

**LORD & BENOIT REPORT:  
NAIC ANNUAL FINANCIAL REPORTING MODEL REGULATION**

**(NAIC Model Regulation)  
(Formerly called: Model Audit Rule)  
Findings out of 415 Publicly Held Insurance Companies**

NAIC Model Regulation

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## INTRODUCTION

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The new ***Annual Financial Reporting Model Regulation (AFRMR) of the*** National Association of Insurance Commissioners (NAIC), formerly called the Model Audit Rule or MAR now requires non public insurance companies to include certain key provisions of the Sarbanes-Oxley Act Section 404 in its financial reporting model.

Besides renaming the Model Audit Rule, there has been little recent change to the rule and the new Model Regulation draft has been finalized by the National Association of Insurance Commissioners, set to be adopted by the various states via legislative action, regulatory adoption, or other means. Many states will adopt the Model as written while others may choose to modify the Model in some way. The Model Regulation seeks to regulate auditor independence, internal control assessment and financial disclosure in order to restore confidence in capital markets.

Current regulations require insurers with \$1 million or more in written premiums or 1,000 or more policyholders or certificate holders to file audited, annual statutory financial statements with state insurance departments. But in June 2006, the NAIC adopted significant changes to the regulation. The revised Model Audit Rule, called the Annual Financial Reporting Model Regulation or AFRMR, incorporates best-practice corporate governance standards and elements that are found within Sarbanes-Oxley.

The NAIC hopes to achieve transparency, fraud prevention and restored public confidence in the insurance industry by raising its own level of self-governance with that of the Public Company Accounting Reform and Investor Protection Act, otherwise known as the Sarbanes-Oxley Act (SOX), was passed as a result of corporate governance scandals. These scandals cost investors billions of dollars and undermined public confidence in the U.S. financial markets. Many viewed the SOX Act as a drastic but necessary step towards restoring and sustaining investor credence in response to the public's negative perception of corporate integrity.

The NAIC Model Regulation, like Section 404 of the Act includes a number of reforms that seek to eliminate conflicts of interest while strengthening companies' internal controls over financial reporting. SOX's reforms, however, only apply to publicly traded companies or to those registered with the Securities and Exchange Commission, since the overall goal is to protect investors and restore the public's confidence in securities markets. SEC oversight is dependent on a company's internal reporting and the external audits by their retained outside accounting firms. However, in the case of the insurance industry, regulators also have ongoing oversight and perform regular, substantial, on-site examinations of the companies' records.

The Public Company Accounting Oversight Board (PCAOB) is a private-sector, non-profit agency assembled under the Sarbanes-Oxley Act responsible for supervising and disciplining auditors of public companies. The mission of the agency is "to protect the interests of the investors and further the public interest in the preparation of informative, fair, and independent audit reports."<sup>1</sup> The PCAOB has the power to set auditing, quality controls, ethics and independence standards with regard to audit reports by issuers, and conduct inspections, investigations and disciplinary proceedings in addition to other various functions as the SEC deems necessary.

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<sup>1</sup> <http://www.pcaobus.org/>

Under the Annual Financial Reporting Model Regulation, insurance companies who reach a \$300 million requisite threshold are required to form an audit committee whose sole responsibility is to oversee the company's audit process. Fifty percent of the committee must be composed of individuals distinct from management in order to ensure auditor independence. Once a company exceeds the \$500 million threshold, the composition of their audit committee must comply with "Supermajority member independence" (75% independent members).

Another revision to the Model is the new Section 16, the focus of which is to draw attention to internal controls over financial reporting. According to the NAIC, "Financial reporting is the underpinning of many of the solvency oversight activities of insurance regulators. Section 16 of the Model identifies management's responsibilities for internal control over financial reporting and provides regulators additional assurances of the effectiveness of internal control practices in a cost effective manner."

The revisions to the model regulation will take effect on Jan. 1, 2010, for the financial year ending Dec. 31, 2010, and will impact both public and nonpublic insurers. Pending the adoption of the Model by individual states, nonpublic insurance companies will be required to comply with various SOX-type provisions, while public insurers that are already SOX-compliant will be subject to additional reporting requirements regarding their statutory financial statements.

## SUMMARY INTERNAL CONTROLS OVER FINANCIAL REPORTING (ICFR)

### MATERIAL WEAKNESSES OF COMPANIES IN THE INSURANCE INDUSTRY FROM YEARS 2004 TO 2008

Newly compliant NAIC Model Regulation non public insurance companies can glean information about material weaknesses in internal controls over financial reporting by analyzing the results of publicly held insurance companies.

The following is a summary of ALL of the adverse 404 reports that were issued from companies in the Insurance industry with years ended in 2004 through 2008. These were all publicly held insurance companies reporting material weaknesses in internal controls over financial reporting. The management assessments were gathered using the online research tool called Audit Analytics, an Ives Group, Inc company. Since SOX assesses internal controls over financial reporting similar to AFRMR, this data represents likely deficiencies to be found with companies undertaking AFRMR.

The following table is a summary of the material internal control weaknesses and the accounting weaknesses reported in the ten adverse SOX Section 404 Self Assessments.

Material Weaknesses Related to Internal Controls	2008	2007	2006	2005	2004
Accounting documentation, policy and/or procedures	9	10	11	13	12
Accounting personnel resources, competency/training	6	7	7	7	10
Material and/or numerous auditor /YE adjustments	6	4	8	9	8
Information technology, software, security & access issue	4	3	4	5	5
Untimely or inadequate account reconciliations	3	1	3	6	6
Journal entry control issues	2	1	2	2	3
Segregations of duties/ design of controls (personnel)	1	3	3	3	8
Ineffective, non-existent or understaffed audit committee	1	0	1	0	2
Restatement or nonreliance of company filings	0	3	3	8	5
Non-routine transaction control issues	0	1	1	2	2
Inadequate disclosure controls (timely, accuracy, complet	0	1	0	0	0
Ineffective regulatory compliance issues	0	1	0	0	0
Management/Board/Audit Committee investigation(s)	0	1	0	0	2
Insufficient or non-existent internal audit function	0	0	1	1	2
Remediation of material weakness identified	0	0	1	0	0
SAB 108 adjustments noted	0	0	1	1	0
Ethical or compliance issues with personnel	0	0	0	1	3
Restatement of previous 404 disclosures	0	0	0	3	2
Scope (disclaimer of opinion) or other limitations	0	0	0	2	1
SEC or other regulatory investigations and/or inquiries	0	0	0	0	1
Senior management competency, tone, reliability issues	0	0	0	0	5

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We can see from the following chart that the NAIC Model Regulation will not only relate to identifying material weaknesses in internal controls, but also material weaknesses in financial reporting (internal controls over financial reporting). Therefore many material weaknesses related to the misapplication of generally accepted accounting principles and related financial statement disclosures.

One should keep in mind too that the codification of the Statements of the Financial Accounting Standards will take place after July 1, 2009.

The following illustrates the departures from GAAP:

Material Weaknesses Related to Financial Reporting	2008	2007	2006	2005	2004
Tax expense/benefit/deferral/other (FAS 109) issues	3	1	3	3	4
Liabilities, payables, reserves and accrual est failures	2	3	5	9	6
Unspecified/unidentified/inapplicable FASB/GAAP issues	2	1	1	0	0
Income statemt classification, margin and EPS issues	2	1	0	1	0
Revenue recognition issues	2	0	4	6	3
Fin Stmt, footnote, US GAAP conversion, segment disclosures	1	3	2	1	4
Financial derivatives/hedging (FAS 133) acctg issues	1	2	0	2	1
Lease, FAS 5, legal, contingency & commit issues	1	1	2	7	3
Expense recording (payroll, SG&A) issues	1	1	1	1	2
Foreign, related party, affiliated and/or subsid issues	1	1	1	2	5
Deferred, stock-based or executive comp issues	1	1	0	1	0
Acquisition, merger, disposal or reorganization issues	1	0	1	1	3
Consolidation, (Fin46r/Off BS) & foreign curr transl iss	1	0	1	1	3
Depreciation, depletion or amortization issues	1	0	0	0	1
Accounts/loans receivable, investments & cash issues	0	4	3	8	7
Debt ,quasi-debt, warrants & equity ( BCF) security	0	1	0	0	1
Gain or loss recognition issues	0	1	0	0	0
PPE, intangible or fixed asset (value/diminution) issu	0	0	3	1	2
Capitalization of expenditures issues	0	0	1	3	0
Debt and/or equity classification issues	0	0	1	0	0
Inventory, vendor and cost of sales issues	0	0	1	4	0
Balance sheet classification of asset issues	0	0	0	0	1
Cash flow statement (FAS 95) classification errors	0	0	0	1	0
Intercompany/Investment w/ sub/affil issues	0	0	0	3	3

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The following reports are copies of excerpts from the Section 404 reports issued from 2004 through 2008. For those looking to comply with the NAIC Model Regulation for the first time, one might look at reports issued in the year 2004. Many of these companies had a significant list of reportable material weaknesses.

Another surge of findings were reported in 2007 as well, because smaller public companies reported control weaknesses for the first time. These management assessments were not subject to auditor attestation however, as required by the NAIC Model Regulation, so the 2004 year may still be a better comparison for first time compliance.



## 2008

The following are excerpts of material weaknesses<sup>2</sup> of companies reporting in 2008. These represented all insurance companies (accelerated and non accelerated filers) that issued reports in the year 2008. This was the second year non accelerated filers needed to opine on their internal controls. Auditor attestation of the internal controls for non accelerated filers was not required at this point however.

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ALLIANCE HEALTHCARD INC  
CONSECO INC  
CORVEL CORP  
DCAP GROUP, INC  
JACOBS FINANCIAL GROUP, INC.  
PHL VARIABLE INSURANCE CO /CT/  
PHOENIX COMPANIES INC/DE  
PREVENTION INSURANCE COM INC  
SUN LIFE ASSURANCE CO OF CANADA US

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<sup>2</sup> Data was obtained using Audit Analytics

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## ALLIANCE HEALTHCARD INC

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Because of the incomplete assessment of the effectiveness of our internal controls over financial reporting, our management was unable to issue its report on the effectiveness of our internal controls at September 30, 2008. This is a material weakness in our internal controls, because we have not completed our assessment of the reliability, effectiveness of our internal controls and compliance with laws and regulations. Until our assessment has been completed, we are not positioned to implement corrective procedures as they are identified.

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## CONSECO INC

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Conseco did not maintain effective controls over the accounting and disclosure of insurance policy benefits, amortization expense, the liabilities for insurance products and the value of policies enforce at the Effective Date. Specifically, the design of controls over the actuarial reporting process to ensure the completeness and accuracy of certain enforce policies in our Conseco Insurance Group segment was not effective. These control deficiencies resulted in an audit adjustment to Conseco's consolidated financial statements during the fourth quarter of 2008. Additionally, these control deficiencies could result in a material misstatement of the aforementioned accounts and disclosures in our annual or interim consolidated financial statements that would not be prevented or detected on a timely basis. Accordingly, Conseco's management has determined that these control deficiencies constitute a material weakness. Because of this material weakness, management concluded that Conseco did not maintain effective internal controls over financial reporting as of December 31, 2008 based on criteria in the Internal Control - Integrated Framework - issued by COSO.

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## CORVEL CORP

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Accounts Payable. We did not maintain adequate controls to ensure the proper inclusion or exclusion of expenditures within the reporting period and, therefore, the accuracy and completeness of our accounts payable. Financial close and reporting. We did not maintain adequate controls to support: (i) effective and timely analysis and correction of errors noted when reconciling significant accounts, (ii) complete and accurate financial statement disclosures, and (iii) restricted access to certain financial systems and files necessary to maintain the integrity of journal entry reviews, account reconciliations, and financial reports. Furthermore, the indirect lines of responsibilities within our accounting and reporting function do not provide direct oversight and accountability to allow for timely and accurate financial reporting.

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## DCAP GROUP, INC.

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Management identified the following material weaknesses in our internal control over financial reporting as of December 31, 2008: Information Technology Applications and Infrastructure. We did not maintain effective controls over financial reporting related to information technology applications and infrastructure. Specifically, the following deficiencies in the aggregate constituted a material weakness:

- We did not maintain effective design of controls over access to financial reporting applications and data. Controls did not limit access to programs and data to only authorized users. In addition, controls lack the requirement of periodic reviews and monitoring of such access.
- We did not maintain effective controls to communicate policies and procedures governing information technology security and access. Furthermore, we did not maintain effective logging and monitoring of servers and databases to ensure that access was both appropriate and authorized.

