Crowe

How the Model Audit Rule is **a Platform for More Effective Risk Management**

Building on experience to move beyond compliance and add genuine value

Smart decisions.
Lasting value.™

A lot has changed since the latest amendments to the Model Audit Rule (MAR) went into effect in 2010. By applying insights gained from nearly 10 years of experience with the amended rule, Crowe can help insurance companies streamline their compliance efforts — and **use the MAR as a platform for improving your overall risk management programs.**

Streamline MAR compliance and add value at the same time

For many insurance organizations, developing an effective and efficient MAR program has proven to be challenging. Companies often find themselves struggling with resource constraints that force them to balance the competing priorities of initially establishing or improving their MAR program and financial reporting quality on the one hand, and controlling compliance and administrative costs on the other.

But it doesn't have to be that way. In the years since 2010, a growing number of companies have succeeded in developing and executing sustainable MAR compliance programs.

Your company can build on the proven success of others by pursuing two broad strategies.

Regardless of whether your company is approaching MAR compliance for the first time or already has a mature MAR program in place, the lessons learned since 2010 can help you achieve more effective financial reporting controls while managing compliance costs efficiently.

1. Streamline MAR compliance.

Over the years, many insurers that chose a one-size-fits-all approach to MAR compliance – under the mistaken assumption that what worked for others would work for them – eventually discovered that such an approach was not generally effective because it was not customized to their particular business. The net result was a less-than-adequate effort. Concentrating on the following four priorities can help you develop a MAR compliance program that is both effective and streamlined.

Understand the basics.
First, be sure you know what the MAR requires you to do, why it's needed, and when it must be done. It might seem obvious, but many organizations have made incorrect – and costly – assumptions that could have been avoided with a better understanding of the rule's requirements.

Never underestimate the value of planning.
The focus and priorities of your MAR program should be driven from an annual risk assessment. Such an assessment will identify risks that are likely to result in material misstatements. This is where to focus your evaluation of the existing control environment. Be sure to incorporate the concept of materiality when scoping your MAR program.

Recognize where you can get off track.
Learn from the experiences of others. Don't underestimate the controls that will be needed, but don't overcomplicate the program either.

Get an early start and maintain focus.
Begin preparing for compliance well in advance. Then develop a solid project road map and apply a structured, disciplined approach to the effort. If your company is preparing to implement the MAR for the first time, it is important to document and test internal controls well in advance of your effective date. If your company has already been subject to the rule, it could be advantageous to transition from a year-end financial reporting exercise to a continuous MAR program.

2. Add value beyond compliance.

We have seen numerous instances in which a successful MAR compliance program has become the spark that ignites additional improvements in risk management – and ultimately in financial performance. The following four strategies can help accelerate these benefits.

Develop smarter, coordinated controls.
Financial reporting controls should be effective and consistent throughout the organization, without imposing unnecessary complications or administrative burdens. Focus on the quality of the controls – not the quantity.

Break down silos.
Management should attest to internal controls within their operational area. Effective MAR programs engage cross-functional operational areas by developing common goals. Open communication between business lines fosters innovation and collaboration.

Implement a stronger, customized governance structure.
The MAR's basic governance requirements leave room for you to fine-tune your governance components to address your company's specific situation. Explore using effective entity-level controls to reduce the number of specific internal controls at the account level.

Grasp new opportunities to elevate risk management.
Implementing an effective and sustainable MAR compliance effort can pave the way for broader improvements, including more responsive risk assessment and remediation, new or enhanced internal audit performance, and ultimately a successful enterprisewide risk management (ERM) system.

What the **MAR requires** you to do

The National Association of Insurance Commissioners (NAIC) established the MAR — officially known as the NAIC Annual Financial Reporting Model Regulation — in 2006 and implemented a series of amendments in 2010. Its purpose was to provide guidelines for the various state insurance regulators to use in monitoring the financial condition of insurers operating in their states and protecting the interests of consumers.

In that sense, most private insurers regard the Model Audit Rule as the insurance industry's regulatory counterpart to the *Sarbanes-Oxley Act of 2002* (SOX). In fact, insurers that are subject to and compliant with SOX are considered compliant with the MAR as long as the company's control environment for GAAP financial reporting is the same as statutory financial reporting.

But unlike SOX, which applies to publicly traded companies with more than $75 million in market capitalization, the MAR applies to all insurance companies with more than $500 million in direct written and assumed premiums. Companies over that threshold are required to take a number of steps, including:

1. **Submit an annual financial statement audit by an independent CPA.**
   The audit must be submitted by June 1 for companies with Dec. 31 year-ends. Even smaller insurers must arrange for annual audits, of course, but the MAR imposes additional requirements, such as prohibiting the auditing firm from performing other nonaudit services for the company.

2. **Issue a Report of Internal Controls Over Financial Reporting (ICOFR).**
   The report must describe any weaknesses in financial reporting controls that the audit identified, spell out what actions have been taken or are planned to remediate them, and offer additional assurances regarding management's financial reporting controls and the reliability of the statutory financial statements. In most states the ICOFR report is due 60 days after the annual financial statement is filed with the state regulators, or by Aug. 1.

