

Auditing Acquisitions in the Insurance Industry

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Agenda

- Introduction
- Overview of Mergers & Acquisitions
- Case Study
 - Review the approach, objectives and steps taken to audit acquisitions in the insurance industry.
 - Challenges and lessons learned.
 - Recommendations
- Q&A



Overview of M&As

- **Mergers & Acquisitions (M&As)** – Why, what, how, when and who
- **Case Study** – Discuss and present IT Audit's role in three (3) M&As
- **The Analysis** – Value Drivers, Due Diligence, Pre and Post Merger, Audit comments



M&As

- **Why?:** Companies with cash acquire other companies.
- **What?:** One company (private/public) purchases another (private/public).
- **How?:** Completed in phases
 - Pre-merger (pre-close), integration, post-merger (post-close) etc.
- **When?:** Anytime mutual interest or not.
- **Who?:** Executives, Corporate Governance, Senior Management, Program/Project Managers, Audit, IT and Business Units.



Case Study

- Discuss and present three (3) M&As completed by a large regional property and casualty insurance provider, headquartered in the northeastern US.
 - M&A# 1: Cost ~ \$10 million in Q2/2007
 - M&A# 2: Cost ~ \$29 million in Q1/2008
 - M&A# 3: Cost ~ \$100 million in Q4/2008



Case Study

Review the Phases

- Due Diligence – Financial and IT (Playbook)
- Pre-Close
 - ❖ Project management approach
 - ❖ Schedule
- Completing the M&A transaction
- Integration (milestone template)
 - ❖ Transition



M&A #1 Cost ~ \$10 million

● Value Drivers

- Publicly traded specializes in professional liability insurance to law firms.
 - Strong future growth.
 - Lawyers professional liability market.
 - Superior risk assessment capabilities.
 - Significant cross-sell opportunities.
 - Experience and committed management.
- Expertise @ Acquired
 - Sales, Underwriting, Claims, Commissions, Billing and Premium Financing.



M&A #2 Cost ~ \$29 million

Value Drivers

- Startup specializes in high-risk property insurance to manufacturers and distributors of chemical-related products
 - Strong future growth - 25% annual growth for prior year.



M&A #3 Cost ~ \$100 million

- Value Drivers for M&A #3
 - Venture backed startup with a thoughtful business model on program business.
 - UW well managed.
 - Favorable economics.
 - Strong future growth.
 - Accelerate core distribution channel.

Approach

Area

1 - Underwriting

- Policy and Procedures
- Policy issuance narrative
- Review process
- Account reconciliation

2 - Case Reserves

- Policy and Procedures
- Reserve process narrative
- Review process
- Account reconciliation

3 - Claims

- Policy and Procedures
- Claim processing narrative
- Review process
- Account reconciliation

