

Regulatory Analysis Form

(Completed by Promulgating Agency)

INDEPENDENT REGULATORY
REVIEW COMMISSION

SEP 28 PM 2:48

IRRC

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(All Comments submitted on this regulation will appear on IRRC's website)

(1) Agency

Insurance Department

(2) Agency Number:

Identification Number: 11-254

IRRC Number: 3129

(3) PA Code Cite:

31 Pa. Code Chapter 147

(4) Short Title:

Annual Financial Reporting Requirements

(5) Agency Contacts (List Telephone Number and Email Address):

Primary Contact:

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(6) Type of Rulemaking (check applicable box):

- Proposed Regulation
 Final Regulation
 Final Omitted Regulation

- Emergency Certification Regulation;
 Certification by the Governor
 Certification by the Attorney General

(7) Briefly explain the regulation in clear and nontechnical language. (100 words or less)

The amendments in this rulemaking are based upon changes to National Association of Insurance Commissioners ("NAIC") Model Regulation # 205 adopted by the NAIC in 2014. The amendments to the NAIC model were developed as a result of the NAIC's determination that it was necessary for 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. As such, the NAIC 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). Model Regulation #205 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. The proposed amendments add corporate governance-related functions to the audit committee's responsibilities.

(8) State the statutory authority for the regulation. Include specific statutory citation.

Sections 206, 506, 1501 and 1502 of The Administrative Code of 1929 (71 P.S. §§ 66, 186, 411 and 412) relating to the general rulemaking authority of the Department; sections 320, 1007, 2452 and 630 of The Insurance Company Law of 1921 (40 P.S. §§ 443, 967, 991.2452 and 764a) relating to the authority of the Insurance Commissioner (Commissioner) to require insurance companies, associations, exchanges, fraternal benefit societies and preferred provider organizations to file statements concerning their affairs and financial condition; and sections 205 and 206 of The Pennsylvania Fair Plan Act (40 P.S. §§ 1600.205 and 1600.206); section 731 of the Medical Care Availability and Reduction of Error (Mcare) Act (40 P.S. § 1303.731); 40 Pa. C.S. §§ 6125, 6331 and 6701 (relating to reports and examinations; and regulation); sections 11 and 14 of the HMO Act (40 P.S. §§ 1561 and 1564); sections 7 and 25 of the Continuing-Care Provider Registration and Disclosure Act (40 P.S. §§ 3207 and 3225) which respectively, relate to the specific regulatory and rulemaking authority of the Department regarding financial reporting by the Pennsylvania Fair Plan, the Pennsylvania Professional Liability Joint Underwriting Association, hospital plan corporations, professional health service corporations, beneficial associations, health maintenance organizations and continuing care providers.

(9) Is the regulation mandated by any federal or state law or court order, or federal regulation? Are there any relevant state or federal court decisions? If yes, cite the specific law, case or regulation as well as, any deadlines for action.

No. However the amendments are expected to be part of the financial regulation standards the Department must meet in order to maintain its accreditation by the NAIC.

(10) State why the regulation is needed. Explain the compelling public interest that justifies the regulation. Describe who will benefit from the regulation. Quantify the benefits as completely as possible and approximate the number of people who will benefit.

Because the amendments are expected to be part of the financial regulation standards set forth by the NAIC, Pennsylvania regulations must include the internal audit function requirement in order for the Department to maintain its accreditation by the NAIC. Additionally, the amendments to Chapter 147 will promote strong corporate governance practices by insurers transacting business in Pennsylvania.

Since the final-form rulemaking concerns the solvency requirements applied to insurers, particularly the insurer's maintenance of an effective internal audit function, the public will benefit to the extent the rulemaking promotes a financially sound insurance industry that has the ability to fulfill its contractual obligations under insurance policies.

(11) Are there any provisions that are more stringent than federal standards? If yes, identify the specific provisions and the compelling Pennsylvania interest that demands stronger regulations.

There are no federal standards applicable to the substance of these regulations.

(12) How does this regulation compare with those of the other states? How will this affect Pennsylvania's ability to compete with other states?

The rulemaking will not negatively affect Pennsylvania's ability to compete with other states. The rulemaking is based upon an NAIC model, the requirements of which must be enacted to maintain accredited regulator status. As such, other jurisdictions are also required to adopt a substantially similar regulation in order to maintain their accreditation standards. Likewise, many insurers operate in multiple states, several of which are in the process of adopting amendments substantially similar to the NAIC model. Thus, Pennsylvania's adoption of the amendments will help achieve consistency and ease administrative burdens on Pennsylvania domestic insurers who would otherwise be subject to disparate regulatory requirements in multiple jurisdictions.

(13) Will the regulation affect any other regulations of the promulgating agency or other state agencies? If yes, explain and provide specific citations.

This regulation will not affect regulations of the Department or other state agencies.

(14) Describe the communications with and solicitation of input from the public, any advisory council/group, small businesses and groups representing small businesses in the development and

drafting of the regulation. List the specific persons and/or groups who were involved. (“Small business” is defined in Section 3 of the Regulatory Review Act, Act 76 of 2012.)

The Department circulated an exposure draft of this final-form rulemaking to The Insurance Federation of Pennsylvania, Inc., The Pennsylvania Association of Mutual Insurance Companies, Highmark, Inc., Capital Blue Cross, Independence Blue Cross, and Blue Cross of Northeastern Pennsylvania. No comments were received.

(15) Identify the types and number of persons, businesses, small businesses (as defined in Section 3 of the Regulatory Review Act, Act 76 of 2012) and organizations which will be affected by the regulation. How are they affected?

The amendments would apply to insurers that: (1) have 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, more than \$500,000,000; or (2) are members 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. The amendments would not apply to continuing care providers.

As further explained below, the Department has determined that two regulated entities may fall within the definition of a “small business.”

(16) List the persons, groups or entities, including small businesses that will be required to comply with the regulation. Approximate the number that will be required to comply.

