



## MEMORANDUM

**To:** Florida Property and Casualty Association Members

**From:** Fred E. Karlinsky, Esq, Richard J. Fidei, Esq., and Andromeda Monroe, Esq.

**Date:** October 16, 2009

**Re:** Proposed Amendments to Florida Rule 69O-137.002, Annual Audited Financial Reports

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### GENERAL OVERVIEW

The Office of Insurance Regulation ("OIR") proposes to amend Rule 69O-137.002, *Annual Audited Financial Reports*, of the Florida Administrative Code ("Proposed Amendments"). The Proposed Amendments are in draft form and the OIR has scheduled a workshop for comments on the Proposed Amendments on October 21, 2009 at 9:30 a.m., Room 116, Larson Building, and 200 East Gaines Street, Tallahassee, Florida.

The purpose of the Proposed Amendments is to implement what the industry has termed the "Model Audit Rule," which was adopted by the National Association of Insurance Commissioners ("NAIC") in June, 2006. The purpose of the Model Audit Rule is to implement Sarbanes-Oxley (SOX) type financial controls for insurers. The NAIC, as part of its insurance department accreditation process, has given state insurance departments until 2010 to adopt a law or rule substantially similar to the Model Audit Rule.

The Proposed Amendments primarily relate to (1) financial statement note standards, (2) a process to obtain a extension of time to file audited annual financial statements, (3) required communications to the OIR regarding unremediated material weaknesses in internal controls, (4) the establishment of an audit committee, (5) audit committee requirements, (6) additional qualifications for the independent Certified Public Accountant performing the audit, (7) lead (coordinating) audit partner requirements, and (7) for certain financially troubled insurers or insurers with direct written and assumed premiums of \$500,000,000, excluding premiums reinsured with the Federal Crop Insurance Corporation and Federal Flood Program, management's report of internal control over financial reporting.

The audited financial statement requirement will continue to apply to every insurer issued a certificate authority to transact insurance in Florida. Insurers having direct premiums written in Florida of less \$1,000,000 in any calendar year and less than 1,000 policyholders or certificate holders of directly written policies nationwide at the end of the calendar year will continue to be exempt from the rule for that year, unless the OIR makes a specific finding that compliance is necessary for the OIR to perform its statutory responsibilities. However, insurers falling within the above exemption and having



assumed premiums pursuant to reinsurance contracts or treaties of \$1,000,000 or more will continue to be subject to the rule. In addition, an exempt insurer must still submit by March 1 following the exemption year a sworn affidavit of one of its responsible officers specifying the direct premiums written in Florida and the number of policyholders or certificate holders. One of amendments to the rule incorporates Form OIR-DO-1431 which is to be submitted for exemption from compliance with the annual audited financial requirement.

If the Proposed Amendments are adopted, an insurer otherwise subject to the rule can request an exemption from any and all provisions of the rule and such exemption will be granted if the OIR finds that compliance with the rule would constitute a financial or organizational hardship upon the insurer. In addition, if the OIR denies such exemption request, the insurer can request a hearing, which is to be held in accordance with the rule and administrative hearing procedures. Further, if the Proposed Amendments are adopted, an insurer can obtain an exemption from other provisions of the rule, if certain conditions are met.

### EFFECTIVE DATES

The audit committee requirements, as set forth below, are to be in effect as of January 1, 2010 and thereafter.

The requirements concerning the independence of the lead partner of the auditing independent certified public accountant are to be in effect for the audits beginning January 1, 2010 and thereafter.

Insurers subject to all other changes in the rule must comply with such other changes for the reporting period ending December 31, 2010 and each year thereafter, unless the OIR permits otherwise.

### PROPOSED AMENDMENTS

The Proposed Amendments include, but are not limited to, the following:

1. **Financial Statement Notes Standards.** The notes to the audited financial statements must include not only those required by the appropriate NAIC Annual Statement Instructions and any notes required by generally accepted accounting principles, but also the notes required by the NAIC Accounting Practices and Procedures Manual.
2. **Extension of Time to File Annual Audited Financials.** Extensions of the June 1 deadline to file the annual audited financial statements may be granted for 30-day periods upon a good cause determination by the OIR. Such request must be made not less than 10 days before the due date of the annual audited financial statement.



3. **Communication regarding Unremediated Material Weakness in Internal Control over Financial Reporting.** Under the present rule, an insurer must provide an annual audited financial report. Under the rule, as proposed to be amended, insurers will also be required to file a written report with OIR of any unremediated material weaknesses in internal controls over financial reporting noted during the audit. The report is to be prepared by the accountant within 60 days of the filing of the audited financial report and contain a description of any unremediated weakness as of the prior December 31. The definition of material weakness is set forth in Statement on Auditing Standard (SAS) 60, *Communication of Internal Control Related Matters Noted in an Audit* or its substitute. The report should also state if there are no unremediated material weaknesses.

