

# Casualty Loss Reserve Seminar

## Model Audit Rule and P/C Actuaries

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# Agenda/Contents

Overview of Model Audit Rule and Controls Testing  
Process, Risks and Controls in Loss Reserving  
Related Topics

Section one

**Overview of Model Audit Rule and Controls Testing**  
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## Model Audit Rule

### Selected highlights:

- Upcoming statutory requirement in the US
- Effective no earlier than January 2010 (varies by state based on when it is adopted)
- Contains requirements related to financial statement audits of companies, including:
  - Independent CPA qualifications
  - Communication of internal control related matters
  - Audit committee requirements

## Model Audit Rule (continued)

Also contains an attestation requirement regarding controls:

- Certain companies must file an annual attestation regarding the effectiveness of their internal controls over financial reporting
- Similar to Sarbanes-Oxley Section 404 attestation of internal controls by management

## What is Sarbanes-Oxley Section 404?

Sarbanes-Oxley Act of 2002, Section 404, which was effective at year-end 2004 (accelerated filers)

- Current requirement for public companies in the US
- Requires management and independent accountant to provide attestation as to the effectiveness of the control framework that supports the company's consolidated financial reporting
- Generally resulted in improved loss reserving processes, controls and documentation

What have we observed several years into 404?

Some companies embraced the value of a strong control environment, other companies tended to be minimalists

Benefits from having a strong control environment:

- Greater efficiency in operation
- Reduced risk of reserve misstatement
- Reduced likelihood of surprises
- Few or no deficiencies in controls
- More effective and more efficient external audit
- Smoother regulatory exam

## Management Report on Internal Controls

### Summary of new reporting requirements:

- Annually, each insurance company or group will provide a report to their domiciliary insurance department with a report on internal controls over the statutory financial statement process
- Report is signed by CEO and CFO
- Smaller companies are exempt (i.e., only impacts companies with gross written premium of at least \$500 million)
- Evaluation and reporting requirements may vary depending on whether or not the company is:
  - Already compliant with 404
  - Not already 404 compliant

## US Statutory Model Audit Rule and Section 404

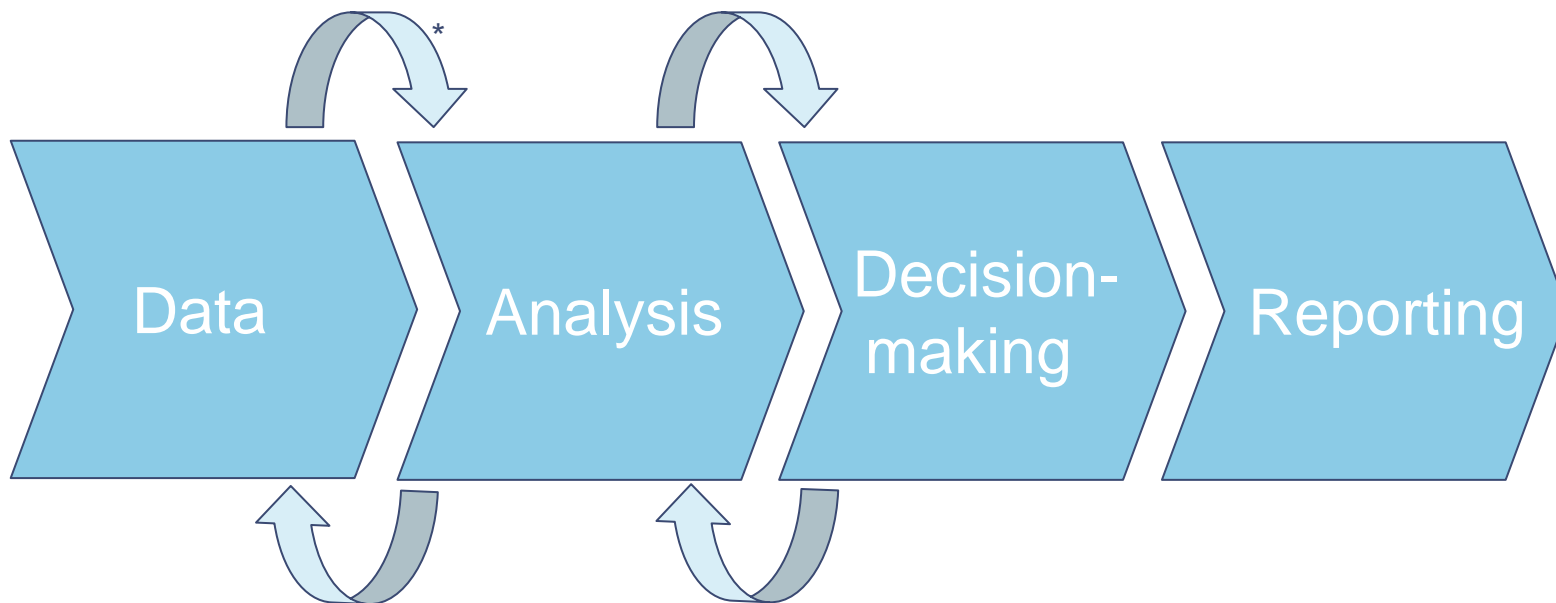
### Some notable differences:

