Figure 6: The Stages on the Road to Readiness

Compliant Now	Staged Implementation	Wait and See
PROS • Demonstrates commitment of internal controls to stakeholders and regulators • Helps jump-start efforts and address any issues early **CONS** • Requires significant resources upfront • More external resources may be required • High upfront cost • May not allow taking advantage of additional NAIC guidance and peer company experiences as effectively	**PROS** • Allows putting the right resources, tools, and training in place over time and building internal competencies you don't have today • Allows focus on high risk areas first, where more time and resources are required • Less strenuous on internal resources and helps manage costs better **CONS** • Could be distracted by other priorities which could ultimately lead to high costs	**PROS** • No cost — business as usual • The NAIC may come out with further clarification on implementation guidance **CONS** • High cost when you decide to implement • Behind peer companies which could demonstrate a lack of commitment to internal controls to stakeholders and regulators

Will the Road Be Bumpy or Smooth?

Companies may experience some bumps in the road before it gets smooth, if implementation follows the same path as Sarbanes-Oxley. However, organizations can derive value in working towards compliance with the NAIC Model Audit Rule if the process is well-planned and well-executed. The key challenge to management teams may be to identify that value and develop the right plan to capture it.

One of the most important actions a company may be able to take to effectively implement the Model Audit Rule is to proactively develop a detailed action plan and to make this implementation process a part of day-to-day processes so it is ingrained in the infrastructure and the culture of the company. Weaving a proactive mindset into the company's operations may prove to smooth out, or even alleviate, some of the bumps in the ongoing journey of compliance.

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Health Plans

Will the Road be Bumpy or Smooth?

NAIC Model Audit Rule and Implementation

By: Nancy Litwinski, Director, Health Plan Statutory Services Leader, Deloitte Services LP and Lynn Friedrichs, Senior Manager, Deloitte & Touche LLP

Over the last five years of the Sarbanes-Oxley era, the National Association of Insurance Commissioners (NAIC) has reviewed and modified regulations and has adopted revisions to the Annual Financial Reporting Model Regulation (Model Audit Rule). Regulators and the NAIC have continued to uphold additional financial solvency standards due, in part, to the potential for Federal regulation of insurers as well as a greater need for effective corporate governance.

This Point of View provides thoughtful steps for facilitating an effective and efficient implementation of the Model Audit Rule and outlines:

- Changes to the rule
- Implementation considerations including lessons learned from Sarbanes-Oxley
- Steps for developing a Model Audit Rule readiness plan
- Opportunities to leverage relationships between the Model Audit Rule and SAS 70

By gaining a firm understanding of the Model Audit Rule — the requirements, implications, and paths to success — companies may find a smoother road to compliance.

The History of Regulation

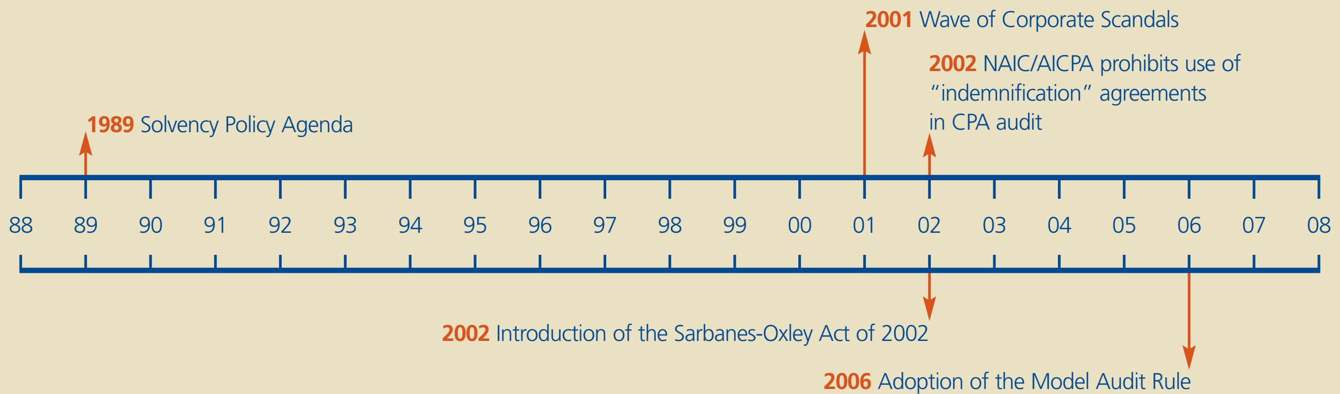
The solvency policy agenda of the NAIC in the late 80s and early 90s attempted to establish minimal benchmarks for monitoring the financial conditions of insurers at the state level (see Figure 1 on the following page). Some of the initiatives included accreditation of the state insurance departments, development of model laws and regulations including the Model Audit Rule, and initiation of the process to codify statutory accounting, which became effective in 2001. Corporate scandals also became the issue of the day in 2001, prompting the introduction of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley).

