

## ANNUAL FINANCIAL REPORTING MODEL REGULATION

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### Section 1. Authority

This regulation is promulgated by the commissioner of insurance pursuant to Sections [insert applicable sections] of the [insert state] insurance law.

### Section 2. Purpose and Scope

The purpose of this regulation is to improve the [insert state] Insurance Department's surveillance of the financial condition of insurers by requiring (1) an annual audit of financial statements reporting the financial position and the results of operations of insurers by independent certified public accountants, (2) Communication of Internal Control Related Matters Noted in an Audit, and (3) Management's Report of Internal Control over Financial Reporting.

Every insurer (as defined in Section 3) shall be subject to this regulation. Insurers having direct premiums written in this state of less than \$1,000,000 in any calendar year and less than 1,000 policyholders or certificate holders of direct written policies nationwide at the end of the calendar year shall be exempt from this regulation for the year (unless the commissioner makes a specific finding that compliance is necessary for the commissioner to carry out statutory responsibilities) except that insurers having assumed premiums pursuant to contracts and/or treaties of reinsurance of \$1,000,000 or more will not be so exempt.

Foreign or alien insurers filing the audited financial report in another state, pursuant to that state's requirement for filing of audited financial reports, which has been found by the commissioner to be substantially similar to the requirements herein, are exempt from Sections 4 through 13 of this regulation if:

- A. A copy of the audited financial report, Communication of Internal Control Related Matters Noted in an Audit, and the Accountant's Letter of Qualifications that are filed with the other state are filed with the commissioner in accordance with the filing dates specified in Sections 4, 11 and 12, respectively (Canadian insurers may submit accountants' reports as filed with the Office of the Superintendent of Financial Institutions, Canada).
- B. A copy of any Notification of Adverse Financial Condition Report filed with the other state is filed with the commissioner within the time specified in Section 10.

Foreign or alien insurers required to file Management's Report of Internal Control over Financial Reporting in another state are exempt from filing the report in this state provided the other state has substantially similar reporting requirements and the report is filed with the commissioner of the other state within the time specified.

This regulation shall not prohibit, preclude or in any way limit the commissioner of insurance from ordering or conducting or performing examinations of insurers under the rules and regulations of the [insert state] Department of Insurance and the practices and procedures of the [insert state] Department of Insurance.

### **Section 3. Definitions**

The terms and definitions contained herein are intended to provide definitional guidance as the terms are used within this regulation.

- A. "Accountant" or "independent certified public accountant" means an independent certified public accountant or accounting firm in good standing with the American Institute of Certified Public Accountants (AICPA) and in all states in which he or she is licensed to practice; for Canadian and British companies, it means a Canadian-chartered or British-chartered accountant.
- B. An "affiliate" of, or person "affiliated" with, a specific person, is a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified.
- C. "Audit committee" means a committee (or equivalent body) established by the board of directors of an entity for the purpose of overseeing the accounting and financial reporting processes of an insurer or group of insurers, the internal audit function of an insurer or group of insurers (if applicable), and external audits of financial statements of the insurer or group of insurers. The audit committee of any entity that controls a group of insurers may be deemed to be the audit committee for one or more of these controlled insurers solely for the purposes of this regulation at the election of the controlling person. Refer to Section 14F for exercising this election. If an audit committee is not designated by the insurer, the insurer's entire board of directors shall constitute the audit committee.
- D. "Audited financial report" means and includes those items specified in Section 5 of this regulation.

- E. “Indemnification” means an agreement of indemnity or a release from liability where the intent or effect is to shift or limit in any manner the potential liability of the person or firm for failure to adhere to applicable auditing or professional standards, whether or not resulting in part from knowing of other misrepresentations made by the insurer or its representatives.
- F. “Independent board member” has the same meaning as described in Section 14C.
- G. “Insurer” means a licensed insurer as defined in Sections [insert applicable sections] of the [insert state] insurance law or an authorized insurer as defined in Sections [insert applicable sections] of the [insert state] insurance law.
- H. “Group of insurers” means those licensed insurers included in the reporting requirements of [insert state law equivalent of the model Insurance Holding Company System Regulatory Act], or a set of insurers as identified by management, for the purpose of assessing the effectiveness of Internal control over financial reporting.
- I. “Internal audit function” means a person or persons that provide independent, objective and reasonable assurance designed to add value and improve an organization’s operations and accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.
- J. “Internal control over financial reporting” means a process effected by an entity’s board of directors, management and other personnel designed to provide reasonable assurance regarding the reliability of the financial statements, i.e., those items specified in Section 5B through 5G of this regulation and includes those policies and procedures that:
- (1) Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of assets;
  - (2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of the financial statements, i.e., those items specified in Section 5B through 5G of this regulation and that receipts and expenditures are being made only in accordance with authorizations of management and directors; and
  - (3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of assets that could have a material effect on the financial statements, i.e., those items specified in Section 5B through 5G of this regulation.
- K. “SEC” means the United States Securities and Exchange Commission.
- L. “Section 404” means Section 404 of the Sarbanes-Oxley Act of 2002 and the SEC’s rules and regulations promulgated thereunder.
- M. “Section 404 Report” means management’s report on “internal control over financial reporting” as defined by the SEC and the related attestation report of the independent certified public accountant as described in Section 3A.

- N. “SOX Compliant Entity” means an entity that either is required to be compliant with, or voluntarily is compliant with, all of the following provisions of the Sarbanes-Oxley Act of 2002: (i) the preapproval requirements of Section 201 (Section 10A(i) of the Securities Exchange Act of 1934); (ii) the Audit committee independence requirements of Section 301 (Section 10A(m)(3) of the Securities Exchange Act of 1934); and (iii) the Internal control over financial reporting requirements of Section 404 (Item 308 of SEC Regulation S-K).

**Section 4. General Requirements Related to Filing and Extensions for Filing of Annual Audited Financial Reports and Audit Committee Appointment**

- A. All insurers shall have an annual audit by an independent certified public accountant and shall file an audited financial report with the commissioner on or before June 1 for the year ended December 31 immediately preceding. The commissioner may require an insurer to file an audited financial report earlier than June 1 with ninety (90) days advance notice to the insurer.
- B. Extensions of the June 1 filing date may be granted by the commissioner for thirty-day periods upon a showing by the insurer and its independent certified public accountant of the reasons for requesting an extension and determination by the commissioner of good cause for an extension. The request for extension must be submitted in writing not less than ten (10) days prior to the due date in sufficient detail to permit the commissioner to make an informed decision with respect to the requested extension.
- C. If an extension is granted in accordance with the provisions in Section 4B, a similar extension of thirty (30) days is granted to the filing of Management’s Report of Internal Control over Financial Reporting.
- D. Every insurer required to file an annual audited financial report pursuant to this regulation shall designate a group of individuals as constituting its audit committee, as defined in Section 3. The audit committee of an entity that controls an insurer may be deemed to be the insurer’s audit committee for purposes of this regulation at the election of the controlling person.

**Section 5. Contents of Annual Audited Financial Report**

The annual audited financial report shall report the financial position of the insurer as of the end of the most recent calendar year and the results of its operations, cash flows and changes in capital and surplus for the year then ended in conformity with statutory accounting practices prescribed, or otherwise permitted, by the Department of Insurance of the state of domicile.

The annual Audited financial report shall include the following:

- A. Report of independent certified public accountant.
- B. Balance sheet reporting admitted assets, liabilities, capital and surplus.
- C. Statement of operations.
- D. Statement of cash flow.
- E. Statement of changes in capital and surplus.

- F. Notes to financial statements. These notes shall be those required by the appropriate NAIC *Annual Statement Instructions* and the NAIC *Accounting Practices and Procedures Manual*. The notes shall include a reconciliation of differences, if any, between the audited statutory financial statements and the annual statement filed pursuant to Section [insert applicable section] of the [insert state] insurance law with a written description of the nature of these differences.
- G. The financial statements included in the audited financial report shall be prepared in a form and using language and groupings substantially the same as the relevant sections of the annual statement of the insurer filed with the commissioner, and the financial statement shall be comparative, presenting the amounts as of December 31 of the current year and the amounts as of the immediately preceding December 31. (However, in the first year in which an insurer is required to file an audited financial report, the comparative data may be omitted).