These deficiencies have had a pervasive impact on our information technology control environment. Additionally, these deficiencies could result in a misstatement of account balances or disclosure to substantially all accounts that could result in a material misstatement to the consolidated financial statements that would not be prevented or detected.

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## JACOBS FINANCIAL GROUP, INC.

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JFG management identified control deficiencies that, in the aggregate, constitute a material weakness in internal control over financial reporting as of May 31, 2008. Such control deficiencies relate to inadequate segregation of duties, lack of effective board of directors oversight, use of internally developed non-integrated accounting systems, lack of internal review of account reconciliations, and lack of internal review of general journal entries, elimination entries and the financial statement consolidation process.

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## PHL VARIABLE INSURANCE CO /CT/

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Management has concluded that, as of December 31, 2008, the Company had a material weakness in its internal control over financial reporting designed to ensure proper accounting for income taxes, including the allocation of its income tax provision (benefit) among income from continuing operations and other comprehensive loss. This material weakness, or difficulties encountered in implementing new or improved controls or remediation, could prevent the Company from accurately reporting its financial results, result in material misstatements in its financial statements or cause it to fail to meet its reporting obligations. Additionally, this control deficiency could have resulted in misstatement of the financial statements that would not be prevented or detected. Accordingly, management determined that this control deficiency constitutes a material weakness in the Company's internal control over financial reporting.

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## PHOENIX COMPANIES INC/DE

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Management has concluded that, as of December 31, 2008, the Company had a material weakness in its internal control over financial reporting designed to ensure proper accounting for income taxes, including the allocation of its income tax provision (benefit) among income from continuing operations, income from discontinued operations and other comprehensive loss. This material weakness, or difficulties encountered in implementing new or improved controls or remediation, could prevent the Company from accurately reporting its financial results, result in material misstatements in its financial statements or cause it to fail to meet its reporting obligations. Additionally, this control deficiency could have resulted in misstatement of the consolidated financial statements that would not be prevented or detected.

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## PREVENTION INSURANCE COM INC

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Our management has not made a comprehensive review, evaluation, and assessment of our internal control over financial reporting as of April 30, 2008. Based on that, management concluded that, as of April 30, 2008, our internal control over financial reporting was not effective.

### INEFFECTIVE CONTROLS RELATED TO THE ACCOUNTING PROCESS

The Company's design and operation of controls with respect to the process of preparing and reviewing the annual and interim financial statements are ineffective. Deficiencies identified include the inadequate segregations of duties, lack of controls over procedures used to enter transactions into the general ledger, and lack of appropriate review of the reconciliations and supporting workpapers used in the financial close and reporting process. Additionally the revenue and disbursement cycles were also identifies as areas of significant internal control deficiency. While these deficiencies did not result in a material misstatement of the financial statements, due to the potential pervasive effect on the financial statement account balances and disclosures and the importance of the annual and interim financial closing and reporting process, in the aggregate, management has concluded that there is more than a remote likelihood that a material misstatement in our annual or interim financial statements could occur and would not be prevented or detected.

Management's assessment identified a material weakness in the Company's processes related to the implementation and subsequent recording of certain reinsurance transactions with affiliated companies. This deficiency resulted in adjustments to net investment income and net derivative income in the Company's consolidated financial statements for the year ended December 31, 2008. Additionally, management concluded that there is a reasonable possibility that this deficiency could result in a material misstatement of net investment income and net derivative income in the Company's annual or interim consolidated financial statements that would not be prevented or detected on a timely basis. Management has discussed the matter with the Company's board of directors and the Company's independent registered public accounting firm.



## 2007

The following are excerpts of the 2007 material weaknesses reported by all public insurance companies (accelerated and non accelerated filers).

This was the first year that management of non accelerated filers expressed an opinion on their internal controls. Auditor attestation of the internal controls for non accelerated filers was not required at this point however.

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AMERICAN EQUITY INVESTMENT LIFE HOLDING CO  
AMERICAN INTERNATIONAL GROUP INC  
CONSECO INC  
CORVEL CORP  
DCAP GROUP INC  
PROCENTURY CORP  
RADIAN GROUP INC  
SCOTTISH RE GROUP LTD  
STANDARD MANAGEMENT CORP  
WELLCARE HEALTH PLANS, INC.

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## AMERICAN EQUITY INVESTMENT LIFE HOLDING CO

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Based on the assessment, management has determined that we did not maintain effective internal control over financial reporting as of December 31, 2007, due to the identification of a material weakness in internal control over financial reporting related to our accounting for policy benefit reserves for index annuities. Specifically, as of December 31, 2007, our newly implemented controls to ensure the completeness and accuracy of data to calculate policy benefit reserves for index annuities in accordance with Statement of Financial Accounting Standards ("SFAS") No. 133, Accounting for Derivative Instruments and Hedging Activities ("SFAS 133"), and policies to monitor the effectiveness of controls within the process for calculating policy benefit reserves for index annuities had not operated for a sufficient period of time to conclude as to their effectiveness.

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## AMERICAN INTERNATIONAL GROUP

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As of December 31, 2007, controls over the AIGFP super senior credit default swap portfolio valuation process and oversight thereof were not effective. AIG had insufficient resources to design and carry out effective controls to prevent or detect errors and to determine appropriate disclosures on a timely basis with respect to the processes and models introduced in the fourth quarter of 2007. As a result, AIG had not fully developed its controls to assess, on a timely basis, the relevance to its valuation of all third party information. Also, controls to permit the appropriate oversight and monitoring of the AIGFP super senior credit default swap portfolio valuation process, including timely sharing of information at the appropriate levels of the organization, did not operate effectively. As a result, controls over the AIGFP super senior credit default swap portfolio valuation process and oversight thereof were not adequate to prevent or detect misstatements in the accuracy of management's fair value estimates and disclosures on a timely basis, resulting in adjustments for purposes of AIG's December 31, 2007 consolidated financial statements. In addition, this deficiency could result in a misstatement in management's fair value estimates or disclosures that could be material to AIG's annual or interim consolidated financial statements that would not be prevented or detected on a timely basis. Solely as a result of the material weakness in internal control over the fair value valuation of the AIGFP super senior credit default swap portfolio described above, AIG management has concluded that, as of December 31, 2007, AIG's internal control over financial reporting was not effective based on the criteria in Internal Control – Integrated Framework issued by the COSO. The effectiveness of AIG's internal control over financial reporting as of December 31, 2007 has been audited by PricewaterhouseCoopers LLP, an independent registered public 202 AIG 2007 Form 10-K

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## CONSECO INC

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Conseco did not maintain effective controls over the accounting and disclosure of insurance policy benefits, amortization expense, the liabilities for insurance products and the value of policies enforce at the Effective Date. Specifically, controls over the actuarial reporting process related to the design of controls to ensure the completeness and accuracy of certain enforce policies in our Bankers Life segment, Conseco Insurance Group segment and Other Business in Run-off segment were not effective. These control deficiencies resulted in the misstatement of our insurance policy benefits, amortization expense, the liabilities for insurance products and the value of policies enforce at the Effective Date and related disclosures in the consolidated financial statements, and in the restatement of our consolidated financial statements for 2006 and 2005, each of the quarters of 2006 and the first three quarters of 2007. Additionally, these control deficiencies could result in the misstatement of the aforementioned accounts and disclosures that would result in a material misstatement in our annual or interim consolidated financial statements that would not be prevented or detected. Accordingly, our management has determined that these control deficiencies constitute a material weakness.

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## CORVEL CORP

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Control environment. We did not maintain an effective control environment. Specifically, (i) we did not ensure that the Board of Directors' committees evaluated its performance against the functions mandated by their associated charters, (ii) the lines of responsibilities within our accounting and

reporting function do not support adequate control over financial reporting, and (iii) we did not maintain sufficient anti-fraud controls, such as an effective independent whistleblower program, effective human resource procedures, such as background investigations and consistent performance reviews for key personnel, effective communication regarding performance expectations and ensuring adequate understanding and reinforcement of the code of conduct and (iv) we failed to maintain a sufficient complement of skilled personnel in the areas of accounting and financial reporting.

Segregation of duties. We did not maintain proper segregation of duties. Specifically, proper segregation of duties affecting expenditures, accounts payable, payroll and cash disbursements was not maintained. Management identified multiple instances where various employees were responsible for custody, initiating, recording, and/or approving transactions, as well as custody of assets.

Accounting for income taxes. Effective controls over income tax accounting were not maintained. Specifically, controls were not designed and in place to ensure that: (i) calculations, assumptions, exposures, estimates, and disclosures were properly reviewed, (ii) temporary and permanent book to tax differences are properly identified, (iii) deferred tax assets are recoverable, (iv) all tax-related accounts, including the income tax provision rate and pre-tax income, are properly reconciled to the trial balance and tax returns, (v) all quarterly tax payments are accurately tracked and recorded, and (vi) accounting personnel possessed sufficient knowledge with respect to GAAP in this area.

Financial close and reporting. We did not maintain enough skilled accounting resources supporting the financial close and reporting processes to ensure (i) changes and entry to spreadsheets utilized in the financial reporting process were properly reviewed, (ii) significant estimates and judgments were adequately supported, reviewed, approved and evaluated against actual experiences, (iii) effective and timely analysis and reconciliation of significant accounts, and (iv) a proper review of period close entries and procedures.

Accounts Payable. We did not maintain adequate controls to ensure the proper inclusion of out-of-period invoices with respect to goods and services we received, and therefore, the completeness of our accounts payable.

Stock-based Compensation. We did not maintain adequate controls to ensure that compensation expense associated with stock option grants was recognized in a manner consistent with the performance conditions of Statement of Financial Accounting Standards No. 123(R), "Share-based Payment." Additionally, our detective controls over certain inputs made into our stock option accounting software did not operate effectively.

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## DCAP GROUP INC

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Financial Reporting of a Subsidiary Payments Inc., our wholly-owned subsidiary, utilized a third party service provider that does not provide a Type II SAS 70 report on its internal control. As a result, we determined that the internal control over financial reporting for Payments Inc. was not effective and was not designed to ensure that all information required to be disclosed by us in the reports we file or submit under the Exchange Act were accurately recorded, processed, summarized and reported. As more fully described in Item 1 of this Annual Report, the assets and liabilities of this subsidiary were sold in February 2008.

Information Technology Applications and Infrastructure We did not maintain effective controls over financial reporting related to information technology applications and infrastructure. Specifically, the following deficiencies in the aggregate constituted a material weakness:

- We did not maintain effective design of controls over access to financial reporting applications and data. Controls do not limit access to programs and data to only authorized users. In addition, controls lack the requirement of periodic reviews and monitoring of such access.
- We did not maintain effective controls to communicate policies and procedures governing information technology security and access. Furthermore, we did not maintain effective logging and monitoring of servers and databases to ensure that access was both appropriate

and authorized.

- We did not maintain effective controls designed to ensure that information technology program and data changes were authorized and properly managed. In addition, our controls did not ensure that the information technology program data changes were adequately tested for accuracy before implementation.

These deficiencies have had a pervasive impact on our information technology control environment. Additionally, these deficiencies could result in a misstatement of account balances or disclosure to substantially all accounts that could result in a material misstatement to the consolidated financial statements that would not be prevented or detected. We are in the process of developing and implementing a remediation plan to address the material weaknesses related to information technology applications and infrastructure.

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## RADIAN GROUP INC

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We did not maintain a sufficient complement of personnel with an appropriate level of accounting knowledge, experience and training in the application of generally accepted accounting principles commensurate with our financial reporting requirements. Specifically, this deficiency resulted in audit adjustments to the Derivative Liabilities and Change in Fair Value of Derivative Instruments line items in our consolidated financial statements for the year ended December 31, 2007 primarily arising from insufficient

- (1) identification of derivative instruments;
- (2) review, approval and testing of complex derivative valuation models, including assumptions, data inputs and results and
- (3) identification of contract terms and transactions requiring consolidation in accordance with generally accepted accounting principles related to such financial statement line items.