Today: A New Model Audit Rule

The NAIC adopted revisions to the Model Audit Rule during the last half of 2006. Over the next couple of years, states will be considering adoption of the new provisions of the Model Audit Rule either through their legislative changes or through regulations. Once adopted by the states, the first management's report of internal control over financial reporting (similar to the report required by Section 404 of Sarbanes-Oxley) will be due in 2011 for the 2010 reporting period.

What does this mean for insurers? For insurers domiciled and operating in many states, it means the Model Audit Rule may differ by state, and each state may use a different benchmark to evaluate management's internal control assertions and to determine whether those assertions are supported. For insurers operating in only one state, this benchmark could change between state examinations, so it is important for insurers to confirm at the outset that there is adequate documentation and that management's assertion is supportable.

Figure 1: The Evolution of Strengthening Regulation Continues



Overview of Changes to Model Audit Rule

The purpose of this regulation is to improve the state insurance departments' surveillance of the financial condition of insurers. Any individual or stand-alone non-public company, including insurance companies, captive insurance companies, nonprofit insurers or health plans, that files an annual statement with their domiciliary state regulator is affected. The Model Audit Rule modifications enhance provisions in three areas:

- Management report of internal control over financial reporting (ICFR)
- Auditor independence and scope of services
- Enhancements to the requirements for independence of audit committee members

Management Report of ICFR

The Model Audit Rule requires management to file annually with the commissioner management's report of ICFR. The report is required to be signed by the CEO and CFO or an equivalent of the insurer and must include the following:

- Management's responsibility for ICFR
- Verification that management has established ICFR
- Assertion by management as to whether ICFR is effective
- Approach to evaluate effectiveness of ICFR
- Description of scope of work
- Internal controls excluded from scope
- Inherent limitation of internal control systems

Management's ICFR report also requires disclosure of unremediated material weaknesses in ICFR. Insurers cannot conclude that ICFR is effective if any unremediated material weaknesses are identified.

The Model Audit Rule ICFR reporting requirements apply to:

- Insurers with annual direct written and assumed premiums in excess of $500 million
- Insurers with less than $500 million in annual direct written and assumed premiums when an insurer has a risk-based capital action level event, or meets any one or more of the standards of an insurer deemed to be in hazardous financial condition

One key consideration in the Model Audit Rule ICFR lies in the definition of a Sarbanes-Oxley compliant entity, which is an entity that either is required to be compliant with or voluntarily is compliant with certain sections of Sarbanes-Oxley. An insurer that is a Sarbanes-Oxley compliant entity or a direct or indirect wholly-owned subsidiary of a Sarbanes-Oxley compliant entity will be able to file its or its parent's Sarbanes-Oxley Section 404 report in satisfaction of the Model Audit Rule ICFR reporting requirement. However, there is also an addendum that needs to be filed with the Sarbanes-Oxley Section 404 report that would include a positive statement that there were no material processes related to the preparation of the audited statutory financial statements that were excluded from the Section 404 report.

