

PROJECT HISTORY - 2014

ANNUAL FINANCIAL REPORTING MODEL REGULATION (#205)

1. Project Description

U.S. insurance regulators concluded that a greater regulatory focus on corporate governance is required and formed the Corporate Governance (E) Working Group in September 2009. The Working Group received a charge to outline high-level corporate governance principles for use in U.S. insurance regulation. To do so, regulators analyzed the statutory and regulatory requirements and initiatives and best practices of the states, other countries, other regulators, and the insurance industry. The Working Group was also asked to determine the appropriate method to ensure adherence with such principles, giving due consideration to development of a model law and to development of additional regulatory guidance, including detailed best practices for the corporate governance of insurers.

In completing work on this charge, regulators developed a summary of existing corporate governance requirements found within NAIC/insurance-specific sources—as well as more general, broadly based sources—to identify potential changes in the existing insurance regulatory structure that could be affected through the NAIC Solvency Modernization Initiative (SMI). The Working Group then compared those existing U.S. requirements to regulatory needs, best practices and principles outlined in the Insurance Core Principles adopted by the International Association of Insurance Supervisors (IAIS). The results of this comparative analysis indicated the need to require large insurers to maintain an effective internal audit function capable of providing the insurer’s audit committee with independent assurance regarding the insurer’s governance, risk management and internal controls.

The Working Group determined that the best way to implement an internal audit requirement would be to place the requirement within the NAIC’s existing *Annual Financial Reporting Model Regulation* (#205). This model regulation currently includes a requirement for insurers to receive an annual financial statement audit, as well as requirements related to the establishment of audit committees and maintenance of effective internal controls over financial reporting.

2. Group Responsible for Drafting the Revisions

The project to review and produce revisions to Model #205 to incorporate an internal audit function requirement was given to the Corporate Governance (E) Working Group. The Working Group created an Internal Audit (E) Subgroup to develop an initial draft of the proposed revisions for the Working Group to consider. Members of the Subgroup included Virginia (chair), Connecticut, New York, Ohio and Oklahoma. After the initial draft was developed by the Subgroup, it was reviewed and revised by the Working Group, whose members included Vermont (chair), New York (vice chair), Alabama, California, Connecticut, Florida, Iowa, Indiana, Louisiana, New Hampshire, Ohio, Oklahoma, Pennsylvania, Virginia, and Washington.

3. Charge Authorizing the Project

On April 8, 2013, the Financial Condition (E) Committee adopted a request for model law development to develop an internal audit function requirement as an addition to the existing Model #205. The Executive (EX) Committee and Plenary adopted this request July 26, 2013. The Financial Condition (E) Committee delegated the assignment of developing revisions to Model #205 to the Corporate Governance (E) Working Group, and drafting work began soon after the 2013 Summer National Meeting.

4. General Description of the Drafting Process and Due Process

- During September and October 2013, the Internal Audit (E) Subgroup held regulator-to-regulator conference calls to develop the initial draft of proposed revisions to Model #205.
- After finalizing an initial draft of revisions, the Subgroup referred the draft to the Corporate Governance (E) Working Group for review on a Nov. 8, 2013, conference call.
- The Working Group voted to expose the draft for a 30-day public comment period ending Dec. 6, 2013. Several comment letters were received during the exposure period suggesting a number of changes to the draft.
- The comment letters were reviewed and discussed during a meeting of the Corporate Governance (E) Working Group held Dec. 16, 2013. As a result of its discussions, the Working Group agreed to make a number of amendments to the proposed draft and voted to re-expose the updated draft for a 45-day public comment period ending Jan. 31, 2014.
- One comment letter was received from the Pennsylvania Insurance Department during the second exposure period. Members of the Working Group discussed and agreed to accept the amendments proposed by

Pennsylvania before adopting the proposed revisions as final at its March 30, 2014, meeting.

5. Discussion of Key Issues

Revisions were made to several sections of the existing model regulation to incorporate an internal audit function requirement for large insurers. A summary of the revisions is provided below.

- i. A definition of “internal audit function” was added to the model as follows:

Section 3 – Definitions

- 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.

- ii. Responsibilities and instructions for audit committees to follow in overseeing the internal audit function were added as follows:

Section 14 – Requirements for Audit Committees

- 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.
- iii. A new section was added to the model regulation to outline the specific requirements and expectations related to the internal audit function employed by large insurers as follows:

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; or,
- (2) If the insurer is a member of a group of insurers that 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.
- (3) 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 subordinate 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.

iv. An effective date for the new internal audit function requirement was added to the model as follows:

Section 18 – Exemptions and Effective Dates

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.

6. Any Other Important Information

No other items identified at this time.

