
Sarbanes-Oxley for Smaller Insurance Companies: New Amendments to the NAIC Model Audit Rule

Background of NAIC Proposed Amendment

- **2002: Adoption of Sarbanes-Oxley Act (“SOX”)**
 - Designed to protect investors by
 - Improving the accuracy and reliability of corporate disclosures
 - Enhancing oversight by independent directors and independent auditors
- **2003: NAIC/AICPA Working Group formed**
- **2004-2005: Subgroups (divided by SOX Titles II, III and IV) develop proposed amendments**
- **Current status**
 - Approved by NAIC on June 11, 2006
 - Effective for financial statements for accounting periods after January 1, 2010



Title II: Auditor Independence: Qualifications

Audit partner rotation requirement

- Lead audit partner required to rotate every 5 years (down from every 7 years) and rotated partner subject to 5 year “time-out”
- Commissioner may grant relief from the requirement upon request
- Requirement would take effect on January 1, 2010
{MAR §7D and SOX §203}



Title II: Auditor Independence: Non-Audit Services

Non-Audit Services

- Nine non-audit services that, if provided by the accounting firm, impair the firm's independence:
 - a) Bookkeeping or other services related to the accounting records or financial statements of the insurer;
 - b) Financial information systems design and implementation;
 - c) Appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
 - d) Actuarial advisory services (other than certain limited actuarial opinion services);
 - e) Internal audit outsourcing services;
 - f) Management functions or human resources;

Title II: Auditor Independence: Non-Audit Services

- g) Broker or dealer, investment adviser, or investment banking services;
- h) Legal services and expert services unrelated to the audit; and
- i) Any other services that the commissioner determines, by regulation, are impermissible.

{MAR §7G and SOX §201}

- Other non-audit services are permitted, provided service is approved in advance by the audit committee of the insurer
{MAR §7H and SOX §201}



Title II: Auditor Independence: Non-Audit Services

Three principles of independence with respect to services provided by the qualified independent certified public accountant:

- The independent accountant
 - cannot function in the role of management,
 - cannot audit his or her own work, and
 - cannot serve in an advocacy role for the insurer.

{MAR §7G(2)}

Title II: Auditor Independence: Pre-Approval Requirements

Pre-approval Requirements

- Requires that audit committees pre-approve all audit and permissible non-audit services to be rendered by the audit firm, with certain, limited exceptions.

{MAR §71 and SOX §202}

Title II: Auditor Independence: Conflicts of Interest

Conflicts of Interest

- Establishes a one-year cooling off period before a partner or senior manager involved in an audit for an insurer may accept employment in certain designated positions with that insurer. The insurer may apply to the commissioner for relief from this requirement.

{MAR §7L and SOX §206}



Title II: Auditor Independence: Reports to Audit Committee

Auditors' Report to Audit Committee

- Requires auditors to report to the client's audit committee:
 - All critical accounting policies and practices used by the insurer;
 - All material alternative accounting treatments of financial information that have been discussed with management and the auditor's preferred treatment; and
 - Other material written communications with management.

{MAR §14F and SOX §204}



Title III: Corporate Governance: Audit Committee

Audit Committee Required

- Every insurer required to designate an “audit committee” {MAR §4D}
- Audit Committee is directly responsible for the appointment, compensation and oversight of the work of any accountant employed by the insurer (including resolution of disagreements between management and the accountant regarding financial reporting) for the purpose of preparing or issuing an audit report or related work and each accountant shall report directly to the audit committee. {MAR §14A}
- An audit committee of a holding company may act as the audit committee of the insurer. {MAR §4D}
- If no audit committee appointed, then the entire board shall constitute the audit committee. {MAR §3C}

Title III: Corporate Governance: Audit Committee

Audit Committee Member Independence

- Each member of the audit committee of the insurer must be a member of the board of directors of the insurer, provided a parent company can designate its audit committee to act as the audit committee for any company in the group.
- In order to be “independent,” a member of an audit committee may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee, accept any consulting, advisory or other compensatory fee from the insurer or be an affiliated person of the insurer or any subsidiary thereof.
- If domiciliary law requires board participation by otherwise non-independent members, such law shall prevail and such members may participate in the audit committee and will be treated as “independent” for purposes of the committee.