If there are internal controls that have a material impact on the preparation of the audited statutory financial statements excluded from the Section 404 report, the insurer may either file management's Model Audit Rule ICFR report or their Section 404 report would have to include information on the effectiveness of those controls. The incremental work to include internal controls material to the audited statutory financial statements, but excluded from the Section 404 report, may be significant, especially if the insurer is considerably smaller than the Sarbanes-Oxley compliant parent entity. In particular, companies should consider whether the internal controls identified incorporate the processes and controls over statutory accounting and reporting. For many companies this process may be outside the reporting processes used for the parent or consolidated entity.

Auditor Independence and Scope of Services

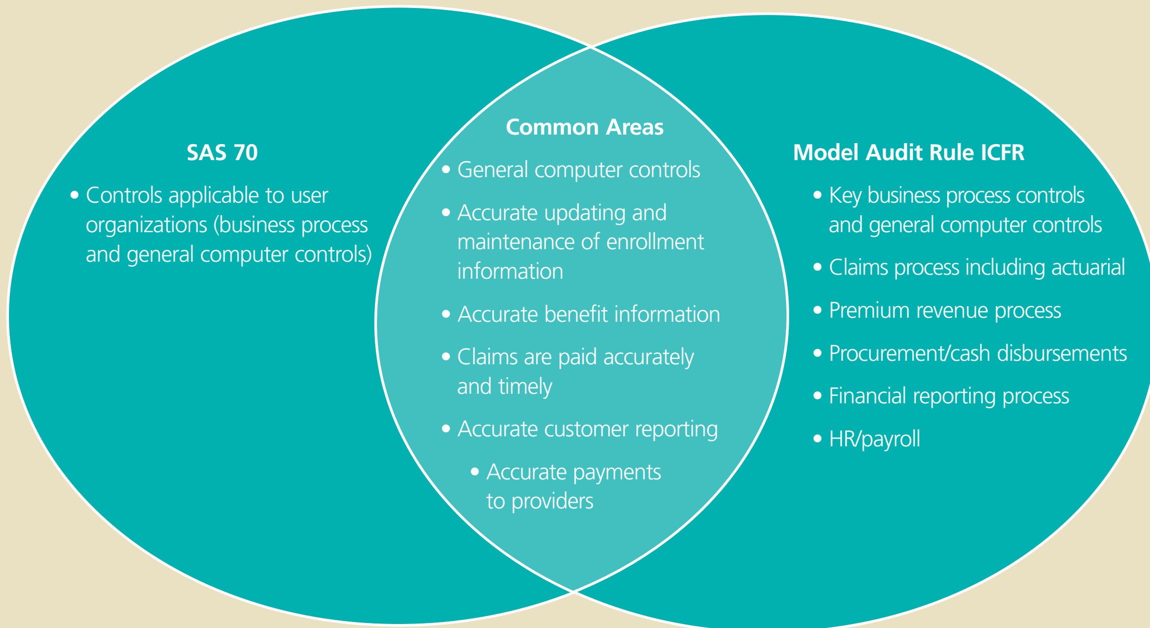
The primary change to the Model Audit Rule's rotation requirement for the audit partner is the extension of the cooling-off period once the partner has served an account for five years. Currently the rotation is required after seven years with only a two-year cooling off period. This revision will require a partner serving for five years to have a five-year cooling-off period, effective for 2010 audits. The Model Audit Rule implementation guide provides guidance for transitioning partners.

Revisions to the definitions of non-audit services have mirrored the Sarbanes-Oxley prohibited services and are intended to maintain independence for the audit firm that serves insurers (see Figure 2 on the following page). These revisions are also effective for 2010. There is a hardship waiver outlined in the Model Audit Rule that allows small companies in a small state with very limited access to CPA firms to request a waiver from the requirements of these prohibited services.

