

## Sarbanes-Oxley 404

Internal Controls in Financial Reporting:  
Implications for Actuaries

## Sarbanes-Oxley Background

- Legislation passed July 30, 2002
- Applies to GAAP financial statements filed with SEC
- Effective 12/31/2004 for “accelerated filers”
  - Capitalization > \$75 million
- Effective 12/31/2006 for others
- Created Public Company Accounting Oversight Board (PCAOB) to oversee audits of public companies

## Goals of Sarbanes-Oxley

- “... to restore public confidence in the accounting profession ... (and) improve the quality of financial reporting – to make the numbers accurate.”
  - SEC Chairman William Donaldson 7/30/03
- To provide “reasonable assurance” regarding the reliability of financial reporting
- To increase investor confidence

## SOX 404 – Internal Controls

- Two short paragraphs
- Asks management to answer this question:
  - Are there adequate controls in place to ensure that the company prevents or detects material errors in financial statements on a timely basis?

## SOX 404 – Steps

- Identify significant accounts
- Identify “financial statement assertions”
- Define and document each “process” (“narrative”)
- Define “risks”
- Define “controls” which mitigate each risk
- Execute controls
- Document execution of controls
- Test effectiveness of controls
- Remediate “control deficiencies”
- Issue management report on control effectiveness
- Obtain opinion from external auditor on effectiveness of controls

## Significant Accounts - Actuarial

- Benefit Reserves
- Claims Reserves
- Deferred Acquisition Costs (“DAC”)
- Value of Business Acquired (“VOBA”)
- Other - deemed significant based on:
  - Size of Account
  - Subjectivity in determining balance
  - Complexity

## Impacts - Statutory Reporting

- Regulators propose to apply 404 rules to statutory financials
  - Modification to Model Audit Rule - Draft
  - Effective 12/31/2006? (possibly staggered)
  - May apply at holding company level
  - Requires management assertion on effectiveness of internal controls
  - Requires audit opinion on internal controls
  - Imposes significant additional work effort and cost
  - Industry does not perceive benefit in proportion to cost
- Statutory reserves may already be in scope if GAAP reserves are based on statutory (purchase)

## Impacts – Tax/Pricing/Other

- Tax reserves may already be in scope due to deferred tax implications
- Pricing area may be involved in hand-off of models to financial reporting
- Cash flow testing models used for GAAP purposes (such as loss recognition) may be subjected to SOX requirements
- Some companies adopting “SOX-lite” requirements on other processes outside of GAAP financial reporting (experience studies, economic capital, embedded value, product development)
- Company actuaries outside of valuation areas may play role in testing of controls

## SOX Language

- Financial Statement Assertion
- Process Narrative
- Risk
- Internal Control
- Risk Control Matrix
- Documentation
- Testing
- Remediation

## Financial Statement Assertion

- Existence or occurrence
  - Assets, liabilities and ownership interest exists at a particular date; transactions are recorded in the correct period.
- Completeness
  - All transactions or events which should have been reflected in a period were reflected/
- Valuation or measurement
  - Assets, liabilities, income and expenses are recorded at correct amounts (computed correctly, summarized correctly)
- Rights or obligations
  - Assets are rights and liabilities are obligations of the entity at a given date.
- Presentation and disclosure
  - Items in the financial statement are properly described and classified.

## Examples of Actuarial “Processes”

- Benefit reserve calculation for traditional whole life block
- DAC computation for universal life block
- Loss recognition testing
- Claims reserve calculation
- Experience study
- New product introduction

## Process Narrative

- Written documentation describing:
  - Flow of data
  - Calculations
  - Internal Controls
  - Names of systems, spreadsheets
  - Titles of persons performing various steps

## Abbreviated Process Narrative – FAS 60 Prem-Paying Life Reserves

- Actuarial student receives runs of V42 valuation system in text format (LifeRsvYYYYYQQ.txt).
- Student imports file into Excel (FAS60PPRsvYYYYYQQ.xls).
- Student updates pivot table to summarize policy count, face amount, and GAAP reserves.
- Student reconciles count and face amounts to administrative system (Exhibit Life Ins YYYYYQQ.xls) and explains differences (control R10).
- Actuarial Assistant VP reviews reconciliation (R11).
- Student updates trends in reserves per thousand using a VB macro with output in Excel file F60RsvPerMYYYQQ.xls.
- Student reviews trends in reserves per thousand and investigates/explains unusual trends (control R46).

## Abbreviated Process Narrative – FAS 60 Life Reserves (Continued)

- Actuarial Assistant VP reviews reserve per thousand trends and analysis (control R47).
- Student imports summarized results into Excel file LifeRsvYYYYYQQ.xls via a VB macro.
- All life reserve files are password protected (R8).
- Reserve spreadsheets include internal cross-checks (R5).
- Actuarial Assistant VP reviews draft financial statements to ensure that reserves provided to accounting are appropriately reflected (control R48).
- Access to actuarial directories is limited to GAAP financial reporting staff (control R2).
- Following each quarter-end, files are backed up to CD (R11).