{MAR §14B and 14C}



Title III: Corporate Governance: Audit Committee

Audit Committee Independence Requirements Vary Based on Premium Volume:

Prior Calendar Year Direct Written and Assumed Premiums		
\$0 - \$300,000,000	\$300,000,001 - \$500,000,000	Over \$500,000,000
No minimum independence requirements.	Majority (50% or more) of members must be independent.	Supermajority (75% or more) of members must be independent.

*(MAR §14G)

Title III: Corporate Governance: Conduct of Insurer

Conduct of Insurer in Connection with Preparation of Required Reports and Documents

- No director or officer of an insurer may:
 - (1) Make or cause to be made a materially false or misleading statement to an accountant in connection with any audit, review or communication required under this regulation; or
 - (2) Omit to state, or cause another person to omit to state, any material fact necessary in order to make statements made, in light of the circumstances under which the statements were made, not misleading, to an accountant in connection with any audit, review or communication required under this regulation.

{MAR §15A and Rule 13b2-2}



Title III: Corporate Governance: Conduct of Insurer

Conduct of Insurer in Connection with Preparation of Required Reports and Documents

- Officers and directors may not take any action to coerce, manipulate, mislead or fraudulently influence any auditor if that person knew or should have known that such action, “if successful, could result in rendering the insurer’s financial statements materially misleading” (as defined in MAR §15C).

{MAR §15B and SOX §303}

Title III: Corporate Governance: Notification of Material Change

Notification of Material Change

- Insurers are required to disclose to the commissioner, within 5 days of receipt, a written report from the auditors that the insurer has materially misstated its financial condition.

{MAR §10A and SEC Form 8-K}

Communication of Unremediated Material Weaknesses

- Insurers are required to provide to the commissioner, within 60 days of the filing of the annual audited report, a written communication from the auditors detailing any unremediated material weaknesses that the auditors noted.

{MAR §11A}

Title IV: Internal Controls: Management's Report

Original Title IV proposals prompted criticism from the industry

- Included management report on adequacy of internal controls and auditor attestation of the report
- \$25 million (direct written premium) threshold

“Interested Parties” Compromises in 2005

- \$500 million (direct written premium) threshold
- No auditor attestation requirement
- “SOX Compliant” companies exempted

Title IV: Internal Controls: Management's Report

Management must file an annual report of the company's "Internal control over financial reporting"

- Internal control is defined as the process effected by management to provide "reasonable assurance regarding reliability of the financial statements," including policies and procedures for:
 - Maintenance of records;
 - Proper approval and recording of transactions; and
 - Detection of unauthorized use of assets.

{MAR §16A and 3(I)}

Title IV: Internal Controls: Management's Report

Management's Report includes:

- Statement that management is responsible for internal control;
- Statement that management has established internal control and whether management believes that internal control is effective;
- Description of the process used to evaluate effectiveness;
- Description of the evaluation's scope;
- Disclosure of any unremediated material weaknesses in internal control;
- Statement regarding any inherent limitations of internal control; and
- Signatures of the CEO and CFO

{MAR §16D}



Title IV: Internal Controls: Exemptions from Section 16

- **Companies with less than \$500 million of annual direct written and assumed premiums**
 - Note: if company is below threshold, commissioner may still require report if company is in any RBC level event
- **Companies that are:**
 - Subject to Sarbanes-Oxley Section 404
 - Part of a holding company that is subject to Section 404
 - Not subject to 404, but is a “SOX Compliant Entity”
 - Part of a holding company system that is a “SOX Compliant Entity”
 - Note: these companies still have to file the 404 report, plus an addendum stating that all of the company’s internal controls were included within the scope of the 404 report



Effective Dates of Amendments

- **Section 7D (Rotation of Lead Audit Partner)**
 - Effective January 1, 2010
- **Section 14 (Composition of Audit Committee)**
 - Effective January 1, 2010
- **Section 16 (Management's Report of Internal Controls)**
 - Effective beginning with the reporting period ending December 31, 2010



Next Steps

- Monitor NAIC activity on the MAR Implementation Guide
- Begin development of implementation strategies
 - Assess applicability based on premium volume
 - Prepare updates for Board of Directors
 - Develop implementation strategies
 - Internal controls assessment
 - Systems analysis
 - Evaluate Board independence
 - Identify prospective Board candidates
 - Evaluate non-audit services currently provided by auditors
 - Identify qualified consultants and advisors
 - Develop timelines, budgets and implementation plans

Questions?

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