Model Audit Rule resource

The NAIC has adopted an Implementation Guide for the Model Audit Rule that is incorporated in the March 2007 Accounting Practices and Procedures Manual. This 40-page guide provides guidance for implementing the significant changes and can be found on the NAIC website at www.naic.org.

Figure 5: Common Areas of SAS 70 and Model Audit Rule ICFR



Remember: Model Audit Rule ICFR is assessed at the "as of" date. SAS 70 covers a period of time.

SAS 70 report and Model Audit Rule ICFR are two separate deliverables that derive from a common internal control compliance program.

The Model Audit Rule internal control reporting requirements and the scope of most insurer SAS 70 reports overlap in many common areas (as depicted in Figure 5). These are the areas where an organization can gain efficiencies by leveraging common business processes and general computer control environments for both reporting requirements. It is important to note that the Model Audit Rule internal control report is an "as of" date, at the end of the year, versus the SAS 70 report, which covers a period of time. If there are issues identified through a SAS 70 report, they may need to be reported, but they may also be remediated for the Model Audit Rule reporting requirement.

Where Are You on the Road to Readiness?

Insurers are at various stages in working to achieve full compliance with the Model Audit Rule. Figure 6 (following page) depicts three potential stages of readiness and the pros and cons of each. Companies that conclude that they are "compliant now" with the regulation should ensure that their documentation and testing of controls encompass those necessary for supporting the audited statutory financial statements. A "wait and see" approach may not be advantageous for an organization because the Model Audit Rule is finalized and will be adopted by the states as a part of the overall regulatory framework. Waiting to see what happens may not provide adequate lead time. A "staged implementation" could be a better approach for most companies. Taking the time to develop a thoughtful and reasonable approach to implementing the new provisions of the Model Audit Rule will likely result in a process which enhances the company's overall control environment in addition to achieving compliance with the regulation. To begin, companies should consider identifying a team, determining the internal and external resources needed, and developing a timeline that includes a potential for identifying material weaknesses.

What's the first thing a company can do to begin the process of implementing the Model Audit Rule?

Organizations simply cannot do too much planning, which was an important lesson of Sarbanes-Oxley. The process should start with planning, assessing, and understanding the Model Audit Rule and what it means to a company's business. It is important not to underestimate the resources and the time needed to administer, manage, and monitor the project going forward. Time should be allotted to react to changes in the environment and for any remediations needed.

What is a SAS 70?

A SAS 70 report is, in basic terms, a common standard for reporting on internal controls under AICPA Statement of Auditing Standards No. 70, *Reports on the Processing of Transactions by Service Organizations (SAS 70).* A SAS 70 report on the processing of transactions by a service organization provides an independent assessment of an organization's internal control procedures and whether those internal controls met the management's stated objectives. For example, when an insurer serves as a service provider for a self-insured employer group (their customer), the insurer may use a SAS 70 report to provide to their customers and their customers' auditors information regarding the insurer's claim administration processing.

the standards the company has adopted. Finally, in this phase organizations should develop a testing methodology. Remediation policies should be applied, and the plan for performing ongoing tests of remediation should be developed.

Phase 4: Sustain, Monitor, and Assert

The process for reaching compliance is not a one-time event. Companies may not be able to just quickly comply and move on; this is a continuing requirement that can become an intrinsic part of the process and part of the culture of the organization. Companies should continuously monitor and improve the control environment to support an annual certification requirement and conduct ongoing reporting and communication processes to senior management or the steering committee. This may include:

- Defining ongoing roles and responsibilities
- Performing self-assessments at various regular intervals
- Using the internal audit function (or a similar function) to monitor the effectiveness of the entire internal control program and infrastructure
- Challenging the controls that have been identified and implementing new controls as the business changes.