## **Section 6. Designation of Independent Certified Public Accountant**

- A. Each insurer required by this regulation to file an annual audited financial report must within sixty (60) days after becoming subject to the requirement, register with the commissioner in writing the name and address of the independent certified public accountant or accounting firm retained to conduct the annual audit set forth in this regulation. Insurers not retaining an independent certified public accountant on the effective date of this regulation shall register the name and address of their retained independent certified public accountant not less than six (6) months before the date when the first audited financial report is to be filed.
- B. The insurer shall obtain a letter from the accountant, and file a copy with the commissioner stating that the accountant is aware of the provisions of the insurance code and the regulations of the Insurance Department of the state of domicile that relate to accounting and financial matters and affirming that the accountant will express his or her opinion on the financial statements in terms of their conformity to the statutory accounting practices prescribed or otherwise permitted by that Insurance Department, specifying such exceptions as he or she may believe appropriate.
- C. If an accountant who was the accountant for the immediately preceding filed audited financial report is dismissed or resigns, the insurer shall within five (5) business days notify the commissioner of this event. The insurer shall also furnish the commissioner with a separate letter within ten (10) business days of the above notification stating whether in the twenty-four (24) months preceding such event there were any disagreements with the former accountant on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure; which disagreements, if not resolved to the satisfaction of the former accountant, would have caused him or her to make reference to the subject matter of the disagreement in connection with his or her opinion. The disagreements required to be reported in response to this section include both those resolved to the former accountant's satisfaction and those not resolved to the former accountant's satisfaction. Disagreements contemplated by this section are those that occur at the decision-making level, i.e., between personnel of the insurer responsible for presentation of its financial statements and personnel of the accounting firm responsible for rendering its report. The insurer shall also in writing request the former accountant to furnish a letter addressed to the insurer stating whether the accountant agrees with the statements contained in the insurer's letter and, if not,

stating the reasons for which he or she does not agree; and the insurer shall furnish the responsive letter from the former accountant to the commissioner together with its own.

## **Section 7. Qualifications of Independent Certified Public Accountant**

- A. The commissioner shall not recognize a person or firm as a qualified independent certified public accountant if the person or firm:
- (1) Is not in good standing with the AICPA and in all states in which the accountant is licensed to practice, or, for a Canadian or British company, that is not a chartered accountant; or
  - (2) Has either directly or indirectly entered into an agreement of indemnity or release from liability (collectively referred to as *indemnification*) with respect to the audit of the insurer.
- B. Except as otherwise provided in this regulation, the commissioner shall recognize an independent certified public accountant as qualified as long as he or she conforms to the standards of his or her profession, as contained in the Code of Professional Ethics of the AICPA and Rules and Regulations and Code of Ethics and Rules of Professional Conduct of the [insert state] Board of Public Accountancy, or similar code.
- C. A qualified independent certified public accountant may enter into an agreement with an insurer to have disputes relating to an audit resolved by mediation or arbitration. However, in the event of a delinquency proceeding commenced against the insurer under [cite applicable receivership statute], the mediation or arbitration provisions shall operate at the option of the statutory successor.
- D. (1) The lead (or coordinating) audit partner (having primary responsibility for the audit) may not act in that capacity for more than five (5) consecutive years. The person shall be disqualified from acting in that or a similar capacity for the same company or its insurance subsidiaries or affiliates for a period of five (5) consecutive years. An insurer may make application to the commissioner for relief from the above rotation requirement on the basis of unusual circumstances. This application should be made at least thirty (30) days before the end of the calendar year. The commissioner may consider the following factors in determining if the relief should be granted:
- (a) Number of partners, expertise of the partners or the number of insurance clients in the currently registered firm;
  - (b) Premium volume of the insurer; or
  - (c) Number of jurisdictions in which the insurer transacts business.
- (2) The insurer shall file, with its annual statement filing, the approval for relief from Subsection D(1) with the states that it is licensed in or doing business in and with the NAIC. If the nondomestic state accepts electronic filing with the NAIC, the insurer shall file the approval in an electronic format acceptable to the NAIC.

- E. The commissioner shall neither recognize as a qualified independent certified public accountant, nor accept an annual audited financial report, prepared in whole or in part by, a natural person who:
- (1) Has been convicted of fraud, bribery, a violation of the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. Sections 1961 to 1968, or any dishonest conduct or practices under federal or state law;
  - (2) Has been found to have violated the insurance laws of this state with respect to any previous reports submitted under this regulation; or
  - (3) Has demonstrated a pattern or practice of failing to detect or disclose material information in previous reports filed under the provisions of this regulation.
- F. The commissioner of insurance, as provided in Section [insert applicable section] of the insurance code, may, as provided in [insert applicable citation], hold a hearing to determine whether an independent certified public accountant is qualified and, considering the evidence presented, may rule that the accountant is not qualified for purposes of expressing his or her opinion on the financial statements in the annual audited financial report made pursuant to this regulation and require the insurer to replace the accountant with another whose relationship with the insurer is qualified within the meaning of this regulation.
- G. (1) The commissioner shall not recognize as a qualified independent certified public accountant, nor accept an annual audited financial report, prepared in whole or in part by an accountant who provides to an insurer, contemporaneously with the audit, the following non-audit services:
- (a) Bookkeeping or other services related to the accounting records or financial statements of the insurer;
  - (b) Financial information systems design and implementation;
  - (c) Appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
  - (d) Actuarially-oriented advisory services involving the determination of amounts recorded in the financial statements. The accountant may assist an insurer in understanding the methods, assumptions and inputs used in the determination of amounts recorded in the financial statement only if it is reasonable to conclude that the services provided will not be subject to audit procedures during an audit of the insurer's financial statements. An accountant's actuary may also issue an actuarial opinion or certification ("opinion") on an insurer's reserves if the following conditions have been met:
    - (i) Neither the accountant nor the accountant's actuary has performed any management functions or made any management decisions;

- (ii) The insurer has competent personnel (or engages a third party actuary) to estimate the reserves for which management takes responsibility; and
  - (iii) The accountant's actuary tests the reasonableness of the reserves after the insurer's management has determined the amount of the reserves;
- (e) Internal audit outsourcing services;
  - (f) Management functions or human resources;
  - (g) Broker or dealer, investment adviser, or investment banking services;
  - (h) Legal services or expert services unrelated to the audit; or
  - (i) Any other services that the commissioner determines, by regulation, are impermissible.

**Drafting Note:** Any additions or deletions from the list of prohibited services by a state must be carefully considered as uniformity among states is essential in this section. In determining whether other services are impermissible, the commissioner shall consider utilizing the guidance provided in the SEC's Final Rule No. 33-8183, *Strengthening the Commission's Requirements Regarding Auditor Independence* adopted January 28, 2003, in order to evaluate whether the provision of such services impairs the independence of the accountant.

- (2) In general, the principles of independence with respect to services provided by the qualified independent certified public accountant are largely predicated on three basic principles, violations of which would impair the accountant's independence. The principles are that the accountant cannot function in the role of management, cannot audit his or her own work, and cannot serve in an advocacy role for the insurer.

- H. Insurers having direct written and assumed premiums of less than \$100,000,000 in any calendar year may request an exemption from Subsection G(1). The insurer shall file with the commissioner a written statement discussing the reasons why the insurer should be exempt from these provisions. If the commissioner finds, upon review of this statement, that compliance with this regulation would constitute a financial or organizational hardship upon the insurer, an exemption may be granted.
- I. A qualified independent certified public accountant who performs the audit may engage in other non-audit services, including tax services, that are not described in Subsection G(1) or that do not conflict with Subsection G(2), only if the activity is approved in advance by the Audit committee, in accordance with Subsection J.

**Drafting Note:** A qualified independent certified public accountant who performs the audit may also engage in other non-audit services for an insurer, including tax services, that are not described in Subsection G(1) or that do not conflict with Subsection G(2) if the audit committee is in compliance with the SEC's Final Rule No. 33-8183, *Strengthening the Commission's Requirements Regarding Auditor Independence* adopted January 28, 2003, and has approved such activity.

- J. All auditing services and non-audit services provided to an insurer by the qualified independent certified public accountant of the insurer shall be preapproved by the audit committee. The preapproval requirement is waived with respect to non-audit services if the insurer is a SOX Compliant Entity or a direct or indirect wholly-owned subsidiary of a SOX Compliant Entity or:



- (1) The aggregate amount of all such non-audit services provided to the insurer constitutes not more than five percent (5%) of the total amount of fees paid by the insurer to its qualified independent certified public accountant during the fiscal year in which the non-audit services are provided;
  - (2) The services were not recognized by the insurer at the time of the engagement to be non-audit services; and
  - (3) The services are promptly brought to the attention of the audit committee and approved prior to the completion of the audit by the audit committee or by one or more members of the audit committee who are the members of the board of directors to whom authority to grant such approvals has been delegated by the audit committee.
- K. The audit committee may delegate to one or more designated members of the audit committee the authority to grant the preapprovals required by Subsection J. The decisions of any member to whom this authority is delegated shall be presented to the full audit committee at each of its scheduled meetings.
- L. (1) The commissioner shall not recognize an independent certified public accountant as qualified for a particular insurer if a member of the board, president, chief executive officer, controller, chief financial officer, chief accounting officer, or any person serving in an equivalent position for that insurer, was employed by the independent certified public accountant and participated in the audit of that insurer during the one-year period preceding the date that the most current statutory opinion is due. This section shall only apply to partners and senior managers involved in the audit. An insurer may make application to the commissioner for relief from the above requirement on the basis of unusual circumstances.
- (2) The insurer shall file, with its annual statement filing, the approval for relief from Subsection L(1) with the states that it is licensed in or doing business in and the NAIC. If the nondomestic state accepts electronic filing with the NAIC, the insurer shall file the approval in an electronic format acceptable to the NAIC.

