

Sarbanes-Oxley Act of 2002, Section 404: The Impact on Actuaries

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**Background on the Act
The Company Point of View
The Service Providers Point of View**

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Background on the Act

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Disclaimer

This presentation reflects the views of the speaker, and not necessarily those of KPMG, nor the co-sponsors of the CLRS.

Anyone who says otherwise is not only wrong, but is itching for a fight.

Most Important Takeaways

- ❑ The introduction of the act introduces a significant opportunity for Actuaries to improve the environment in which reserve analysis is performed**
- ❑ There are additional responsibilities that come along with the opportunity**
- ❑ The scope of Section 404 controls should be read literally to include all aspects of company operation that can affect financial reporting (i.e. reserve) accuracy**
- ❑ The scope of Section 404 controls need go no further than implied by the point above**
- ❑ Actuaries are not generally used to operating in an environment as formal as that implied by Section 404**
- ❑ The best opportunity to improve the environment per the first point is at implementation of the Act (now)**

SOX Overview

- SOX Section 404 Company Requirements:
 - ◆ **State management's role in establishing and maintaining an adequate control structure and procedures for financial reporting**
 - ◆ **Report annually on the effectiveness of their internal controls over financial reporting procedures**
 - Including supporting documentation of controls, and testing of their effectiveness

SOX Overview

- SOX Section 404 Auditor Requirements:
 - ◆ **Attest to and report on management's assessment of internal controls**
 - ◆ **Attest to the effectiveness of internal controls**

- Both management's and the auditor's reports must be included in the company's annual report filed with the SEC.

What's Different?

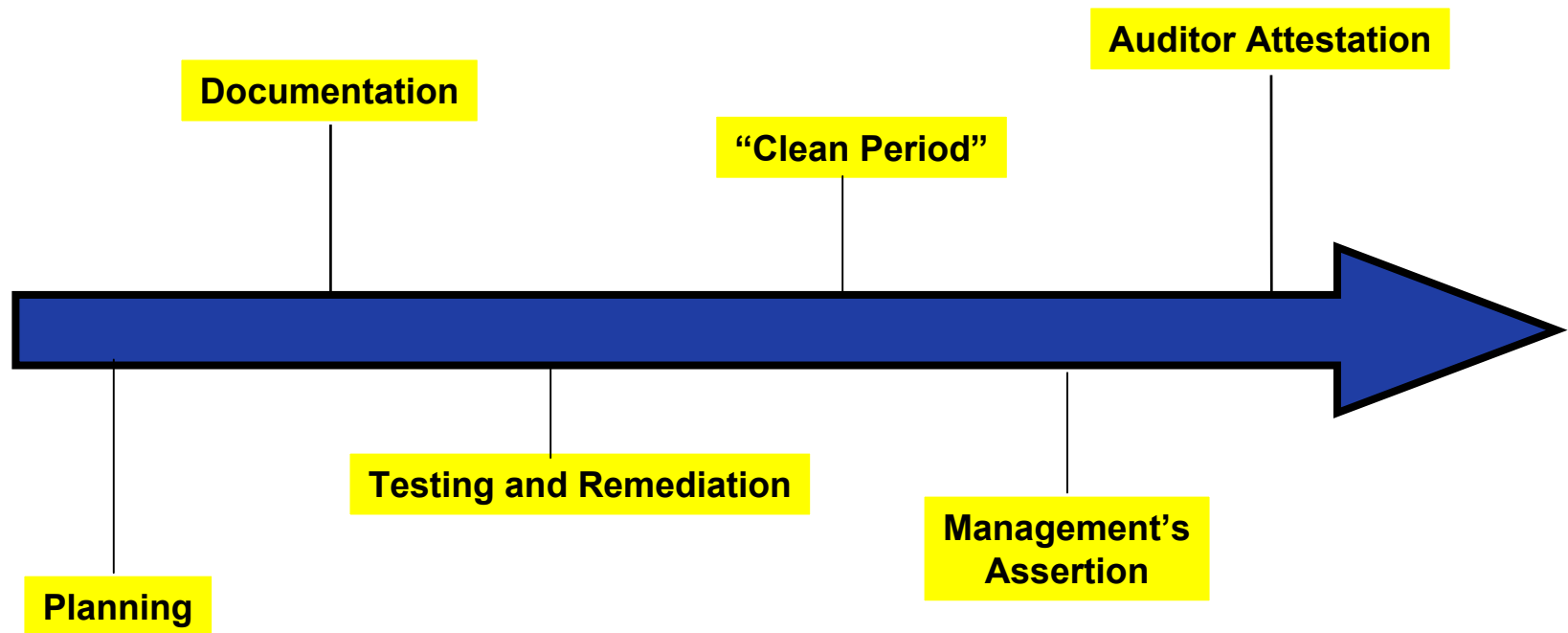
Financial statement audit focuses on the quality of the information in the financial statements,