Approximately 273 Pennsylvania domestic insurers and 227 continuing care providers are subject to the requirements of Chapter 147, generally. However, only 118 of these entities would be subject to the internal audit function requirement proposed by this rulemaking. All others would be exempt pursuant to section 147.8a(a), which specifies that the internal audit function requirement would apply only to: (1) insurers with greater than \$500,000,000 in premium; and (2) members of an insurance group with more than \$1,000,000,000 in premium.

(17) Identify the financial, economic and social impact of the regulation on individuals, small businesses, businesses and labor communities and other public and private organizations. Evaluate the benefits expected as a result of the regulation.

The amendments may have a financial impact on some insurers. However, the amendments do not specifically require insurers to incur costs to establish an internal audit function. Existing statutory and regulatory requirements require insurers to have an audit committee. The amendments merely add the overseeing of certain corporate governance related functions to the audit committee’s responsibilities.

Insurers may reallocate existing resources to create an internal audit function and may reorganize internal corporate structure to ensure that such function is independent.

(18) Explain how the benefits of the regulation outweigh any cost and adverse effects.

The amendments to Chapter 147 will promote strong corporate governance practices by insurers transacting business in Pennsylvania. Since the final-form rulemaking concerns the solvency requirements applied to insurers, particularly the insurer's maintenance of an effective internal audit function, the public will benefit to the extent the rulemaking promotes a financially sound insurance industry that has the ability to fulfill its contractual obligations under insurance policies.

(19) Provide a specific estimate of the costs and/or savings to the **regulated community** associated with compliance, including any legal, accounting or consulting procedures which may be required. Explain how the dollar estimates were derived.

The amendments do not specifically require insurers to incur costs to establish an internal audit function. Existing statutory and regulatory requirements require insurers to have an audit committee. The amendments merely add the overseeing of certain corporate governance related functions to the audit committee's responsibilities. Insurers may reallocate existing resources to create an internal audit function and may reorganize internal corporate structure to ensure that such function is independent. Costs, if any, for legal or consulting procedures necessary to ensure compliance with the proposed requirement will vary depending on an insurer's existing processes and procedures.

(20) Provide a specific estimate of the costs and/or savings to the **local governments** associated with compliance, including any legal, accounting or consulting procedures which may be required. Explain how the dollar estimates were derived.

This final-form rulemaking will not impose any costs and/or savings to local governments.

(21) Provide a specific estimate of the costs and/or savings to the **state government** associated with the implementation of the regulation, including any legal, accounting, or consulting procedures which may be required. Explain how the dollar estimates were derived.

This final-form rulemaking will not impose any costs and/or savings to state government.

(22) For each of the groups and entities identified in items (19)-(21) above, submit a statement of legal, accounting or consulting procedures and additional reporting, recordkeeping or other paperwork, including copies of forms or reports, which will be required for implementation of the regulation and an explanation of measures which have been taken to minimize these requirements.

The final-form rulemaking does not impose any specific reporting, recordkeeping or paperwork requirements upon the regulated community.

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(23) In the table below, provide an estimate of the fiscal savings and costs associated with implementation and compliance for the regulated community, local government, and state government for the current year and five subsequent years. N/A

	Current FY Year	FY +1 Year	FY +2 Year	FY +3 Year	FY +4 Year	FY +5 Year
SAVINGS:	\$	\$	\$	\$	\$	\$
Regulated Community						
Local Government						
State Government						
Total Savings						
COSTS:						
Regulated Community						
Local Government						
State Government						
Total Costs						
REVENUE LOSSES:						
Regulated Community						
Local Government						
State Government						
Total Revenue Losses						

(23a) Provide the past three year expenditure history for programs affected by the regulation. N/A

Program	FY -3	FY -2	FY -1	Current FY

(24) For any regulation that may have an adverse impact on small businesses (as defined in Section 3 of the Regulatory Review Act, Act 76 of 2012), provide an economic impact statement that includes the following:

- (a) An identification and estimate of the number of small businesses subject to the regulation.
- (b) The projected reporting, recordkeeping and other administrative costs required for compliance with the proposed regulation, including the type of professional skills necessary for preparation of the report or record.
- (c) A statement of probable effect on impacted small businesses.
- (d) A description of any less intrusive or less costly alternative methods of achieving the purpose of the proposed regulation.

Identification and estimate of small businesses subject to the regulation

The Department reviewed the standards set forth by 13 C.F.R. § 121.201 and the U.S. Small Business Administration (SBA) Table of Small Business Size Standards Matched to North American Industry Classification System (NAICS) Codes to determine the applicability of this rulemaking to small businesses. Two entities have been identified as “small businesses” based upon these standards.

The standards for small business classification vary by type of business written as follows:

Subsector 524 – Insurance Carriers and Related Activities		
524113	Direct Life Insurance Carriers	\$7.0 million annual receipts
524114	Direct Health and Medical Insurance Carriers	\$7.0
524126	Direct Property and Casualty Insurance Carriers	1,500 employees
524127	Direct Title Insurance Carriers	\$7.0
524128	Other Direct Insurance (except Life, Health and Medical) Carriers	\$7.0
524130	Reinsurance Carriers	\$7.0
524210	Insurance Agencies and Brokerages	\$7.0
524291	Claims Adjusting	\$7.0
524292	Third Party Administration of Insurance and Pension Funds	\$7.0
524298	All Other Insurance Related Activities	\$7.0

Property and Casualty Insurance Carriers

With regard to entities classified as “Direct Property and Casualty Insurance Carriers” (#524126), those insurers with fewer than 1500 employees would qualify as “small businesses.” The Department has

identified 61 Pennsylvania domestic property and casualty carriers that would be subject to the internal audit function requirement. However, none of these 61 entities is an unaffiliated insurer. Rather these 61 carriers are part of 16 insurance groups. An insurance "group" is a group of companies under common management, ownership or control. Thus, for purposes of determining whether these entities are "small businesses," the Department considered the number of employees employed by the entire insurance group.