- Unlike Section 404, an auditor attestation of the effectiveness of internal controls is not required under the Model Audit Rule
- Level of documentation and amount of testing under the Model Audit Rule may be subject to somewhat more management judgment than under Section 404
- Focus under Model Audit Rule for statutory reporting process, while Section 404 focuses on the consolidated financial statements

## Section two

# Overview of Model Audit Rule and Controls Testing **Process, Risks and Controls in Loss Reserving** Related Topics

# Raising the Bar on Reserving Controls



## Possible Risk Areas

Completeness / Accuracy Manual Adjustments External benchmarks Segmentation Level of Detail	Methods/ Assumptions	Actuarial value/range versus Management best-estimate	Documentation Communication
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**\* The process is generally not linear; iterations tend to occur.  
For example, new data are gathered based on initial findings from analysis.**

## Steps to Evaluating Controls around the Reserving Process

### Key steps:

1. Document the reserving process
2. Identify risks that could cause misstatement
3. Identify or create controls that mitigate the risk of misstatement
4. Test key controls for operating effectiveness

Remember - check with your internal accountants and/or external auditor for advice and support

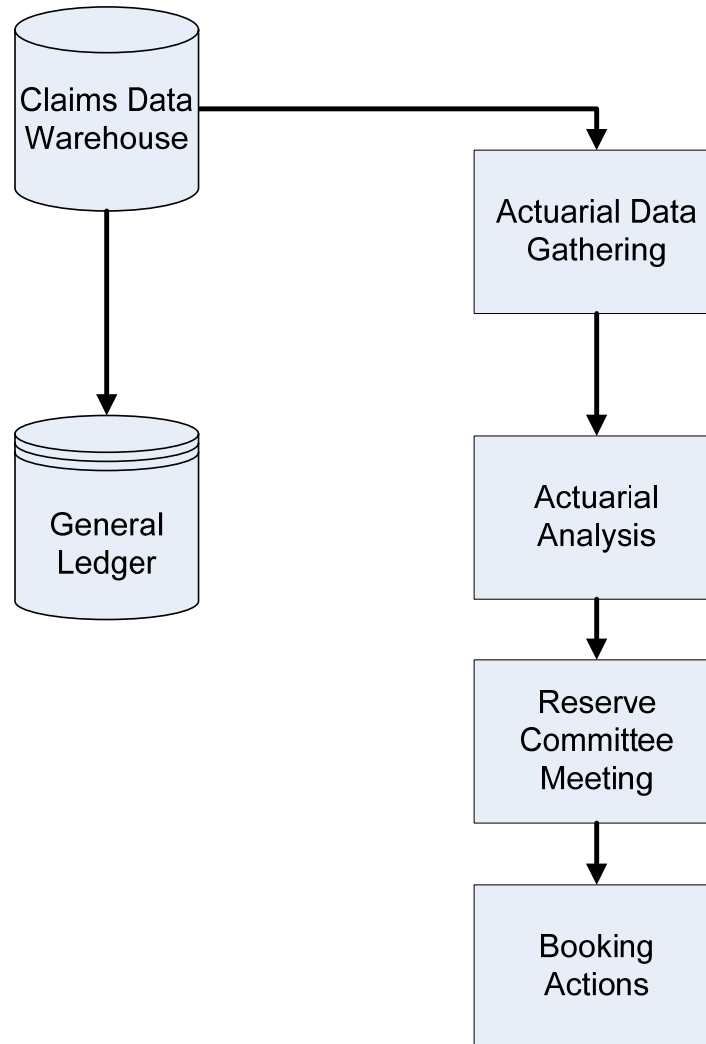
## Documentation of the Reserving Process