PROJECT HISTORY - 2006

ANNUAL FINANCIAL REPORTING MODEL REGULATION (#205)

1. Description of the Project, Issues Addressed, etc.

The purpose of this regulation is to improve a state's surveillance of the financial condition of insurers by requiring an annual audit by independent certified public accountants (CPA) of the financial statements reporting the financial position and the results of operations. The proposed amendments strengthen requirements related to CPA independence. In addition, the proposed amendments include new corporate governance standards, primarily requiring that an insurer have an audit committee that is responsible for the appointment, oversight and compensation of the CPA. The proposed amendments also indicate that management of insurers that meet a minimum premium threshold shall provide the regulator with an assessment of its internal control over financial reporting.

2. Name of Group Responsible for Drafting the Model and States Participating

The NAIC/AICPA Working Group (the Working Group) of the Financial Condition (E) Committee drafted the revisions to the model. Virginia is the chair of the Working Group, and its members include California, Delaware, Illinois, Iowa, Michigan, Minnesota, Missouri, Nebraska, New Hampshire, New York, Ohio, Oregon, Pennsylvania, Texas and Utah.

3. Project Authorized by What Charge and Date First Given to the Group

The following charge was given to the Working Group in 2003: "Monitor the Sarbanes-Oxley Bill and additional rules and regulations promulgated by the newly formed Public Accounting Oversight Board."

In 2005, the charge was expanded to the following: "Based on the study of the Sarbanes-Oxley Act, the NAIC/AICPA Working Group will propose revisions to the NAIC's Model Regulation Requiring Annual Audited Financial Reports for best practices regarding Title II Auditor Independence, Title III Corporate Responsibility and Title IV Enhanced Financial Disclosures of the Sarbanes-Oxley Act.

4. A General Description of the Drafting Process (e.g., drafted by a subgroup, interested parties, the full group, etc). Include any parties outside the members that participated

The drafting process began in conjunction with a review of the Sarbanes-Oxley Act of 2002. During that review process, it was noted that the model did not contain requirements related to corporate governance and did not require positive assurance regarding the effectiveness of an insurer's internal control over financial reporting. In addition, the model did not specifically discuss what services a CPA may not provide to an insurer if it also performs the audit of that insurer.

Proposed amendments to the model were first drafted in early 2004 and a public hearing was held at the 2004 Summer National Meeting. Based on comments received, three (3) subgroups were formed to handle the three (3) main topics addressed by the revisions: auditor independence, corporate governance and internal control over financial reporting. These subgroups consisted of regulators, members of industry and representatives from CPA firms. The subgroups related to auditor independence and corporate governance held numerous conference calls during 2004 and 2005. Revisions related to these topics were adopted by the Working Group in mid-2005.

The subgroup formed to discuss internal control over financial reporting met during four (4) separate interim meetings in 2005. During this process, members of the interested parties provided the subgroup with an alternative proposal, and the revisions eventually adopted by the Working Group were based on this alternative proposal rather than the original draft revisions.

Once each of the three (3) subgroups finalized its revisions, the "collective" revisions were exposed by the Working Group for a forty-five (45) day comment period, and comments received were discussed during a series of three (3) conference calls.

5. A General Description of the Due Process (e.g., exposure periods, public hearings, or any other means by which widespread input from industry, consumers and legislators was solicited)

Widespread input was solicited on many occasions as all conference calls and meetings were held in open session. Approximately seventeen (17) conference calls and six (6) interim meetings were held in addition to any meetings held during national meetings. Both written and oral comments were accepted at any time throughout this process, and the

revisions were officially exposed for comment on at least five (5) different occasions. Members of industry and representatives from trade associations actively participated throughout the drafting process.

6. A Discussion of the Significant Issues (items of some controversy raised during the due process and the group's response)

Auditor independence requirements – Representatives from CPA firms were concerned that the new requirements regarding prohibited non-audit services would be burdensome for smaller insurers or those insurers in rural areas where there is a limited number of CPA firms. Based on this concern, the Working Group agreed that insurers with less than \$100 million in direct and assumed premium may request an exemption from this requirement.

Recruiting and retaining qualified, independent audit committee members – Certain industry representatives were concerned that smaller insurance companies may not be able to recruit or retain individuals independent from management that would be qualified to serve on the insurer's audit committee. As such, the Working Group agreed that insurers with less than \$500 million in direct and assumed premium may apply for a waiver from the audit committee requirements. In addition, the Working Group revised the independence requirements for audit committee members, so that only a percentage of audit committee members, if any, are required to be independent. This is also based on an insurer's premium level.

Audit committee membership contemplated in state law – Concern was raised that state corporation law may include requirements related to audit committee membership that would conflict with requirements set forth in the model. The Working Group drafted language indicating that if state law requires board participation by otherwise non-independent members, that law shall prevail and 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.