3. **Establish audit committee oversight and adequate corporate governance.**
   The MAR requires every insurance company to designate a group of board members to serve as its audit committee. This committee must be composed of board members who are independent of the company – that is, they are not company officers or employees. The audit committee hires and supervises the external auditor and also receives regular reports from the company's internal audit department. Internal audit personnel are employed by the company, but the function must be organizationally independent from management.

Most provisions of the MAR become applicable two calendar years after a company first exceeds the $500 million premium threshold, but most insurers find they should begin preparing well before the threshold is reached.

What you must include in the ICOFR report

Unlike SOX, the MAR does not require the CPAs who conduct the external audit to issue an opinion on the company's internal controls. Instead, the company must file with the state insurance department an ICOFR report that assesses its internal controls over financial reporting.

The ICOFR report is signed by the insurer's CEO and CFO, and must include the following:

A statement that management is responsible for establishing and maintaining adequate internal controls over financial reporting

A statement that adequate internal controls have in fact been established and are operating effectively

A brief description of the approach or processes management used to evaluate its internal controls

A description of the scope of work that was included and any internal controls that were excluded

Disclosure of unremediated material weaknesses in internal controls

A statement describing the inherent limitations of internal control systems

The MAR also requires management to document the review, monitoring, and testing activities it used as the basis for its assertions about financial controls and to have that documentation available for examination.

Why companies struggle with MAR

In addition to the risks to which company officers can be exposed, the MAR also presents several other recurring challenges to insurance companies.

Expectations have changed since 2010.

Many accepted risk management practices and expectations have changed since the amended rule first went into effect. As a result, even companies with long-established compliance programs could be exposed to unrecognized risks. For example, a MAR program now is expected to have a formalized risk assessment and work papers to support conclusions about control design and operational effectiveness. Identified control failures are subject to a remediation plan and evaluation of compensating controls.

The meaning of "diligent inquiry" has shifted.

Your organization is required to certify it has performed diligent inquiry – a term that traditionally meant you've conducted a thorough search and review of documents containing significant information about internal controls and have made reasonable inquiries of the responsible employees and agents. But "diligent inquiry" has evolved over the years. Today it is generally understood to include testing for both operational and design effectiveness. In the same way, common understandings regarding documentation, risk assessments, and the definition of materiality also have shifted since the MAR was first implemented. As a result, even companies with long-established compliance programs could be exposed to unrecognized risks.

The MAR does not offer a simple checklist to follow.

Broadly speaking, the MAR is not prescriptive. It spells out reporting requirements, but does not prescribe a specific risk management framework. While the ambiguity can complicate your compliance efforts, it also can be an advantage – it allows you to customize a MAR methodology that fits your company's risk profile, operations, and business strategies. Business units and the executive management team should come to consensus on the MAR methodology early on, to expedite the execution of MAR activities.

Business has changed since 2010 — and so have the risks.

Functions such as information technology, cybersecurity, vendor management, and model risk management have changed dramatically since the MAR amendments went into effect. Many insurers that have been subject to the MAR for years are now discovering their compliance programs have not kept pace with these changes and the risks associated with them. These evolving risks can have a direct impact on internal controls and financial reporting.

Developing **a better approach** to MAR compliance

In light of all the changes that have occurred since 2010, a one-size-fits-all approach to MAR compliance is no longer adequate. The times demand a more customized approach — one that is tailored to your company's specific risk profile.

The following insights and guidelines, drawn from years of direct experience with successful MAR programs, can be helpful in developing such an approach.

Use more preventive controls, rather than detective controls alone.
Ideally, controls should be designed to prevent errors or misstatements, rather than detecting them after the fact.

Consider automated controls instead of manual controls.
Automation can help reduce errors, lower costs, and free up resources.

Prioritize controls – and choose quality over quantity.
Controls should be reexamined and limited to those that genuinely drive risk mitigation. Fewer – but more effective – controls should be the goal.

Eliminate duplicative or inconsistent controls.
Streamline the system and eliminate inconsistencies by setting controls at the operational segment level rather than the account level. Designing controls that work across multiple functions in the business also can help reduce the number of process-level controls.

Take in the big picture.
Evaluate the use of entity-level controls that affect the audited financial statements. Using centralized or organizationwide controls can offer opportunities for more efficiency.

Start with a formalized risk assessment.
A risk assessment should guide your MAR methodology. The risk assessment should consider input from business lines, strategic objectives, and qualitative and quantitative data.

Assess both design effectiveness and operational effectiveness.
You can assess the effectiveness of controls' design through inquiry and via a walk-through of the control processes. Assessing operational effectiveness, on the other hand, requires control testing. Your MAR methodology may allow for rotating schedules for annual control testing.

Map controls to financial statement line items.
Align financial reporting controls to correspond with management assertions and risks. Furthermore, management should scope financially significant areas for MAR, based on materiality.