## **Section 8. Consolidated or Combined Audits**

An insurer may make written application to the commissioner for approval to file audited consolidated or combined financial statements in lieu of separate annual audited financial statements if the insurer is part of a group of insurance companies that utilizes a pooling or 100 percent reinsurance agreement that affects the solvency and integrity of the insurer's reserves and the insurer cedes all of its direct and assumed business to the pool. In such cases, a columnar consolidating or combining worksheet shall be filed with the report, as follows:

- A. Amounts shown on the consolidated or combined audited financial report shall be shown on the worksheet;
- B. Amounts for each insurer subject to this section shall be stated separately;
- C. Noninsurance operations may be shown on the worksheet on a combined or individual basis;

- D. Explanations of consolidating and eliminating entries shall be included; and
- E. A reconciliation shall be included of any differences between the amounts shown in the individual insurer columns of the worksheet and comparable amounts shown on the annual statements of the insurers.

**Section 9. Scope of Audit and Report of Independent Certified Public Accountant**

Financial statements furnished pursuant to Section 5 shall be examined by the independent certified public accountant. The audit of the insurer's financial statements shall be conducted in accordance with generally accepted auditing standards. In accordance with AU Section 319 of the Professional Standards of the AICPA, *Consideration of Internal Control in a Financial Statement Audit*, the independent certified public accountant should obtain an understanding of internal control sufficient to plan the audit. To the extent required by AU 319, for those insurers required to file a Management's Report of Internal Control over Financial Reporting pursuant to Section 17, the independent certified public accountant should consider (as that term is defined in Statement on Auditing Standards (SAS) No. 102, *Defining Professional Requirements in Statements on Auditing Standards* or its replacement) the most recently available report in planning and performing the audit of the statutory financial statements. Consideration shall be given to the procedures illustrated in the *Financial Condition Examiners Handbook* promulgated by the National Association of Insurance Commissioners as the independent certified public accountant deems necessary.

**Section 10. Notification of Adverse Financial Condition**

- A. The insurer required to furnish the annual audited financial report shall require the independent certified public accountant to report, in writing, within five (5) business days to the board of directors or its audit committee any determination by the independent certified public accountant that the insurer has materially misstated its financial condition as reported to the commissioner as of the balance sheet date currently under audit or that the insurer does not meet the minimum capital and surplus requirement of the [insert state] insurance code as of that date. An insurer that has received a report pursuant to this paragraph shall forward a copy of the report to the commissioner within five (5) business days of receipt of the report and shall provide the independent certified public accountant making the report with evidence of the report being furnished to the commissioner. If the independent certified public accountant fails to receive the evidence within the required five (5) business day period, the independent certified public accountant shall furnish to the commissioner a copy of its report within the next five (5) business days.
- B. No independent certified public accountant shall be liable in any manner to any person for any statement made in connection with the above paragraph if the statement is made in good faith in compliance with Subsection A.
- C. If the accountant, subsequent to the date of the audited financial report filed pursuant to this regulation, becomes aware of facts that might have affected his or her report, the commissioner notes the obligation of the accountant to take such action as prescribed in Volume 1, Section AU 561 of the Professional Standards of the AICPA.

## Section 11. Communication of Internal Control Related Matters Noted in an Audit

- A. In addition to the annual audited financial report, each insurer shall furnish the commissioner with a written communication as to any unremediated material weaknesses in its internal control over financial reporting noted during the audit. Such communication shall be prepared by the accountant within sixty (60) days after the filing of the annual audited financial report, and shall contain a description of any unremediated material weakness (as the term material weakness is defined by Statement on Auditing Standard 60, *Communication of Internal Control Related Matters Noted in an Audit*, or its replacement) as of December 31 immediately preceding (so as to coincide with the audited financial report discussed in Section 4(A)) in the insurer's internal control over financial reporting noted by the accountant during the course of their audit of the financial statements. If no unremediated material weaknesses were noted, the communication should so state.

**Drafting Note:** The insurer is expected to maintain information about significant deficiencies communicated by the independent certified public accountant. Such information should be made available to the examiner conducting a financial condition examination for review and kept in such a manner as to remain confidential.

- B. The insurer is required to provide a description of remedial actions taken or proposed to correct unremediated material weaknesses, if the actions are not described in the accountant's communication.

## Section 12. Accountant's Letter of Qualifications

The accountant shall furnish the insurer in connection with, and for inclusion in, the filing of the annual audited financial report, a letter stating:

- A. That the accountant is independent with respect to the insurer and conforms to the standards of his or her profession as contained in the Code of Professional Ethics and pronouncements of the AICPA and the Rules of Professional Conduct of the [insert state] Board of Public Accountancy, or similar code;
- B. The background and experience in general, and the experience in audits of insurers of the staff assigned to the engagement and whether each is an independent certified public accountant. Nothing within this regulation shall be construed as prohibiting the accountant from utilizing such staff as he or she deems appropriate where use is consistent with the standards prescribed by generally accepted auditing standards;
- C. That the accountant understands the annual audited financial report and his opinion thereon will be filed in compliance with this regulation and that the commissioner will be relying on this information in the monitoring and regulation of the financial position of insurers;
- D. That the accountant consents to the requirements of Section 13 of this regulation and that the accountant consents and agrees to make available for review by the commissioner, or the commissioner's designee or appointed agent, the workpapers, as defined in Section 13;
- E. A representation that the accountant is properly licensed by an appropriate state licensing authority and is a member in good standing in the AICPA; and
- F. A representation that the accountant is in compliance with the requirements of Section 7 of this regulation.

**Section 13. Definition, Availability and Maintenance of Independent Certified Public Accountants Work Papers**

- A. Work papers are the records kept by the independent certified public accountant of the procedures followed, the tests performed, the information obtained, and the conclusions reached pertinent to the accountant's audit of the financial statements of an insurer. Work papers, accordingly, may include audit planning documentation, work programs, analyses, memoranda, letters of confirmation and representation, abstracts of company documents and schedules or commentaries prepared or obtained by the independent certified public accountant in the course of his or her audit of the financial statements of an insurer and which support the accountant's opinion.
- B. Every insurer required to file an audited financial report pursuant to this regulation, shall require the accountant to make available for review by Insurance Department examiners, all work papers prepared in the conduct of the accountant's audit and any communications related to the audit between the accountant and the insurer, at the offices of the insurer, at the Insurance Department or at any other reasonable place designated by the commissioner. The insurer shall require that the accountant retain the audit work papers and communications until the Insurance Department has filed a report on examination covering the period of the audit but no longer than seven (7) years from the date of the audit report.
- C. In the conduct of the aforementioned periodic review by the Insurance Department examiners, it shall be agreed that photocopies of pertinent audit work papers may be made and retained by the department. Such reviews by the department examiners shall be considered investigations and all working papers and communications obtained during the course of such investigations shall be afforded the same confidentiality as other examination work papers generated by the department.

**Section 14. Requirements for Audit Committees**

This section shall not apply to foreign or alien insurers licensed in this state or an insurer that is a SOX Compliant Entity or a direct or indirect wholly-owned subsidiary of a SOX Compliant Entity.

- A. The audit committee shall be directly responsible for the appointment, compensation and oversight of the work of any accountant (including resolution of disagreements between management and the accountant regarding financial reporting) for the purpose of preparing or issuing the audited financial report or related work pursuant to this regulation. Each accountant shall report directly to the audit committee.
- B. The audit committee of an insurer or group of insurers shall be responsible for overseeing the insurer's Internal audit function and granting the person or persons performing the function suitable authority and resources to fulfill their responsibilities if required by Section 15 of this regulation.
- C. Each member of the audit committee shall be a member of the board of directors of the insurer or a member of the board of directors of an entity elected pursuant to Subsection F and Section 3C.
- D. In order to be considered independent for purposes of this section, a member of the audit committee may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee, accept any

consulting, advisory or other compensatory fee from the entity or be an affiliated person of the entity or any subsidiary thereof. However, if law requires board participation by otherwise non-independent members, that law shall prevail and such members may participate in the audit committee and be designated as independent for audit committee purposes, unless they are an officer or employee of the insurer or one of its affiliates.

- E. If a member of the audit committee ceases to be independent for reasons outside the member's reasonable control, that person, with notice by the responsible entity to the state, may remain an audit committee member of the responsible entity until the earlier of the next annual meeting of the responsible entity or one year from the occurrence of the event that caused the member to be no longer independent.

**Drafting Note:** In determining independence, the commissioner shall consider utilizing guidance provided in the SEC's Final Rule No. 33-8220, *Standards Relating to Listed Company Audit Committees* adopted April 9, 2003.