Cost of internal control over financial reporting requirements – To address the issue of whether the reporting requirements would be overly burdensome to smaller companies, the Working Group agreed that only those insurers with direct and assumed premium of more than \$500 million would be subject to the management assessment requirement. To address expense issues, the Working Group agreed to remove a requirement that the insurer's CPA perform an annual attestation of management's assessment of internal control over financial reporting. In an industry study, this CPA attestation accounted for approximately 74% of the external costs. In addition, the Working Group agreed that an adequate implementation period and implementation guidance would be provided. This was based on a 2005 SEC roundtable discussion during which SEC filers noted that a short implementation period and insufficient guidance were the main cost drivers in compliance with the SEC's requirements related to internal control over financial reporting.

Insurers currently filing internal control reports for SEC purposes – Concern was raised that redundant reporting of internal control over financial reporting would be required for those insurers that are already required to file a management assessment of internal control over financial reporting for SEC purposes. The Working Group agreed that the SEC reports filed in accordance with Section 404 of Sarbanes-Oxley would be sufficient for regulator purposes. However, if there are internal controls of the insurer that have a material impact on the preparation of the insurer's statutory financial statements and those internal controls were not included in the scope of the Section 404 report, the insurer would need to provide an additional report for those internal controls.

How states have adopted the model – Currently, eleven (11) states have adopted the model via law, twenty-eight (28) via regulation and twelve (12) have adopted it by reference through adoption of the Annual Statement Instructions. The model is required for accreditation purposes, although historically a state that has not adopted the model but has adopted the Annual Statement Instructions has been found to be in compliance with the accreditation standard. This is because the Annual Statement Instructions include, verbatim, the significant elements of the model. Some have raised concern that allowing this process to continue may usurp the legislative process. As such, the Working Group has strongly encouraged those twelve (12) states to adopt the model through either law or regulation.

7. Any Other Important Information (e.g., amending an accreditation standard).

The model is currently a Part A: Laws and Regulations accreditation standard of the Financial Regulation Standards and Accreditation Program. If adopted by the NAIC membership, the Financial Regulation Standards and Accreditation (F) Committee would need to consider the revisions to the model. This process would begin at the Spring National Meeting after approval by Executive and Plenary and would include a combined exposure and seasoning period of four (4) years. In order to hear testimony from industry and legislators, and a minimum of two (2) public hearings would be held at the Committee level. In addition, actions taken by the Committee would be subject to approval by Executive and Plenary.

A group of the collective interested parties is currently drafting an implementation guide to assist in application of and compliance with the new requirements. The implementation guide is not intended to create additional requirements, but to explain and clarify the requirements in the model. The Working Group is holding an interim meeting on May 23, 2006, to discuss the first draft of the implementation guide.

PROJECT HISTORY - 2003

ANNUAL FINANCIAL REPORTING MODEL REGULATION (#205)

1. Project Description

The Model Rule Requiring Annual Audited Financial Reports has been revised to address the independent certified public accountant's consideration of the *NAIC Financial Condition Examiners Handbook*. The intention of the revision is to place more onus on the independent certified public accountant to consider the Examiners Handbook in completing financial statement audits of insurers. The revision affects only Section 9, *Scope of Examination and Report of Independent Certified Public Accountant* of the Model.

2. Group Responsible for Drafting Model and States Participating

The NAIC/AICPA Working Group of the Financial Condition (E) Committee originally developed and adopted this revision. The working group includes: Virginia (Chair), California, Delaware, Illinois, Iowa, Minnesota, Missouri, Nebraska, New Hampshire, New York, Ohio, Oregon, Pennsylvania and Texas.

3. Charge Authorizing Project

One of the 2003 charges of the working group is, "The NAIC/AICPA Working Group will establish subgroups for the specific areas of concern noted in the Use of CPA Workpapers Survey." One of the items noted in this survey was regulator concern regarding the independent certified public accountant's consideration of the Examiners Handbook.

4. General Description of Drafting Process

The drafting process was open as the NAIC/AICPA Working Group solicited comments from all interested parties, including interested regulators and industry representatives. The revision to the model was first discussed at an open meeting of the working group on March 9, 2003. At that time, the working group voted to expose the proposed revisions for comment. Only one comment letter was received during the exposure period. The revision to the model was adopted at an open meeting of the working group on June 23, 2003.

5. Significant Issues Raised

No significant issues were raised or discussed by the working group and/or interested parties. A representative from the American Institute of Certified Public Accountants (AICPA) provided testimony during the June 23, 2003, meeting stating that the AICPA is supportive of initiatives to improve communication and understanding between auditors and financial examiners and that the AICPA is supportive of this revision.

6. Other Pertinent Information

The model is currently required as a Part A: Laws and Regulation standard of the Financial Regulation Standards and Accreditation Program. If adopted by the NAIC membership, the Financial Regulation Standards and Accreditation (F) Committee will consider the revision during the Spring 2004 National Meeting.