4 - Reinsurance

- Reinsurance process narrative
- Account reconciliation

Testing

- Inquiry and observation
- Substantive control testing

- Inquiry and observation
- Substantive control testing

- Inquiry and observation
- Substantive control testing

- Inquiry and observation *

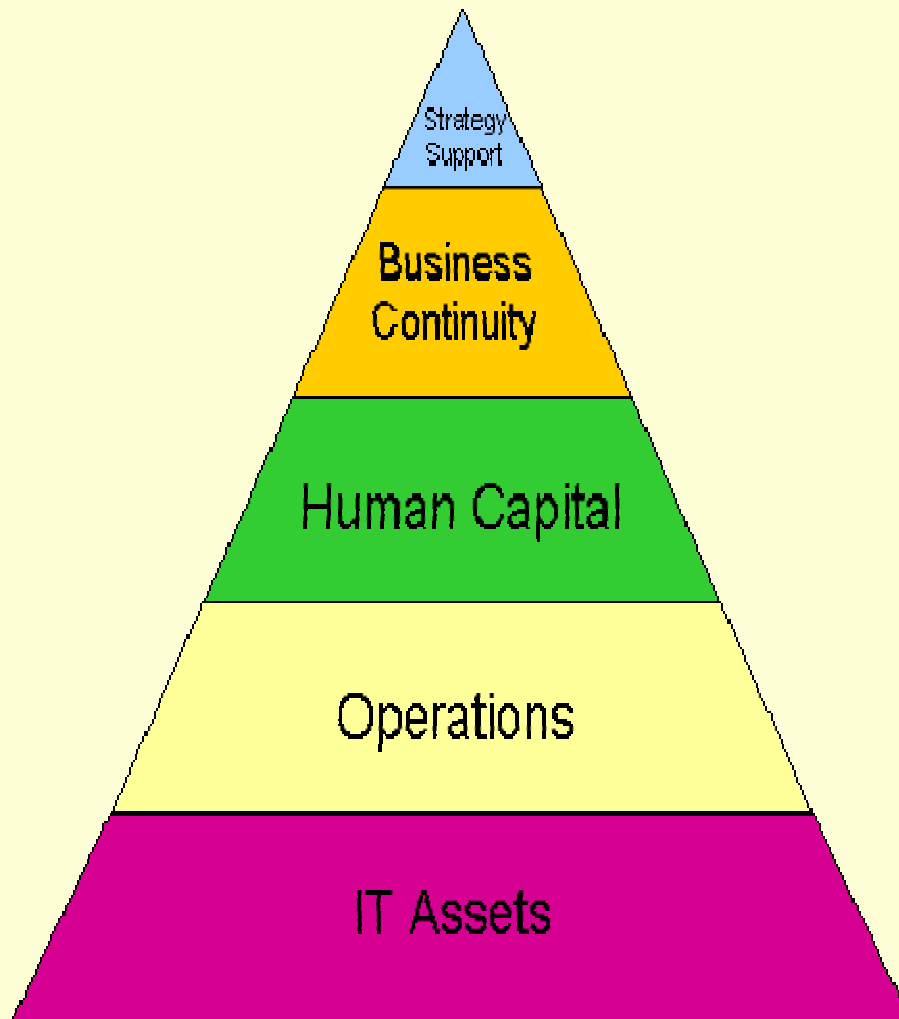
Approach continued

Area	Testing
5 - Premium Financing Financing process narrative Review process Account reconciliation	Inquiry and observation *
6 - Commissions Commission process narrative Review process Account reconciliation	Inquiry and observation
7 - Investment Transactions Review process Account reconciliation	Inquiry and observation
8 - Billing Billing process narrative Control review	Inquiry and observation
9 - Financial information flow Acquired to Parent mapping M & A review	Inquiry and observation <u>Substantive testing</u>
10 - Accounting Accounting narrative	Inquiry and observation <u>Substantive testing</u>

Approach continued

Area	Testing
1 - General Computer Controls	
IT Policy and Procedures	Testing
Network Infrastructure	Inquiry and observation
Physical Security	Testing
Informational Security	Testing
Environmental Controls	Inquiry and observation
Change Control	Testing
Continuity Controls	Inquiry and observation
2 - Application Controls	
Information Security Control	Testing
Transmission Control	Inquiry and observation
Change Control	Testing
Continuity Controls	Inquiry and observation
3 - System development project Controls	
Project Management	Inquiry and observation
Project Documentation	Inquiry and observation
Testing Methodology	Testing
Test Results	Testing
Implementation Management	Testing

Approach continued





Approach continued

- Information Technology Assessment Due Diligence Methodology
 - Pre-acquisition template
 - Questionnaires
 - Dashboard
 - Pre Report
 - Post-acquisition template
 - Post Report



Approach Pre Acquisition

- Pre-acquisition template is comprised of
 - Organizational Integrity
 - Business Continuity
 - Data Integrity
 - Data Center Facility
 - Human Capital
 - System Administration
 - Network Security
 - Hardware
 - Application Software

