw this regulation coming," said Ward Bondurant, a partner in the Atlanta office of law firm Morris, Manning & Martin, who practices in areas of corporate securities, health care, and insurance. "Before it was passed, there were debates on precisely when the cutoff would be."

Insurers should be prepared for key differences between GAAP reporting under Sarbanes-Oxley and statutory reporting under the model audit rule, Bondurant said, adding that they should have hired a consultant who has experience testing both types of different systems, data and activities.

"If you haven't gotten someone lined up, you are going to have a tough time finding a SOX consultant, especially a SOX consultant who can do double duty with the model audit rule's statutory requirements," Bondurant said, adding that many experienced consultants are currently advising smaller public companies on how to become compliant with Section 404(b). "It's sort of a double whammy."

Insurers should have already designed their internal controls and should be testing their operating effectiveness, so they have time to identify and correct deficiencies, said Dennis Bell, senior partner at Interactive Solutions LLC, which provides process audit and compliance services.

"Now is the time," Bell said. "We're getting up against the deadline, and some of these controls are going to be annual controls. Firms only have one more time to test them before next year."

Insurers should not take testing lightly, according to a June 22 study from Lord & Benoit that used AuditAnalytics data to analyze Section 404 reports from public insurers from 2004 through 2008. The study found that 12 insurers filed adverse reports in 2004, the first year they were required to under Sarbanes-Oxley.

All insurers should revisit their internal control structure to ensure sufficient coverage of the statutory requirements, Bell said, because state insurance departments, such as Pennsylvania's, have stressed contemplating risks outside of the financial report. Ideally, insurers would use the model audit rule as an opportunity to streamline their efforts by introducing enterprise risk management, which would improve their overall risk management and business performance.

"However, insurance companies are so concerned right now with strategic risks, reputational risks, and a lot of other risks," Bell said. "The model audit rule is another thing on their plate. They might be doing the bare minimum, and saying 'I'll do enterprise risk management at some point'."

Insurers who try to comply with the model audit rule by doing the minimum should consider how the environment has changed since a March 30 Time Magazine cover depicted AIG as "The Bailout Bomb," Chamberlain said.

"I have a feeling there is going to be much closer scrutiny," Chamberlain said. "That image is going to drive regulators and examiners, and bodies like the NAIC, to hold companies to a high standard, and hold them to stricter standards, in terms of what is acceptable and what is too risky."