Although the Department does not collect specific data regarding the number of employees of insurance companies, the Department has reviewed publicly available data and has determined that two of these 16 insurer groups employ less than 1500 employees.

Other Lines of Authority

With regard to all types of entities except property and casualty insurance carriers, "annual receipts" is used to determine if a company is a "small business." The Department determined that there are two active health insurers not exempt from the regulation that would fall below the \$7 million threshold. However, neither of these entities is an unaffiliated insurer, but is rather part of a much larger insurance group with annual receipts well beyond the \$7 million threshold. Thus, there are no life, health or other insurers that would be considered small businesses pursuant to the standards set forth by the U.S. Small Business Association.

Projected Costs and Impact on Small Businesses

Despite having less than 1500 employees, the two entities that have been identified as possibly falling within the SBA definition of "small business" are large companies that operate throughout the country and/or internationally in the property and casualty market. They are Sarbanes-Oxley compliant, publicly traded entities that have already implemented corporate governance procedures and safeguards and have the infrastructure that would accommodate this additional requirement with minimal, if any, costs.

Alternative methods

The Department is unaware of any less intrusive or less costly alternative methods for achieving the purpose of the amendments, which is to create an internal audit function to provide independent, objective and reasonable assurances to the insurer's audit committee to evaluate and improve the effectiveness of the risk management, control and governance processes. Furthermore, the amendments are expected to be part of the financial regulation standards the Department must meet in order to maintain its accreditation by the NAIC. Any substantial deviation from the NAIC model regulation will jeopardize the Department's status as an accredited regulator.

(25) List any special provisions which have been developed to meet the particular needs of affected groups or persons including, but not limited to, minorities, the elderly, small businesses, and farmers.

No provisions were developed to meet the particular needs of minorities, the elderly, or farmers. As further explained below, the exemption provision was crafted to exempt “smaller” insurers from the requirements of this proposed rulemaking.

(26) Include a description of any alternative regulatory provisions which have been considered and rejected and a statement that the least burdensome acceptable alternative has been selected.

No other regulatory schemes were considered.

(27) In conducting a regulatory flexibility analysis, explain whether regulatory methods were considered that will minimize any adverse impact on small businesses (as defined in Section 3 of the Regulatory Review Act, Act 76 of 2012), including:

- a) The establishment of less stringent compliance or reporting requirements for small businesses;
- b) The establishment of less stringent schedules or deadlines for compliance or reporting requirements for small businesses;
- c) The consolidation or simplification of compliance or reporting requirements for small businesses;
- d) The establishment of performing standards for small businesses to replace design or operational standards required in the regulation; and
- e) The exemption of small businesses from all or any part of the requirements contained in the regulation.

The Department determined that it was not possible to consider alternative regulatory methods because the amendments are based upon NAIC model regulations, because it is expected that substantially similar provisions must be enacted by Pennsylvania in order for the Department to maintain its status as an accredited regulator. As noted in section 147.8a(a), the NAIC choose to exempt what it considered to be “smaller” insurers from the requirements of the amendment. However, the NAIC used premium volume – instead of annual receipts or number of employees-- as a threshold for compliance. The Department believes that premium volume is an appropriate threshold for determining the “size” of the insurer and therefore the exemption applicability, since the Department does not collect data on an insurer’s employees and annual receipts is not a concept traditionally associated with insurance regulation. As such, the Department believes any adverse impact on small businesses has been appropriately addressed by the regulation’s exemption provision.

(28) If data is the basis for this regulation, please provide a description of the data, explain in detail how the data was obtained, and how it meets the acceptability standard for empirical, replicable and testable data that is supported by documentation, statistics, reports, studies or research. Please submit data or supporting materials with the regulatory package. If the material exceeds 50 pages, please provide it in a searchable electronic format or provide a list of citations and internet links that, where possible, can be accessed in a searchable format in lieu of the actual material. If other data was considered but not used, please explain why that data was determined not to be acceptable.

No data was used as a basis for this regulation.

(29) Include a schedule for review of the regulation including:

- | | |
|---|------------------|
| A. The date by which the agency must receive public comments: | <u>2/22/2016</u> |
| B. The date or dates on which public meetings or hearings will be held: | <u>NONE</u> |
| C. The expected date of promulgation of the proposed regulation as a final-form regulation: | <u>1/15/2017</u> |
| D. The expected effective date of the final-form regulation: | <u>2/14/2017</u> |
| E. The date by which compliance with the final-form regulation will be required: | <u>2/14/2017</u> |
| F. The date by which required permits, licenses or other approvals must be obtained: | <u>NONE</u> |

(30) Describe the plan developed for evaluating the continuing effectiveness of the regulations after its implementation.

The Department reviews each of its regulations for continued effectiveness on a triennial basis.

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**FACE SHEET
FOR FILING DOCUMENTS
WITH THE LEGISLATIVE REFERENCE BUREAU
(Pursuant to Commonwealth Documents Law)**

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<p>Copy below is hereby approved as to form and legality. Attorney General</p> <p>BY: _____ (DEPUTY ATTORNEY GENERAL)</p> <p>_____ DATE OF APPROVAL</p> <p><input type="checkbox"/> Check if applicable Copy not approved. Objections attached.</p>	<p>Copy below is here by certified to be a true and correct copy of a document issued, prescribed or promulgated by:</p> <p>_____ Insurance Department (AGENCY)</p> <p>DOCUMENT/FISCAL NOTE NO. _____ 11-254</p> <p>DATE OF ADOPTION: _____</p> <p>BY: _____ Teresa D. Miller Insurance Commissioner</p> <p>TITLE _____ (EXECUTIVE OFFICER, CHAIRMAN OR SECRETARY)</p>	<p>Copy below is hereby approved as to form and legality. Executive or Independent Agencies.</p> <p>BY: _____ Manisa A. Z. Dele</p> <p>SEP 22 2016 DATE OF APPROVAL</p> <p>Deputy General Counsel (Chief Counsel, Independent Agency) (Strike inapplicable title)</p> <p><input type="checkbox"/> Check if applicable. No Attorney General approval or objection within 30 days after submission.</p>
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**NOTICE OF FINAL-FORM RULEMAKING
INSURANCE DEPARTMENT**