SAS 70 Considerations

Many insurers currently issue a SAS 70 report, and requests for them to provide a SAS 70 report are increasing, especially by self-insured employer groups and more specifically, self-insured employer groups that are a Sarbanes-Oxley compliant entity. A SAS 70 report may minimize customer audits, but it demands a lot of time from an organization's operations. Preparing for Model Audit Rule readiness is an opportunity to evaluate those customer requests, and the SAS 70 report can be a by product of the company's approach to internal control.

With proper planning and administration, insurers should be able to effectively combine customer SAS 70 report requests and Model Audit Rule requirements to develop an integrated internal control action plan as the phases of the action plans are common for both the Model Audit Rule and SAS 70 readiness projects. Additionally, there are a significant amount of common areas in the scope of SAS 70 and Model Audit Rule ICFR. Figure 4 depicts the four-phased Model Audit Rule readiness action plan and includes how customer SAS 70 requirements could become part of the action plan — the

Figure 4: An Integrated Readiness Action Plan: Model Audit Rule and SAS 70

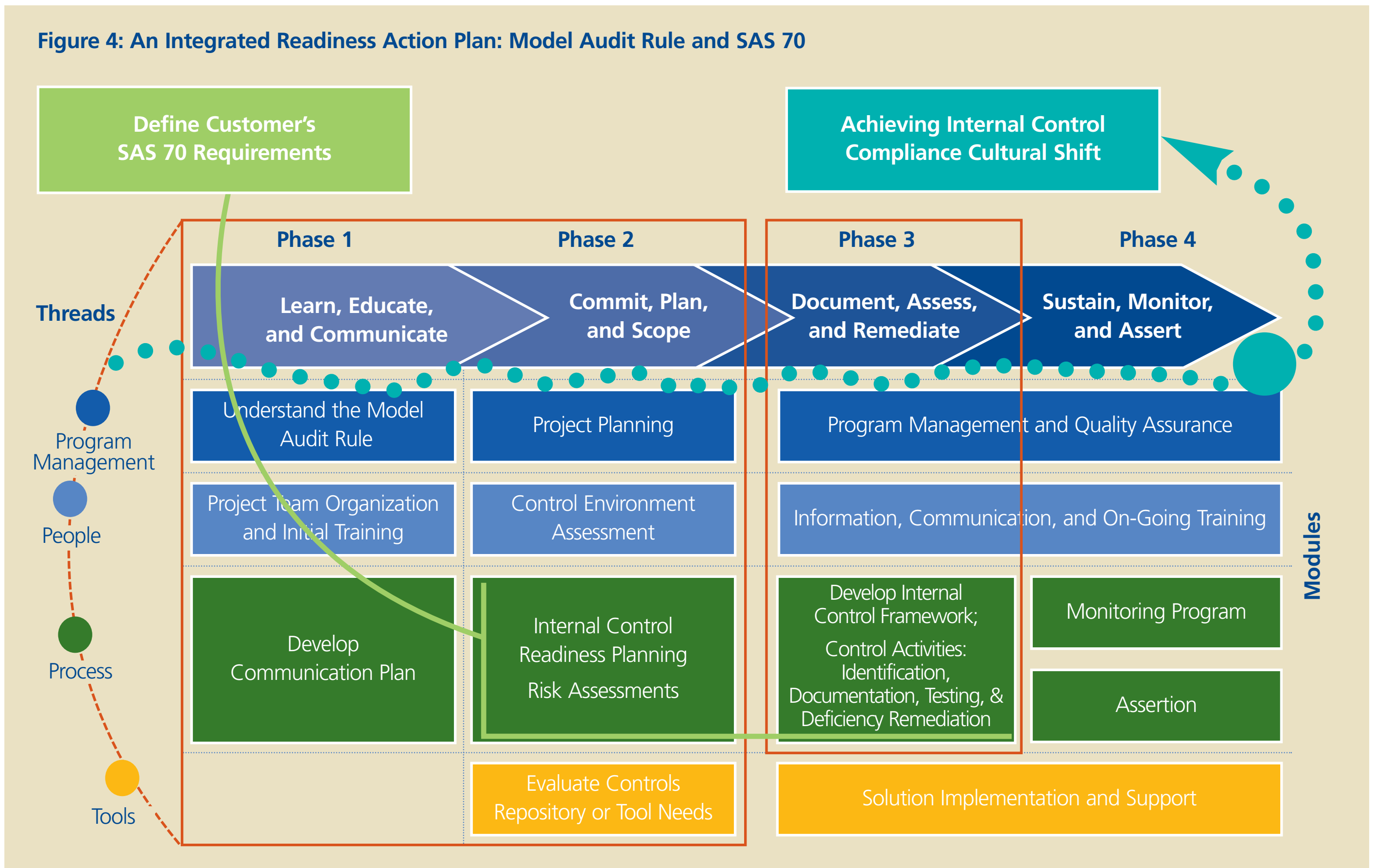


Figure 2: Principles of Auditor Independence

Three principles of independence

- Cannot function in the role of management
- Cannot audit own work
- Cannot serve in an advocacy role for the insurer

- Bookkeeping or related services
- Financial information systems design and implementation
- Appraisal or valuation services
- Actuarially-oriented advisory services involving determinations of amounts recorded in the financial statements
- Internal audit outsourcing
- Management functions or HR
- Broker or dealer, investment advisor, or investment banking
- Legal services or expert services

Enhancements to Requirements of Independence for Audit Committee Members

The audit committee is directly responsible for appointment, compensation, and oversight of the independent CPA. The independent CPA must report directly to the audit committee, and all audit and non-audit services must be pre-approved by the audit committee. The auditor must provide the audit committee with communications as required by SAS 61, Communication with Audit Committees, or its replacement. In terms of independence:

- 50% of audit committee members need to be independent if a company has between $300 and $500 million in prior calendar year direct written and assumed premiums.
- Over 75% of audit committee members need to be independent if a company has more than $500 million in prior year direct written and assumed premiums.