Whereas

404 Attestation focuses on the quality of the processes that produce the information in the financial statements.

404 Attestation raises the bar for management, audit committee, board and its independent auditors.

The Process



Major Deliverables in the SOX Process: POV of the Company Actuaries

Evaluate and build documentation supporting five element COSO framework

- **Control Environment-General to the corporation**
- **Risk Assessment-Specific to the Actuarial process**
- **Control Activities-Specific to Actuarial process. Often involves process analysis, although not specifically required**
- **Information and Communication-Interpreted as communication within organization to management on the control environment.**
- **Monitoring-Not interpreted as data monitoring (e.g. not price monitoring). This is monitoring of the effectiveness of the controls**

Perform management testing, documentation, and assertion

And then work with the Auditor on:

Walkthroughs

Auditor testing and documentation

Outcomes Possible when Evaluating Controls

- “Adequate”-The outcome most of the time, (we hope and expect)
- “Deficiency”-A shortcoming in the controls. Could become significant if situation changes.
- “Significant Deficiency”-More than remote likelihood of a misstatement that is “more than inconsequential”
- “Material Weakness”-More than remote likelihood of “material misstatement”
- Significant Deficiencies go to audit committee
- Material Weaknesses go in audit report, and result in adverse opinion
- Significance can change over time, if circumstances change

Testing and Documentation

- Controls need to be specific in order to test
 - ◆ **Refer to specific reports, documents, sign-off memos, transmittal documents, frequency of procedures**
- Management tests first, in order to make their assertion
 - ◆ **Auditor reviews their tests, and forms an opinion but cannot rely exclusively, or even primarily on internal tests for their own conclusions**
- For Auditor tests: No need to test every control
 - ◆ **But auditor is required to obtain evidence on all relevant financial statement assertions and all significant accounts**
 - ◆ **Prioritize testing based on size, importance, and risk**

Criteria for Controls That Should be Tested at or Close to Statement Evaluation Date PCAOB standard 2004-2

Higher degree of emphasis if

- Significant non-routine transaction
- High degree of subjectivity in measurement
- Controls over period end adjustments

Manual controls need more extensive testing than automated controls

Test less frequent controls more extensively

Note that Actuarial balances meet much of the above criteria

Control Deficiencies

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions to prevent or detect misstatements on a timely basis.

Design deficiency – When a control necessary to meet the control objective is missing or an existing control is not properly designed so that, even if the control operates as designed, the control objective is not always met.

Operating deficiency – When a properly designed control does not operate as designed, or when the person performing the control does not possess the necessary authority or qualifications to perform the control effectively.

Management's Documentation

Management's documentation should include:

- Design of controls over all relevant assertions related to all significant accounts and disclosures;
- Information about how significant transactions are initiated, authorized, recorded, processed and reported;
- Information about the flow of transactions sufficient to identify where a material misstatement could occur;
- Controls designed to prevent or detect fraud;
- Controls over period-end financial reporting process (includes annual and interim periods);
- Controls over safeguarding of assets; and
- Results of management's testing and evaluation.

Inadequate documentation is a deficiency in internal control over financial reporting

Industry Background-Today

- Many of the root causes of financial statement charges related to reserves are still in place today.
 - ◆ **Controls related to primary risk taking activities of the company in underwriting and claims may be overlooked**
 - ◆ **Controls ensuring incorporation of changes in internal and external risk environment, including pricing, underwriting, and claims trends, may not be effective**
- AM BEST has published similar comments on these root causes of financial misstatements leading to insolvency...
 - ◆ **“The cause for insolvency has remained consistent over the past 10 years, with more than 51% of all such cases the result of insufficient reserves, and/or inadequate pricing”-AM BEST Report on Insolvencies, which adds that an additional 10% are due to “change in business” to which the company did not adapt**