Additionally, this control deficiency could result in misstatements of the aforementioned financial statement line items that would result in a material misstatement to our annual or interim consolidated financial statements that would not be prevented or detected.

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## SCOTTISH RE GROUP LTD

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2007, the Company had a material weakness in internal control over financial reporting relating to its controls over its process for analyzing and concluding on other-than temporary impairments of invested assets. On March 7, 2008 the Company announced that it would delay the filing of its Form 10-K for the year ended December 31, 2007 because of the additional work necessary to complete the financial statements and address accounting and disclosure requirements related to the Company's holdings in sub-prime and Alt-A residential mortgage-backed securities as well as the Company's recently announced change in strategic focus. As part of this process, and based on their evaluation, management has concluded that as of September 30 2007, the Company had a material weakness relating to its controls over its process for analyzing and concluding on other-than temporary impairments. The Company has determined that the design and operation of internal controls over the accounting for other-than-temporary impairments of investments were inadequate to ensure full conformance with GAAP. Based on their evaluation, management has also concluded that the material weakness relating to its controls over its process for analyzing and concluding on other-than temporary impairments remained as of December 31, 2007. As a result of the material weakness in internal control over financial reporting described above, management has concluded that, as of December 31, 2007, the Company's internal control over financial reporting was not effective based on the criteria in "Internal Control — Integrated Framework" issued by the COSO.

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## STANDARD MANAGEMENT CORP

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Since mid-2006, the Company has been undergoing a major transition as it reorganizes and attempts to launch the strategic plans described earlier in this report. One of the results of this transition was the Company entering into substantial, non-routine accounting transactions which required a higher level of accounting knowledge to complete. This situation, combined with the loss of certain accounting personnel in 2006, and significant cash restraints during the same time period, resulted in the Company not having, as of December 31, 2007, a sufficient complement of personnel to support the Chief Accounting Officer with the requisite level of accounting knowledge, experience, and training in the application of U.S. generally accepted accounting principles to properly analyze, review, monitor and record these more complicated and certain other accounting transactions. In addition, somewhat due to the significant attention required of our currently limited accounting and financial staff in our efforts to raise capital and identify appropriate acquisition targets, the Company was unable to timely finalize its accounting for 2007 and to fully control its financial statement closing process. These material weaknesses lead to delays and correction of previously-recorded amounts while finalizing the 2007 financial statements included in this report. As a result, management has concluded that there was some likelihood that a material misstatement of the Company's annual financial statements may not have been prevented or could have gone undetected as part of the financial statement closing process for 2007.

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## WELLCARE HEALTH PLANS, INC.

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Management has identified the following material weaknesses in WellCare's internal controls over financial reporting as of December 31, 2007: (a) former senior management set an inappropriate tone in connection with the Company's efforts to comply with the regulatory requirements related to the AHCA and Healthy Kids contracts that led to a deficiency in the design in our internal controls, and therefore a material weakness existed in a portion of the control environment and control activities components of our internal controls, and (b) former senior management's failure to ensure effective communications regarding the AHCA contract and Healthy Kids contract with, among others, our Board and certain regulators resulted in a material weakness in the information and communication system.

We identified a material weakness in a portion of the control environment and control activities components of our internal controls. We have determined that certain former members of senior management set an inappropriate tone in connection with our efforts to comply with the regulatory requirements related to the AHCA and Healthy Kids contracts that led to a deficiency in the design of our internal controls. Specifically, there was inadequate control over financial reporting as of December 31, 2007 with respect to interpreting and complying with regulatory guidance and other contracted terms when calculating, submitting and reserving for estimated self-reported retrospective settlements with a state agency with which certain of our subsidiaries were contracted to provide Medicaid services.

We have determined that certain former members of senior management failed to ensure effective communications with, among others, our Board and certain regulators regarding the AHCA and Healthy Kids contracts, and therefore a material weakness existed in a portion of the information and communication system. Specifically, there was a lack of communication regarding the Company's interpretation of and compliance with regulatory guidance and other contracted terms pertaining to self-reported retrospective settlements as well as with regard to inquiries from a state agency pertaining to the retrospective settlement process.



## 2006

The following are excerpts of the 2006 material weaknesses reported by all accelerated filer public insurance companies.

At this point, non accelerated filers did not have to attest to the effectiveness of internal controls over financial reporting. This was the third year that management of accelerated filers expressed an opinion on their internal controls. Auditor attestation of the internal controls for accelerated filers was in effect as well.

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21<sup>ST</sup> CENTURY HOLDING CO  
AMERICAN INTERNATIONAL GROUP INC  
CITIZENS INC  
CONSECO INC  
CORVEL CORP  
FAIRFAX FINANCIAL HOLDINGS LTD  
FINANCIAL INDUSTRIES CORP  
HILB ROGAL & HOBBS CO  
PENN TREATY AMERICAN CORP  
QUANTA CAPITAL HOLDINGS LTD

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## 21<sup>ST</sup> CENTURY HOLDING CO

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In connection with management's assessment of the Company's internal control over financial reporting, the Company identified two control deficiencies as of December 31, 2006 relating to (i) the recognition and accounting of unrecorded premium transactions and (ii) income tax issue relating to computing our income tax liability where we failed to consider a prior year tax refund applied to the current year. These control deficiencies existed in varying degrees and resulted in adjustments to the annual consolidated financial statements.

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## AMERICAN INTERNATIONAL GROUP I

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Controls over income tax accounting: AIG did not maintain effective controls over the determination and reporting of certain components of the provision for income taxes and related income tax balances. Specifically, AIG did not maintain effective controls to review and monitor the accuracy of the components of the income tax provision calculations and related income tax balances and to monitor the differences between the income tax basis and the financial reporting basis of assets and liabilities to effectively reconcile the differences to the deferred income tax balances. These control deficiencies resulted in adjustments to income tax expense, income taxes payable and deferred income tax asset and liability accounts in the 2006 annual and interim consolidated financial statements. Furthermore, these control deficiencies could result in a material misstatement of the annual or interim Form 10-K 2006 AIG 177.

AIG consolidated financial statements that would not be prevented or detected. Accordingly, AIG management has concluded that these control deficiencies constitute a material weakness.

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## CITIZENS, INC.

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A material weakness existed at December 31, 2006 relating to the financial statement closing process, which resulted from inadequate support and resources at appropriate levels within the finance and accounting organization to enable the timely review of supporting work papers for prior and current accounting periods and to prevent and detect misapplications of U.S. GAAP. As a result of this material weakness, the following adjustments were recorded in the 2006 consolidated financial statements:

- Stockholders' equity as of January 1, 2006 was reduced by \$3.1 million as a result of the Company's adoption of SAB 108.
- Pre-tax income was reduced by \$1.7 million due to an impairment of goodwill (excess cost over net assets acquired) of approximately \$1.0 million and additional amortization of intangible assets (cost of customer relationships acquired) of approximately \$0.7 million for the year ended December 31, 2006.

Change in Internal Control over Financial Reporting During the course of preparing the interim financial statements for the quarter ended September 30, 2006, we discovered cumulative misstatements of approximately \$2.8 million in periods prior to December 31, 2005, and disclosed our intention to correct these errors by increasing our retained deficit as of January 1, 2006, upon the adoption of Staff Accounting Bulletin ("SAB") 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements (SAB 108) as of December 31, 2006.

At that time, we also determined that not identifying and quantifying these misstatements on a timely basis was indicative of a material weakness in internal control over financial reporting, which resulted from the non-timely review of supporting work papers and documentation for prior accounting periods, where the effects of prior misstatements could materially affect our financial statements for subsequent reporting periods, and inadequate analyses to assure that the accounting treatment conformed with U.S. GAAP.

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## CONSECO, INC.

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We did not maintain effective controls over the accounting and disclosure of insurance policy benefits

and the liabilities for insurance products. We identified a material weakness in internal controls over the actuarial reporting processes related to the design of controls to ensure the completeness and accuracy of the enforce policies for a block of single premium immediate annuities in our Bankers Life segment, controls to ensure that accurate reserves are established for all policy benefits related to certain supplemental insurance coverages applicable to a block of specified disease policies in the Conseco Insurance Group segment, and controls to ensure the accuracy of benefit reserves on certain long-term care policies with inflation riders, lifetime benefit features or non-forfeiture provisions in our Other Business in Run-off segment. These control deficiencies resulted in adjustments to insurance policy benefits and the liabilities for insurance products in the consolidated financial statements for the year ended December 31, 2006. Additionally, these control deficiencies could result in the misstatement of the aforementioned accounts that would result in a material misstatement in our annual or interim consolidated financial statements that would not be prevented or detected.

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## CORVEL CORP

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CorVel did not maintain a sufficient complement of personnel with an appropriate level of accounting knowledge, experience and training to: (i) ensure the preparation of interim and annual financial statements in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP), (ii) effectively execute the principal control activities noted below, and (iii) remediate previously communicated deficiencies. The Company's finance and accounting structure also did not support appropriate lines of authority, reporting, and accountability to achieve desired reliable financial reporting controls. In addition, the Company placed substantial reliance on manual procedures and detective controls that lacked adequate management monitoring for compliance.

We did not maintain an effective control environment. Specifically, we did not maintain: (i) a documented risk assessment process that adequately addresses COSO objectives, including strategic plans, budgets and clearly defined and communicated goals and objectives aligned with the assessment (ii) sufficient anti-fraud controls, such as the whistleblower program, communications, and training employees and the Board regarding fraud, (iii) adequate monitoring of existing controls over financial reporting and individual and corporate performance against expectations, (iv) appropriate human resource policies, such as background investigations and consistent performance reviews for key personnel, and (v) adequate documentation of actions taken by the Board regarding: fraud oversight, review and approval of external financial statements, actions supporting the Board independence and executive performance and compensation (including stock options, compliance with respective Board charters, and remediation of prior internal control weaknesses).

Effective controls related to revenue and receivables reporting were not maintained. Specifically, controls were not properly designed or operating effectively to ensure: (i) adequate documentation of customer agreements, (ii) proper cutoff of revenue at month end, (iii) consistent evaluation of customer credit worthiness, (iv) complete and timely reviews of revenue entries, write-offs, and sales adjustments, (v) all receivable and allowance accounts are appropriately analyzed, (vi) the timely posting of all cash receipts, (vii) completed transactions were appropriately offset or reclassified via journal entries in a timely manner.

Effective controls related to segregation of duties and restrictions on access to systems, financial applications and data were not maintained. The segregation of duties and systems access deficiencies affect financial reporting, payroll master and processing files, expenditure, fixed assets, revenue, and treasury controls. Specifically, management identified instances where various employees are responsible for custody, initiating, recording, and/or approving transactions thereby creating segregation of duties conflicts.

We did not maintain adequate controls over expense recognition through accounts payable and accrual procedures and systems. Out-of-period invoices were not specifically identified and accrued through accounts payable and accrued expense processes to ensure an accurate cutoff and proper matching of revenues and expenses. Accruals related to salaries and wages, bonuses, workers compensation, rebates, professional fees, and PPO expenses were not properly identified and recorded. Specifically, there was no consistent verification of: (i) completeness of supporting documents, (ii) review and approval of supporting documents by appropriate personnel, and (iii)

completeness and accuracy of month-end accruals.

Effective controls related to expenditure processing were not maintained. Specifically, controls were not properly designed or operating effectively to ensure: (i) payroll and benefit entries are reviewed and approved, (ii) accounts payable entries were reviewed and (iii) capital asset transactions are properly approved and recorded. In addition, controls over vendor master access and change monitoring were inadequate.

Effective controls over period-end financial reporting processes were not maintained to effectively ensure: (i) the security and validity of data transfers between financial applications, including consolidation and associated spreadsheets, (ii) key reconciliations, account analyses, and summaries are performed and approved with appropriate resolution of reconciling items, (iii) journal entries, both recurring and non-recurring, are approved, (iv) the resulting financial information, statements and disclosures are reviewed and appropriate checklists are used for compliance with U.S. GAAP, (v) monthly closing checklists were used consistently and thoroughly to ensure all financial reporting procedures and controls were performed, and (vi) documented reviews of financial results are compared to budgets and expectations. In some cases, inaccurate or incomplete account analyses, account summaries and account reconciliations were prepared during the financial close and reporting process in the areas of cash, accounts receivable, fixed assets, and accruals.