- F. To exercise the election of the controlling person to designate the audit committee for purposes of this regulation, the ultimate controlling person shall provide written notice to the commissioners of the affected insurers. Notification shall be made timely prior to the issuance of the statutory audit report and include a description of the basis for the election. The election can be changed through notice to the commissioner by the insurer, which shall include a description of the basis for the change. The election shall remain in effect for perpetuity, until rescinded.
- G. (1) The audit committee shall require the accountant that performs for an insurer any audit required by this regulation to timely report to the audit committee in accordance with the requirements of SAS 61, *Communication with Audit Committees*, or its replacement, including:
- (a) All significant accounting policies and material permitted practices;
  - (b) All material alternative treatments of financial information within statutory accounting principles that have been discussed with management officials of the insurer, ramifications of the use of the alternative disclosures and treatments, and the treatment preferred by the accountant; and
  - (c) Other material written communications between the accountant and the management of the insurer, such as any management letter or schedule of unadjusted differences.
- (2) If an insurer is a member of an insurance holding company system, the reports required by Subsection G(1) may be provided to the audit committee on an aggregate basis for insurers in the holding company system, provided that any substantial differences among insurers in the system are identified to the audit committee.

- H. The proportion of independent audit committee members shall meet or exceed the following criteria:

<b>Prior Calendar Year Direct Written and Assumed Premiums</b>		
<b>\$0 - \$300,000,000</b>	<b>Over \$300,000,000 - \$500,000,000</b>	<b>Over \$500,000,000</b>
No minimum requirements. See also Note A and B.	Majority (50% or more) of members shall be independent. See also Note A and B.	Supermajority of members (75% or more) shall be independent. See also Note A.

**Note A:** The commissioner has authority afforded by state law to require the entity's board to enact improvements to the independence of the audit committee membership if the insurer is in a RBC action level event, meets one or more of the standards of an insurer deemed to be in hazardous financial condition, or otherwise exhibits qualities of a troubled insurer.

**Note B:** All insurers with less than \$500,000,000 in prior year direct written and assumed premiums are encouraged to structure their Audit committees with at least a supermajority of independent audit committee members.

**Note C:** Prior calendar year direct written and assumed premiums shall be the combined total of direct premiums and assumed premiums from non-affiliates for the reporting entities.

- I. An insurer with direct written and assumed premium, excluding premiums reinsured with the Federal Crop Insurance Corporation and Federal Flood Program, less than \$500,000,000 may make application to the commissioner for a waiver from the Section 14 requirements based upon hardship. The insurer shall file, with its annual statement filing, the approval for relief from Section 14 with the states that it is licensed in or doing business in and the NAIC. If the nondomestic state accepts electronic filing with the NAIC, the insurer shall file the approval in an electronic format acceptable to the NAIC.

## **Section 15. Internal Audit Function Requirements**

- A. Exemption – An insurer is exempt from the requirements of this section if:
- (1) The insurer has annual direct written and unaffiliated assumed premium, including international direct and assumed premium but excluding premiums reinsured with the Federal Crop Insurance Corporation and Federal Flood Program, less than \$500,000,000; and
  - (2) If the insurer is a member of a group of insurers, the group has annual direct written and unaffiliated assumed premium including international direct and assumed premium, but excluding premiums reinsured with the Federal Crop Insurance Corporation and Federal Flood Program, less than \$1,000,000,000.

**Drafting Note:** An insurer or group of insurers exempt from the requirements of this section is encouraged, but not required, to conduct a review of the insurer business type, sources of capital, and other risk factors to determine whether an Internal audit function is warranted. The potential benefits of an Internal audit function should be assessed and compared against the estimated costs.

- B. **Function** – The insurer or group of insurers shall establish an internal audit function providing independent, objective and reasonable assurance to the Audit committee and insurer management regarding the insurer’s governance, risk management and internal controls. This assurance shall be provided by performing general and specific audits, reviews and tests and by employing other techniques deemed necessary to protect assets, evaluate control effectiveness and efficiency, and evaluate compliance with policies and regulations.
- C. **Independence** – In order to ensure that internal auditors remain objective, the internal audit function must be organizationally independent. Specifically, the internal audit function will not defer ultimate judgment on audit matters to others, and shall appoint an individual to head the internal audit function who will have direct and unrestricted access to the board of directors. Organizational independence does not preclude dual-reporting relationships.
- D. **Reporting** – The head of the internal audit function shall report to the audit committee regularly, but no less than annually, on the periodic audit plan, factors that may adversely impact the internal audit function’s independence or effectiveness, material findings from completed audits and the appropriateness of corrective actions implemented by management as a result of audit findings.
- E. **Additional Requirements** – If an insurer is a member of an insurance holding company system or included in a group of insurers, the insurer may satisfy the internal audit function requirements set forth in this section at the ultimate controlling parent level, an intermediate holding company level or the individual legal entity level.

**Section 16. Conduct of Insurer in Connection with the Preparation of Required Reports and Documents**

- A. No director or officer of an insurer shall, directly or indirectly:
  - (1) Make or cause to be made a materially false or misleading statement to an accountant in connection with any audit, review or communication required under this regulation; or
  - (2) Omit to state, or cause another person to omit to state, any material fact necessary in order to make statements made, in light of the circumstances under which the statements were made, not misleading to an accountant in connection with any audit, review or communication required under this regulation.
- B. No officer or director of an insurer, or any other person acting under the direction thereof, shall directly or indirectly take any action to coerce, manipulate, mislead or fraudulently influence any accountant engaged in the performance of an audit pursuant to this regulation if that person knew or should have known that the action, if successful, could result in rendering the insurer’s financial statements materially misleading.

- C. For purposes of Subsection B of this section, actions that, “if successful, could result in rendering the insurer’s financial statements materially misleading” include, but are not limited to, actions taken at any time with respect to the professional engagement period to coerce, manipulate, mislead or fraudulently influence an accountant:
- (1) To issue or reissue a report on an insurer’s financial statements that is not warranted in the circumstances (due to material violations of statutory accounting principles prescribed by the commissioner, generally accepted auditing standards, or other professional or regulatory standards);
  - (2) Not to perform audit, review or other procedures required by generally accepted auditing standards or other professional standards;
  - (3) Not to withdraw an issued report; or
  - (4) Not to communicate matters to an insurer’s audit committee.

**Drafting Note:** In determining what types of sanctions or penalties could be assessed for violations of items included in Subsections A through C, each state should refer to its individual authority provided by state statutes.

#### **Section 17. Management’s Report of Internal Control over Financial Reporting**

- A. Every insurer required to file an audited financial report pursuant to this regulation that has annual direct written and assumed premiums, excluding premiums reinsured with the Federal Crop Insurance Corporation and Federal Flood Program, of \$500,000,000 or more shall prepare a report of the insurer’s or group of insurers’ internal control over financial reporting, as these terms are defined in Section 3. The report shall be filed with the commissioner along with the Communication of Internal Control Related Matters Noted in an Audit described under Section 11. Management’s Report of Internal Control over Financial Reporting shall be as of December 31 immediately preceding.
- B. Notwithstanding the premium threshold in Subsection A, the commissioner may require an insurer to file Management’s Report of Internal Control over Financial Reporting if the insurer is in any RBC level event, or meets any one or more of the standards of an insurer deemed to be in hazardous financial condition as defined in (include reference to Corrective Action statute).
- C. An insurer or a group of insurers that is
- (1) directly subject to Section 404;
  - (2) part of a holding company system whose parent is directly subject to Section 404;
  - (3) not directly subject to Section 404 but is a SOX Compliant Entity; or
  - (4) a member of a holding company system whose parent is not directly subject to Section 404 but is a SOX Compliant Entity;



may file its or its parent's Section 404 Report and an addendum in satisfaction of this Section 17 requirement provided that those internal controls of the insurer or group of insurers having a material impact on the preparation of the insurer's or group of insurers' audited statutory financial statements (those items included in Section 5B through 5G of this regulation) were included in the scope of the Section 404 Report. The addendum shall be a positive statement by management that there are no material processes with respect to the preparation of the insurer's or group of insurers' audited statutory financial statements (those items included in Section 5B through 5G of this regulation) excluded from the Section 404 Report. If there are internal controls of the insurer or group of insurers that have a material impact on the preparation of the insurer's or group of insurers' audited statutory financial statements and those internal controls were not included in the scope of the Section 404 Report, the insurer or group of insurers may either file (i) a Section 17 report, or (ii) the Section 404 Report and a Section 17 report for those internal controls that have a material impact on the preparation of the insurer's or group of insurers' audited statutory financial statements not covered by the Section 404 Report.

D. Management's Report of Internal Control over Financial Reporting shall include:

- (1) A statement that management is responsible for establishing and maintaining adequate internal control over financial reporting;
- (2) A statement that management has established internal control over financial reporting and an assertion, to the best of management's knowledge and belief, after diligent inquiry, as to whether its internal control over financial reporting is effective to provide reasonable assurance regarding the reliability of financial statements in accordance with statutory accounting principles;
- (3) A statement that briefly describes the approach or processes by which management evaluated the effectiveness of its internal control over financial reporting; and
- (4) A statement that briefly describes the scope of work that is included and whether any internal controls were excluded;
- (5) Disclosure of any unremediated material weaknesses in the internal control over financial reporting identified by management as of December 31 immediately preceding. Management is not permitted to conclude that the internal control over financial reporting is effective to provide reasonable assurance regarding the reliability of financial statements in accordance with statutory accounting principles if there is one or more unremediated material weaknesses in its internal control over financial reporting;
- (6) A statement regarding the inherent limitations of internal control systems; and
- (7) Signatures of the chief executive officer and the chief financial officer (or equivalent position/title).