Scope of Internal Controls Required for Actuarial Balances

- Management and actuaries must evaluate, advise, test, and assert on the internal controls related to establishment of loss and loss expense reserves
- All factors that can impact the adequacy of the loss reserves should be considered in scope
- Controls around estimated balances other than loss reserves should also be in scope
- Note that the requirements of SOX 404 add responsibility to Actuaries, but also add tools to the actuarial toolbox
 - ◆ **But the bar has been raised for reserving actuaries**
- Primary consideration should be around whether the controls are appropriate and effective
- Evidence of past procedure, or past success, does not mean the same procedure is appropriate in 2004 or any other future period

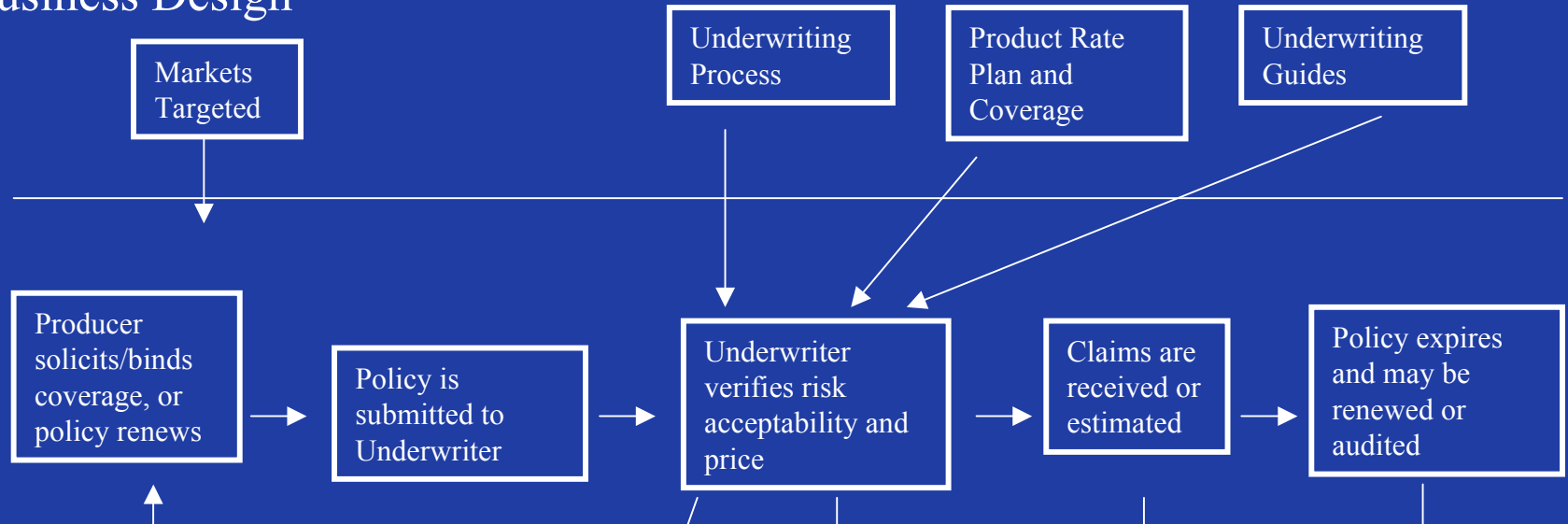
Significant Areas of Risk within Property-Casualty Insurance Companies

Areas where control failure could cause misstatements:

- Loss and LAE Reserves often comprise 60% of total insurance liabilities, average 115% of surplus, and 10-15 times annual net income
 - ◆ Reserve calculations reflect assumptions, estimates, interpretations of regulations, recognition of changes in claims and underwriting operations, and trends
 - ◆ Should reflect all information available on the risks the company underwrites
- Other estimated balances include:
 - ◆ Premium deficiency reserves or unrecoverable DAC
 - ◆ Reinsurance recoverable
 - ◆ Estimates underlying the unearned premium
 - ◆ Estimated expense accruals such as contingent commissions
 - ◆ Policyholder dividends