An insurer may be exempt from this section of the Model Audit Rule regulation if it is a Sarbanes-Oxley compliant entity.

Regardless of premium volume, it is important for all companies to know the requirements around audit committee composition. The audit committee composition in compliance with the independence requirements needs to be in place by January 1, 2010.

Lessons Learned from Sarbanes-Oxley

Many lessons can be derived from experiences with Sarbanes-Oxley — some positive, others challenging. Many organizations have had the chance to reinforce their message from the leadership that internal controls really do matter. Governance changes concerning the composition of audit committees and the independent nature of audit committees all seem to be constructive modifications.

The primary challenge often lies in the significant amount of time, effort, resources, and costs that were required to reach compliance, specifically with Section 404 of Sarbanes-Oxley. Many organizations may have benefited from starting earlier and being more realistic about the resources that were required. Many found that Sarbanes-Oxley compliance was a burden due to the cost of attestation. This is an important difference between the Model Audit Rule and Sarbanes-Oxley. The Model Audit Rule only requires management assertion and not an external auditor attestation.

Myths to Overcome

Lessons learned from public companies in implementing Sarbanes-Oxley point to some common misconceptions insurers may need to consider in addressing the internal controls aspects of the Model Audit Rule. Overcoming these myths and understanding the reality of Model Audit Rule requirements and implications should help companies move forward with a smoother implementation of internal control programs.

Making the Commitment

Myth 1: For well-controlled organizations, the NAIC changes to the Model Audit Rule should not require a significant commitment.

In reaching compliance with Sarbanes-Oxley, the most time-consuming exercise that many entities appeared to encounter was simply preparing documentation for controls that management believed already existed, but did not.

What types of companies are affected by these Model Audit Rule changes?

Any individual or stand-alone non-public company — including insurance companies, captive insurance companies, nonprofit insurers or health plans — that files an annual statement with their domiciliary regulator is affected. The only state where a health plan could be domiciled and not subject to the Model Audit Rule is in California, where health plans are subject to the Knox Keene Act.