Approach Questionnaire

Organizational Integrity Questionnaire

Target: CIO, or head Technology Employee and Strategist

Name:
 Title:
 Salary:
 Date:
 Work Telephone:

	Yes	No	Does Not Know	N/A
Is there a long term IT Strategy?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
How many years out does the strategy plan for? <input type="text"/>				
Is the policy published and known by employees?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
What is the size of the IT budget? What is the percentage of revenue? Number of Employees: <input type="text"/>				
Are there any projects currently underway?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
If Yes: Project Name: <input type="text"/> Budget Size: <input type="text"/> Completion Date: <input type="text"/>				
Have there been any recent major IT failures?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
If Yes, describe: <input type="text"/>				
	Passed	Deficiency	Significant Deficiency	Material Weakness
What was your last Internal Control Audit rating?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Comments: <input type="text"/>				

Approach Questionnaire continued

Network Security Questionnaire

Target: Network Security Manager

Name: [REDACTED]

Title: [REDACTED]

Salary: [REDACTED]

Date: [REDACTED]

Work Telephone: [REDACTED]

	Yes	No	Does Not Know	N/A
Are all network ports, connectors, switches, hubs, and cabling <u>clearly</u> labeled?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Is a strong password policy enforced on the users?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Is network congestion within acceptable limits?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Are hubs used being in place of switches in critical areas <u>of</u> the network?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Does the company process credit card transactions?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Does the company connect to an Extranet?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Does the company host an Intranet for its employees?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Does the company provide VPN access to its employees?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Additional Comments: [REDACTED]

Approach Dashboard

			ITADD DASHBOARD	
ITADD Domain	Question Category	Assesment Criteria	Raw Score (1-5)	Weighted Score
A.	Strategy Support	Organizational Integrity	Is IT adequately funded?	0
B.		Organizational Integrity	Is Information Systems, including e-commerce, adequately meeting business needs?	0
C.	Business Continuity	Business Continuity Practices	Are operational practices adequate to ensure business continuity?	0
D.		Data Integrity	Are information capture, processing, storage and reporting controls adequate to ensure reliable financial reporting?	0
E.		Data Center Security	Are data center business continuity controls adequate to ensure continuity of operations?	0
F.	Human Capital	Human Capital	Are key IT staff competent to support the business after acquisition?	0
G.		Human Capital	Would the departure of key personnel create significant business continuity issues?	0
H.	Operations	Systems Administration	Are key operational responsibilities being discharged?	0
I.		Systems Administration	Are capacity and performance adequate to business needs?	0
J.		Network Security	Has the network architecture been designed and deployed such that it provides adequate security?	0
K.	IT Assets	Hardware	Is hardware infrastructure capable and up to date enough to support the business?	0
L.		Application Software	Are the primary and dependent business applications functioning adequately?	0
M.		Application Software	Are corporate and end user software licensed and adequately maintained?	0
			ITADD INDEX:	0



Approach Pre Report

■ Summary

- Critical risks relative to business continuity or compliance that must be addressed prior to the transaction through hold-back or otherwise, based on the information provided by CIO, CFO, IT Manager, etc. Acquiring entity should confirm budgeting for hardware & OS replacements post-transaction, and other purchases as appropriate.

Approach Post Acquisition

Summary of Additional Costs

Item	Category	Estimate of Additional Costs	
		Minimum	Maximum
1	IT Control Environment	\$ -	\$ -
2	Program Development	\$ -	\$ -
3	Program Changes	\$ -	\$ -
4	Access to Programs and Data	\$ -	\$ -
5	Computer Operations	\$ -	\$ -
6	End-User Software	\$ -	\$ -
7	Hardware	\$ -	\$ -
8	Server Software	\$ -	\$ -
9	System Capacity	\$ -	\$ -
11	FAC Inventory - Location 1	\$ -	\$ -
	TOTAL	\$ -	\$ -



Approach Post Report

■ Executive Summary

- Provides a quick overview of significant factors and opportunities that could reduce risks of business continuity and costs of business operations, and their estimated related costs of implementation.