- E. Management shall document and make available upon financial condition examination the basis upon which its assertions, required in Subsection D above, are made. Management may base its assertions, in part, upon its review, monitoring and testing of internal controls undertaken in the normal course of its activities.
- (1) Management shall have discretion as to the nature of the internal control framework used, and the nature and extent of documentation, in order to make its assertion in a cost effective manner and, as such, may include assembly of or reference to existing documentation.
  - (2) Management's Report on Internal Control over Financial Reporting, required by Subsection A above, and any documentation provided in support thereof during the course of a financial condition examination, shall be kept confidential by the State Insurance Department.

**Drafting Note:** It is the recommendation that the company officer responsible for financial reporting would not be a member of the audit committee and that the independent committee members would meet periodically, with no management present, with the independent certified public accountant to discuss the strengths and weaknesses of the insurer's or group of insurers' internal control environments.

## Section 18. Exemptions and Effective Dates

- A. Upon written application of any insurer, the commissioner may grant an exemption from compliance with any and all provisions of this regulation if the commissioner finds, upon review of the application, that compliance with this regulation would constitute a financial or organizational hardship upon the insurer. An exemption may be granted at any time and from time to time for a specified period or periods. Within ten (10) days from a denial of an insurer's written request for an exemption from this regulation, the insurer may request in writing a hearing on its application for an exemption. The hearing shall be held in accordance with the regulations of the [insert state] Department of Insurance pertaining to administrative hearing procedures.
- B. Domestic insurers retaining a certified public accountant on the effective date of this regulation who qualify as independent shall comply with this regulation for the year ending December 31, 20[ ], and each year thereafter unless the commissioner permits otherwise.
- C. Domestic insurers not retaining a certified public accountant on the effective date of this regulation who qualifies as independent may meet the following schedule for compliance unless the commissioner permits otherwise.
- (1) As of December 31, 20[ ], file with the commissioner an audited financial report
  - (2) For the year ending December 31, 20[ ], and each year thereafter, such insurers shall file with the commissioner all reports and communication required by this regulation.
- D. Foreign insurers shall comply with this regulation for the year ending December 31, 20[ ], and each year thereafter, unless the commissioner permits otherwise.
- E. The requirements of Section 7D shall be in effect for audits of the year beginning January 1, 2010, and thereafter.

- F. The requirements of Section 14 are to be in effect January 1, 2010. An insurer or group of insurers that is not required to have independent audit committee members or only a majority of independent audit committee members (as opposed to a supermajority) because the total written and assumed premium is below the threshold and subsequently becomes subject to one of the independence requirements due to changes in premium shall have one (1) year following the year the threshold is exceeded (but not earlier than January 1, 2010) to comply with the independence requirements. Likewise, an insurer that becomes subject to one of the independence requirements as a result of a business combination shall have one (1) calendar year following the date of acquisition or combination to comply with the independence requirements.

**Drafting Note:** Adoption of Section 14 is assumed to occur one year prior to the effective date of Section 17.

- G. The requirements of Section 17 and other modified sections [identify modified sections], except for Section 14 covered above, are effective beginning with the reporting period ending December 31, 2010, and each year thereafter. An insurer or group of insurers that is not required to file a report because the total written premium is below the threshold and subsequently becomes subject to the reporting requirements shall have two (2) years following the year the threshold is exceeded (but not earlier than December 31, 2010) to file a report. Likewise, an insurer acquired in a business combination shall have two (2) calendar years following the date of acquisition or combination to comply with the reporting requirements.
- H. The requirements of Section 15 are to be in effect January 1, 2016. If an insurer or group of insurers that is exempt from the Section 15 requirements no longer qualifies for that exemption, it shall have one year after the year the threshold is exceeded to comply with the requirements of this article.

#### **Section 19. Canadian and British Companies**

- A. In the case of Canadian and British insurers, the annual audited financial report shall be defined as the annual statement of total business on the form filed by such companies with their supervision authority duly audited by an independent chartered accountant.
- B. For such insurers, the letter required in Section 6B shall state that the accountant is aware of the requirements relating to the annual audited financial report filed with the commissioner pursuant to Section 4 and shall affirm that the opinion expressed is in conformity with those requirements.

#### **Section 20. Severability Provision**

If any section or portion of a section of this regulation or its applicability to any person or circumstance is held invalid by a court, the remainder of the regulation or the applicability of the provision to other persons or circumstances shall not be affected.

*Chronological Summary of Actions (all references are to the Proceedings of the NAIC).*

- 1980 Proc. I 29, 37, 212, 262, 266-272 (adopted).*
- 1991 Proc. I 9, 17, 225-226, 426, 428, 429-434 (amended and reprinted).*
- 1998 Proc. 2<sup>nd</sup> Quarter 12, 13, 158, 226, 230, 231-232 (amended).*
- 2001 Proc. 4<sup>th</sup> Quarter 6, 13-14, 531, 551, 561-563 (amended).*
- 2003 Proc. 2<sup>nd</sup> Quarter 473, 489, 491 (amended and adopted by parent committee).*
- 2003 Proc. 3<sup>rd</sup> Quarter 15 (adopted by Plenary).*
- 2006 Proc. 2<sup>nd</sup> Quarter 779-793 (amended and adopted by Plenary).*
- 2014 Proc. 2<sup>nd</sup> Quarter, Vol. I 115, 129-134, 173, 194, 216 (amended).*
- 2015 Proc. 2<sup>nd</sup> Quarter, Vol. I 126, 141, 147, 156-157 (editorial changes adopted).*

## ANNUAL FINANCIAL REPORTING MODEL REGULATION

**This chart is intended to provide readers with additional information to more easily access state statutes, regulations, bulletins or administrative rulings related to the NAIC model. Such guidance provides readers with a starting point from which they may review how each state has addressed the model and the topic being covered. The NAIC Legal Division has reviewed each state’s activity in this area and has determined whether the citation most appropriately fits in the Model Adoption column or Related State Activity column based on the definitions listed below. The NAIC’s interpretation may or may not be shared by the individual states or by interested readers.**

**This chart does not constitute a formal legal opinion by the NAIC staff on the provisions of state law and should not be relied upon as such. Nor does this state page reflect a determination as to whether a state meets any applicable accreditation standards. Every effort has been made to provide correct and accurate summaries to assist readers in locating useful information. Readers should consult state law for further details and for the most current information.**

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**KEY:**

**MODEL ADOPTION:** States that have citations identified in this column adopted the most recent version of the NAIC model in a **substantially similar manner**. This requires states to adopt the model in its entirety but does allow for variations in style and format. States that have adopted portions of the current NAIC model will be included in this column with an explanatory note.

**RELATED STATE ACTIVITY:** Examples of Related State Activity include but are not limited to: older versions of the NAIC model, statutes or regulations addressing the same subject matter, or other administrative guidance such as bulletins and notices. States that have citations identified in this column **only** (and nothing listed in the Model Adoption column) have **not** adopted the most recent version of the NAIC model in a **substantially similar manner**.

**NO CURRENT ACTIVITY:** No state activity on the topic as of the date of the most recent update. This includes states that have repealed legislation as well as states that have never adopted legislation.

NAIC MEMBER	MODEL ADOPTION	RELATED STATE ACTIVITY
Alabama		ALA. ADMIN. CODE r. 482-1-141.01 to 482-1-141.20 (2008) (previous version of model); ALA. ADMIN. CODE r. 482-1-095-.05 (2000/2009); 482-1-138-.03 to 482-1-138-.04 (2006/2008); BULLETIN 10-1-2009 (2009).
Alaska		ALASKA ADMIN. CODE tit. 3, §§ 21.700 to 21.799 (2008/2011) (previous version of model); ALASKA ADMIN. CODE tit. 3, § 21.09.200 (2007/2011); BULLETIN B 02-05 (2002).
American Samoa	NO CURRENT ACTIVITY	
Arizona		ARIZ. REV. STAT. ANN. § 20-223 (1954/2009); §§ 20-698 to 20-698.01 (2009/2011); ARIZ. ADMIN. CODE § 054-00-025 (2010) (previous version of model); BULLETIN 2009-3 (2009).
Arkansas		ARK. CODE R. § 25 (1991/2010) (previous version of model).