### Step 1 – Document the reserving process

- Describe the underlying processes used to determine the recorded amounts
- A good practice is to use a flowchart (see sample flowchart on the following page) accompanied with narrative text as needed
- Document personnel responsible for each step, and when and how often each step is performed
- Common steps include:
  - Data gathering and reconciliation
  - Analysis and peer review
  - Senior actuary and management review, decisions on recorded amounts
  - Booking reserves



# Simplified Flowchart of a Sample Reserving Process

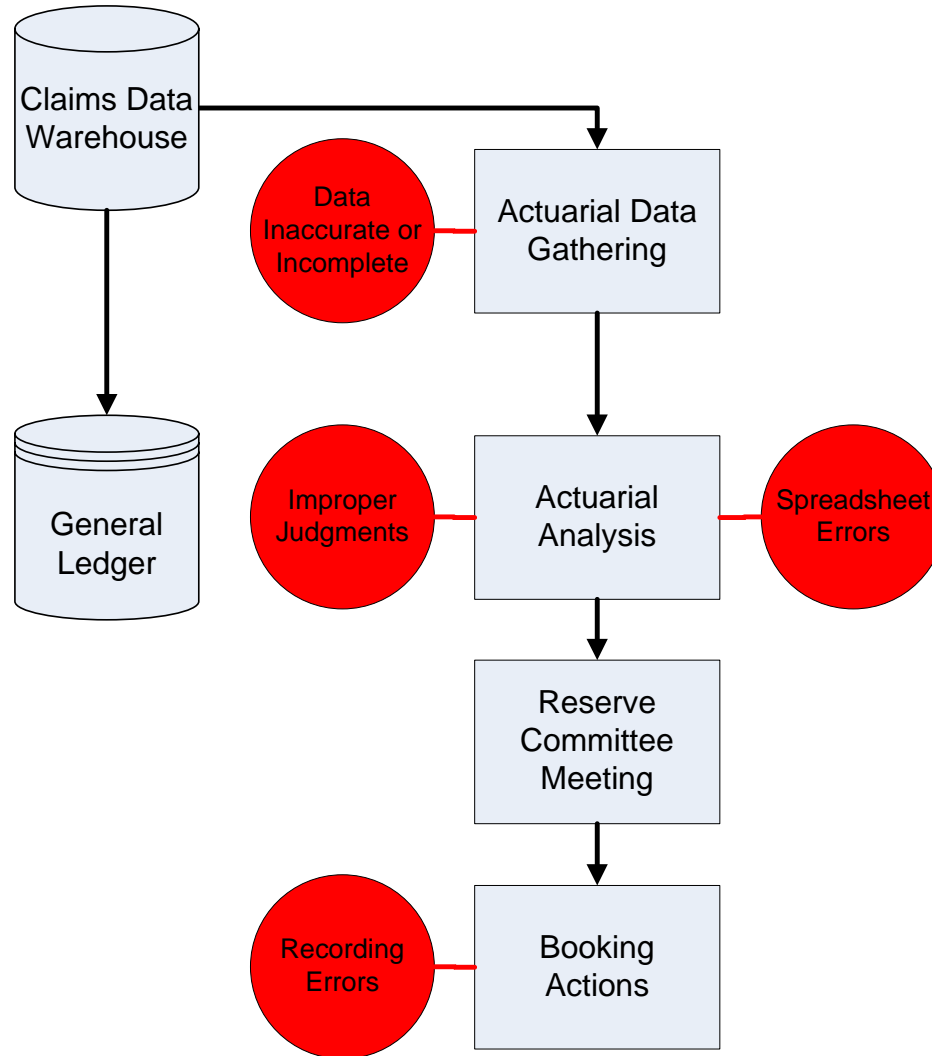


## Identifying Risks

### Step 2 – Identify risks of misstatement

- Evaluate flowchart to identify risks that could lead to a misstatement of loss reserves
- Common risks include:
  - Data may be inaccurate or incomplete
  - Mathematical errors in actuarial analysis (including spreadsheet errors)
  - Improper judgments in analysis
  - Errors when amounts are recorded
- Handoffs between groups, reliance on manual processes and system limitations tend to increase risk of misstatement