## Actuarial Valuation “Risk” Areas

- Where can something go wrong, resulting in misstated financial results?
  - Data
  - Actuarial Valuation Systems
  - Spreadsheets
  - Compilation of Results
  - Management Review

## Examples of “Risks”

- Inforce in reserve runs does not reflect complete inventory.
- DAC is not recoverable.
- Inappropriate assumptions are used.
- Incorrect calculations are performed.
- New accounting guidance is not followed.
- Accounting does not book numbers provided by actuarial.
- System crashes and all files are lost.

## Internal Control

- A process designed and implemented by management to provide reasonable assurance of the reliability of financial reporting

## Examples of “Internal Controls”

- Risk: Inforce in reserve run does not reflect complete inventory
- Control: Reconciliation of inforce between valuation system and administrative system
- Risk: Incorrect calculations are performed
- Control: Recalculate sample items (reserves, DAC)
- Risk: Accounting does not book numbers provided by actuarial
- Control: Actuaries review final financials and check actuarial items

## “Key Control”

- A key control is a control which, if it fails, can have a material financial impact
  - No formal definition
- Control: Reconciliation of inforce between valuation system and administrative system
  - “Control” – Reconciliation on ADB riders
  - “Key Control” – Reconciliation on premium-paying life policies

## Are “Internal Controls” New?

- No, internal controls have always existed.
- Historically, auditors assessed the control environment and determined extent of testing based on control assessment.
- “Controls”: new language for actuaries
- Actuarial processes have always had internal controls.
- Many companies have added new controls as part of SOX 404 implementation.

## Risk Control Matrix

- Each process has a “risk control matrix”
- Displays all of the controls for the process
  - Indicates which controls are “key” controls
- Identifies the type of risk each control is intended to mitigate
- “Key control matrix” = subset of the risk control matrix, including only key controls

## Control Effectiveness

- Control appropriately designed
- Control operates as designed
- Control operates consistently
- Control not overridden by management
- Control executed in a timely manner
- Control performed by a qualified person

## Control Deficiencies

- Deficiencies include:
  - Missing controls
  - Controls which do not operate as designed
  - Controls which do not accomplish their objectives
  - Control performed by unqualified person
  - Documentation deficiency

## Levels of Deficiency

- **Control Deficiency:** The design or operation of a control does not allow management to prevent or detect misstatements on a timely basis.
- **Significant Deficiency:** There is more than a remote likelihood that a misstatement of more than an inconsequential amount would not be prevented or detected.
- **Material Weakness:** There is more than a remote likelihood that a material misstatement would not be prevented or detected.
- Significant judgement involved
- “Material weakness” means internal control environment must be deemed ineffective (adverse opinion).

## Documentation

- No clear documentation standards
- Evolving standards:
  - Provide adequate evidence that control was executed
    - In writing
    - Signed or initialed and dated
    - Include evidence that the control was reviewed; evidence of review may include review notes, circled items, etc.
  - Provide evidence that control was executed in a timely manner (prior to releasing results).
    - Documentation may occur later.
  - Documentation of testing should include test plans and results of testing, remediation, and retesting.
  - Stored in central documentation location

## Sample Documentation

- Control R10: Actuary reconciles inforce in valuation extract to inforce in administrative system within 10 policies and 500 units.
- Description of control: Actuary verifies that valuation listing V42 includes all premium-paying traditional life policies inforce as of the valuation date by comparing count and units in V42 to count and face amount in administrative system report LifeSys933.
- Valuation Date: 9/30/2005
- Policy count valuation system: 29,999; units = 1,489,000
  - Source: "FAS60PPRSv200503.xls, cell D256 (policy count) and cell E256 (units); file populated from valuation listing V42.
- Policy count administrative system: 30,000; units = 1,500,000
  - Source: "Exhibit Life Ins 20050930.xls", sheet "TradLife", cell C14 (count) and D14 (units)
- Preparer Comments: Difference within tolerance. No further investigation required.
- Preparer Initials: \_\_\_\_\_ Date: \_\_\_\_\_
- Reviewer Comments: Checked policy counts and units against sources. Difference within tolerance. Also noted that new WL plan 994 is included in valuation reports as expected.
- Reviewer Initials: \_\_\_\_\_ Date: \_\_\_\_\_

## Management "Testing"

- Management cannot "test" own work
- Management testers cannot be company's external auditors
- Independent parties "test" execution of controls of behalf of management
- Management testers may be:
  - Independent external consultants
  - Internal audit department
  - Actuaries in another department
- Testing covers multiple periods

## "Remediation"

- If issues ("deficiencies") are found in testing, these must be "remediated" to prevent an adverse opinion
- Remediation performed by person who "owns" the control, not by independent tester
  - May require adding new controls, redesigning controls, or enhancing documentation of controls
- Following remediation, controls are retested
- Allow time in project plan for remediation and retesting several periods following remediation

## Reports and Audit Opinions

- Management issues "management report"
  - States management's responsibility for establishing and maintaining adequate internal controls over financial reporting
  - Identifies framework used by management to evaluate the effectiveness of internal controls
  - Includes management's assessment of effectiveness of internal controls over financial reporting ("effective" or "ineffective")
  - Includes a statement that the auditor has issued an attestation report on management's assessment
- External auditor gives 404 opinion on effectiveness of internal controls
  - Separate opinion from opinion on financials
- External auditor attests to management's assertion
  - Agree/disagree with management?