Focus relentlessly on data. Evaluate IT system controls carefully.
Also consider access controls, Service Organization Control (SOC 1 or SOC 2) Reports, and controls over the completeness and accuracy of data inputs and outputs.

Centralize testing and documentation.
Work to involve process owners from all critical areas of the business. A strong centralized approach to risk management can break down silos. Each business line should attest to the key controls of its operational area. Internal audit's role should be assessing the control, not owning it.

Continue seeking new opportunities.
As your MAR compliance program matures, be open to additional strategies to streamline testing. Examples include fine-tuning materiality definitions, introducing computer assisted audit techniques (CAAT), establishing a rotational schedule for control testing, and developing an internal audit quality control process. You also might be able to improve MAR efficiency by rationalizing the sampling methodology or frequency of controls, which can help you reduce unnecessary or overly aggressive testing schedules.

Move beyond compliance – **building on the MAR foundation**

1. **MAR reporting needs to be more than just an annual compliance exercise.**
   Rather, it should be recognized as a valuable tool that is part of your ongoing strategic risk management process. In this way, systematic, continuous assessment can help drive ongoing remediation.

2. **Use the MAR program as a platform for launching larger improvements.**
   Ultimately, the goal is to take MAR compliance to the next level, with it serving as the structural foundation for a complete internal audit program – and a launching point for an overall ERM system. Such an effort can add real value to an organization, in terms of both immediate bottom-line performance and long-term strategic direction.

3. **Employ the MAR framework for strategic advantage.**
   Building on the MAR effort can provide your company with more accurate data and reporting structures for decision-making. After all, managing risks is an obvious and paramount issue for all insurers. Insurers with effective ERM systems should find themselves better positioned to control risk – and gain a significant strategic advantage.

4. **Apply MAR-driven insights proactively.**
   An effective MAR program also can serve as an early warning system, reducing reputation risk by helping your company identify and remediate deficiencies proactively, before regulators, policyholders, or other third parties become engaged. Many of today's investors and credit ratings agencies also incorporate ERM effectiveness as one of the criteria they consider when assessing your company's financial strength.

Where to start

Crowe insurance industry and risk management professionals have extensive experience helping insurers develop, implement, and optimize their MAR compliance efforts, as well as their broader risk management programs and strategies.

Use this guide to help you decide which Crowe services could be most beneficial to your company.

Does your company have an established internal audit function?

Yes

No

Does your insurance company write over $500M of premiums?

Yes

What has been the biggest obstacle in developing an internal audit program?

- Don't know how to get started — A
- Lack of time/resources — B

No

How would you describe your company's approach to risk mitigation - and internal controls?

- Centralized but not formalized — C
- Ad hoc by department — A

How would you assess the maturity of your internal audit program?

Traditional audit

Your primary goal for your internal audit program is compliance, and the number of controls identified in your internal audit plan are:

- Too few — B
- Too many — C
- Just right

Your primary goal for your internal audit program is to drive value through risk mitigation, and the biggest risk your company faces is:

- Underwriting and pricing — D
- Claims and reserves — D
- Continuous ERM assurance — E

Somewhere in-between

Which concerns you more about your internal audit program?

- **Efficiency:** Identifying the "right" key controls and not overtesting — B
- **Effectiveness:** Driving value-add opportunities and industry best practices — B

Integrated auditing and diagnostic monitoring

Given your current risk management structure, your company has the most unmitigated risk related to:

- Cybersecurity and IT environment/systems — D
- **Data:** Accuracy, timeliness, having the right information to make the right decisions — E
- "The unknown" or the next big risk no one has thought of — E

A Risk assessment

The first step in developing an internal audit/MAR scope, a risk assessment begins with Crowe risk professionals spending weeks on-site researching your company. Their in-depth review results in a detailed report with information on which risks most need your attention now, as well as the risks you can anticipate based on your risk profile and industry and regulatory trends.

B Outsourced internal audit/MAR services

Crowe professionals can help you take the guesswork out of internal audit and MAR compliance, using our long-established methodology that has withstood regulatory scrutiny. With in-depth industry knowledge, we can help with specific areas of need like financial reporting and MAR compliance, or cover all your internal audit and risk management practices.

C IA program assessment

Whether you have an established internal audit/MAR program or are setting one up for the first time, Crowe IA program assessments can give you a valuable road map. Using deep industry specialization, we prepare an assessment tailored specifically to your needs while identifying opportunities to gain efficiencies, mitigate risk, or better meet your MAR and internal audit objectives.

D Targeted, cosourced internal audit

Supplement your team when your organization's risk profile and internal audit capabilities evolve with highly responsive, flexible cosourcing services. Delivered on a recurring basis by professionals with recognized internal audit and insurance industry expertise, cosourced Crowe internal audit services allow you flexibility and the ability to keep up with new challenges.

E Enterprise risk management

Successful ERM encompasses much more than regulatory compliance and financial reporting issues. It also addresses broader organizational issues including your company's risk appetite, culture, and values. Crowe ERM professionals can help you address these expanding priorities in a structured and systematic way, bring a risk mindset to your decision-making, and realize the benefits ERM can deliver.

Learn more

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