Effective controls over the accounting for income taxes were not maintained. Specifically, controls were not designed and in place to ensure that: (i) temporary and permanent book to tax differences are properly identified, (ii) deferred tax assets are recoverable, (iii) all tax-related accounts, including the income tax provision rate and pre-tax income, are properly reconciled to the trial balance or tax return, and (iv) all quarterly tax payments are accurately tracked and recorded.

Controls to ensure current, accurate and complete accounting for fixed assets were inadequate. The Company had no formal purchasing system or asset disposal system to help manage property and equipment. Additionally, there was insufficient formal, timely review of certain processes associated with the fixed asset management system. Specifically, there was: (i) no documented controls or monitoring of purchase orders for fixed assets, (ii) inadequate processes over the timely and complete receipt of receiving information and invoices for fixed asset additions to ensure timely recording of the fixed asset additions, (iii) limited review of the input of new acquisitions of property and equipment, (iv) no formal documented review of capital pending amounts to determine final categorization as capital or expense items, (v) no review of placed-in service dates, (vi) no review of system-generated depreciation expense, (vii) no documented periodic review of depreciable lives, and (viii) no formal approval of the fixed assets sub ledger reconciliation to the general ledger, with appropriate resolution of reconciling items.

Effective controls related to certain treasury processes were not maintained. Specifically, controls were not properly designed or operating effectively to ensure: (i) proper authorization, monitoring and segregation of duties over wire transfers and other banking activities, (ii) proper authorization of stock option transactions, and (iii) timely bank account reconciliations are performed. 28

Effective monitoring of third party controls supporting our financial reporting were not maintained. Specifically, controls were not properly designed or operating effectively to ensure adequate review of Independent Auditors' Reports on Controls Placed in Operation and Tests of Operating Effectiveness (SAS 70 Type II reports) or additional control evaluation of the third party controls that support the accounting of benefit accruals and payroll transactions.

Effective controls related to lease accounting were not maintained to ensure that lease transactions are adequately analyzed and the financial accounts properly reflect all lease agreements. Consequently, a restatement for lease activity in prior periods was required for the fiscal year 2004 and 2005 financial statements.

Effective controls over the documentation of accounting policies and procedures were not maintained. Written documentation of accounting policies, procedures and authority limits for approving various transactions were considered inadequate for: (i) fixed asset disposals, impairment analysis and physical inventory of assets, (ii) corporate purchasing policies, including policies covering dollar limits

of approval for various levels of management on expenditures, check signing, wire transfers and other banking transactions, (iii) internally developed software costs, (iv) cash receipts processing, (v) income taxes, (vi) various accrual and reserve calculations, (vii) vendor set-up, and (viii) the extension of customer credit.

The Company does not maintain effective controls over payroll processing. There was inadequate segregation of duties relating to access to the payroll master files and processing files. In addition, there was insufficient review of the master file data for accuracy and completeness. There was no documented review of the comparison of the amounts paid for payroll, related taxes and payroll tax returns to the amounts recorded in the general ledger. Security Access over Consolidating Spreadsheets. The Company did not maintain effective controls over spreadsheets used in the Company's financial reporting process. Specifically, controls were not designed and in place throughout the year to ensure that unauthorized modification of the data or formulas within spreadsheets was prevented. These control deficiencies result in a more than remote likelihood of material misstatements to the annual or interim financial statements that would not be prevented or detected. Accordingly, management has determined that these control deficiencies constitute material weaknesses in these control activities.

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### FAIRFAX FINANCIAL HOLDINGS LTD

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1. The company did not maintain a sufficient complement of accounting personnel to support the activities of the company and lines of communication between the company's operations and accounting and finance personnel at head office and the subsidiaries were not adequate to raise issues to the appropriate level of accounting personnel. Further, the company did not maintain personnel with an appropriate level of accounting knowledge, experience and training to support the size and complexity of the organization and its financial reporting requirements. This control deficiency contributed to the other material weakness identified.

2. The company did not maintain effective controls over the completeness and accuracy of period-end financial reporting and period-end close processes at the Fairfax head office consolidation level. Specifically, the company did not maintain effective review and monitoring processes and documentation relating to the (i) recording of recurring and non-recurring journal entries, and (ii) translation of foreign currency transactions and subsidiary company results.

Each of these control deficiencies could result in misstatements of the company's financial statement accounts and disclosures that would result in a material misstatement to the annual or interim consolidated financial statements that would not be prevented or detected.

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### FINANCIAL INDUSTRIES CORP

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The Company's assessment has identified the following material weaknesses of internal control over financial reporting: Control Environment The Company's control environment did not sufficiently promote effective internal control over financial reporting throughout its financial management organization and this material weakness contributed to the development of other material weaknesses described below.

Principal contributing factors included:

- Formal policies and procedures documenting management's expectations have not been established or communicated consistently for all key business processes across the Company.
- Control documentation is incomplete and inadequate to support management's assertions related to Internal Controls over Financial Reporting.
- A comprehensive anti-fraud program has not been established.
- Unclear lines of authority and responsibility exist between the Board of Directors and management.

These deficiencies represented design deficiencies in internal control and in the aggregate resulted in more than a remote likelihood that a material error would not have been prevented or detected, and

constitute a material weakness.

The Company has not established adequate systems and processes for monitoring the Company's internal controls over financial reporting. The Company does not have a sustainable process for periodically evaluating control design and operating effectiveness across the Company on an ongoing basis. The Company does not have an internal audit function to review financial reporting, compliance and operational controls and activities, review adequacy of remediation for known deficiencies, and provide guidance to the Company on significant control or accounting issues. These deficiencies represented a design deficiency in internal controls which resulted in more than a remote likelihood that a material error would not have been prevented or detected, and constituted a material weakness.

The Company's processes for preparing the consolidated financial statements were not clearly defined and lacked the appropriate controls to ensure the completeness, accuracy, timeliness, appropriate valuation, and proper presentation and disclosure of financial transactions. This lack of financial reporting controls has resulted in the late filing of required interim and annual financial information. These deficiencies represented a design deficiency in internal controls which resulted in more than a remote likelihood that a material error would not have been prevented or detected, and constituted a material weakness.

The Company did not maintain effective controls to ensure that reinsurance premiums are computed with the terms of the reinsurance agreement, properly approved for payment and/or recorded in the proper period. These deficiencies represent an operating effectiveness deficiency in internal controls which result in more than a remote likelihood that a material error would not have been prevented or detected, and constitute a material weakness.

The Company did not have appropriate controls to ensure that supplemental contracts are accurately recorded in the general ledger. This deficiency represented an operating effectiveness deficiency in internal controls which resulted in more than a remote likelihood that a material error would not have been prevented or detected, and constituted a material weakness.

The Company does not have appropriate controls in place to adequately control purchases and payments for goods and services of the company to include:

- Appropriate segregation of duties within the accounts payable accounting application to ensure all payments are appropriately authorized and made for goods and services received.
- Amounts posted to accounts payable are input and processed accurately and timely, and are recorded in the proper period.
- All changes to the vendor master file are valid, accurate and processed timely.

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#### HILB ROGAL & HOBBS CO

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The material weakness pertains to insufficient controls over the identification of reporting units to conduct impairment testing of recorded goodwill. Since the adoption of Financial Accounting Standards Board Statement 142, "Goodwill and Other Intangible Assets" (Statement 142), the Company has incorrectly identified the reporting units to conduct impairment testing of recorded goodwill. This control deficiency resulted in the failure to record a goodwill impairment charge for the year ended December 31, 2003. The correction of this error resulted in restatement of the Company's financial statements for the years ended December 31, 2005, 2004 and 2003 and its unaudited quarterly results for those years and 2006. The error was not identified by the Company's existing controls over accounting for goodwill. Accordingly, management has determined that this accounting resulted in a material misstatement and reflects a material weakness in internal control over financial reporting as defined by the Public Company Accounting Oversight Board.

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#### PENN TREATY AMERICAN CORP

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As of December 31, 2006, we did not have adequate actuarial expertise with respect to our ability to

review the results related to reserves calculated by our consulting actuarial firm. As a result, we had an error in the application of a certain assumption used to calculate benefit reserves. Policy reserves and deferred acquisition costs were calculated incorrectly and required a restatement of the previously issued financial statements for the year ended December 31, 2005.

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## QUANTA CAPITAL HOLDINGS LTD

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1. We did not maintain an appropriate complement of technically qualified personnel in certain areas of the accounting function to enable the preparation, on a timely basis, of accurate consolidated financial statements and internal control assessments. Specifically, as a consequence of the Company being placed in run-off, certain key accounting personnel left the Company during the second half of 2006. Their replacements, along with the addition of one senior level manager, were not in place for a sufficient period of time to develop and demonstrate the requisite knowledge of processes and controls. This was exacerbated by the complexities inherent in our manual-intensive accounting process. This control deficiency could result in a misstatement of significant accounts or disclosures which could result in a material misstatement in our consolidated financial statements that would not be prevented or immediately detected. The absence of an appropriate complement of technically qualified personnel in certain areas of the accounting function contributed to the material weakness described in the next paragraph.
2. With respect to our non-Lloyd's businesses that were put into run-off during 2006, effective controls were not in place over the timely completion of reconciliations and analyses of significant components of certain assets and liabilities, including premiums receivable and reinsurance balances payable. This control deficiency could result in a misstatement of significant accounts or disclosures which could result in a material misstatement in our consolidated financial statements that would not be prevented or detected in a timely manner.



## 2005

The following are excerpts of the 2005 material weaknesses reported by all accelerated filer public insurance companies.

Non accelerated filers did not have to attest to the effectiveness of internal controls over financial reporting. This was the second year that management of accelerated filers expressed an opinion on their internal controls. Auditor attestation of the internal controls for accelerated filers was in effect as well.

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AFFIRMATIVE INSURANCE HOLDINGS INC  
AMERICAN INTERNATIONAL GROUP INC  
CNA FINANCIAL CORP  
CORVEL CORP  
FINANCIAL INDUSTRIES CORP  
HCC INSURANCE HOLDINGS INC/DE/  
LANDAMERICA FINANCIAL GROUP INC  
MAX CAPITAL GROUP LTD  
ODYSSEY RE HOLDINGS CORP  
PENN TREATY AMERICAN CORP  
QUANTA CAPITAL HOLDINGS LTD  
UNIVERSAL AMERICAN CORP.

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## AFFIRMATIVE INSURANCE HOLDINGS

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(a) We did not maintain effective controls over access to, and changes in, our information technology systems' operational and financial applications and underlying financial data. Specifically, we lacked adequate controls over: (i) the design, documentation and enforcement of internal access security policies and procedures, and (ii) changes to master file or standing data to prevent errors and irregularities in financial information. Changes to tables and standing data did not follow the approved change management process and lacked user approval and/or testing. Furthermore, access to financial applications and underlying financial data was not adequately restricted or monitored to ensure unauthorized individuals do not have access to add, change or delete the underlying premiums, commissions and fee income, claims, commission expense, accounts payable, or general accounting data. This control deficiency did not result in any adjustments to our 2005 annual or interim consolidated financial statements. However, this deficiency could result in a material misstatement to significant accounts and disclosures including premium revenue, claims expense and the related receivables and reserves that would result in a material misstatement to our annual or interim consolidated financial statements that would not be prevented or detected.

(b) We did not maintain effective internal control over the elimination of intercompany transactions. Specifically, effective controls were not designed and in place over the review and approval of manual intercompany elimination journal entries. This control deficiency resulted in the restatement of our 2004 annual and interim consolidated financial statements and the interim consolidated financial statements for each of the three quarters in 2005, to correct commissions, fee income, policy acquisition expenses, operating expenses, premiums and fees receivable, commissions receivable, amounts due reinsurers and other liabilities. Additionally, this control deficiency could result in a misstatement of the aforementioned accounts that would result in a material misstatement to our annual or interim consolidated financial statements that would not be prevented or detected.

(c) We did not maintain effective controls over the accuracy and completeness of the reconciliation of certain balance sheet accounts. Specifically, reconciling items were not timely and adequately resolved for premiums and fees receivable. In addition, reconciliations to underlying detail of other liability accounts were not adequately performed. This control deficiency resulted in audit adjustments to the Company's 2004 and 2003 annual consolidated financial statements to correct receivables from affiliates and amounts due reinsurers. Additionally, this control deficiency could result in a misstatement of the aforementioned accounts, premiums and fees receivable, the related provision for uncollectible accounts and other liabilities that would result in a material misstatement to our annual or interim consolidated financial statements that would not be prevented or detected.