31 Pa. Code Chapter 147

ANNUAL FINANCIAL REPORTING REQUIREMENTS

FINAL RULEMAKING
INSURANCE DEPARTMENT

31 PA. CODE Ch. 147

Annual Financial Reporting Requirements

[Pa.B.]
[Saturday, , 201]

Preamble

The Insurance Department (Department) amends Chapter 147 of the Department's regulations (31 Pa. Code Ch. 147) (regarding Annual Financial Reporting Requirements) to read as set forth in Annex A. This rulemaking is made under the authority of sections 206, 506, 1501 and 1502 of The Administrative Code of 1929 (71 P.S. §§ 66, 186, 411 and 412), regarding the general rulemaking authority of the Department, sections 320, 630, 1007, and 2452 of The Insurance Company Law of 1921 (40 P.S. §§ 443, 764a, 967, and 991.2452), regarding the authority of the Insurance Commissioner (Commissioner) to require insurance companies, associations, exchanges, fraternal benefit societies and preferred provider organizations to file statements concerning their affairs and financial condition, sections 205 and 206 of The Pennsylvania Fair Plan Act (40 P.S. §§ 1600.205 and 1600.206), section 731 of the Medical Care Availability and Reduction of Error (Mcare) Act (40 P.S. § 1303.731), 40 Pa. C.S. §§ 6125, 6331 and 6701 (relating to reports and examinations; and regulation), sections 11 and 14 of the Health Maintenance Organization Act (40 P.S. §§ 1561 and 1564) and sections 7 and 25 of the Continuing-Care Provider Registration and Disclosure Act (40 P.S. §§ 3207 and 3225) regarding the specific regulatory and rulemaking authority of the Department as to financial reporting by the Pennsylvania Fair Plan, the Pennsylvania Professional Liability Joint Underwriting Association, hospital plan corporations, professional health service corporations, beneficial associations, health maintenance organizations and continuing care providers respectively.

Purpose

The purpose of this final-form rulemaking is to update Chapter 147, commonly referred to as the "CPA Audit Rule." Chapter 147 was initially adopted in 1979 and requires insurers to have annual audits of their year-end statutory financial statements performed by independent certified public accountants. It is based on a model regulation developed by the National Association of Insurance Commissioners (NAIC) and included in the NAIC's Financial Regulation Standards and Accreditation Program.

The amendments are based upon changes to NAIC Model Regulation # 205 adopted by the NAIC in 2014, which were developed as a result of the NAIC's determination that it was necessary for 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. As such, the NAIC 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). Model Regulation #205 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. The amendments add corporate governance-related functions to the audit committee's responsibilities.

The Department expects that the proposed amendments to Chapter 147 will be required for the Department to maintain accreditation by the NAIC.

Comments and Responses

Notice of the proposed rulemaking was published at 46 Pa.B. 458 (January 23, 2016) with a thirty-day comment period. Comments were received from the Pennsylvania Association of Mutual Insurance Companies, the Insurance Federation of Pennsylvania and the Pennsylvania Institute of Certified Public Accounts (PICPA).

Both PAMIC and the IFP expressed support for the regulation as drafted.

Although the comment letter from PICPA expressed general support for the regulation, the comments made by PICPA were not responsive to the rulemaking as proposed by the Department. Instead, the comments focused on provisions of the NAIC model and provisions of Chapter 147 that the Department is not amending pursuant to this rulemaking. The comment letter, does, however, recognize that the comments made are more appropriately directed to the NAIC. As such, because the PICPA comments were not relevant to the amendments to Chapter 147, the Department has declined to make any revisions to the regulation based upon the comments from the PICPA.

IRRC submitted comments to the proposed rulemaking on March 23, 2016. First, IRRC noted that the language of subsection 147.8a(f) contained non-regulatory language which was inappropriate. In response to the IRRC's comments, the Department has deleted subsection (f) of section 147.8a. The Department intends to include this information in a policy statement as suggested.

Additionally, IRRC requested the Department clarify the date of compliance for insurers that no longer qualify for an exemption. In response to IRRC's comment, the Department has added language to clarify that the period to attain compliance with the regulation referenced in section 147.13(j) is one calendar year after the threshold is exceeded, as shown on the insurer's annual statement. As stated in section 147.8a (a), the exemption is determined by the amount of company's "*annual* direct written and unaffiliated assumed premium" (emphasis added). These numbers are reported on an insurer's annual statement, which is filed on March 1 but is based upon the previous year's data. See 40 P.S. § 443 (requiring a company to file "a statement which shall exhibit its financial condition on the thirty-first day of December of the previous year"). For example, if a company's annual premium exceeds the threshold on December 31, 2017, and the insurer reports accordingly on its annual statement due on March 1, 2018, it will have until December 31, 2018 to come into compliance with the requirements of this rulemaking.

Affected Parties

The amendments apply to insurers licensed to transact business in this Commonwealth that are not exempt pursuant to section 147.8a(a).

Fiscal Impact

State Government

The final-form rulemaking will strengthen and clarify existing regulatory requirements. There will be no material increase in cost to the Department as a result of this final-form rulemaking.

General Public

The public will benefit to the extent the final-form rulemaking strengthens financial solvency regulatory requirements for insurers, thereby promoting the ability of the insurance industry to meet obligations under insurance policies.

Political Subdivisions

The final-form rulemaking will not impose additional costs on political subdivisions.

Private Sector

The final-form rulemaking may impose additional costs on insurers that have not yet established an internal audit function. However, the strengthened requirements are consistent with national standards to be adopted by all states participating in the NAIC Financial Regulation Standards and Accreditation Program. The rulemaking minimizes costs by including a number of exemptions for smaller insurers.