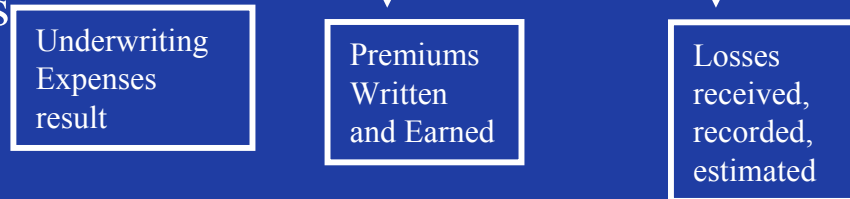
The P/C Company Risk Assumption Process

Business Design



Transactional Data Systems

Resulting Financial Flows



The PC Company Risk Assumption Process-Traditional Audit

Business Design

Markets Targeted

Underwriting Process

Product Rate Plan and Coverage

Underwriting Guides

Underwriting/Claims Transaction

Producer solicits/binds coverage, or policy renews

Policy is submitted to Underwriter

Underwriter verifies risk acceptability and price

Claims are received or estimated

Policy expires and may be renewed or audited

Transactional Data Systems

Resulting Financial Flows

Underwriting Expenses result

Premiums Written and Earned

Losses received, recorded, estimated

Traditional Financial Statement Audit Focus

The P/C Company Risk Assumption Process-Additional 404 Areas

Business Design

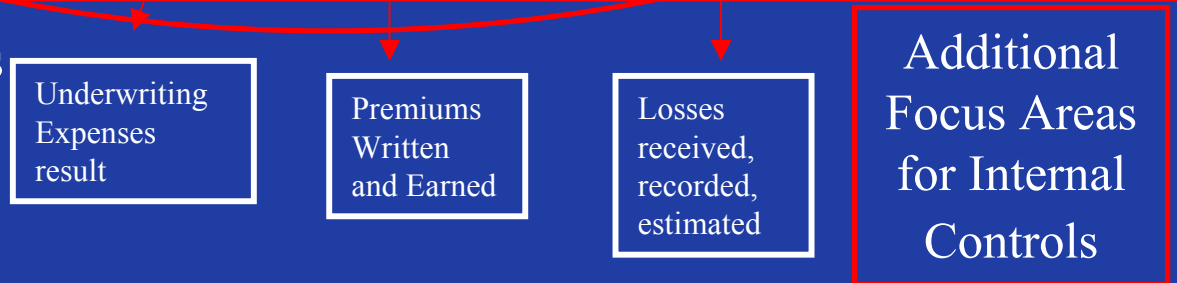


Underwriting/Claims Transaction



Transactional Data Systems

Resulting Financial Flows



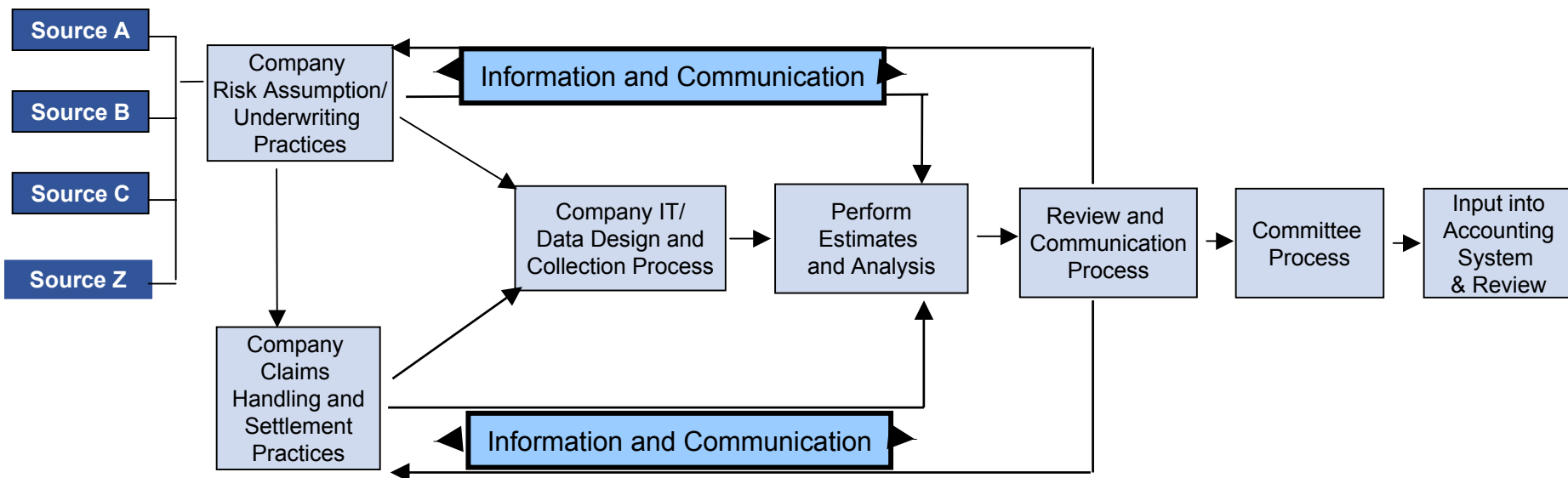
Comments on Operational Internal Controls and Sarbanes-Oxley, Section 404

