

Complying with service provider provisions of Sarbanes-Oxley

By now, corporate risk managers are well aware of the Sarbanes-Oxley Act of 2002 and its new corporate governance and financial reporting requirements. Less recognized is what insurers can do to facilitate publicly traded customers' compliance with a critical provision of the Act.



Section 404 of the Sarbanes-Oxley Act of 2002 requires publicly held companies to assess and report on the effectiveness of their internal controls over financial reporting. This requirement extends to controls at third-party organizations whose services affect the internal control environment of user organizations.

Commercial insurers of publicly traded companies often provide services relevant to Section 404 compliance. Of particular note is what insurers do to assess and quantify a corporation's claim exposure so that this liability can be appropriately reflected on the balance sheet. Hence, post-Sarbanes-Oxley 404, CEOs and CFOs are responsible for assuring that appropriate internal controls are in place in the claims operations of insurers that provide them with financial information.

Possible options for complying with Section 404

Publicly traded companies can choose from two options to meet Section 404 reporting requirements related to insurers:

1. A company can conduct a review of the insurer's internal control environment that is relevant to the company's needs or hire a third party to perform a review on the company's behalf.
2. A company can obtain a Report on Controls Placed in Operation and Tests of Operating Effectiveness, issued by an independent auditing firm. Commonly referred to as a Type II Statement on Auditing Standards (SAS) 70 report, these reports allow management to obtain an independent assessment of controls placed in operation at the insurer and their operating effectiveness.

An overview of SAS 70

SAS 70, a standard first issued in 1993 by the American Institute of Certified Public Accountants, provides guidance for independent auditors to examine and report on the controls in place at service organizations, including insurers.

There are two types of SAS 70 reports and each provides a different level of assurance. A Type I SAS 70 examines the service organization's description of controls to determine whether:

1. It presents fairly, in all material respects, the relevant aspects of the service organization's controls that have been placed in operation as of a specified date.
2. The controls were suitably designed to provide reasonable assurance that the specified control objectives would be achieved if those controls were complied with satisfactorily.

Because a Type I SAS 70 audit report does not include independent testing of controls at the service organization, the Type II report is generally more useful in supporting management assertions of effective controls at service organizations.

A Type II SAS 70 report includes the procedures described for a Type I report. It also includes tests of operating effectiveness of those controls specified by the service organization. These tests determine whether the controls were in fact operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the related control objectives were achieved during the period specified.

Relevant Section 404 guidance requires that management of publicly traded companies perform testing of controls placed in operation by service organizations to reach their conclusions. Because a Type I SAS 70 audit report does not include independent testing of controls at the service organization, the Type II report is generally more useful in supporting management assertions of effective controls at service organizations.

An easy choice

For Zurich, a leading insurer of large corporations worldwide, the choice to obtain a Type II SAS 70 report was simple. "Our dedication to service excellence meant our only option was to obtain a Type II SAS 70 report," said John Kelm, President and CEO of Global Corporate in North America.

Consequently, in December 2003, Zurich hired an independent audit firm to test specified internal controls related to Zurich's claim adjudication and payment services. "For a period of six months, our controls to provide policyholders with information to quantify liabilities were examined," said Steve Arrambide, Zurich's Vice President, claims administration and customer service.

Following this testing, Zurich received a Type II SAS 70 report that can be provided to its customers and their independent auditors to augment the testing customers are already doing to comply with Section 404. Consequently, Zurich's customers seeking to comply with Section 404 have a portion of the documentation they need readily accessible.

To reach its opinion, management generally needs to have the independent testing required by SAS 70 performed annually. This is an investment Zurich fully intends to make for its customers in 2005 and beyond.

"We are proud to provide our customers with the Type II SAS 70 report. This report provides our clients with specific information on the controls we have placed in operation over claims adjudication and payment services and should help reduce the effort they need to expend to comply with the requirements of Section 404," said Jim Engel, Zurich North America Executive Vice President and Chief Claims Officer.