Paperwork

The final-form rulemaking would not impose additional paperwork on the Department, as no filing is required to be made by insurers regarding this new requirement. To the extent that insurers document internal audit function requirements in written format, the amendments may impose additional paperwork on insurers.

Effectiveness/Sunset Date

The final-form rulemaking will become effective on _____, 30 days after final-form publication in the Pennsylvania Bulletin. The Department continues to monitor the effectiveness of regulations on a triennial basis; therefore, no sunset date has been assigned.

Contact Person

Questions or comments regarding the proposed rulemaking may be addressed in writing to Bridget Burke, Regulatory Coordinator, Insurance Department, 1341 Strawberry Square, Harrisburg, PA 17120, within 30 days following the publication of this notice in the *Pennsylvania Bulletin*. Questions and comments may also be e-mailed to briburke@pa.gov or faxed to (717) 772-1969.

Regulatory Review

Under section 5(a) of the Regulatory Review Act (71 P.S. § 745.5(a)), on January 11, 2016, the Department submitted a copy of this proposed rulemaking to the Independent Regulatory Review Commission (IRRC) and to the Chairpersons of the Senate Banking and Insurance Committee and the House Insurance Committee. In addition to the submitted proposed rulemaking, the Department has, as required by the Regulatory Review Act, provided IRRC and the Committees with a copy of a detailed Regulatory Analysis Form prepared by the Department. A copy of that material is available to the public upon request.

Under section 5(c) of the Regulatory Review Act (71 P.S. § 745.5(c)), IRRC and the Chairpersons of the Senate and House Committees were provided with copies of the comments received during the public comment period. In preparing the final-form rulemaking, the Department considered all comments from IRRC, the House and Senate Committees and the public.

Under section 5.1(j.2) of the Regulatory Review Act (71 P.S. § 745.5a(j.2)), on _____, 2016, the final rulemaking was deemed approved by the House and Senate Committees. Under section 5.1(e) of the Regulatory Review Act (71 P.S. § 745.5a(e)), IRRC met on _____ and approved the final-form rulemaking.

Findings

The Commissioner finds that:

- (1) Public notice of intention to adopt this final-form rulemaking was given under sections 201 and 202 of the act of July 31, 1968 (P.L. 769, No. 240)(45 P.S. §§ 1201 and 1202) and the regulations thereunder, 1 Pa. Code §§ 7.1 and 7.2.
- (2) The adoption of this final-form rulemaking in the manner provided in this order is necessary and appropriate for the administration and enforcement of the authorizing statutes.

Order

The Commissioner, acting under the authorizing statutes, orders that:

- (a) The regulations of the Department, 31 Pa. Code Chapter 147, are amended by amending sections 147.2, 147.3a, 147.13 and adding section 147.8a as set forth in 46 Pa.B. 458 and Annex A.

(b) The Department shall submit this order, 46 Pa.B. 458 and Annex A to IRRC and the Committees as required by law.

(c) The Department shall submit this order, 46 Pa.B. 458 and Annex A to the Office of General Counsel and Office of Attorney General for approval as to form and legality as required by law.

(d) The Department shall certify this order, 46 Pa.B. 458 and Annex A and deposit them with the Legislative Reference Bureau as required by law.

(e) The final-form regulation adopted by this order shall take effect 30 days following publication in the Pennsylvania Bulletin.

Teresa D. Miller
Insurance Commissioner

Annex A

TITLE 31. INSURANCE

PART VIII. MISCELLANEOUS PROVISIONS

CHAPTER 147. ANNUAL FINANCIAL REPORTING REQUIREMENTS

Sec.

147.2. Definitions.

147.3. Filing and extensions for filing required reports and communications.

147.3a. Requirements for audit committees.

147.4. Contents of annual audited financial report.

147.5. Designation of independent certified public accountant.

147.6. Recognition, qualification and responsibilities of an independent certified public accountant.

147.6a. Letter of qualifications of independent certified public accountant.

147.6b. Conduct of insurer relating to audits.

147.7. Consolidated or combined audits.

§ 147.8a. Internal Audit Function Requirements.

147.8. Scope of audit and report of independent certified public accountant.

147.9. Notification of adverse financial condition.

147.9a. Establishment and communication of internal control over financial reporting.

147.9b. Management's report of internal control over financial reporting.

147.10. [Reserved].

147.11. Definitions, availability and maintenance of independent certified public accountant workpapers.

147.12. [Reserved].

147.13. Effective date and exemption.

147.14. Penalties.

147.15. [Reserved].

§ 147.2. Definitions.

The following words and terms, when used in this chapter, have the following meanings, unless the context clearly indicates otherwise:

* * * * *

Audit committee

(i) A committee or equivalent body established by the board of directors or equivalent body of an [insurer] **entity** for the purpose of overseeing [the accounting and financial reporting processes, audits of financial statements, and internal control structure of the insurer or insurer group.] **the following functions of an insurer or insurer group:**

(A) Accounting and financial reporting processes.

(B) Internal audit function.

(C) External audits of financial statements.

(D) Internal control structure.

* * * * *

Internal audit function—The role of a person or persons in providing independent, objective and reasonable assurances that add value to and improve upon organization’s operations and assist the organization in accomplishing its objectives by employing a systematic, disciplined approach to evaluate and improve the effectiveness of the risk management, control and governance processes.

* * * * *

§ 147.3a. Requirements for audit committees.

* * * * *

(f) The audit committee shall retain an independent certified public accountant to conduct the annual audit and issue an audited financial report under this chapter in accordance with the following requirements:

(1) The audit committee shall be directly responsible for the appointment, compensation and oversight of the work of the independent certified public accountant and resolve disagreements between management and the independent certified public accountant relating to financial reporting for the purpose of preparing or issuing the audited financial report or related work under this chapter.