- AICPA gives guidance as to how Sarbanes-Oxley applies to Internal controls in operational areas
 - ◆ **Only controls which affect financial statement balances are subject to Sarbanes-Oxley**
- Examples and the AICPA guidance are in the following table

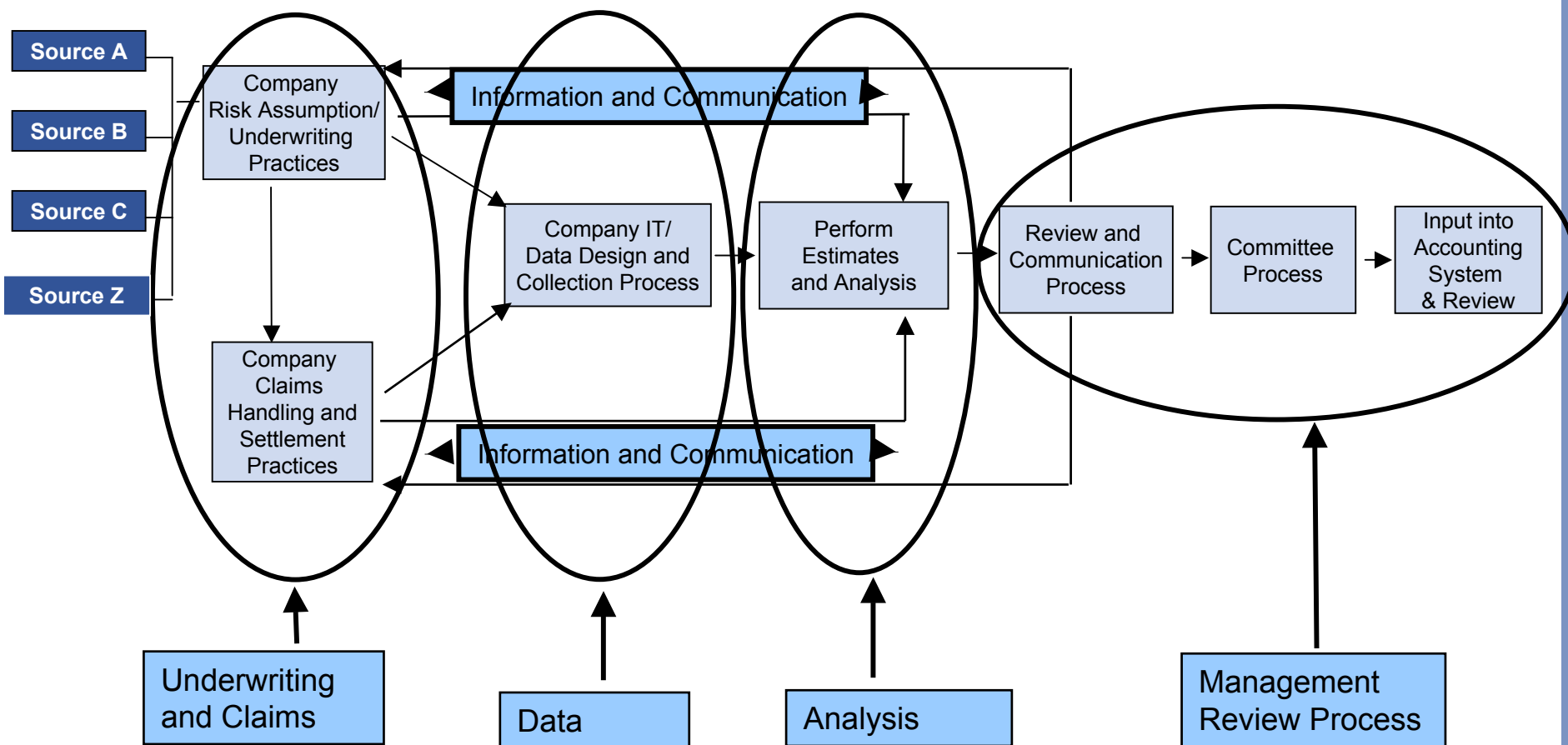
Operational Controls; Management Responsibility Contrasted with Section 404 Goals