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NAIC MEMBER	MODEL ADOPTION	RELATED STATE ACTIVITY
California		CAL. CODE REGS. tit. 10, §§ 2309.2 to 2309.20 (2009) (previous version of model); CAL. INS. CODE § 900.2 (1991/2009); CAL. CODE REGS. tit. 10, §§ 2308.1 to 2308.3 (2009).
Colorado	COLO. CODE REGS. § 702-3:3-1-4 (2016).	
Connecticut	CONN. AGENCIES REGS. §§ 38a.54-1 to 38a.54-14 (1991/2016).	CONN. GEN. STAT. § 38a-54 (1990/2009); BULLETIN FS-4-2009 (2009); BULLETIN FS-4AR-2013 (2013); BULLETIN FS-4-2013 (2013).
Delaware		DEL. ADMIN. CODE tit. 18, § 301 (1987/2008) (previous version of model); BULLETIN 10-002-IB (2010).
District of Columbia		D.C. CODE §§ 31-301 to 31-314 (1993/2011) (previous version of model).
Florida		FLA. ADMIN. CODE ANN. r. 690-137.001 to 690-137.002 (1992/2013) (previous version of model); FLA. STAT. § 624.424 (1985/2014).
Georgia	GA. COMP. R. & REGS. 120-2-60 (1994/2015).	GA. CODE ANN. § 33-50-5 (1992/2011).
Guam	NO CURRENT ACTIVITY	
Hawaii		HAW. CODE R. §§ 16-185-101 to 16-185-118 (2010) (previous version of model); HAW. REV. STAT. § 431:3-302.5 (1991/2009).



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NAIC MEMBER	MODEL ADOPTION	RELATED STATE ACTIVITY
Idaho		IDAHO ADMIN. CODE r. 62.18.01.62 (1992/2009) (previous version of model); BULLETIN 2012-2 (2012).
Illinois		ILL. ADMIN. CODE tit. 50, §§ 925.20 to 925.150 (1975/2014) (previous version of model); BULLETIN 2009-10 (2009).
Indiana	IND. CODE §§ 27-1-3.5-1 to 27-1-3.5-17 (1989/2015); 760 IND. ADMIN. CODE 1-78-1 to 1-78-18 (2015).	760 IND. ADMIN. CODE 1-41-1 to 1-41-2 (1988).
Iowa		IOWA ADMIN. CODE 98.1 to 98.20 (2008) (previous version of model).
Kansas		KAN. ADMIN. REGS. § 40-1-37 (1989/2012) (Adopts model by reference) (previous version of model).
Kentucky		806 KY. ADMIN. REGS. 3:170 (1991/2009) (previous version of model).
Maryland		MD. CODE ANN., INS. § 4-118 (1995/2010); MD. CODE REGS. 31.05.11.01 to 31.05.11.17 (2009) (previous version of model); MD. CODE ANN., INS. § 4-116 (1987/2010).
Louisiana		LA. ADMIN. CODE tit. 37, PT. XIII §§ 13701 to 13739 (2009) (previous version of model); LA. REV. STAT. ANN. §§ 22:1321 to 22:1325 (1990/1995); § 22:366 (2008/2009); § 22:386 (2008/2009).

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NAIC MEMBER	MODEL ADOPTION	RELATED STATE ACTIVITY
Maine		ME. REV. STAT. ANN. tit. 24-A, § 221-A (1985/2010) (portions of model); 02-031 ME. CODE R. § 235 (2005/2010) (previous version of model).
Massachusetts		211 MASS. CODE REGS. §§ 26.01 to 26.20 (1976/2008) (previous version of model).
Michigan		MICH. COMP. LAWS §§ 500.1001 to 500.1025 (1992) (previous version of model).
Minnesota		MINN. STAT. § 60A.1291 (2009) (previous version of model).
Mississippi		MISS. CODE ANN. §§ 83-5-101 to 83-5-113 (1991/2009) (previous version of model).
Missouri		MO. REV. STAT. §§ 375.1025 to 375.1062 (1991/2009) (previous version of model); MO. CODE REGS. ANN. tit. 20, § 200-1.150 (1993); § 200-1.005 (2010).
Montana		MONT. ADMIN. R. 6.6.3501 to 6.6.3514 (1993/2011) (previous version of model).
Nebraska		210 NEB. ADMIN. CODE §§ 56-001 to 56-19 (1990/2009) (previous version of model); Notice 3-9-2009 (2009).
Nevada	NEV. ADMIN. CODE §§ 680A.172 to 680A.204 (1996/2017).	NEV. REV. STAT. § 680A.265 (1991/2012); NEV. ADMIN. CODE §§ 680A.001 to 680A.005 (2017).
New Hampshire	N.H. CODE ADMIN. R. ANN. INS. 4501.01 to 4501.18 (2016).	BULLETIN 12-016-AB (2012).

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NAIC MEMBER	MODEL ADOPTION	RELATED STATE ACTIVITY
New Jersey		N.J. ADMIN. CODE §§ 11:2-26.1 to 11:2-26.19 (1989/2010) (previous version of model); N.J. ADMIN. CODE §§ 11:19-1.1 to 11:19-1.4 (2009).
New Mexico		N.M. CODE R. §§ 13.2.5.1 to 13.2.5.27 (1994/2012) (previous version of model).
New York		N.Y. COMP. CODES R. & REGS. tit. 11, §§ 89.1 to 89.3 (Regulation 118) (2009/2010) (previous version of model); N.Y. INS. LAW § 307 (1984/2013); N.Y. COMP. CODES R. & REGS. tit. 11 §§ 83.1 to 83.5 (2000/2014); Circular Letter 2010-10 (2010).
North Carolina		N.C. GEN. STAT. 58-10-185 to 58-10-265 (2009); 11 N.C. ADMIN. CODE 11A.0501 to 11A.0515 (1990/2004) (previous version of model).
North Dakota	N.D. ADMIN. CODE 45-03-20-01 to 45-03-20-13 (2014/2016).	
Northern Marianas		11-55 N. MAR. I. ADMIN. CODE § 15.
Ohio	OHIO ADMIN. CODE § 3901-1-50 (1990/2015).	OHIO REV. CODE ANN. § 3901.48 (1990/2002).
Oklahoma		OKLA. STAT. tit. 36, § 311A.1 to 311A.18 (2009) (previous version of model); OKLA. STAT. tit. 36, § 311.4 (2009).
Oregon		OR. ADMIN. R. 836-011-0000 to 836-011-0230 (1992/2013) (previous version of model).

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NAIC MEMBER	MODEL ADOPTION	RELATED STATE ACTIVITY
Pennsylvania	31 PA CODE 147.2 to 147.13 (2017).	
Puerto Rico		P.R.R. RULE XIV-A (1980/2011) (previous version of model).
Rhode Island	RI ADMIN CODE 11-5-87:1 to 11-5-87:20 (2016).	
South Carolina		S.C. CODE ANN. REGS. 69-70 §§ 1 to 20 (2009/2010) (previous version of model); BULLETIN 6-2009 (2009); BULLETIN 20-2009 (2009); BULLETIN 19-2009 (2009).
South Dakota		S.D. CODIFIED LAWS §§ 58-43-1 to 58-43-25 (1992/2009) (previous version of model); S.D. ADMIN. R. §§ 20:06:25:01 to 20:06:25:02 (1997/2014).
Tennessee		TENN. COMP. R. & REGS. 0780-1-65 (1995/2009) (previous version of model); TENN. CODE ANN. § 56-8-107 (2009).
Texas		TEX. INS. CODE ANN. § 1.15A (1989/2005) (previous version of model); 28 TEX. ADMIN. CODE § 7.84 (2010); § 7.85 (1995/2014); §§ 7.65 to 7.68 (2009/2012); § 7.88 (2010); BULLETIN B-0038-10 (2010).
Utah		UTAH ADMIN. CODE r. 590-254-1 to 590-254-21 (2009) (previous version of model); UTAH ADMIN. CODE r. 590-225-1 to 590-225-15 (2009/2014).

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NAIC MEMBER	MODEL ADOPTION	RELATED STATE ACTIVITY
Vermont		VT. STAT. ANN. tit. 8, §§ 3578a (1992/2009); 21-020-062 VT. CODE R. (2010) (previous version of model); VT. STAT. ANN. tit. 8, § 3561 (2009); VT. STAT. ANN. tit. 18, § 9414(2013); 4-6 VT. CODE R. § 4:1 (2012).
Virgin Islands		V.I. CODE ANN. tit. 22, § 222a (1992) (previous version of model).
Virginia	14 VA. ADMIN. CODE §§ 5-270-10 to 5-270-180 (1991/2015).	Admin. Letter 2009-7 (2009).
Washington		WASH. ADMIN. CODE 284-07-100 to 284-07-230 (1992/2014) (previous version of model); WASH. ADMIN. CODE 284-07-500 to 284-07-540 (2008/2013).
West Virginia		W. VA. CODE §§ 33-33-1 to 33-33-16 (1989/2009) (previous version of model).
Wisconsin		WIS. ADMIN. CODE INS. §§ 50.01 to 50.19 (1993/2009) (previous version of model).
Wyoming		WYO. STAT. ANN. §§ 26-3-301 to 26-3-314 (1994/2004) (previous version of model).