(2) The independent certified public accountant retained to conduct the annual audit under this chapter shall report directly to the audit committee. The audit committee shall require the independent certified public accountant to report to the audit committee in sufficient time to enable the committee to take appropriate action as required by Statement on Auditing Standards 114 (SAS 114), *The Auditor’s Communication with Those Charged With Governance*, or successor publication and all of the following requirements:

(i) All significant accounting policies and material permitted practices.

(ii) All material alternative treatments of financial information within statutory accounting principles that have been discussed with the management of the insurer, ramifications of the use of alternative disclosures and treatments, and the treatment preferred by the independent certified public accountant.

(iii) Other material written communications between the independent certified public accountant and the management of the insurer, such as any management letter or schedule of unadjusted differences.

(3) The report required under paragraph (2) may be provided to the audit committee on an aggregate basis for insurers in an insurer group, if the report identifies any substantial differences in reported items among the insurers in the group.

(g) The audit committee is 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 as required by section 147.8a.

[(g)](h) Exemptions are as follows.

(1) The requirements of subsections (b), (c), (e) and (f) do not apply to an insurer with direct written and assumed premiums less than \$500,000,000, excluding premiums reinsured with the Federal Crop Insurance Corporation and the Federal Flood Program, which has been granted an exemption by the Department on the basis of financial or organizational hardship under § 147.13(g) (relating to effective date and exemption).

(2) This section does not apply to continuing care providers.

(3) The requirements of subsections (b)—(e) do not apply to insurers subject to section 1405(c)(4) and (5) of The Insurance Company Law of 1921 (40 P. S. § 991.1405(c)(4) and (5)), Sarbanes Oxley [complaint] **compliant** entities or direct or indirect wholly owned subsidiaries of Sarbanes Oxley [complaint] **compliant** entities.

[(h)](i) This section may not be interpreted to limit the Department's authority to require an insurer to take specific corrective action relating to the independence of audit committee members under sections 501—563, 501-A—515-A, and 501-B—515-B of The Insurance Department Act of 1921 (40 P. S. §§ 221.1 – 221.63, 221.1-A—221.15-A, and 221.1-B—221.15-B) (relating to suspension of business and risk-based capital requirements), 31 Pa. Code Chapter 160 (relating to standards to define insurers deemed to be in hazardous financial condition) or other provisions of law.

§ 147.8a. Internal Audit Function Requirements.

(a) Exemption – An insurer is exempt from the requirements of this section if:

(1) The insurer meets the following requirements:

(i) 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.

(ii) 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.

(2) It is a continuing care provider licensed to transact business in this Commonwealth under the Continuing Care Provider Registration and Disclosure Act (40 P. S. § § 3201—3255)).

(b) Function – The insurer or group of insurers shall establish an internal audit function that provides independent, objective and reasonable assurance to the audit committee and the insurer’s management regarding the insurer’s governance, risk management and internal controls. This function shall include the performance of general and specific audits, reviews and tests and employ 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 shall 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.

~~(f) Internal Review by Exempt Entities – 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.~~

§ 147.13. Effective date and exemption.

* * * * *

(i) In the case of insurers organized in Canada or the United Kingdom of Great Britain and Northern Ireland, the annual audited financial report is defined as the annual statement of total business on the form filed by the insurers with their domiciliary supervision authority, audited by an independent chartered accountant. For these insurers, the letter required in § 147.6a (relating to letter of qualifications of independent certified public accountant) must state that the independent certified public accountant is aware of the requirements relating to the annual audited financial report filed with the Commissioner under § 147.3 (relating to filing and extensions for filing of annual audited financial report) and affirm that the opinion expressed is in conformity with those requirements.

(i) If an insurer or group of insurers exempt from the requirements of section 147.8a no longer qualifies for that exemption, it shall have ~~one year after the year~~ UNTIL DECEMBER 31 OF THE YEAR IN WHICH THE ANNUAL STATEMENT WAS FILED SHOWING the threshold is exceeded to comply with the requirements of that section.

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:

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- 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 14E 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.
- JK. "SEC" means the United States Securities and Exchange Commission.
- KL. "Section 404" means Section 404 of the Sarbanes-Oxley Act of 2002 and the SEC's rules and regulations promulgated thereunder.
- LM. "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.
- MN. "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

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- (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 4617, 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 E-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.

DE. 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.

EF. 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.

GF. (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 **FG**(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.

GH. The proportion of independent Audit committee members shall meet or exceed the following criteria:

Prior Calendar Year Direct Written and Assumed Premiums		
\$0 - \$300,000,000	Over \$300,000,000 - \$500,000,000	Over \$500,000,000
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.

- HJ. 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; 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 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:

Annual Financial Reporting Model Regulation

- (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 1617. 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 16-17 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 ~~16-17~~ report, or (ii) the Section 404 Report and a Section ~~16-17~~ 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 1718. 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 1617.

- G. The requirements of Section ~~16-17~~ 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 ~~18~~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 ~~19~~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. 1 29, 37, 212, 262, 266-272 (adopted).
1991 Proc. 1 9, 17, 225-226, 426, 428, 429-434 (amended and reprinted).
1998 Proc. 2nd Quarter 12, 13, 158, 226, 230, 231-232 (amended).
2001 Proc. 4th Quarter 6, 13-14, 531, 551, 561-563 (amended).
2003 Proc. 2nd Quarter 473, 489, 491 (amended and adopted by parent committee).
2003 Proc. 3rd Quarter 15 (adopted by Plenary).
2006 Proc. 2nd Quarter 779-793 (amended and adopted by Plenary).

Insurance Department

Notice of Final-Form Rulemaking

31 Pa. Code Chapter 147

ANNUAL FINANCIAL REPORTING REQUIREMENTS

Document/Fiscal Note No. 11-254

INSURANCE COMMISSIONER'S CERTIFICATION

I, Teresa D. Miller, hereby certify that I have reviewed this Final-Form Regulation and determined that it is consistent with the principles outlined in Executive Order 1996-1.