# Identifying Risks

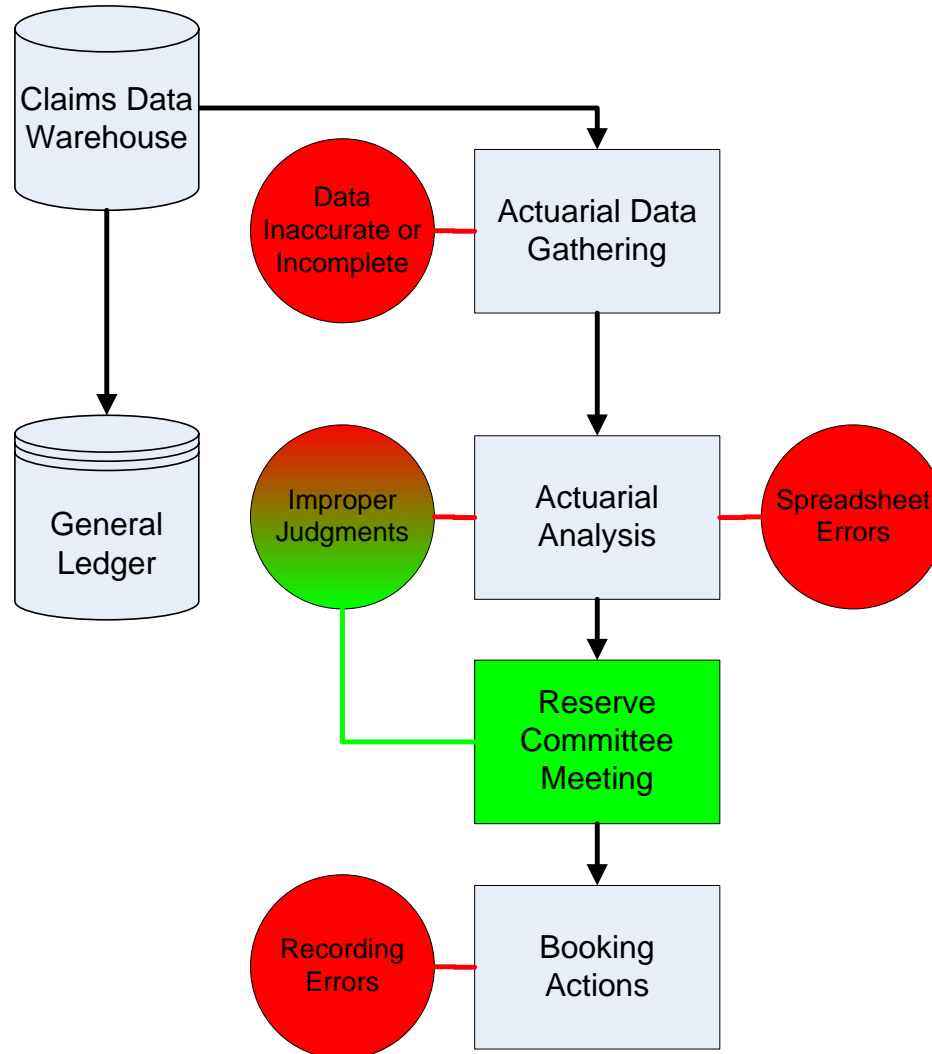


## Identifying or Creating Controls

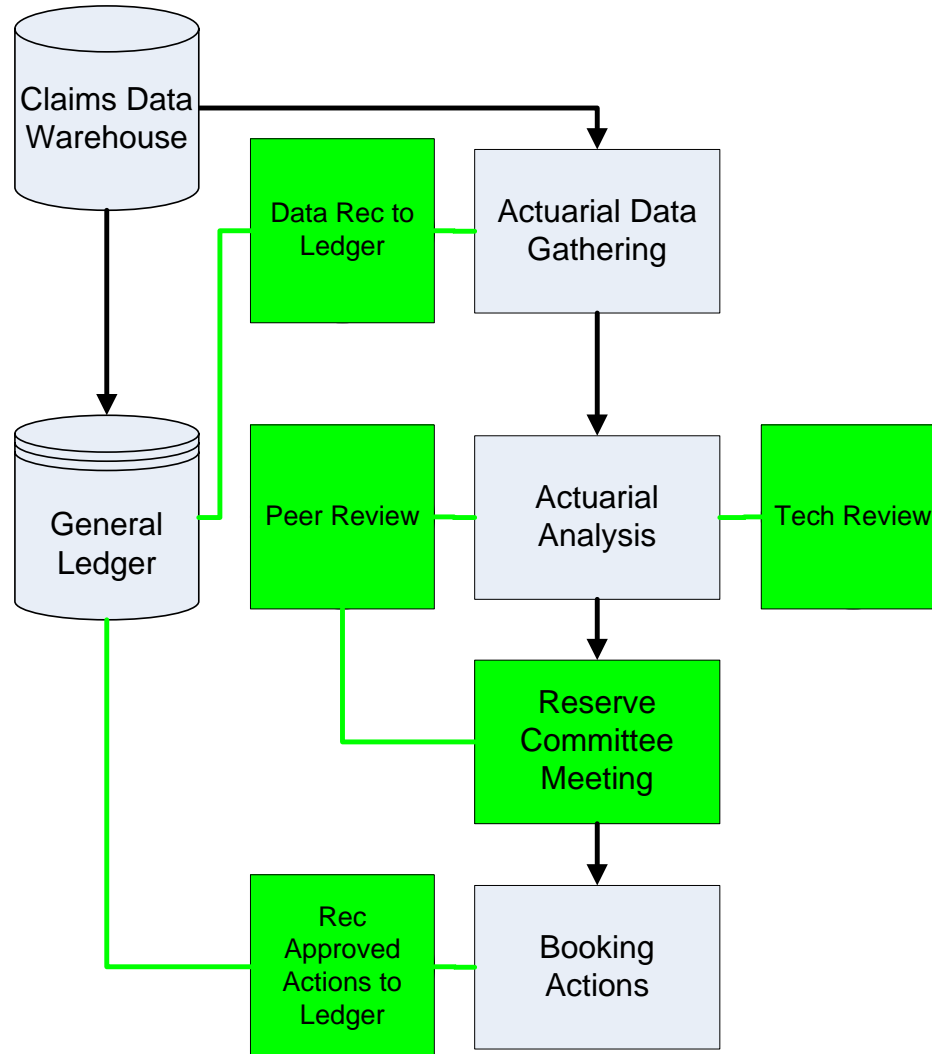
### Step 3 – Identify or create controls that mitigate the risk of misstatement

- Where existing controls are insufficient to mitigate the risk of misstatement, the design of existing controls should be enhanced or new controls should be implemented
- Assign ownership to appropriate personnel / company officers
- Some common areas where controls are needed:
  - Reserving data reconciliations
  - Spreadsheet controls
  - Actuarial peer review process
  - Reconcile approved booking actions

# Identifying or Creating Controls



# Identifying or Creating Controls



## Testing Key Controls

### Step 4 – Test Key Controls

- Separate “key” controls from other controls, focus testing on the key controls
- Develop a test plan – how frequently testing is done, nature of the testing, qualifications of the tester, sample size, etc.
- Perform testing - test that control operated, and that it operated effectively

Work with accounting department regarding:

- Handling of exceptions/deficiencies
- Documentation of testing and conclusions on operating effectiveness

## Section three

Overview of Model Audit Rule and Controls Testing  
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**Related Topics**

## Consolidated Compliance and New Statutory Reporting Requirement

Issue – an insurance group complies with Section 404 from a consolidated perspective

- Begin with the group report from Section 404
- Determination of reserve amounts under the statutory reporting process should be documented, assigned controls and tested
- Might create the need for ancillary flow charts and documentation of this part of the process
- Processes and necessary controls will vary from company to company

## Other than Loss Reserves

Actuaries may lead or have a significant role in processes other than loss reserves:

- Premium and other asset accruals
- Premium sufficiency assessments, premium deficiency reserves
- Provisions for unrecoverable reinsurance

## Management Report on Internal Controls How will Reserving Actuaries be Impacted?

Based on experiences with public companies adopting Section 404 of Sarbanes Oxley:

- Increased documentation
  - For many companies, the reserving process becomes documented in detail for the first time
- Increased focus on possible risks of misstatement
- Increased focus on the identification, use and enhancement of controls that mitigate the risk of misstatement
- Significant time and resources may be required initially
- Will be more significant for companies not already compliant under Section 404

# Questions / Comments