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## ANNUAL FINANCIAL REPORTING MODEL REGULATION

### Proceedings Citations

Cited to the Proceedings of the NAIC

The Committee on Examination Processes evaluated the examination system in place and made some recommendations on improvements. Their report stated that an abundance of testimony was presented by both industry representatives and regulators that the NAIC's model regulation requiring CPA audits should be adopted by all states and that a greater reliance on independent CPA audits would be a valuable supplement to the examination system. **1991 Proc. IA 54.**

An organization of financial examiners also encouraged the use of CPA workpapers to supplement the examination process. They spoke in support of requiring annual independent CPA audits. They felt this would enhance the efficiency of examinations. **1991 Proc. IA 51.**

#### Section 1. Authority

In the mid-1970s the NAIC considered adopting a position concerning whether or not all companies should be required to have an annual CPA audit as an adjunct of the examination process. The Financial Condition Handbook explicitly recognized the use of CPA audits and workpapers with respect to those insurers so audited. This situation provided a laboratory environment to ascertain the value of CPA audits. If the conclusion was favorable, the NAIC could recommend that all states require audits—perhaps with a model regulation. **1977 Proc. II 98-99.**

In 1979 a task force was appointed to develop a model rule. That task force would consider the question of whether such audits should be mandated. **1979 Proc. II 223.**

When recommending the model for adoption by the NAIC, the task force which drafted it recommended it to those states which might be interested in adopting a CPA audit requirement, but did not suggest CPA audits be required in all the states. **1980 Proc. I 266.**

In February 1988 a Financial Regulation Standards Committee was appointed to develop and establish for the NAIC a comprehensive list of standards for financial surveillance and regulation of insurers operating in the United States. It was determined that the financial regulation standards should be presented in the form of an NAIC Policy Statement. **1989 Proc. I 43.** The Policy Statement adopted includes a provision that state statutes or regulations should contain a requirement for annual audits of domestic insurance companies by independent certified public accountants, such as contained in the NAIC's model rule. **1989 Proc. II 35.**

The annual statement instructions were modified, effective for the 1991 blank, requiring a CPA audit. The language offered for the instructions was taken from the model language. **1991 Proc. IA 310.** One department staff member raised a concern over what would take precedence if the annual statement instructions were adopted and the state already had legislation requiring CPA audits. The reply was that the specific legislation would probably take precedence but that states would be urged to conform or repeal their existing legislation regarding CPA audits. **1991 Proc. IA 428.**

## ANNUAL FINANCIAL REPORTING MODEL REGULATION

### Proceedings Citations

Cited to the Proceedings of the NAIC

#### Section 2. Purpose and Scope

In the mid-1970's the NAIC undertook the development of a program to improve the state regulation of financial condition of insurers. They devoted considerable attention to improving the examination process and suggested incorporating a requirement for a CPA audit. Two states already had a requirement for insurers to have an annual audit by an independent certified public accountant and to file the audited financial reports with the insurance department. Also the CPA work papers must be made available. These regulations in no way inhibited or limited the authority of insurance department examiners but provided an additional tool to facilitate and expedite an examination in appropriate situations. **1977 Proc. II 97-98.**

The original model exempted insurers having less than \$250,000 direct premiums written in the state and less than 500 policyholders. The revisions adopted in 1990 raised those numbers to \$1,000,000 and 1,000 policyholders. **1991 Proc. IA 429.**

#### Section 3. Definitions

A. The definition of accountant was modified at the suggestion of the American Institute of Certified Public Accountants (AICPA) to clarify the qualification requirements. **1980 Proc. I 275.**

C. The definition of indemnification was added in conjunction with the prohibition on indemnification clauses added to Section 7 in 2001, and adopted by the NAIC in early 2002. **2001 Proc. 4<sup>th</sup> Quarter 562.**

#### Section 4. Filing and Extension for Filing of Annual Audits Financial Reports

The AICPA expressed concern about this section. They suggested that requests for extensions of the June 30th filing deadline should be the responsibility of the insurer only. Since extension requests may be made for reasons unrelated to the independent certified public accountant, a statement from the accountant would appear to be inappropriate. The drafters reviewed the suggestions of the AICPA but did not adopt their suggested wording changes. **1980 Proc. I 275.**

With the revisions of 1990, the filing date became June 1. **1991 Proc. IA 430.**

#### Section 5. Contents of Audited Financial Report

The modifications made in 1990 changed the required elements to be included in the report. D was changed from "changes in financial position" to "cash flow." F added the reference to the annual statement instructions. **1991 Proc. IA 430.**



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#### Section 5 (cont.)

An organization of financial examiners recommended that CPA opinions on statutory financial statements should state that they are in accordance with statutory accounting practices prescribed by the NAIC. When an insurance company departs from the policies and procedures prescribed by the NAIC (presumably with the permission of the domiciliary state), the independent auditor's opinion should identify the departures from NAIC promulgations and disclose a reconciliation between the practices employed in the financial statements and those promulgated by the NAIC. **1991 Proc. IA 51.**

F. After the codification of statutory accounting was completed, a working group reviewed a suggestion to change the model audit rule. The model had formerly referred to "any other notes required by generally accepted accounting principles." This reference was no longer needed because codification addressed GAAP-like disclosures. Any new GAAP pronouncements would be addressed in the codification maintenance process. **1998 Proc. 2<sup>nd</sup> Quarter I 231.**

One of the advantages of referring to the *Accounting Practices and Procedures Manual* is that future changes would not necessitate change to the model audit rule. **1998 Proc. 2<sup>nd</sup> Quarter I 231.**

An interested party opined that the reconciliation of differences between codification guidance and permitted and prescribed practices of the states amounts to a second audit and would at least double the cost of statutory audits for small companies. He asked the working group to amend the audit rule so this information would not be required or collected. A commissioner responded that the disclosure was not a second audit and would not double costs for insurers. The codification preamble ensures the right of states to determine their own prescribed and permitted practices and this disclosure was critical to the fundamental goal of codification of achieving comparability of financial information. **1998 Proc. 2<sup>nd</sup> Quarter I 229-230.**

Another regulator pointed out that the disclosure requirement has been a part of the model audit rule since its original adoption and merely requires a disclosure of differences, if any, between the filed annual statement blank and the financial statements accompanying the independent auditor's report. **1998 Proc. 2<sup>nd</sup> Quarter I 230.**

An interested party said that the majority of interested parties support the disclosure requirement and did not believe it would double the cost of annual audits of insurer financial statements. **1998 Proc 2<sup>nd</sup> Quarter I 230.**

#### Section 6. Designation of Independent Certified Public Accountant

Changes to this section included in the 1990 amendments were: adding the requirements to notify the insurer within 5 business days if the accountant for the preceding audit is dismissed or resigns and notifying the commissioner within 10 days, and adding two sentences about the types of disagreements contemplated by the section. **1991 Proc. IA 430.**

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#### Section 7. Qualifications of Independent Certified Public Accountant

To conform to changes made to the definitions section, the drafters also modified the language of the first paragraph of Section 7. **1980 Proc. I 275.**

A. In December 2000 an interested party asked regulators for their impression of certified public accountants seeking indemnification agreements from management of mutual companies and other non-publicly traded companies in their engagement letters. The working group asked for a copy of an engagement letter containing one of these indemnification agreements so that the issue could be researched further. **2000 Proc. 4<sup>th</sup> Quarter 360.**

In an example provided by the interested party, the engagement letter attempted to indemnify auditors against intentional misrepresentations by management. Another interested party submitted samples including a release clause, an indemnification clause, and a mediation/arbitration clause. A regulator said these types of clauses concerned him greatly as regulators often took the place of management in cases of receivership and therefore they were bound by the terms of those engagement letters. **2001 Proc. 1<sup>st</sup> Quarter 401.**

A representative for the professional organization for certified public accountants stated that it was in the public interest to allow an auditor to agree with his or her client to an indemnity for knowing misrepresentations by management of nonpublic companies. He opined that the responsibility for intentional wrongdoing should rest with the company. Indemnity provisions in the engagement letter encourage management to disclose and communicate any issues to the auditor completely and accurately. **2001 Proc. 1<sup>st</sup> Quarter 416.**

A regulator responded that the professional organization comments did not address the situation where the regulator became company management in a liquidation case. He believed the model audit rule should be amended to address this situation. Another regulator noted that the Securities and Exchange Commission (SEC) did not allow indemnification and therefore it should not be allowed for insurance companies as insurers are regulated similarly. **2001 Proc. 1<sup>st</sup> Quarter 401.**

A legal opinion by NAIC staff reinforced the concerns that a receiver would be precluded from taking action against an auditor for professional negligence if the problem was the failure to find or disclose erroneous or fraudulent information put forth by the management of the insurer. Staff noted that fraud or misrepresentations by management was often involved in insurer insolvencies. **2001 Proc. 2<sup>nd</sup> Quarter 398.**

An interested party opined that indemnification clauses increased the likelihood of concealment by management. A representative from the CPA professional organization responded that the clauses were intended to protect CPAs from situations where auditing procedures would not reveal misrepresentations. **2001 Proc. 2<sup>nd</sup> Quarter 396.**

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#### Section 7 (cont.)