## COSO Framework

- Committee of Sponsoring Organizations of the Treadway Commission
- 1992 – "Internal Control – Integrated Framework"
  - Framework against which companies can measure effectiveness of internal controls
- Internal control consists of
  - Control environment
  - Risk assessment
  - Control activities
  - Information and communication
  - Monitoring

## The Old World

- Processes existed, but often not defined or documented
- Controls existed, but not always applied consistently
- Controls often not documented
- Execution of controls rarely documented
- Effectiveness of controls not tested
- No reports or opinions issued on controls
- Internal audit departments typically did not employ actuaries

## The New World

- Processes are defined and documented
- Controls are consistently applied
- Existing controls are documented; new controls added and documented
- Control execution documented
- Control effectiveness tested by management and retested by external auditors
- Mgt report and audit opinion on controls
- Internal audit departments hiring actuaries



## CFO Sentiment on SOX 404

- Too strict
- Too much testing
  - Management testing
  - Testing by external auditors
- Too expensive
- Competitive disadvantage versus foreign companies not filing US GAAP statements

## How to Lessen the Burden

- Automate, automate, automate
- Create checklist of quarterly controls
- Build documentation templates for each control into existing spreadsheets: description of the control, section for results and sign-off
- Keep narratives up-to-date
- Create documentation binder or CD of controls executed each period
- Test actuarial controls by using internal actuarial resources in other departments
- Outsource management testing

## Results of SOX

- Introduction of new controls to prevent/detect errors
- Enhanced financial accountability
- Enhanced systems
- Fewer system conversions in 4<sup>th</sup> quarter
- Less M&A activity toward the end of the year
- Fewer new product introductions in 4<sup>th</sup> quarter
- Smaller companies considering "going private"
- Significant work and expense to implement
- Significant work and expense on on-going basis
- Apathetic market response to adverse opinions

## Cost of Sarbanes-Oxley

- Internal costs:
  - Lost productivity
  - Addition of internal resources
- Increases in fees to external audit firms
- Increases in fees to directors
- Increases in fees to consultants
- Total cost estimated at \$5 billion per year 2004-2005 (AMR Research)
- Soft costs:
  - Job satisfaction in financial areas
  - Relationship with external audit firm
- Ongoing costs significant but unknown

## What Have We Learned

- Start implementation early
  - Test IT controls early in the process
  - Test early enough to allow for remediation
- Commit appropriate time and resources for implementation
- Expect high ongoing cost (time, dollars)
  - Integrate into normal quarterly process
- Anticipate deficiencies in actuarial documentation
- Designate actuarial SOX “owner”

## What We Have Learned (cont.)

- Automate
  - Financial reporting process
  - SOX documentation
- Revisit spreadsheets; implement controls
- Perform testing throughout the year
- Limit testing of low risk areas
- Involve external auditor early in process
- Get expert advice/assistance

## Spreadsheet Controls

- Access controls
  - Password protection of files
  - Access limitations to directories
  - Protection of formulas or sheets within workbook
- Structure: Sections for input, output, documentation
- Segregation of duties: creator, tester, user
- Second person review of manual entries
- Peer review of formulas
- Change management process
- Controls around macros and links
- Version control
- Internal cross-checks
- Back-up processes

## Ernst & Young Survey Sept. 2005: Emerging Trends in Internal Controls

- Over 70% of companies conducted significant remediation of IT systems and controls prior to initial SOX implementation
- 41% of insurance companies remediated between 101 and 250 controls prior to initial SOX implementation
- 404 implementation costs were more than 50% above original estimates for 75% of insurance companies
- 54% of insurance companies dedicate more than half of internal audit resources to 404 activities
- 62% of insurance companies invested 10,00 – 50,000 hours in 404 activities
- 67% of insurance companies spent \$1 - \$5 million on 404 implementation
- 46% of insurance companies tested 1001 – 5000 controls
- 8% of insurance companies reported a material weakness in their internal controls at 12/31/2004 (vs 14% of all companies)
- More info at [www.ey.com](http://www.ey.com)

## Sources of Guidance

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- SEC Regulations
  - [www.sec.org](http://www.sec.org)
- Auditing Standards No. 2 issued by PCAOB
  - [www.pcaobus.org](http://www.pcaobus.org)
- NAIC (proposed statutory changes)
  - [www.naic.org](http://www.naic.org)
  - [http://www.naic.org/frs/solvency\\_regulation/naic\\_aicpa\\_wg/MAR041304.pdf](http://www.naic.org/frs/solvency_regulation/naic_aicpa_wg/MAR041304.pdf)
- Websites of Accounting Firms
  - [www.deloitte.com](http://www.deloitte.com)
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