Teresa D. Miller
Insurance Commissioner

The Insurance Federation of Pennsylvania, Inc.

**1600 Market Street
Suite 1720
Philadelphia, PA 19103
Tel: (215) 665-0500 Fax: (215) 665-0540
E-mail: smarshall@ifpenn.org**

Samuel R. Marshall
President & CEO

February 19, 2016

Bridget E. Burke
Regulatory Coordinator
Pennsylvania Insurance Department
1341 Strawberry Square
Harrisburg, PA 17120

Re: Insurance Department Proposed Regulation 11-254 – annual financial reporting requirements

Dear Bridget:

The Insurance Federation supports the Department's proposed regulation, with appreciation for the collaborative efforts that went into its drafting.

We note the Pennsylvania Institute of Certified Public Accountants submitted a letter raising concerns with provisions of Chapter 147 that aren't part of the Department's proposed changes to that chapter (indeed, their concerns cite sections in the NAIC model, not Chapter 147 itself).

Those concerns may fall outside the scope of the IRRC's review of the proposed regulation, but we hope the Department is open to discussing them with the industry, with the CPA community and with the NAIC.

Sincerely,

Samuel R. Marshall

February 17, 2016

Via E-Mail

Bridget Burke, Regulatory Coordinator
Insurance Department
Commonwealth of Pennsylvania
1341 Strawberry Square
Harrisburg, PA 17120

Re: Annual Financial Reporting Requirements 11-254 (IRRC #3129)

Dear Ms. Burke:

The Pennsylvania Institute of Certified Public Accountants (PICPA) is a professional association of more than 22,000 members working to improve the CPA profession and better serve the public interest. Founded in 1897, the PICPA is the second-oldest CPA organization in the United States. Membership includes practitioners in public accounting, education, government, and industry. We appreciate the opportunity to provide our input on the proposed Pennsylvania Insurance Department regulations 11-254 (IRRC #3129) relating to new internal auditing requirements. We support the proposed changes related to the internal auditor requirements. In connection with our review, we noted several additional points for enhancement and clarification. We understand that these changes may need to originate from the NAIC. Our comments are included below by section number.

Section 2 – Definitions Accountant – The requirement that the independent certified public accountants must be a member of the American Institute of Certified Public Accountants (AICPA) goes beyond the requirements for licensing purposes.

Section 7 A – Qualifications of Independent Certified Public Accountant – (1) – The requirement that the independent certified public accountants be in good standing with the AICPA goes beyond the requirements for licensing purposes.

Section 3 J – The definition of internal control uses outdated language and requires a conforming change to current guidance (AT501). Specifically, change “board of directors” to “those charged with governance.”

Section 7 E (3) – The requirement to reject an annual audited financial report from someone who “demonstrated a pattern or practice of failing to detect or disclose material information in

previous reports filed under the provisions of this regulation” is not clear. What constitutes “material information” that should be filed under the provisions of this regulation? Is “material information” a defined term? Where does the requirement to “detect material information” come from? Is this defined in the standards?

Section 9 – The regulations repeat verbiage from the AICPA professional standards that has been superceded. For example, the requirement to “obtain an understanding of internal control sufficient to plan the audit” is no longer consistent with the standards. The current standards at AU-C Section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, requires the auditor to “obtain an understanding of internal control relevant to the audit.” The purpose of repeating the AICPA guidance in the regulations is unclear.

Section 9 – The meaning of the following sentence is unclear: “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.”

Section 12 C – Requires the accountant to issue a letter stating “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.” While the accountant should consider the nature of the filing, the scope of this statement extends beyond the parameters of the results of an audit performed in accordance with generally accepted auditing standards. Therefore, the accountant should not make this statement directly. Instead, the accountant will typically include a statement such as the statement noted below. We recommend including this language in the regulations so that accountants do not issue a letter with an improper statement.

While the accountant should understand that an objective of issuing a report on the statutory financial statements is to satisfy regulatory requirements, an audit is not planned to satisfy all objectives or responsibilities of insurance regulators. In this context, the Company and the insurance commissioners should understand that the objective of an audit of statutory financial statements in accordance with generally accepted auditing standards is to form an opinion and issue a report on whether the statutory financial statements present fairly, in all material respects, the admitted assets, liabilities, and capital and surplus, as well as the results of operations and cash flow in conformity with accounting practices prescribed or permitted by the Pennsylvania Insurance Department. Consequently, under generally accepted auditing standards, the accountant has the responsibility, within the inherent limitations of the auditing process, to plan and perform

the audit to obtain reasonable assurance about whether the statutory financial statements are free of material misstatement, whether caused by error or fraud, and to exercise due professional care in the conduct of the audit. The concept of selective testing of the data being audited, which involves judgment both as to the number of transactions to be audited and the areas to be tested, has been generally accepted as a valid and sufficient basis for an auditor to express an opinion on financial statements. Audit procedures that are effective for detecting errors, if they exist, may be ineffective for detecting misstatement resulting from fraud. Because of the characteristics of fraud, a properly planned and performed audit may not detect a material misstatement resulting from fraud. In addition, an audit does not address the possibility that material misstatements caused by error or fraud may occur in the future. Also, the accountant's use of professional judgment and the assessment of materiality for the purpose of our audit means that matters may exist that would be assessed differently by insurance commissioners.

It is the responsibility of the management of the Company to adopt sound accounting policies, to maintain an adequate and effective system of accounts, and to establish and maintain an internal control that will, among other things, provide reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in conformity with accounting practices prescribed or permitted by the Pennsylvania Insurance Department.

The insurance commissioner should exercise due diligence to obtain whatever other information may be necessary for the purpose of monitoring and regulating the statutory financial position of insurers, and should not rely solely upon the independent auditor's report.