Area of Control	Section 404 Internal Controls Include:	Examples of Additional Management Responsibilities, not section 404
In General (from AICPA 319, item 40)	Address “Inherent and control risks to evaluate the likelihood that material misstatement could occur in the financial statements”	Address “identify, analyze, and manage risks that affect entity objectives”
Underwriting	Company intent around which exposures to insure, at what prices, terms and conditions is clear, is followed, and consistent with assumptions underlying balance sheet and income statement estimates	Management executes an underwriting strategy that provides appropriate returns with reasonable risk to capital providers. Staffing resource is appropriate to the volume of business.
Claims	Case reserving philosophy, and claims processes are understood, impacts of changes are understood, and consistent with assumptions underlying profit, loss, and balance sheet estimates	Claim settlements are fair to both claimants and capital providers. Appropriate legal strategies are pursued to defend policyholders. Claims staffing resource is appropriate to the volume of claims.

Estimated Balances Must Properly Reflect the Following Company Operations



Estimated Balances Must Properly Reflect the Following Company Operations



Internal Controls as part of the “Five Component” Framework

Recalling the five component framework includes

- Control Environment:
- Risk Assessment
- Control Activities
- Information and Communication
- Monitoring Activities

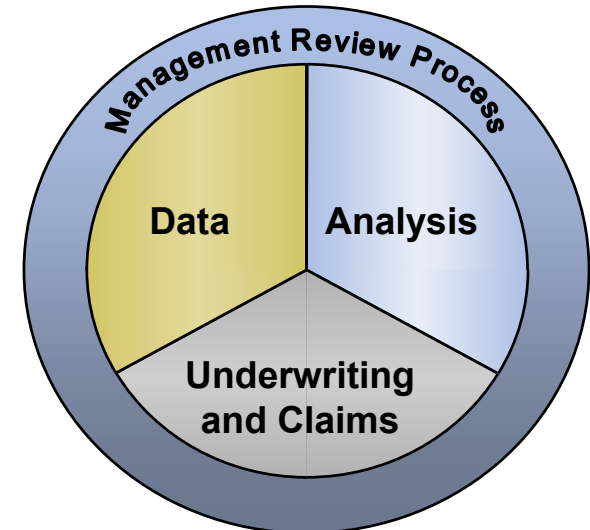


And underpinning these are four key risk areas for Property/Casualty

- **Underwriting and Claims** Operations
- **Data** Gathering and Interpreting
- Performing **Analysis**/Compiling Results
- **Management Review Process**

And evaluating for each risk area:

- **Completeness**: Is something missing?
- **Accuracy**: Is information accurate?
- **Judgments**: Are judgments appropriate?