PROJECT HISTORY - 2001

ANNUAL FINANCIAL REPORTING MODEL REGULATION (#205)

1. Project Description

The purpose of this regulation is to improve a state's surveillance of the financial condition of insurers by requiring an annual examination by independent certified public accountants (CPA) of the financial statements reporting the financial position and the results of operations of insurers. This amendment prohibits a commissioner from recognizing a person or firm as a qualified independent certified public accountant that if the person or firm has either directly or indirectly entered into an agreement of indemnity or release from liability with respect to the audit of the insurer.

2. Group Responsible for Drafting the Act

The project was assigned to the NAIC/AICPA Working Group of the Financial Condition (E) Committee (working group). The members of the working group are: Doug Stolte, Chair (VA); Ramon Calderon (CA); Darryl Reese (DE); James Hanson (IL); Jim Armstrong (IA); Jaki Gardner (MN); J. Douglas Conley (MO); David Krumm (NE); Thomas Burke (NH); Jeff Angelo (NY); Mike Motil (OH); Neeraj Gupta (OR); Steve Johnson (PA) and Betty Patterson (TX).

3. Charge Authorizing the Project

2001 Charge: "The NAIC/AICPA working group will address financial solvency issues and respond to the American Institute of Certified Public Accountants (AICPA) exposure drafts. This charge is ongoing."

4. General Description of the Drafting Process and Due Process

William Boyd of the National Association of Mutual Companies first raised the issue of CPAs including indemnification clauses in the engagement letters with insurers with the working group on December 4, 2000. The working group spent the first part of 2001 conducting an investigative review of engagement letters on file with different states and found many cases where CPAs were in fact including the clauses. In general, "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 or other misrepresentations made by the insurer or its representatives.

The working group also discovered that the Securities and Exchange Commission (SEC) has specifically addressed the issue of indemnification and concluded that such clauses would lead the SEC to declare that the accountant could not be recognized as independent for the purpose of certifying the financial statements of public entities. The following is excerpted from SEC Financial Reporting Release § 602.02.i.i - Indemnification by Client:

Inquiry was made as to whether an accountant who certifies financial statements included in a registration statement or annual report filed with the Commission under the Securities Act of the Exchange Act would be considered independent if he had entered into an indemnity agreement with the registrant. In the particular illustration cited, the board of directors of the registrant formally approved the filing of a registration statement with the Commission and agreed to indemnify and save harmless each and every accountant who certified any part of such statement "from any and all losses, claims, damages or liabilities arising out of such act or acts to which they or any of them may be subject under the Securities Act, as amended, or at "common law" other than for their willful misstatements or omissions".

When an accountant and its client, directly or through an affiliate, have entered into an agreement of indemnity which seeks to assure to the accountant immunity from liability for its own negligent acts, whether of omission or commission, one of the major stimuli to objective and unbiased consideration of the problems encountered in a particular engagement is removed and greatly weakened. Such condition must frequently induce a departure from the standards of objectivity and impartiality which the concept of independence implies. In such difficult matters, for example, as the determination of the scope of audit necessary, existence of such an agreement may easily lead to the use of less extensive or thorough procedures than would otherwise be followed. In other cases, it may result in a failure to appraise with professional acumen the information disclosed by the examination. Consequently, the accountant cannot be recognized as independent for the purpose of certifying the financial statements of the corporation.

The working group released the proposed amendments to the model audit rule for comment on June 28, 2001. The working group held a hearing on December 10, 2001 and unanimously adopted the amendment. On December 11, 2001, the Financial Condition (E) Committee also unanimously adopted the amendments.

5. Discussion of Key Issues

The AICPA is in opposition to this change. The AICPA first voiced its resistance in 2000 and reinforced their position at the working group hearing as well as the Financial Condition (E) Committee meeting in December 2001. The AICPA's primary objection is based upon (1) the broad limitation on indemnification, (2) the concern that the NAIC/AICPA Working Group does not fully understand the relationship of indemnification for knowing management misrepresentations, the performance of an audit in accordance with Generally Accepted Auditing Standards (GAAS) and the liability of auditors when there has been knowing management misrepresentations, stating that such indemnification does not relieve the auditor of conducting an audit in accordance with GAAS, and (3) the fact that the provision for arbitration and mediation appear to be contrary to the intent of state legislators when arbitration laws were adopted.

The working group has studied this issue for one year and received an opinion from the NAIC Insolvency Counsel that such indemnification provisions would potentially negatively impact the statutory successor's position in litigation against the independent auditor. The working group also was unable to reconcile the SEC's official position on the issue with the AICPA's opposition. The working group is of the opinion that the regulations governing insurance companies should be at least as strong as those that govern public entities.