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## AMERICAN INTERNATIONAL GROUP

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AIG did not maintain effective controls to ensure the accuracy of certain balance sheet accounts in certain key segments of AIG's operations, principally in the Domestic Brokerage Group. Specifically, accounting personnel did not perform timely reconciliations and did not properly resolve reconciling items for premium receivables, reinsurance recoverables and intercompany accounts. As a result, premiums and other considerations, incurred policy losses and benefits, insurance acquisition and other operating expenses, premiums and insurance balances receivable, reinsurance assets, reserves for losses and loss expenses, reserve for unearned premiums, other assets and retained earnings were misstated under GAAP.

AIG did not maintain effective controls over the evaluation and documentation of whether certain derivative transactions qualified under GAAP for hedge accounting. As a result, net investment income, realized capital gains (losses), other revenues, accumulated other comprehensive income (loss) and related balance sheet accounts were misstated under GAAP.

AIG did not maintain effective controls over the determination and reporting of certain components of the provision for income taxes and related income tax balances. Specifically, AIG did not maintain effective controls to review and monitor the accuracy of the components of the income tax provision calculations and related income tax balances and to monitor the differences between the income tax basis and the financial reporting basis of assets and liabilities to effectively reconcile the differences to

the deferred income tax balances. As a result, income tax expense, income taxes payable, deferred income tax assets and liabilities, retained earnings and accumulated other comprehensive income were misstated under GAAP. The control deficiencies described above resulted in the Second Restatement. In addition, these control deficiencies could result in other misstatements to the aforementioned financial statement accounts and disclosures that would result in a material misstatement to the annual or interim AIG consolidated financial statements that would not be prevented or detected.

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## CNA FINANCIAL CORP

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The Company did not have an effectively designed control process in place to ensure adequate oversight, analysis, reconciliation, documentation and periodic evaluation of the results and balances that comprise the net assets of businesses reported as discontinued operations (discontinued operations). There was also a lack of understanding of subsidiary ledger detail, and the Company failed to eliminate intercompany activity within its discontinued operations and between discontinued and continuing operations. As a result, the balances related to discontinued operations were incorrectly established in the Company's current general ledger system in 1997 in connection with a general ledger conversion, resulting in an overstatement of the reported net assets of discontinued operations. In addition, the Company's evaluation of periodic results of the businesses accounted for as discontinued operations was ineffective, therefore the income or loss from discontinued operations was misstated. The Company did not have an effectively designed control process to ensure correct classification of cash flow activity in the Consolidated Statements of Cash Flows. The classification errors in prior financial statements involved the presentation of certain cash flow components related to trading securities, equity method investees, investment contracts and cumulative translation adjustments. As a result, net cash flows provided by operating activities-continuing operations, cash flows used by investing activities-continuing operations and cash flows provided by financing activities-continuing operations were increased or decreased for the years ended December 31, 2004 and 2003. This deficiency had no impact on the total change in cash from continuing operations within the Consolidated Statements of Cash Flows.

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## CORVEL CORP

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Grant Thornton LLP, our independent registered public accounting firm, has provided us with an unqualified report on our consolidated financial statements for fiscal year ended March 31, 2005. However, in connection with the audit procedures for the audit of our fiscal 2005 financial statements and internal controls assessment, despite substantial efforts, we were not able to complete fully our testing of a sufficient amount of key controls in our processes to satisfy Grant Thornton on their effectiveness. One of the reasons for our inability to complete such testing was that we did not have adequate resources to perform such testing by March 31, 2005. Accordingly, in consultation with Grant Thornton, we have concluded that we are unable to complete the management assessment of our internal control over financial reporting as of March 31, 2005 as required under Section 404 of the Sarbanes-Oxley Act, and Grant Thornton has issued a "disclaimer" opinion, included herein, indicating that they do not express an opinion as to management's assessment and as to the effectiveness of our internal control over financial reporting as of March 31, 2005.

The testing and evaluation of the Company's internal controls was not completed in a timely manner, primarily due to insufficient financial accounting resources, including adequate oversight of the process and expertise associated with the documentation and testing of controls. In addition, many of the Company's controls are undocumented or are automated controls which could not be adequately tested after March 31, 2005, which limited the ability to provide reasonable assurance that the controls were operating effectively as of March 31, 2005. Further, the Company relies heavily on detective, monitoring and foundational controls, which are generally less effective at preventing errors than operational and preventive controls. Consistent operation and monitoring of these controls at the corporate level is critical to ensure that controls assigned to field personnel operate effectively.

- The Company had inadequate controls related to its financial reporting close process, including timely preparation and resolution of reconciling items on balance sheet account reconciliations and the financial consolidation process. Additionally, there was limited evidence of review of reconciliations by

an individual with direct oversight of the process. This deficiency adversely impacts the efficiency, timeliness and accuracy of financial reporting.

- The Company had inadequate controls related to the maintenance of sufficient knowledge and expertise for key accounting personnel with respect to the requirements and application of US GAAP, such as capitalization of internally-developed software and accounting for income taxes.
- The Company had inadequate controls related to application access and system administrator rights. In certain instances, an improper number of or inappropriate personnel were assigned system administrator rights or had excessive system rights, which impairs the Company's ability to maintain adequate segregation of duties.

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## FINANCIAL INDUSTRIES CORP

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The Company's control environment did not sufficiently promote effective internal control over financial reporting throughout its financial management organization and this material weakness contributed to the development of other material weaknesses described below. Principal contributing factors include:

- The lack of sufficient competent accounting personnel in key financial reporting positions.
- The lack of formalized policies and procedures in all areas across the Company.
- The lack of an anti-fraud program.
- Ineffective communication of and education on the control framework, management's expectations for controls, and business process owners' accountability for controls.
- The lack of accountability for ensuring that key internal controls are adequately designed and operating effectively.
- The use of personnel without the appropriate internal control backgrounds and experience to manage and conduct the Company's internal control readiness procedures, including planning, documentation, and testing.
- Inadequate and incomplete documentation and testing of key controls of all business processes across the Company.
- The Company could not sufficiently evidence the performance of many of its internal control activities across the organization including controls over management's assertions with regard to the validity, completeness, timeliness, cutoff and accuracy of calculations and transactions.
- Unclear lines of authority and responsibility between the Board of Directors and management.

These deficiencies represented design deficiencies in internal control and in the aggregate resulted in more than a remote likelihood that a material error would not have been prevented or detected, and constitute a material weakness.

The Company did not perform an entity level risk assessment to evaluate the implication of relevant risks on financial reporting, including the impact of potential fraud related risks and the risks related to non-routine transactions, if any, on its internal control over financial reporting. Lack of an entity-level risk assessment constituted an internal control design deficiency which resulted in more than a remote likelihood that a material error would not have been prevented or detected, and constituted a material weakness. Control Monitoring: The Company had not established adequate systems for monitoring the adequacy of controls to include:

- A sustainable process for periodically evaluating control design and operating effectiveness across the Company on an ongoing basis.
- An internal audit function to review financial reporting, compliance and operational controls and activities, review adequacy of remediation for known deficiencies, and provide guidance to the Company on significant control or accounting issues.

These deficiencies represented a design deficiency in internal controls which resulted in more than a remote likelihood that a material error would not have been prevented or detected, and constituted a material weakness.

The Company's processes for preparing the consolidated financial statements were not clearly defined

and they lack appropriate controls to ensure the completeness, accuracy, timeliness, appropriate valuation, and proper presentation and disclosure of financial transactions. The Company did not evidence reviews, approvals, and reconciliations of accounting transactions with regard to the following financial processes: expenditures, fixed assets, income taxes, financial close and reporting, and agent compensation. Additionally, this lack of financial reporting controls has resulted in the late filing of required interim and annual financial information.

These deficiencies represented a design deficiency in internal controls and based on misstatements requiring correction in the financial statements, they constituted a material weakness.

The Company did not segregate incompatible accounting functions of individuals responsible for several business processes, including:

- The accounts payable clerk could add new vendors, approve new vendors, enter check transactions into the general ledger, and review and approve pending payment transactions.
- The chief actuary had the ability to adjust policy reserve calculations without being subject to any additional reviews or monitoring.
- Senior level accounting personnel could both create and approve journal entries.
- The same person who is responsible for monitoring delinquent reinsurance receivables receives the payments from reinsurers.
- The reinsurance reporting analyst had the authority to make payment requests and approve payments.
- The human resource benefits coordinator had the ability to view, modify, and transfer payroll master file information without approval.

In the aggregate, these deficiencies in the design of internal controls result in more than a remote likelihood that a material error would not have been prevented or detected, and constitute a material weakness.

The Company had not appropriately documented, approved, or completed timely reconciliations in several key areas including:

- Transactions related to the Company's separate accounts
- Premium transactions
- Policy information processed by the Company's Policyholder Services Division
- Payroll transactions
- Agent compensation

These deficiencies represented a design deficiency in internal controls which resulted in more than a remote likelihood that a material error would not have been prevented or detected, and constituted a material weakness.

The Company extensively utilized third party service providers for the processing of payroll, computation of actuarial reserves, calculation of income tax balances, and the processing of separate account transactions. The Company did not have adequate controls in place to ensure completeness and accuracy of neither transactions processed nor calculations produced by these third party service providers. These deficiencies represented a design deficiency in internal controls which resulted in

more than a remote likelihood that a material error would not have been prevented or detected, and constituted a material weakness.

The Company did not have appropriate controls in place to adequately safeguard assets including:

- Fixed asset acquisition, tracking, and disposition
- Procurement of only authorized goods and services

These deficiencies represented a design deficiency in internal controls which resulted in more than a remote likelihood that a material error would not have been prevented or detected, and constituted a material weakness.

The Company did not maintain effective controls to ensure that all policies that are subject to reinsurance were properly accounted for and ceded to the Company's reinsurers. The Company did not have a process to adequately reconcile the in-force policy data maintained on its policy administration systems to the reinsurance settlement statements.

As a result of these control deficiencies, there were many instances that occurred whereby the Company did not properly record reinsurance transactions in an accurate and timely manner. These deficiencies represented a design deficiency in internal controls which resulted in more than a remote likelihood that a material error would not have been prevented or detected, and constituted a material weakness.

The Company utilized multiple policy administrative systems, including both automated and manual systems, to process and account for policy related transactions associated with the various types of insurance business issued and administered by the Company. These systems were not common in nature and ranged from full functioning mainframe-based insurance administrative systems to basic spreadsheet and database systems, as well as manual systems. The Company did not have adequate controls with regard to the management of policy data maintained on these systems. There were not adequate controls with regard to the processing of policy transactions on both manual and automated administration systems, including the transfer of data between systems. Additionally, there were not adequate controls with regard to the review of policy transaction data and the identification and correction of processing errors. This lack of policy data integrity controls could result in material errors going undetected, particularly in the calculation of the Company's policy benefit reserve balances as the actuarial reserve estimates may be based on inaccurate and incomplete policy data. Additionally, these policy data control deficiencies may result in material errors going undetected in other financial statement account balances, including policy loans and policyholder benefits.

These deficiencies represented a design deficiency in internal controls and they constituted a material weakness.

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## HCC INSURANCE HOLDINGS INC/DE/

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We did not maintain an effective control environment based on the criteria established in the COSO framework. We did not maintain adequate controls to prevent or detect management override by certain former members of senior management related to our stock option granting practices and procedures. This lack of an effective control environment permitted certain former members of senior management to override controls and retroactively price stock option grants, resulting in ineffective controls over our stock option granting practices and procedures. Effective controls, including monitoring and adequate communication, were not maintained to ensure the accuracy, valuation and presentation of activity related to our stock option granting practices and procedures. This control deficiency resulted in misstatement of our stock-based compensation expense, additional paid-in capital and related income tax accounts and related disclosures, and in the restatement of our consolidated financial statements for the years ended December 31, 2005, 2004 and 2003 and the condensed consolidated financial statements for the quarter ended March 31, 2006 and all quarters for the years ended December 31, 2005 and 2004, and the adjustment of the condensed consolidated financial statements for the quarters ended June 30, 2006 and September 30, 2006. This control

deficiency could result in misstatement of the aforementioned accounts and disclosures that would result in a material misstatement of our annual or interim consolidated financial statements that would not be prevented or detected.