Casualty Loss Reserve Seminar

The Impact on Actuaries of Sarbanes-Oxley Section 404 Company Perspective

Scott Anderson, FCAS, MAAA

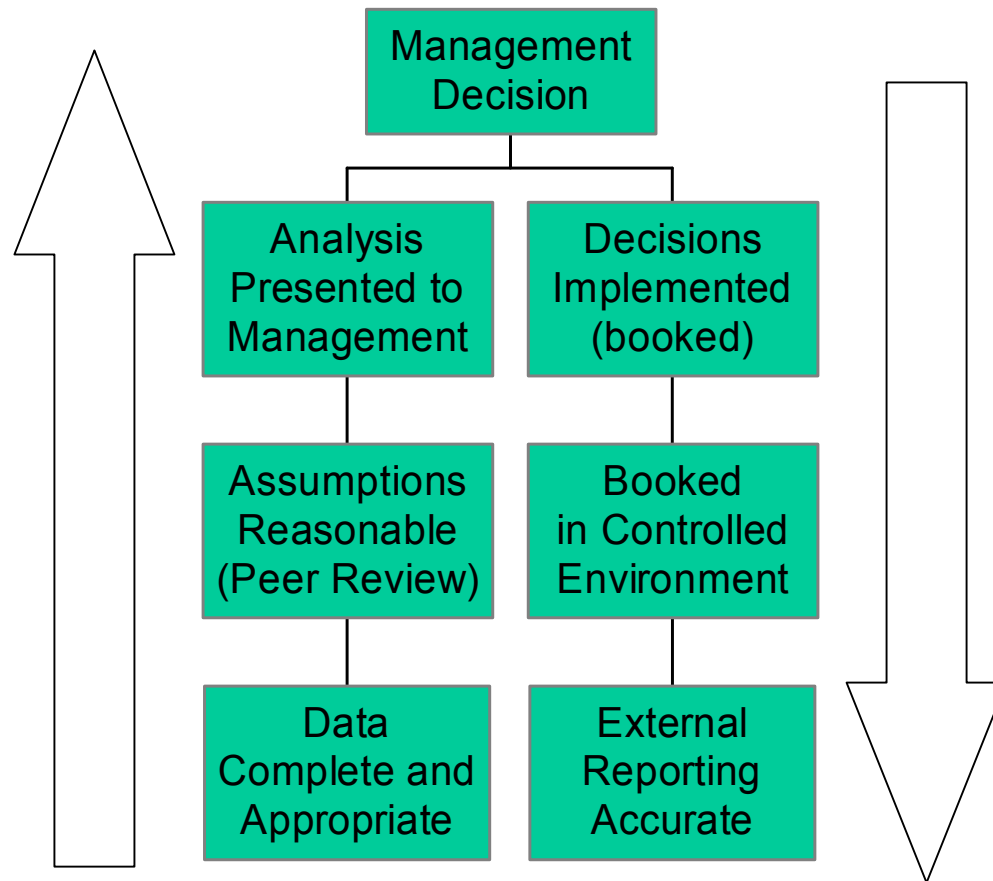
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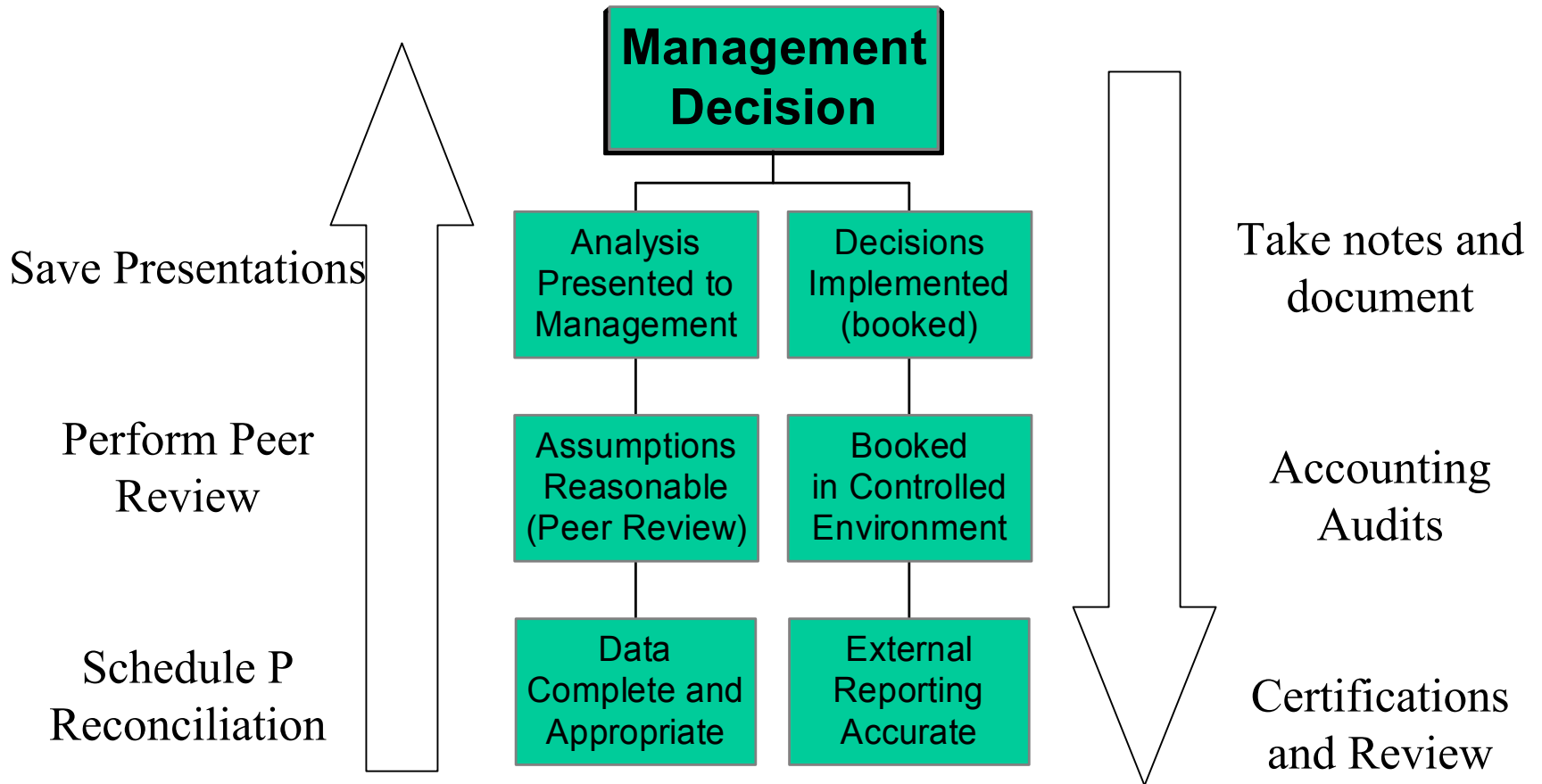
SOX 404 – Company Perspective