Do you need to understand Sarbanes-Oxley to understand the Model Audit Rule?

Because the Model Audit Rule and its requirements are derived, in part, from Sarbanes-Oxley, it is important to at least understand the provisions in Sarbanes-Oxley to be successful in meeting the new requirements. Companies may benefit from looking back to the requirements and how companies reacted to Sarbanes-Oxley compliance to implement the Model Audit Rule.

Organizations discovered that many controls had never truly been documented. They also identified more control design deficiencies than they originally anticipated, some requiring implementation of new controls and systems.

Even if a company is compliant with Sarbanes-Oxley, there likely will be a significant commitment required. Material processes, procedures, and internal controls used to prepare the audited statutory financial statements may not have been included in the scope of the Section 404 report and may not be documented, or may not be documented completely. Companies should consider assessing whether the internal controls material to the audited statutory financial statements are incorporated, including those specific to statutory accounting and reporting for the individual entities subject to the Model Audit Rule.

Importance of Planning

Myth 2: The most significant amount of time and resources will be spent on documentation and testing.

While companies should allocate time for documentation and testing, the amount of time and resources necessary to strategically plan and administer the project should not be underestimated. Early planning can allow companies to anticipate priorities and proactively identify risks so they can effectively mitigate those risks, even with resource constraints.

There are many risk areas that are important for insurers to understand in terms of the audited statutory financial statements. Risk areas include:

- Investments
- Policy and claim reserves
- Benefit payments
- Premiums
- Reinsurance
- Related party transactions
- Operating expenses
- Income taxes
- Contingent liability reserves (litigation, malpractice, and provider disputes)

These risk areas should be documented and tested and could yield a clear understanding of how they impact the preparation of statutory financial statements.

The year 2010 may seem a long way off, but planning for implementation should be done thoughtfully and without time constraint. It may take a long period of time to determine if material weaknesses exist, identify persons responsible for the process, and explore alternative internal control frameworks. It can be beneficial to consider all of these issues in addition to documentation and testing of internal controls.

Cross-functional Integration

Myth 3: NAIC changes to the Model Audit Rule will only impact personnel involved in preparing the financial statements.

Implementation has broad implications across an entire organization. There is often an issue with silos in an organization; for example, the tax department may not have clear and timely communications with the financial department. Human resources may not communicate information about periodic pension plan changes (which ultimately impact the financial statements) across the company.

Every area involved in contributing information to the audited statutory financial statements is a stakeholder in this process; it is not limited to those preparing the financial statements. The process includes those involved in corporate allocation of expenses, internal audits, pension plan issues, and information technology (IT). Education appears critical. One of the most significant challenges that companies may experience is educating non-financial staff with respect to the requirements of the Model Audit Rule.

Inclusion of IT

Myth 4: IT does not need to play a significant role in the implementation of the NAIC changes to the Model Audit Rule.

Documentation and testing of IT systems and applications supporting material processes is important to internal controls, which is why companies should view the entire project as an integrated operation for finance, operations and IT personnel. In fact, it may be wise to give IT management an important role in the project planning and oversight as it is important to ensure the scoping of the IT work is consistent with the overall processing and controls identified. In implementing Sarbanes-Oxley, companies learned that the manual controls are easy to identify; however, it appeared to be more effective and efficient to identify the automated controls within a process.

Ongoing Change

Myth 5: NAIC changes to the Model Audit Rule will only have a significant impact in the initial year of implementation.

On the contrary, documentation to support the Model Audit Rule internal control reporting requirements should be viewed as a living process. While it is likely that the most significant impact will be in the initial year, these changes will be an ongoing requirement. Controls should be assessed by management each year.

Any company that experiences acquisitions, changes in their systems, or organizational structure changes will need to incorporate these changes within the company's operations and as underlying support for the ICFR report. Further, once a control has changed from its previous design, it is required to be documented and tested.