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### LANDAMERICA FINANCIAL GROUP, INC.

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As of December 31, 2005, we did not maintain effective controls over the reconciliation of claims payment and recovery data used to support the estimate of our policy and contract claims reserve. The claims reserve is required to be calculated based on historical claims payments, net of any recoveries. Beginning in 1999 the data used to generate the claims reserve calculated by the actuary and reviewed by management included claims without reduction for recoveries. In 1999 we implemented a new claims system and updated our claim reports. While the data is accurate in the claims reports, the new report format was misinterpreted. Our internal control requiring reconciliation of data used by the actuary was performed with this misinterpretation when reconciled to the financial records. Had the reconciliation been performed accurately, we may have identified the error.

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### MAX CAPITAL GROUP, LTD.

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- We did not maintain effective controls to bifurcate retroactive and prospective elements of coverage within reinsurance contracts purchased, in accordance with SFAS 113, where the dates of agreement in principle of substantial terms and coverage inception differed.
- We did not maintain effective controls over the appropriate accounting for the specific contractual feature contained within the three complex retrocessional contracts purchased.
- We did not maintain effective controls to identify potential extra-contractual agreements, including oral agreements, related to our retrocessional contracts purchased to allow for an appropriate determination of risk transfer.

These control deficiencies resulted in the restatement of our financial statements as described in Part A to correct premiums ceded, net premiums written, earned premiums ceded, net earned premiums, losses and benefits, interest expense and related balance sheet accounts. In connection with management's reassessment of internal control over financial reporting, management determined that these control deficiencies constitute a material weakness within the meaning of Auditing Standards No. 2 of the Public Company Accounting Oversight Board, (PCAOB.)

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### ODYSSEY RE HOLDINGS CORP

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- 1) The Company did not maintain effective controls over the accounting for complex reinsurance transactions. Specifically, the Company did not have effective controls designed and in place over the consideration and application of relevant generally accepted accounting principles and the evaluation and documentation of risk transfer for complex reinsurance transactions. This control deficiency resulted in the restatement of the Company's consolidated financial statements as of and for the years ended December 31, 2004 and 2003 and as of and for each of the quarters in the nine months ended September 30, 2005, as well as audit adjustments in the fourth quarter to the Company's consolidated financial statements as of and for the year ended December 31, 2005, to correct gross premiums written, net premiums written, net premiums earned, losses and loss adjustment expenses, acquisition costs, other underwriting expenses, other expenses and the related balance sheet accounts. Additionally, this control deficiency could result in a misstatement of the aforementioned accounts that would be material to the annual or interim consolidated financial statements and would not be prevented or detected. In connection with management's assessment of our internal control over financial reporting, management has determined that this control deficiency constitutes a material weakness as of December 31, 2005.
- 2) The Company did not maintain effective controls, review procedures and communications related to investment accounting to ensure conformity with generally accepted accounting principles. Specifically, communications and effective controls were not in place surrounding the consideration and application of relevant generally accepted accounting principles to the

identification, valuation and presentation of: 1) derivatives embedded in certain debt securities, and 2) certain equity method investments. This control deficiency resulted in adjustments to the Company's consolidated financial statements as of and for the periods ended December 31, 2001 through 2005, and as of and for each of the related quarters therein. Additionally, this control deficiency could result in a misstatement of net investment income, net realized investment gains (losses), fixed income securities, common stocks, federal and foreign income taxes, other liabilities, shareholders' equity, earnings per share and other comprehensive income, and the related accounts and disclosures that would be material to the Company's annual or interim financial statements and would not be prevented or detected.

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## PENN TREATY AMERICAN CORP

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As of December 31, 2005, we did not have adequate in-house financial and actuarial expertise with respect to our ability to review the results related to reserves calculated by our consulting actuarial firm or to review the results from other outside professionals we utilize in the preparation of our financial statements, such as taxes. As a result, we recorded an adjustment to our claim reserves and completed the final determination of our estimated claim reserves in an untimely manner. This adjustment was recorded prior to the issuance of the financial statements. Due to the timing of the filing of our 2005 Form 10-K and therefore the timing of the remediation of this material weakness, we anticipate that this item will also be a material weakness as of December 31, 2006. However, assuming the successful implementation of Management's Remediation Plan described below, we do not expect this to be a material weakness for the year ended December 31, 2007.

As of December 31, 2005, we had inadequate controls over the selection and application of accounting policies and practices consistent with U.S. generally accepted accounting principles related to assessing materiality of errors. This material weakness resulted from our correction of errors that were considered immaterial to prior years during the 2nd quarter of 2005. These prior year immaterial errors were considered material to the 2nd quarter of 2005. These errors related to accounting for return on premium benefit expense. The correction of these prior year errors will be accounted for as a cumulative adjustment to retained earnings at January 1, 2005 as the Company has early adopted SAB 108 and will require the Company to restate its 2005 quarterly financial statements.

As of December 31, 2005, we did not maintain adequate controls over our claims payment process. The claims system did not have sufficient automated controls in place to ensure accurate claims payments. Although there were compensating procedural controls, they were not effective on a consistent basis and therefore did not appropriately mitigate the risk exposure. Due to the timing of the filing of our 2005 Form 10-K and therefore the timing of the remediation of this material weakness, we anticipate that this item will also be a material weakness as of December 31, 2006. However assuming the successful implementation of Management's Remediation Plan described below, we do not expect this to be a material weakness for the year ended December 31, 2007.

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## QUANTA CAPITAL HOLDINGS, LTD.

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1. We did not maintain a sufficient complement of personnel within our U.S. accounting function with appropriate experience and training commensurate with our financial reporting requirements. Specifically, certain financial reporting positions were not staffed with individuals possessing the appropriate experience and training to meet their responsibilities. In addition, these individuals were not in their positions for an adequate period of time. This control deficiency contributed to the material weaknesses described in 2 and 3 below. Additionally, this control deficiency could result in a misstatement of significant accounts or disclosures, including those described below, that would result in a material misstatement to our annual or interim consolidated financial statements that would not be prevented or detected.

2. We did not maintain effective controls over the accuracy and completeness of, and access to, certain spreadsheets used in the Company's financial reporting process. The spreadsheets used in the financial reporting process are complex and require the manual input of data and formulas used in calculations. These spreadsheets are utilized to accumulate or calculate certain gross and ceded revenue, losses, expenses, and asset and liability balances for transactions processed by our key program manager. Specifically, effective controls were not designed and in place to monitor and

ensure spreadsheet formula logic and input data were adequately reviewed, tested and analyzed to ensure the accuracy and completeness of spreadsheet calculations. In addition, effective controls were not designed and in place to prevent or detect unauthorized access to and modification of the data or formulas contained within the spreadsheets. This control deficiency resulted in an audit adjustment to our 2005 consolidated financial statements to correct commission expense and the related accrual. Additionally, this control deficiency could result in a misstatement of the aforementioned accounts or disclosures that would result in a material misstatement to our annual or interim consolidated financial statements that would not be prevented or detected.

3. We did not maintain effective controls over the completion of reconciliations and analyses for gross and ceded premiums, losses, other expenses, and the related balance sheet accounts for our U.S. processed transactions. Specifically, effective controls were not designed and in place to ensure the reconciliation of (i) gross written premiums and losses reported by our program manager to the underlying administration systems of our program manager; (ii) premium receivables to the general ledger; and (iii) certain cash, underwriting, expense and reported claims data to amounts recorded in the general ledger. This control deficiency did not result in an adjustment to our 2005 consolidated financial statements. However, this control deficiency could result in a misstatement of the aforementioned accounts or disclosures that would result in a material misstatement to our annual or interim consolidated financial statements that would not be prevented or detected.

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## UNIVERSAL AMERICAN CORP

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In performing its assessment of internal control over financial reporting, management determined that a material weakness existed in the Company's internal controls relating to the accounting for our Medicare Supplement claim reserves and the related amounts recoverable from reinsurers. Specifically, the Company's analysis and review controls were not sufficient to ensure that our claim reserves, amounts recoverable from reinsurers and net incurred claims for our Medicare Supplement business were appropriately stated. As a result of this weakness, the Company's internal controls did not detect the need for adjustments to the amounts initially recorded for these items. Based on additional analysis and procedures performed, management made adjustments in the fourth quarter of 2005 to its claim reserves and amounts recoverable from reinsurers as of December 31, 2005 and the related incurred claims expense for the year ended December 31, 2005 for our Medicare Supplement business prior to the issuance of the consolidated financial statements as of December 31, 2005.



## 2004

The following are excerpts of the 2004 material weaknesses reported by all accelerated filer public insurance companies.

This was the first year that management of accelerated filers expressed an opinion on their internal controls. Auditor attestation of the internal controls for accelerated filers was in effect as well.

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AMERICAN EQUITY INVESTMENT LIFE HOLDING CO  
AMERICAN INTERNATIONAL GROUP INC  
AMERICAN PHYSICIANS CAPITAL INC  
ANNUITY & LIFE RE  
CITIZENS INC  
CNA FINANCIAL CORP  
FINANCIAL INDUSTRIES CORP  
HORACE MANN EDUCATORS CORP /DE/  
PRE PAID LEGAL SERVICES INC  
PRESIDENTIAL LIFE CORP  
SCOTTISH RE GROUP LTD  
USI HOLDINGS CORP  
VESTA INSURANCE GROUP INC

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## AMERICAN EQUITY INVESTMENT LIFE HOLDING CO

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Management determined a lack of formal documentation exists surrounding the Company's review of its deferred policy acquisition costs and deferred sales inducements, its unlocking analysis and the related assumptions and estimates used in connection with these items. In addition management concluded that the review of inputs into the models for estimating deferred policy acquisition costs and deferred sales inducements was inadequate. As a result, management has concluded that a material weakness exists and thus is not be able to conclude that its internal control over financial reporting was effective as of the end of the period covered by the Company's Annual Report on Form 10-K. However, this weakness in the Company's internal control over financial reporting did not result in any material misstatement of the Company's financial statements for 2004.

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## AMERICAN INTERNATIONAL GROUP INC

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In connection with the assessment described above, AIG management identified control deficiencies as of December 31, 2004 in the following areas:

Control environment: Certain of AIG's controls within its control environment were not effective to prevent certain members of senior management, including the former Chief Executive Officer and former Chief Financial Officer, from having the ability, which in certain instances was utilized, to override certain controls and effect certain transactions and accounting entries. In certain of these instances, such transactions and accounting entries appear to have been largely motivated to achieve desired accounting results and were not properly accounted for in accordance with GAAP. Further, in certain of these instances, information critical to an effective review of transactions, accounting entries, and certain entities used in these transactions and accounting entries, were not disclosed to the appropriate financial and accounting personnel, regulators and AIG's independent registered public accounting firm. As a result, discussion and thorough legal, accounting, actuarial or other professional analysis did not occur. This control deficiency is based primarily on these overrides. Specifically, this control deficiency permitted the following:

- Creation of Capco, a special purpose entity used to effect transactions that were recorded to convert, improperly, underwriting losses to investment losses and that were not correctly accounted for in accordance with GAAP, resulting in a misstatement of premiums and other considerations, realized capital gains (losses), incurred policy losses and benefits and related balance sheet accounts.
- Incorrect recording under GAAP of reinsurance transactions that did not involve sufficient risk transfer, such as the Gen Re transaction, and in some cases also related to entities which should have been consolidated, such as Union Excess and Richmond. This incorrect recording under GAAP resulted in a misstatement of premiums and other considerations, incurred policy losses and benefits, net investment income, reinsurance assets, deferred policy acquisition costs, other assets, reserve for losses and loss expenses, reserve for unearned premiums, other liabilities and retained earnings. See below for a related discussion under Controls over the evaluation of risk transfer.
- Various transactions, such as Covered Calls and certain "Top Level" Adjustments, converted realized and unrealized gains into investment income, thereby incorrectly applying GAAP, resulting in a misstatement of net investment income, realized capital gains (losses), and accumulated other comprehensive income.
- Incorrect recording under GAAP of changes to loss reserves and changes to loss reserves through "Top Level" Adjustments without adequate support, resulting in a misstatement of incurred policy losses and benefits, reserves for losses and loss expenses, foreign currency translation adjustments and retained earnings.