Section 14 G – Requires the accountant to communicate certain matters to the audit committee in accordance with SAS 61, *Communication with Audit Committee*. However, the wording does not conform to the standards, including the use of the terminology “material permitted practices,” “all material alternative treatments,” and “treatments preferred by the accountant.” The current requirements included with AICPA's generally accepted auditing standards are more comprehensive. Ultimately, the purpose of repeating the AICPA guidance into the regulations is unclear. If the guidance is retained, we recommend conforming it to the current AICPA guidance.

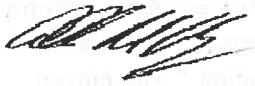
We also noted the following references included within the proposed regulations that have been superceded. As noted below, in some cases the regulations refer to the standards or a replacement standard.

- Section 9

- AU Section 319, *Consideration of Internal Control in a Financial Statement Audit*, is now AU-C Section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. This guidance is included at Section 9 and does not include a reference to a replaced standard.
- SAS No. 102, *Defining Professional Requirements in Statements on Auditing Standards*, is now AU-C Section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards*. Reference included at Section 9 and does not refer to a replaced standard.
- Section 10 C - Section AU 561 of the professional standards of the AICPA is now AU-C Section 560, *Subsequent Events and Subsequently Discovered Facts*. This guidance is included at Section 10 C and does not include a reference to a replaced standard.
- Section 11 A - SAS 60, *Communication of Internal Control Related Matters Noted in an Audit*, is now AU-C Section 265, *Communicating Internal Control Related Matters Identified in an Audit*. This guidance is included at Section 11 A, but includes a reference to its replacement.
- Section 14 F - Reference to SAS 61, *Communication with Audit Committee*, is now AU-C Section 260, *The Auditor's Communication with Those Charged with Governance*. This guidance is included at Section 14 F, but includes a reference to its replacement.

We appreciate your consideration of our comments. We are available to discuss any of these comments with you at your convenience.

Sincerely,



Allison M. Henry, CPA, CGMA
PICPA Staff Liaison, Not-For-Profit Committee

cc: Jodi A. Frantz, Insurance Department Counsel
Independent Regulatory Review Commission

Burke, Bridget

From: IRRC <irrc@irrc.state.pa.us>
Sent: Wednesday, February 03, 2016 9:08 AM
To: Frantz, Jodi (Insurance); Burke, Bridget
Cc: Michelle Elliott
Subject: FW: Dept. of Insurance PROPOSED regulation #11-254 (IRRC #3129): "Annual Financial Reporting Requirements"

Comment received by IRRC.

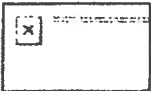
From: Ron Gallagher [<mailto:rgallagher@pamic.org>]
Sent: Wednesday, February 03, 2016 8:35 AM
To: Michelle Elliott
Subject: Re: Dept. of Insurance PROPOSED regulation #11-254 (IRRC #3129): "Annual Financial Reporting Requirements"

Michelle,

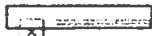
The Pennsylvania Association of Mutual Insurance Companies, Government Affairs Committee, reviewed the proposed changes to the regulation. We support the regulation as submitted.

Respectfully,

Ron Gallagher
President
Pennsylvania Association of Mutual Insurance Companies
W: 717-458-1029 C: 717-736-5949 E: rgallagher@pamic.org



Visit: <http://www.pamic.org/>





GOVERNOR'S OFFICE OF GENERAL COUNSEL

September 28, 2016

Mr. David Sumner
Executive Director
Independent Regulatory Review Comm.
333 Market Street, 14th Floor
Harrisburg, PA 17101

Re: Insurance Department Final-form Regulation No. 11-254, Annual Financial Reporting Requirements

Dear Mr. Sumner:

Pursuant to Section 5a(c) of the Regulatory Review Act, enclosed for your information and review is final-form regulation 31 Pa. Code, Chapter 147, Annual Financial Reporting Requirements.

The purpose of this rulemaking is to add corporate governance-related functions to the audit committee's responsibilities. The amendments in this rulemaking are based upon changes to NAIC Model Regulation # 205 adopted by the NAIC in 2014.

If you have any questions regarding this matter, please contact me at (717) 787-2567.

Sincerely yours,

A handwritten signature in blue ink that reads "Bridget E. Burke".

Bridget E. Burke
Regulatory Coordinator

**TRANSMITTAL SHEET FOR REGULATIONS SUBJECT TO THE
REGULATORY REVIEW ACT**

I.D. NUMBER: 11-254
 SUBJECT: ANNUAL AUDITED INSURERS FINANCIAL REPORT REQUIRED
 AGENCY: DEPARTMENT OF INSURANCE


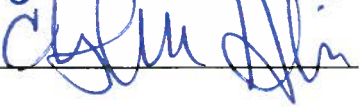



TYPE OF REGULATION

- Proposed Regulation
- X Final Regulation
- Final Regulation with Notice of Proposed Rulemaking Omitted
- 120-day Emergency Certification of the Attorney General
- 120-day Emergency Certification of the Governor
- Delivery of Tolled Regulation
 - a. _____ With Revisions
 - b. _____ Without Revisions

2016 SEP 28 PM 2:48

RECEIVED
IRRC

FILING OF REGULATION

<u>DATE</u>	<u>SIGNATURE</u>	<u>DESIGNATION</u>
		<i>HOUSE COMMITTEE ON INSURANCE:</i>
9.28.16		MAJORITY CHAIR – <u>REP. TINA PICKETT</u>
9/28/16		MINORITY CHAIR – <u>REP. ANTHONY DELUCA</u>
		<i>SENATE COMMITTEE ON BANKING & INSURANCE:</i>
9.28.16		MAJORITY CHAIR: <u>SEN. DONALD C. WHITE</u>
9/28/16		MINORITY CHAIR: <u>SEN. SEAN WILEY</u>
9/28/16		<i>INDEPENDENT REGULATORY REVIEW COMMISSION</i>
_____	_____	<i>ATTORNEY GENERAL (for Final Omitted Only)</i>
_____	_____	<i>LEGISLATIVE REFERENCE BUREAU (for Proposed Only)</i>