IT: Questions to ask

- Did the Section 404 report for a Sarbanes-Oxley compliant entity reach down to the applications and systems supporting the material processes needed for the audited statutory financial statements?
- Have the processes been documented for preparing the audited statutory financial statements, including the sources of information?
- How are automated controls used within a process and have those key automated controls been identified?

Judgments Required in Decision-making

Organizations may need to employ a great deal of judgment when they implement the Model Audit Rule because it is a principles-based standard, whereas Sarbanes-Oxley was a rules-based model. Judgment may be required to:

- Scope and plan to ensure the project is realistic about time, effort, and resources
- Determine a framework to use, COSO (Committee of Sponsoring Organizations) or an alternative
- Test controls
- Develop remediation plans
- Determine whether or not an exception or design flaw identified in the testing is a deficiency, a significant deficiency, or a material weakness

How does an organization deal with applying these judgments? In advance, they may want to identify individuals to assist with and be responsible for the decision making. If internal audit is driving the testing or if external resources are used, a project management office (PMO) or some kind of management lead may be helpful to make those critical judgment decisions, perhaps even as high up as the CFO and CEO.

Model Audit Rule Readiness Action Plan

Most of the Model Audit Rule changes are not effective until 2010, so why should companies start to get ready now? History has taught us that many public companies that have complied with Sarbanes-Oxley wished they had started earlier because they simply ran out of time. If an organization can get off to an early start, they'll likely have plenty of time to do a full test of internal controls. Organizations may consider conducting this test at the end of 2008, if possible, or at the latest at the end of 2009, to determine how ready they truly are. This should give time to remediate any deficiencies or material weaknesses that are identified.

Similar to any large implementation project, it is important to have an action plan to ensure that the goals of the project are achieved. Figure 3 illustrates a four-phased approach for insurers to consider in developing a Model Audit Rule readiness action plan, which is ultimately an internal control compliance program. As depicted, there are some common threads that should be considered in the approach:

- Program management
- People
- Process
- Tools

Each of these common threads is part of all of the project phases and is important to remember during the development of an action plan.

Phase 1: Learn, Educate, and Communicate
Learning the basics of the Model Audit Rule changes is important. However, it is important to gain an in-depth understanding of what the changes mean for a company — to determine how to implement the changes and establish a timeline for implementation. Education should be emphasized across the organization. The Board of Directors and audit committee should understand what's required of them, and the CEO and CFO should understand their responsibility because their assertion relating to the effectiveness of the internal controls over financial reporting will be required with the audited statutory financial statements.

Phase 2: Commit, Plan, and Scope
Again, the importance of planning should not be underestimated. One of the first steps is to assess internal controls. It is beneficial to be honest in this exercise and think about the statutory financial statements that are affected and what goes into creating those financial statements. With Sarbanes-Oxley, many companies were surprised at some of their findings; this may be true in implementing the Model Audit Rule revisions as well.

It is important that the highest levels of the organization — CEO, CFO, Board of Directors, and audit committee — are committed and leading this project. Other steps to consider in Phase 2 include the following:

- Establish a steering committee — They will be the decision makers who guide the project.
- Develop protocols — These should address involvement of internal and external auditors and provide a process for resolving issues as they arise.
- Communicate — Create a formal communication and training program for key management and employees.
- Develop a high level project plan — Determine a timeline and identify the project team roles and responsibilities. Determine whether there are enough resources to manage the project, with a consideration to the administrative effort required.

Phase 3: Document, Assess, and Remediate
Based on planning, companies can then form a PMO, choose a framework, define the scope, and identify and test controls. During this stage, organizations should also look for tools or controls of repository as supporting technology — but this should not define the approach or the development of an action plan. Rather, organizations may define their needs and select a tool that supports those needs. As "exceptions" are identified, they should be evaluated against

Figure 3: Model Audit Rule Readiness Action Plan