Controls over the evaluation of risk transfer: AIG did not maintain effective controls over the proper evaluation, documentation and disclosure of whether certain insurance and reinsurance transactions involved sufficient risk transfer to qualify for insurance and reinsurance accounting. These transactions included Gen Re, Union Excess, Richmond and certain transactions involving AIG Re, AIG Risk Finance and AIG Risk Management. As a result, AIG did not properly account for these transactions under GAAP, resulting in a misstatement of premiums and other considerations, incurred policy losses and benefits, net investment income, reinsurance assets, deferred policy acquisition costs, other assets, reserve for losses and loss expenses, reserve for unearned premiums, other liabilities, and retained

earnings.

Controls over certain balance sheet reconciliations: AIG did not maintain effective controls to ensure the accuracy of certain balance sheet accounts in certain key segments of AIG's operations, principally in the Domestic Brokerage Group.

Specifically, accounting personnel did not perform timely reconciliations and did not properly resolve reconciling items for premium receivables, reinsurance recoverables and intercompany accounts. As a result, insurance acquisition and other operating expenses, premiums and insurance balances receivable, reinsurance assets, other assets and retained earnings were misstated under GAAP.

Controls over the accounting for certain derivative transactions: AIG did not maintain effective controls over the evaluation and documentation of whether certain derivative transactions qualified under GAAP for hedge accounting, resulting in a misstatement of net investment income, realized capital gains (losses), other revenues, accumulated other comprehensive income (loss) and related balance sheet accounts.

Controls over income tax accounting: AIG did not maintain effective controls over the determination and reporting of certain components of the provision for income taxes and related deferred income tax balances. Specifically, AIG did not maintain effective controls to review and monitor the accuracy of the components of the income tax provision calculations and related deferred income taxes and to monitor the differences between the income tax basis and the financial reporting basis of assets and liabilities to effectively reconcile the differences to the deferred income tax balances. As a result, deferred income taxes payable, retained earnings and accumulated other comprehensive income were misstated under GAAP.

The control deficiencies described above resulted in the restatement of AIG's 2003, 2002, 2001 and 2000 annual consolidated financial statements and 2004 and 2003 interim consolidated financial statements, as well as adjustments, including audit adjustments relating to the derivative matter described above, to AIG's 2004 annual consolidated financial statements. Furthermore, these control deficiencies could result in other misstatements in financial statement accounts and disclosures that would result in a material misstatement to the annual or interim AIG consolidated financial statements that would not be prevented or detected. Accordingly, management has concluded that these control deficiencies constitute material weaknesses.

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## AMERICAN PHYSICIANS CAPITAL INC

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As of December 31, 2004, the Company did not maintain effective controls over underwriting and claims processes performed at its New Mexico location. The control deficiency at this location relates to deficiencies in our processing and recording of premiums, paid losses, loss adjustment expenses and the related case reserves at December 31, 2004. Specifically, the deficiencies identified included a lack of segregation of duties, insufficient management monitoring and oversight of the underwriting and claims processes, and a lack of adequate documentation to provide evidence of the performance of key controls. The policy and claim administration systems support the underwriting and claims processing at the New Mexico location. These systems lack controls necessary to ensure all premiums and claims transactions are properly processed and accumulated. In addition, access is not restricted to ensure unauthorized individuals do not have access to add, change or delete the underlying premiums or claims data. The control deficiency did not result in any adjustments to the 2004 annual or interim consolidated financial statements. However, this control deficiency could result in a misstatement of premiums, paid losses, loss adjustment expenses and the related case reserves that would result in a material misstatement to the annual or interim financial statements that would not be prevented or detected. Accordingly, management has determined that this control deficiency constitutes a material weakness. Because of this material weakness, we have concluded that the Company did not maintain effective internal control over financial reporting as of December 31, 2004, based on criteria in Internal Control-Integrated Framework.

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## ANNUITY & LIFE RE

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Management's assessment identified the following material weaknesses in the design of the

Company's internal control over financial reporting:

- A lack of adequate segregation of duties related to the Company's Information Technology Infrastructure. The Company's Director of Information Technology serves as the Company's computer network administrator, possessing the highest level of security access over the Company's computer network. He also provides database support, including the electronic translation of data provided to the Company by its ceding companies, to the Company's Reinsurance Administration Actuary and Chief Actuary. Under the COSO Standards, this lack of segregation of duties is defined as a material weakness.
- A series of significant deficiencies were noted in the Company's system of internal control over financial reporting including: lack of audits of ceding company data, over-reliance on spreadsheets and over-reliance on analytics as preventive controls. The combination of these significant deficiencies is a material weakness under the COSO Standards.

Because of the material weaknesses described above, management believes that, as of December 31, 2004, the Company did not maintain effective internal control over financial reporting based on the COSO standards.

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### CITIZENS INC

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Based on this assessment, and considering the material weakness discussed below, management concluded the Company did not maintain effective internal control over financial reporting as of December 31, 2004.

The material weakness relates to the inadequate and ineffective management oversight and review of the Company's financial reporting process. Specifically, the Company did not revise its management oversight and review protocols to address changes in the qualifications of personnel performing financial reporting functions, and did not provide for effective cross-training of personnel performing financial reporting functions. As a result, numerous material errors were identified in the Company's financial statement footnotes. These errors were corrected prior to issuance of the Company's 2004 consolidated financial statements.

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### CNA FINANCIAL CORP

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In the Company's 2004 annual report on Form 10-K, filed on February 28, 2005, management of the Company included Management's Report on Internal Control Over Financial Reporting, which expressed a conclusion by management that as of December 31, 2004, the Company's internal control over financial reporting was effective. As a result of the restatement of its financial statements, as described further in Note T to the financial statements, management has concluded that a material weakness in internal control over financial reporting existed as of December 31, 2004 and, accordingly, has revised its assessment of the effectiveness of the Company's internal control over financial reporting as of December 31, 2004.

A material weakness is a control deficiency, or a combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. Due to the circumstances described in Note T to the financial statements, the management of CNAF has concluded that a material weakness existed in the Company's internal control over financial reporting as of December 31, 2004 as defined under standards established by the Public Company Accounting Oversight Board. Specifically, there were ineffective controls to identify errors in the application of complex accounting standards to several historical finite reinsurance arrangements with the Company's former affiliate. These errors resulted in the restatement of the Company's 2002-2004 annual financial statements.

In making this revised assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control — Integrated Framework. Based on those criteria and management's revised assessment, management concludes that the Company did not maintain effective internal control over financial reporting as of December 31, 2004, solely as a result of the material weakness described above.

Our management assessed the effectiveness of our internal control over financial reporting as of December 31, 2004, using the criteria established in Internal Control — Integrated Framework issued by the Commission of Sponsoring Organizations of the Treadway Commission (“COSO”), and concluded that we did not maintain effective internal control over financial reporting.

While the Company has reached its conclusion that it did not have effective internal control over financial reporting, the Company considers its assessment to be incomplete due to many instances where it was unable to prove that internal controls were effective due to the lack of sufficient evidence of the controls performed. Although the Company’s assessment is considered to be incomplete, the Company has identified the following material weaknesses of internal control over financial reporting:

Control Environment: The Company’s control environment did not sufficiently promote effective internal control over financial reporting throughout its financial management organization and this material weakness contributed to the development of other material weaknesses described below. Principal contributing factors include:

- The lack of sufficient competent accounting personnel in key financial reporting positions.
- The lack of formalized policies and procedures in all areas across the Company.
- The lack of an anti-fraud program.
- Ineffective communication of and education on the control framework, management’s expectations for controls, and business process owners’ accountability for controls.
- The lack of accountability for ensuring that key internal controls are adequately designed and operating effectively.
- The use of personnel without the appropriate internal control backgrounds and experience to manage and conduct the Company’s internal control readiness procedures, including planning, documentation, and testing.
- Inadequate and incomplete documentation and testing of key controls of all business processes across the Company.
- The Company could not sufficiently evidence the performance of many of its internal control activities across the organization including controls over management’s assertions with regard to the validity, completeness, timeliness, cutoff and accuracy of calculations and transactions.
- Unclear lines of authority and responsibility between the Board of Directors and management.

These deficiencies represented design deficiencies in internal control and in the aggregate resulted in more than a remote likelihood that a material error would not have been prevented or detected, and constitute a material weakness.

Risk Assessment: The Company did not perform an entity level risk assessment to evaluate the implication of relevant risks on financial reporting, including the impact of potential fraud related risks and the risks related to non-routine transactions, if any, on its internal control over financial reporting. Lack of an entity-level risk assessment constituted an internal control design deficiency which resulted in more than a remote likelihood that a material error would not have been prevented or detected, and constituted a material weakness.

Control Monitoring: The Company had not established adequate systems for monitoring the adequacy

of controls to include:

- A sustainable process for periodically evaluating control design and operating effectiveness across the Company on an ongoing basis.
- An internal audit function to review financial reporting, compliance and operational controls and activities, review adequacy of remediation for known deficiencies, and provide guidance to the Company on significant control or accounting issues.

These deficiencies represented a design deficiency in internal controls which resulted in more than a remote likelihood that a material error would not have been prevented or detected, and constituted a material weakness.

Financial Close and Reporting: The Company's processes for preparing the consolidated financial statements were not clearly defined and they lack appropriate controls to ensure the completeness, accuracy, timeliness, appropriate valuation, and proper presentation and disclosure of financial transactions. The Company did not evidence reviews, approvals, and reconciliations of both routine and non-routine accounting transactions with regard to the following financial processes: expenditures, fixed assets, income taxes, financial close and reporting, and agent compensation.

This lack of financial reporting controls has resulted in the late filing of required interim and annual financial information, restatements of prior years consolidated financial statements, and a significant number of errors identified during the course of the audit of the 2004 consolidated financial statements. As a result of these errors, the Company has restated its previously issued consolidated financial statements to correct prior period errors which were related to the following balance sheet accounts, as described in Note 2 to the consolidated financial statements:

- Policy loans,
- Cash and cash equivalents,
- Deferred policy acquisition costs,
- Present value of future profits of acquired businesses,
- Agency advances and other receivables,
- Accrued investment income,
- Other liabilities, and
- Current and deferred federal income taxes related to these errors.

These deficiencies represented a design deficiency in internal controls and based on misstatements requiring correction in the financial statements, they constituted a material weakness.

Segregation of Duties: The Company did not segregate incompatible accounting functions of individuals responsible for several business processes, including:

Expenditures:

- The accounts payable clerk could add new vendors, approve new vendors, enter check transactions into the general ledger, and review and approve pending payment transactions.

#### Policy Liabilities:

- The chief actuary had the ability to adjust policy reserve calculations without being subject to any additional reviews or monitoring.

#### Financial Close and Reporting:

- Senior level accounting personnel could both create and approve journal entries.

#### Reinsurance:

- The same person who is responsible for monitoring delinquent reinsurance receivables receives the payments from reinsurers.
- The reinsurance reporting analyst had the authority to make payment requests and approve payments.

#### Human Resources:

- The human resource benefits coordinator had the ability to view, modify, and transfer payroll master file information without approval.

In the aggregate, these deficiencies in the design of internal controls result in more than a remote likelihood that a material error would not have been prevented or detected, and constitute a material weakness.

Reconciliations: The Company had not appropriately documented, approved, or completed timely reconciliations in several key areas including:

- Transactions related to the Company's separate accounts,
- Premium transactions,
- Policy information processed by the Company's Policyholder Services Division,
- Payroll transactions, and
- Agent compensation.

These deficiencies represented a design deficiency in internal controls which resulted in more than a remote likelihood that a material error would not have been prevented or detected, and constituted a material weakness.

Use of Third Party Service Providers: The Company extensively utilized third party service providers for the processing of payroll, computation of actuarial reserves, calculation of income tax balances, and the processing of separate account transactions. The Company did not have adequate controls in place to ensure completeness and accuracy of neither transactions processed nor calculations produced by these third party service providers. These deficiencies represented a design deficiency in internal controls which resulted in more than a remote likelihood that a material error would not have been prevented or detected, and constituted a material weakness.

Safeguarding of Assets: The Company did not have appropriate controls in place to adequately safeguard assets including:

- Fixed asset acquisition, tracking, and disposition, and
- Procurement of only authorized goods and services

These deficiencies represented a design deficiency in internal controls which resulted in more than a remote likelihood that a material error would not have been prevented or detected, and constituted a material weakness.