The working group decided to add a provision to the model that prohibited the use of indemnity clauses by CPAs, and to solicit comments on the revised model draft. **2001 Proc. 2<sup>nd</sup> Quarter 396.**

Staff prepared the first draft of an indemnification prohibition. It was modeled after the SEC rules, with modified terminology. **2001 Proc. 2<sup>nd</sup> Quarter 393.**

As the working group prepared to vote on the amended model, an association of mutual insurers opined that an indemnification, agreement gave the auditor unacceptably broad opportunity to deny responsibility for managements misrepresentations. Even though the accounting profession asserted that indemnification was only applied in the case of knowing misrepresentation by management, the working of some agreements did not seem to include that limitation. **2001 Proc. 4<sup>th</sup> Quarter 561.**

C. The working group agreed to discuss mediation and arbitration separately. One commenter noted that in general receivers viewed arbitration as an unfriendly environment in that they preferred to have the insolvency claims addressed in state courts rather than through an arbitration hearing. **2001 Proc. 2<sup>nd</sup> Quarter 397.**

The first draft included mediation and arbitration clauses within the proposal for a prohibition of indemnifications. A regulator said those types of clauses required additional study. Another regulator agreed, suggesting the mediation and arbitration clauses need not be prohibited entirely, but they should be set aside if the company was put in receivership by the state. An interested party said the SEC had issued no formal response on the issue, but did not believe these types of clauses impaired independence. A regulator agreed that mediation and arbitration clauses did not affect independence, but they did have a dramatic effect when companies were placed in receivership. **2001 Proc. 2<sup>nd</sup> Quarter 393.**

A representative from the CPAs' professional association protested that the concepts of indemnity, release, arbitration and mediation were combined in the first draft, but they were separate and distinct issues. He said CPAs express an opinion; they do not certify. He opined that the language used in the proposed draft was derogatory to the auditing profession and had no place in NAIC regulations. **2001 Proc. 2<sup>nd</sup> Quarter 393.**

An association of mutual insurers did not speak against the addition of Subsection C. They said that, to the extent that arbitration or mediation did not absolve the auditor from reasonable responsibility and liability for testing financial statements for potential misrepresentations of client management, then arbitration or mediation may be acceptable. **2001 Proc. 4<sup>th</sup> Quarter 561.**

An accounting firm spoke against including an arbitration provision that gave regulators the ability to declare an arbitration provision void in the case of an insolvency of the insurer. **2001 Proc. 4<sup>th</sup> Quarter 559.**

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#### Section 7 (cont.)

Even if there was a good reason for regulators to impose limits on an insurer's ability to agree to binding arbitration, an accounting firm suggested that amending the model audit rule was not a good method for addressing that goal. The proposed amendment would affect only agreements with auditors; it would not affect other alternative dispute resolution agreements entered into by insurance companies. The accounting firm suggested that no reason had been advanced why auditors should be singled out for separate treatment. **2001 Proc. 4<sup>th</sup> Quarter 559.**

D. Subsections D and E of this section were added in 1990. They were a substitute for a model draft on non-acceptance of opinions or audits filed by accounting firms or accountants judged guilty of fraud, misrepresentation, deceit or violation of the Racketeer Influenced and Corrupt Organizations Act. The draft had been exposed a year before but not adopted at that time. **1990 Proc. IA 350-351.**

Just before adoption of the amended model, a provision was added to Subsection D to allow for a two-year transition period for rotation of partners. **1991 Proc. IA 426.**

An organization of financial examiners prepared a report with recommendations for the Committee on Examination Processes. One of their points was the importance of rotation of CPA firms. They did not believe that rotation of partners accomplished an independent review. A change in firms would assure that each company gets a fresh look periodically. The rotation of firms would give examiners more confidence in using CPA work product. **1991 Proc. IA 51.**

In 2001 a working group considered a proposal to amend the model to require insurance-specific professional education requirements. The proposal for 30 hours of training over three years would not be in addition to the education requirements by state boards of accounting, but rather inclusive of those requirements. **2001 Proc. 1<sup>st</sup> Quarter 413.**

A representative from a professional association opined that the industry-specific educational requirements would not provide additional value. Should a regulator believe that a CPA is not compliant with the organization's professional standards, the association recommended follow-up with state board of accountancy. **2001 Proc. 1<sup>st</sup> Quarter 414.**

A regulator questioned how states would track or monitor hours. Staff responded that this requirement would be no different than any of the others stipulated by the model audit rule, in that regulators retain the authority to question CPA firms to determine compliance with the requirements. Another regulator said he wanted to be sure the amendment would add utility to the audits and not be just a burdensome regulatory demand. Another expressed support for the amendment because statutory accounting is very unique and auditors must be informed about those differences. Another regulator noted that he did not want to create an unnecessary policy mechanism for the states and noted that it seemed unlikely that a CPA would engage with clients without specific insurance expertise. **2001 Proc. 1<sup>st</sup> Quarter 414.**

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#### Section 7D (cont.)

A representative from the insurance industry said he thought the requirement was a good idea. Often the industry spends undue time training inexperienced audit staff. Another interested party expressed concern that this requirement would be very costly for accounting firms. **2001 Proc. 1<sup>st</sup> Quarter 414.**

After further consideration, the working group decided not to recommend inclusion of the education requirement. Two major reasons were expressed. The revision to the model would immediately be incorporated into the annual statement instructions and by default become part of most states' laws. Also monitoring the requirements was felt to be a monumental task for the states. **2001 Proc. 1<sup>st</sup> Quarter 401.**

#### Section 8. Consolidated or Combined Audits

While there was considerable support from insurance industry representatives for the adoption of the model rule, they objected to the requirement that prior approval be obtained to file consolidated reports. **1980 Proc. I 262.**

The amendments adopted in 1990 limited the scope of the prior approval requirement to insurers utilizing a pooling or 100 percent reinsurance agreement. **1991 Proc. IA 432.**

#### Section 9. Scope of Examination and Report of Independent Certified Public Accountant

Early in 2003 a proposal was made to revise the model audit rules. The suggested revisions were intended to strengthen the model to emphasize the auditor's consideration and use of the *Examiners Handbook*. **2003 Proc. 1<sup>st</sup> Quarter 368.**

In response to a request for comments on the proposed revision, a representative from the American Institute of Certified Public Accountants (AICPA) stated that his organization was supportive of initiatives to improve communication and understanding between auditors and financial examiners, and spoke in support of the revisions. **2003 Proc. 2<sup>nd</sup> Quarter 489.**

The model was revised in 2003 to replace the words "should be" with "shall" so that the paragraph required consideration of the *Examiners Handbook*. **2003 Proc. 2<sup>nd</sup> Quarter 491.**

#### Section 10. Notification of Adverse Financial Condition

To clarify the first paragraph of Section 10, the drafters changed the wording of the phrase about the balance sheet. **1980 Proc. I 275.**

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#### **Section 10 (cont.)**

When adopting amendments in 1990, several modifications to this section were included. The draft considered stated that the auditor should report any “reasonable belief” that the insurer had misstated its financial condition. Before adoption that was changed to “determination.” The additions also included a paragraph shielding the CPA from liability for statements made in good faith in compliance with the provisions of this section. **1991 Proc. IA 426.**

#### **Section 11. Report on Significant Deficiencies in Internal Controls**

This section was added by the working group drafting amendments in 1990. It replaced a section requiring an evaluation of accounting procedures and internal control which was to be issued annually. **1991 Proc. IA 432-433.**

#### **Section 12. Accountant’s Letter of Qualifications**

This section was added by the working group drafting amendments in 1990. **1991 Proc. IA 433.**

#### **Section 13. Definition, Availability and Maintenance of CPA Workpapers**

The model originally required the accountant to keep the audit work papers for not less than five years. The draft considered in 1990 deleted the time requirement and simply specified retention until the insurance department had filed a report on the examination covering the period of the audit. Just before adoption of the regulation amendments, a phrase was added to put a time limit of seven years on the retention of records. **1991 Proc. IA 426.**

#### **Section 14. Exemptions and Effective Dates**

This section was included in the original draft of the model. **1980 Proc. I 270-271.**

It was modified in 1990 to delete one paragraph. **1991 Proc. IA 433.**

#### **Section 15. Canadian and British Companies**

This provision was included in the original model adopted in 1979. **1980 Proc. I 272.**

#### **Section 16. Severability Provision**

This provision was included in the original model adopted in 1979. **1980 Proc. I 272.**

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#### **Chronological Summary of Actions**

December 1979: Model adopted.

December 1990: Model amended and its standards made part of annual statement instructions. Added sections on qualifications of the CPA, required a report on internal control deficiencies, and established an accountant's letter of qualifications. Two sections were deleted.

September 1998: Section 5F was amended in response to the codification of statutory accounting.

March 2002: Added a definition of indemnification and provisions to Section 7 that did not allow indemnification agreements but specifically allowed mediation or arbitration.

September 2003: Section 9 was changed to require consideration of the *Examiners Handbook*.

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