



# Brown Smith Wallace

Whitepaper

## Model Audit Rule for Insurance Companies Effective in 2010

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Guidelines for Effective  
Implementation of the MAR



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## **Model Audit Rule for Insurance Companies Effective in 2010**

Guidelines for effective implementation of the MAR

### **Executive Summary**

As inevitable as gravity, the Model Audit Rule (MAR) is pulling non-publicly traded insurance companies that hold \$500 million or more in premium volume into its regulatory orbit. The revised MAR is essentially Sarbanes-Oxley (SOX) coming to privately held insurance companies. Corporate governance and financial accountability will be intensely scrutinized, and CEOs and CFOs will need to sign off on financial statements much as their public company counterparts have done for several years because of SOX requirements.

In 2010, executives of non-public insurers will have to explicitly affirm that their accounting practices meet the new MAR requirements and their financial reports are accurate. In addition, their audit committees must have a majority of independent members and the outside auditor must be independent. The MAR guidelines, revised in 2006 but not effective until next year, are aimed at improving transparency, tightening internal controls and improving overall corporate governance of larger, non-public insurance companies.

### **History of the Model Audit Rule**

The MAR was established in the late 1980s to promote the reliability, solvency and financial solidity of insurance institutions. Prior to 2002, the MAR was in place to establish minimum requirements for financial reporting for insurance companies. The MAR is governed by the National Association of Insurance Commissioners (NAIC), whose mission is to assist state insurance regulators – individually and collectively – in serving the public interest and achieving fundamental insurance regulatory goals in a responsive, efficient and cost effective manner, consistent with the wishes of its members.

In 2002, the Sarbanes-Oxley Act was passed as the government's answer to a number of accounting scandals which had cost investors billions of dollars. Sarbanes-Oxley created a number of standards to enhance corporate responsibility and financial disclosure in order to combat corporate and accounting fraud. As many insurance companies are not publicly held, they avoided the sweeping changes delivered through Sarbanes-Oxley until the U.S. Securities and Exchange Commission and the NAIC revisited the existing MAR to bring the industry in line with principals of the Sarbanes-Oxley Act.

On June 11, 2006, a revised version of the MAR was created. The proposed revisions relate to auditor independence, corporate governance, and internal control over financial reporting. These revisions are effective December 31, 2010.

## **Changes to the Model Audit Rule**

Modifications to the MAR that take effect in 2010 are designed to improve three primary areas:

- Services and Independence Auditors
- Audit Committee Members
- Annual Management Reports

### **Services and Independence Auditors**

The first revision to the MAR will invoke stricter guidelines concerning auditor independence. The MAR requires rotating audit partners every five years and restricts non-audit services that may impair independence including:

- Internal Audit outsourcing
- Financial information systems design and implementation
- Appraisal/Valuation services

According to the NAIC, insurance companies with less than \$100 million in direct written and assumed premiums may request an exemption from this requirement.

### **Audit Committee Members**

The MAR revisions also require insurance companies to establish an audit committee that is solely responsible for the appointment, compensation and oversight of the company's auditor. Depending on the insurer's premium volume, a certain percentage of committee members must be independent of the company's management. Additionally, an insurance

company cannot incur consulting fees or hire accountants to create the audited financial report.

### **Annual Management Reports**

Once the MAR is adopted by the state, insurers are required to provide an annual management report of internal control over statutory financial reporting to their respective state insurance commission. This document is similar to the Section 404 report required by the Sarbanes-Oxley Act.

According to Section 404, issuers are required to publish information in their annual reports concerning the scope and adequacy of the internal control structure and procedures for financial reporting. This statement shall also assess the effectiveness of such internal controls and procedures.

The registered accounting firm shall, in the same report, attest to and report on the assessment on the effectiveness of the internal control structure and procedures for financial reporting.

Companies already adhering to SOX requirements may file its or its parent company's Section 404 Report on internal control with an addendum stating that those internal controls having a material impact on the preparation of the statutory financial statements were included in the scope of the Section 404 Reports.

These companies may need to revisit their internal control structure to ensure sufficient coverage of the statutory financial statement process.

This is only required for companies domiciled in states in which the MAR has been adopted. It is anticipated that a significant majority, if not all, of the states will eventually adopt the MAR. Once adopted, the first annual management report will be due in 2011 for the 2010 reporting period.

### **What Does a Management Report Contain?**

The Management Report of Internal Control over Financial Reporting (ICFR) must include the following:

- A statement that management has established ICFR and is responsible for establishing and maintaining adequate ICFR
- An assertion that ICFR is effective to provide reasonable assurance regarding the reliability of financial statements in accordance with statutory accounting principals

- A statement that briefly describes the approach or processes by which management evaluated the effectiveness of its ICFR
- A statement that briefly describes the scope of work that is included and whether any internal controls were excluded
- Disclosure of any unremediated material weaknesses in the ICFR
- A statement regarding the inherent limitations of internal control systems
- Signatures of the chief executive officer and the chief financial officer

## Who Is Impacted by the MAR?

The MAR applies to insurance companies with the following attributes:

- Insurers with annual direct written and assumed premiums of \$500 million and more,
- Insurers with a risk-based capital action level event, or meet any one or more of the standards of an insurer deemed to be in hazardous financial condition,
- and insurers that are:
  - Subject to Section 404 or have a parent company that is subject to Section 404
  - A Sarbanes-Oxley compliant entity or have a parent company that is a Sarbanes-Oxley complaint entity

## Frequently Asked Questions

### ▪ What are the advantages of moving forward with implementing the MAR now as opposed to waiting?

To allow adequate time needed for implementation. If companies wait too long, they may not have enough time to resolve or mitigate any issues identified. Companies can use the available time now, before mandatory compliance takes effect next year, as a dry run to make sure they avoid penalties for not appropriately documenting audit procedures and internal controls, and continuously monitor important financial areas such as investments, cash reserves, revenue, disbursements, billings, claims and payroll.

▪ **Are there any problems that insurance companies can run into during the implementation process of the MAR?**

One problem might be the efficiency and effectiveness of staff based on their lack of understanding of how to process requests related to the implementation. Companies should establish partnerships with firms and/or individuals that have been through the implementation process already to leverage existing thought leadership from subject matter experts that have seen the process through from cradle to grave.

▪ **Is the process time consuming?**

It depends on the size of the company, along with the number of locations and complexity of the business mode. This key question can be answered once several scoping type questions that require management input have been answered. Generally, if a company uses the experience of firms or individuals that have significant SOX experience, they can benefit from efficiencies already realized during SOX implementations.

▪ **Is there any special kind of equipment needed to complete implementation?**

No.

▪ **How many states have adopted the MAR?**

Twelve states have adopted the MAR to date and 13 states have proposed changes to their current statutes/regulations, but not yet adopted. All states intend to either present the changes to their legislature or adopt the MAR by the end of 2009.

▪ **Do you anticipate more changes to the MAR down the road?**

It is unknown at this time.

▪ **Where can I find additional tips as far as implementing the revised MAR?**

This information is available by request. Please contact Ryan Hauber at [rhauber@bswllc.com](mailto:rhauber@bswllc.com) or (314) 488-3048.



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