**Reinsurance:** The Company did not maintain effective controls to ensure that all policies that are subject to reinsurance were properly accounted for and ceded to the Company's reinsurers. The Company did not have a process to adequately reconcile the in-force policy data maintained on its policy administration systems to the reinsurance settlement statements. As a result of these control deficiencies, there were many instances that occurred whereby the Company did not properly record reinsurance transactions in an accurate and timely manner. As a result, the Company recorded restatement adjustments to appropriately cede premiums and reduce reinsurance receivables as described in Note 2 to the consolidated financial statements.

These deficiencies represented a design deficiency in internal controls and based on misstatements requiring correction in the financial statements, they constituted a material weakness.

**Policy Data Integrity:** The Company utilized multiple policy administrative systems, including both automated and manual systems, to process and account for policy related transactions associated with the various types of insurance business issued and administered by the Company. These systems were not common in nature and ranged from full functioning mainframe-based insurance administrative systems to basic spreadsheet and database systems, as well as manual systems. The Company did not have adequate controls with regard to the management of policy data maintained on these systems. There were not adequate controls with regard to the processing of policy transactions on both manual and automated administration systems, including the transfer of data between systems. Additionally, there were not adequate controls with regard to the review of policy transaction data and the identification and correction of processing errors. This lack of policy data integrity controls resulted in material errors, particularly in the calculation of the Company's policy benefit reserve balances. These errors were a result of the actuarial reserve estimates being based on inaccurate and incomplete policy data. Additionally, these control deficiencies have resulted in errors in other financial statement account balances, including policy loans and policyholder benefits. As a result, the Company restated its previously issued consolidated financial statements to correct prior period errors as described in Note 2 to the consolidated financial statements.

These deficiencies represented a design deficiency in internal controls and based on misstatements requiring correction in the financial statements, they constituted a material weakness.

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### HORACE MANN EDUCATORS CORP /DE/

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As a result of its assessment, the Company identified the following material weaknesses in internal control over financial reporting as of December 31, 2004:

- The Company did not maintain policies and procedures sufficient to ensure that reconciliations of the differences between the tax basis and book basis of each component of the Company's deferred tax asset and liability accounts were performed timely and accurately. Specifically, the Company did not employ an adequate number of skilled personnel in its tax department; there was a lack of effective segregation of duties; and there was inadequate and ineffective analysis and management review of the relevant documentation supporting the deferred tax asset and liability accounts. As a result, misstatements were identified in the Company's deferred tax assets and liabilities and income tax expense accounts. Further, there was more than a remote likelihood that the Company's interim or annual financial statements could have been materially misstated. The immaterial misstatements have been recorded in the December 31, 2004 consolidated financial statements.
- The Company did not maintain policies and procedures sufficient to ensure the accurate reporting of cash. Specifically, bank account and suspense account reconciliations, as well as processes for clearing reconciling items, were not performed on a timely basis and the Company misapplied U.S. generally accepted accounting principles related to the classification of outstanding checks.

These deficiencies in policies and procedures related to inadequate management review of cash reconciliations, lack of effective segregation of duties, and inadequate personnel staffing and training. As a result, adjustments were made to cash, unpaid claims and claim expenses, other liabilities, operating expenses, and income tax expense. Further, there was more than a remote likelihood that the Company's interim or annual financial statements could have been materially misstated. The immaterial misstatements have been recorded in the Company's December 31, 2004 consolidated financial statements. Furthermore, the Company has reclassified cash as of December 31, 2004 and 2003 and for each of the years in the three-year period ended December 31, 2004 in the consolidated financial statements.

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### PRE PAID LEGAL SERVICES INC

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We have been informed by Grant Thornton that they have identified two material weaknesses as of December 31, 2004. The first is related to the lack of properly documented financially significant applications, which affects management's ability to effectively monitor risks relating to applications that are significant to financial reporting. In addition, Grant Thornton has also informed management that a material weakness exists as of December 31, 2004, with regard to the Company's controls over commission processes that could potentially result in misstatements. The application system that automates processing of commissions is complex, inadequately documented, and has not been maintained in a manner that provides assurance that all and only authorized changes have been properly designed, tested, and used.

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### PRESIDENTIAL LIFE CORP

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Based on our evaluation, management has concluded that as of December 31, 2004, the Company had material weaknesses in its internal control over financial reporting.

As disclosed in detail in this Form 10-K/A, in February 2005, the Company determined that it had utilized improper accounting treatment for certain principal protected notes in its investment portfolio. Based on applicable accounting standards, the Company determined that it was required to consolidate the issuers of certain of those principal protected notes as of the dates of acquisition of such notes and, as a result, was required to take other than temporary impairment charges against certain of such investments. The Company was required to restate its consolidated financial statements from 1997 to 2003 to effectuate the consolidations and write downs. The changes did not have any impact on the Company's liquidity or net cash flows.

We have determined that, as evidenced by the restatement, there were material weaknesses in our internal control over financial reporting as of December 31, 2004, in that we did not have adequate resources or processes in place to provide reasonable assurances that: (i) emerging accounting standards were assessed properly for applicability to the Company's financial statements on a timely basis or that such assessments were properly documented.; and (ii) unique and complex transactions (e.g., the Company's investments in unique financial instruments) were evaluated thoroughly, including consideration of whether related parties are involved in such transactions, to assess properly the related accounting and financial reporting implications to ensure that appropriate accounting standards were considered and applied and that such assessments were properly documented. In addition, financial reporting resources and processes in place as of December 31, 2004 did not provide adequate segregation of duties to be maintained relative to the processing of certain year-end accounting entries, since finance department personnel with responsibility for reviewing year-end entries had access to make entries to the Company's financial accounting systems. There was no misuse of any such access. However, proper systems management should have segregated such access from those with responsibility for reviewing such entries.

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### SCOTTISH RE GROUP LTD

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Based on their evaluation, management has concluded that a material weakness exists regarding internal control over financial reporting in our U.K. subsidiary as of December 31, 2004. The material weakness identified relates to the monthly financial statement closing process. A significant control over the financial reporting involves the analysis of results of operations and the reconciliation of

premium receivable balances. Such controls were not performed on a timely basis and in sufficient level of detail and resulted in adjustments to various accounts including receivables, premiums, reserves and related accounts..

Because of the material weakness described above, management believes that, as of December 31, 2004, we did not maintain effective internal control over financial reporting based on those criteria.

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### USI HOLDINGS CORP

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Based on this evaluation, management concluded that the Company's internal control over financial reporting was not effective as of December 31, 2004. Management identified internal control deficiencies, none of which individually were considered material; however, when considered in the aggregate, in management's judgment, represented a material weakness in internal control over the financial statement close process. The control deficiencies generally related to (i) segregation of duties around receipts and disbursements in the Company's smaller reporting units, (ii) timely review and approval of account analyses, reconciliations and journal entries, (iii) adequate review of and support for revenue accruals in the Company's core benefits reporting unit and (iv) a lack of operating effectiveness of detection and monitoring controls over the year-end close process. These deficiencies were manifested in a number of adjustments to the financial statements for the year ended December 31, 2004, including those resulting from a complex reclassification of prior years' income taxes related to the Company's decision to discontinue three operations in December 2004. None of the adjustments were material individually or in the aggregate.

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### VESTA INSURANCE GROUP INC

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As of December 31, 2004, management identified the following material weaknesses in the Company's internal control over financial reporting:

1. The Company did not maintain an effective control environment because of the following material weaknesses:

(a) The Company did not effectively communicate the importance of controls throughout the Company or set an adequate tone around control consciousness.

(b) The Company did not maintain a sufficient complement of personnel with an appropriate level of accounting knowledge, experience and training to support the size and complexity of the Company's current organizational structure and financial reporting requirements. Specifically, certain accounting and finance positions were staffed with individuals who did not have the appropriate skills, training, and experience to meet their responsibilities.

(c) The Company did not maintain effective anti-fraud programs and controls. In particular, the Company did not have a consistent process for conducting background checks, which contributed to fraud being perpetrated by a member of senior management.

The Company's failure to maintain an effective control environment contributed to each of the material weaknesses discussed in 2 through 10 below.

2. The Company did not maintain an effective risk assessment function. Specifically, management failed to establish a formal risk assessment process designed to identify, assess and respond to control and fraud risks relevant to financial reporting. The failure to maintain an effective risk assessment function limited management's ability to appropriately and timely respond to matters that impact the entity's risk profile, such as entity size, complexity of operations, and degree of regulation over its activities.

This material weakness contributed to each of the material weaknesses discussed in 3 through 10 below.

3. The Company did not maintain effective controls over the completeness and accuracy of the period end financial reporting and close processes related to financial statement consolidations, intercompany eliminations and reconciliations of sub-ledger to general ledger balances. In addition, management did not have effective review and monitoring over such processes and the documentation supporting these activities was not adequate. Further, the Company lacked standard procedures for the authorization and review of consolidation and post-closing journal entries. This control deficiency resulted in the restatement of the Company's consolidated financial statements for the years ended December 31, 2003 and 2002, for each of the quarters in the year ended December 31, 2003 and for the first and second quarter of the year ended December 31, 2004 as well as audit adjustments to the third and fourth quarter financial statements for the year ended December 31, 2004 to correct significant accounts and disclosures.

4. The Company did not maintain effective controls over vendor setup for the corporate accounts payable system. Specifically, the Company did not maintain a process to independently confirm the validity of vendors prior to such vendors being placed in our accounts payable system to receive payment. This control deficiency resulted in an audit adjustment due to the misappropriation of company funds by the Chief Information Officer. In addition, an individual within the Claims department was able to exploit this control and misappropriate company funds.

5. The Company did not maintain effective controls over the review and evaluation of the recoverability of goodwill. Specifically, management did not maintain effective controls over the review of the periodic evaluation of the carrying amount of goodwill attributable to the Homeowners reporting unit. This control deficiency resulted in errors in the underlying analyses supporting the goodwill impairment evaluation related to (i) the calculation of the discounted cash flow projections and (ii) the calculation of the actuarially determined catastrophe losses.

6. The Company did not maintain effective review and monitoring controls over the accuracy of ceded reinsurance balances. Specifically, certain ceded reinsurance balances subject to manual input were not accurately and completely entered into the general ledger. This control deficiency resulted in an audit adjustment to correct ceded reinsurance balances in the third quarter of 2004.

7. The Company did not maintain effective controls over the accuracy of the reinsurance receivables. Specifically, certain reinsurance receivables were not considered in the analysis of the reserve for uncollectible accounts. This control deficiency resulted in the restatement of the Company's consolidated financial statements for the years ended December 31, 2003 and 2002, for each of the quarters in the year ended December 31, 2003 and for the first and second quarters of the year ended December 31, 2004 as well as audit adjustments to the third quarter financial statements for the year ended December 31, 2004 to correct ceded reinsurance balances.

8. The Company did not maintain effective controls over evaluating its rights and obligations for certain reinsurance contracts at its life insurance subsidiary. Specifically, management failed to establish effective controls over certain third party investments held by the Company under a funds held reinsurance agreement and incorrectly recorded realized gains and losses in its statements of operations related to the sale of investments that belonged to a third party. This control deficiency resulted in the restatement of the Company's consolidated financial statements for the years ended December 31, 2003 and 2002, for each of the quarters in the year ended December 31, 2003 and for the first and second quarters of the year ended December 31, 2004, to correct realized gains and reinsurance balances payable.

9. The Company did not maintain effective controls over the estimation and monitoring of gross insurance reserves for certain discontinued product lines. Specifically, the Company did not have procedures in place to ensure changes in the estimation of life expectancy and other assumptions critical to the calculation were accurate, complete and timely considered in the determination of the gross reserve estimates. This control deficiency resulted in an audit adjustment to the third quarter 2004 financial statements to correct gross insurance reserves and reinsurance recoverable.

10. The Company did not maintain effective controls over access to programs and data. Specifically, certain of the Company's personnel had unrestricted access to various financial application programs and data beyond the requirements of their assigned responsibilities. Furthermore, there were no

effective controls in place to monitor user access. This control deficiency did not result in an audit adjustment or material misstatement to the Company's 2004 interim or annual consolidated financial statements.