■ Overview

M&A #1 - Analysis

#	Summary
1	Business continuity
2	User access to network is not adequately controlled.
3	Access to the server room is not controlled.
4	All source code is not included in daily backup
5	IT experience with applications is limited
6	IM is utilized and not archived.
7	Software moves to production are performed by the developers.
8	Version management controls of application source code are not adequately maintained.
9	User access is not adequately controlled to applications
10	No reviews are performed of user access to applications
11	Terminated employees had active user accounts to network and applications
12	Generic logins existed in Claims, with guest access
13	Claims default passwords setup by admins are not changed
14	Users have access to transactions beyond their roles
15	Application user account administration lacks basic security functionality.
16	Users had excessive access to administrative system functions
17	Two agent accounts were created in an application in error
18	Stored passwords were being used to access applications
19	No current disaster recovery plan exists
20	Controls to require approvals when granting system access to acquired entity applications do not exist.
21	System implementation approvals are not adequate
22	The system test methodology did not follow the Release Management process
23	The post acquisition plan did not recognize the need to retain key employees

M&A #2 - Analysis

#	Summary
1	No access controls at the application level for the Peachtree accounting and journaling application.
2	No access controls at the application level for the marketing application.
4	Door to telecommunications room not secured.
5	Formal training not delivered and provided at the appropriate time to the staff in the acquired entity.
6	IT Help Desk initially unaware of the acquired and the need to provide technical support.
7	Inadequate user authentication controls at the application level for MS-Access application.
8	Incomplete software/hardware inventory of acquired entity.
9	Dashboard Reporting for core project team not completed as reported and planned.
10	Infrastructure Implementation Project Plan listed tasks that are 0% complete with no indication that they were transitioned.
11	Change management process for information technology during Integration



M&A #3 - Analysis

- The administration of user and network accounts exist but needs improvement. The number of administrators is excessive and a shared account is used to administer the application servers.
- Access and information security controls over information submitted via web-based applications over the Internet are inadequate.
- Risk of hardware damage due to the positioning of hardware rack.



M&A #1 - Recommendations

- Develop/retain IT personnel in order to maintain efficient and secure computing operations.
- Document all application systems and changes to ensure adequate knowledge transfer.
- Implement a process to disable the accounts of terminated or unauthorized users until the legacy policy management system is retired.
- Implement a process that requires users to change their default passwords.



M&A #1 - Recommendations

- Discontinue use of stored passwords.
- Implement/document approvals for access requests.
- Remove excessive access to administrative system functions in the legacy policy management system.
- Limit users' access to applications and functions.
- Disable agent accounts in the agency application.
- Lock the server room door and limiting access to authorized staff.



M&A #2 - Recommendations

- Document/communicate the due diligence team's observations downstream to the integration team.
- Identify inter-departmental dependencies not only at the program manager level but also at the departmental level.
- Perform risk assessment of the acquired entity's information technology applications during integration.
- Update/version project documentation.
- Document transition of authority and responsibility from the integration team to specific individuals.



M&A #3 - Recommendations

- The infrastructure integration project should have a formal project charter for each significant area of integration and the project should follow the acquiring entity's change management process for information system projects.



Lessons Learned

- IT organization is best suited to perform the pre and post acquisition assessment.
- IA performs a review of due diligence, the close process, and/or project integration to ensure acquisition is effective.
- Integration planning include not only the regular HR functions, but also an assessment of the HR system.
- Update SOX compliance matrix with internal controls unique to acquired entity.



Lessons Learned

- Financial system integration include short and long-term plans for direct feeds from acquired entity to acquiring entity.
- Enable access to procurement systems.
- Assess telephone system.
- Assess unique reporting needs of the acquired entity.



Q&A

Question & Answer





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