- Scope
- Practical Considerations
- Notable Hurdles
- Change Management

Basic Reserving Process



Basic Reserving Process



Casualty Loss Reserve Seminar

The Impact on Actuaries of
Sarbanes-Oxley Section 404

Concurrent Session 3

September 13, 2004

Casualty Loss Reserve Seminar

The speakers views are not necessarily identical to the views of the cosponsors of the program nor the employers or clients of the speaker

Practical Aspects of Sarbanes 404 Readiness

An Actuarial Perspective

Steven Visner, FCAS, MAAA, FCA
Principal
Deloitte Consulting

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

Example of Loss Reserve Control Set

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

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.

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

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

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 will be challenging
 - Can companies revamp processes and/or systems so quickly
 - Do you stop ongoing processes to fix gaps

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

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

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

DÉJÀ VU – Sarbanes Take Two

Proposed changes to NAIC Model Audit Rule

- Would extend Sarbanes like requirements to Non-Public Insurance Companies
 - Internal Control Certifications, and Attestations
 - Audit Committees – Composition and Responsibilities
 - Auditor Independence and Scope of Services

Sarbanes-Oxley Act of 2002, Section 404: The Impact on Actuaries

Hypothetical Case Studies

Goals of this part of the Presentation

- We will hypothesize several situations similar to those that have occurred in the past, and discuss the impact of the act
- We have noted that Sarbanes-Oxley essentially “raises the bar” for actuaries
- Many actuaries have dealt with situations in the past where significant changes in loss estimates for past years has impacted balance sheet reserves
 - Often in highly public press announcements, and sometimes with accompanying class action litigation
- Panelists will discuss possible future ramifications of such actions in the post Sarbanes environment
 - No one knows what will actually happen and all thoughts are purely hypothetical
 - Yet we need to be prepared as a profession and as individuals for risks in what could possibly result
- Audience participation in this section is highly encouraged!

Hypothesized Situation #1: Soft Market

- ❑ Assume several years of soft market have occurred, with recent hardening**
- ❑ Assume a major insurer announces a significant reserve charge resulting from the past 3-4 accident years**
- ❑ Assume reasoning given in the press release and related SEC filing documents is along the lines of...**
 - ❑ Loss reserves are estimates, with high degree of uncertainty**
 - ❑ Our underwriting actions of the past year have significantly improved the current book of business**
 - ❑ However, we discovered that the results of business in these past years was worse than previously believed, and our reserve actions recognize this**

Hypothesized Situation #2: A&E

- ❑ **Assume a major insurer announces a significant reserve charge resulting from latent claims liabilities from policies in force mainly in the 1960's-1980's**
 - ❑ **And assume the company has a history of similar charges occurring every several years in the past**
- ❑ **Assume reasoning given in the press release and related SEC filing documents is along the lines of...**
 - ❑ **Loss reserves are estimates, with high degree of uncertainty, especially as they relate to A&E**
 - ❑ **We initiated a major review of these claims**
 - ❑ **We discovered adverse litigation decisions and trends have led to the need for additional reserve strengthening**

Hypothesized Situation #3: New Cause of Liability

- Assume new theory of liability arises, for example, liability for tobacco related illnesses is imputed to all distributors, retailers, and companies carrying advertising for tobacco products, becomes significant and is found to be covered under CGL
 - And assume companies throughout the industry begin to announce charges, including your own
- Assume reasoning given in the press release and related SEC filing documents is along the lines of...
 - Loss reserves are estimates, with high degree of uncertainty, especially as they relate to new court decisions
 - We have continually monitored development of these claims
 - We discovered adverse litigation decisions and trends have led to the need for this reserve strengthening