Internal control over financial reporting is a process that is effected by an entity's Board of Directors, management and other personnel. The process of internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of the financial statements and includes policies and procedures that (a) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflects the transactions and dispositions of assets, (b) provides reasonable assurance that transactions are recorded as necessary to permit preparation of the financial statements and that receipts and expenditures are being made only in accordance with authorizations of management and directors, and (c) 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. The financial statement foci of internal control over financial reporting are (a) balance sheet reporting admitted assets, liabilities, capital and surplus, (b) statement of operations, (c) cash flow statement, (d) statement of changes in capital and surplus, (e) notes to financial statements, and (f) form, language and groupings substantially the same as relevant sections of the annual statement of the insurer filed with the OIR with comparatives as of the current December 31 and the preceding December 31 (if applicable).

4. **Establishment of an Audit Committee.** An insurer must have an audit committee. The audit committee of an entity that controls the insurer may be deemed to be the insurer's audit committee, at the election of the controlling entity. If this election is made by the controlling entity, the controlling entity must inform the OIR, in writing and before the issuance of the statutory audit, that it has elected to designate the audit committee and the reason for such election. In addition, if the insurer does not designate an audit committee, its Board of Directors shall constitute the audit committee. The purpose of the audit committee is to oversee the accounting and financial reporting processes of an insurer or group of insurers, as well as the audits of financial statements of the insurer or group of insurers. A group of insurers consists of insurers that are part of an insurance holding company system or a set of insurers



identified by management as assessing the effectiveness of internal control over financial reporting.

5. **Audit Committee Member Independence and Other Requirements.** There are certain requirements for the audit committee. These requirements are not applicable to a foreign or alien insurer licensed in Florida or an insurer that is a SOX Complaint Entity or a direct or indirect wholly owned subsidiary of a SOX Complaint Entity. These requirements may be waived by the OIR if the insurer has direct written and assumed premium of \$500,000,000, excluding Federal Crop Insurance Corporation and Federal Flood Program insurance premiums, on the basis of hardship.

A SOX Compliant Entity is a entity that is required to be, or is voluntarily, compliant with all of the following provisions of Sarbanes-Oxley Act of 2002: (a) the preapproval requirements of Section 201(Section 10A(i) of the Securities Exchange Act of 1934), (b) the audit committee independence requirements of Section 301 (Section 101A(m)(3) of the Securities Exchange Act of 1934) and (c) the internal control over financial reporting requirements of Section 404 (Item 308 of SEC Regulation S-K).

The requirements for the audit committee include, but are not limited to the following: (a) the audit committee is directly responsible for the appointment, compensation and oversight of the accountant's work (including resolution of financial reporting disagreements between the accountant and management), for the purpose of preparing and issuing the audited financial report or related work, and each accountant must report directly to the audit committee, (b) each member of the audit committee must also be a member of the Board of Directors of the insurer or a member of the Board of Directors of an entity and elected pursuant to rule provisions, and (c) under certain conditions, a certain percentage of the audit committee must be independent.

If the prior calendar year direct written and assumed premium of an insurer is \$300,000,000 or less, there is no minimum required number of independent audit committee members. If the prior calendar year direct written and assumed premium is \$500,000,000 or less and more than \$300,000,000, 50% or more of the audit committee members must be independent. If the prior calendar year direct written and assumed premiums is over \$500,000,000, 75% or more of the audit committee members must be independent. The "prior calendar year direct written and assumed premiums" is a combined total of direct premiums and assumed premiums from non-affiliates for the reporting entities.

A member of the audit committee is independent, if other than in her/his capacity as a member of the audit committee, the Board of Directors or any other committee of the entity, (s)he has not accepted any consulting, advisory or other compensatory fee from the entity or is not a person that directly or



indirectly, through one or more intermediaries, controls or is controlled by or is under common control with such entity or a subsidiary thereof.

The OIR may require the entity's Board of Directors to make improvements to the independence of its audit committee membership if the insurer is in an RBC action level event, meets one or more standards of an insurer deemed to be in hazardous financial condition or otherwise exhibits qualities of a troubled insurer. The audit committee must require the accountant that performs any audit subject to the regulation to timely report to the audit committee in accordance with SAS 61, *Communication with Audit Committees*, or its substitute, including material written communications between the accountant and management.

An insurer or group of insurers that either initially is not required to have any independent audit committee members or is required to have 50% independent members on its audit committee and later meets a heightened independent audit committee requirement due to an increase in premiums will have one year following the year the threshold is exceeded, but not earlier than January 1, 2010, to comply with the independence requirements. If an insurer or group of insurers does not meet a particular threshold and becomes subject to a particular independence standard due to a business combination, the insurer or group of insurers will have one calendar year from the date of the acquisition or combination to comply with the independence requirements.

6. **Qualified Independent Certified Public Accountant (Qualified CPA) Requirements.** The qualified independent certified public accountant for the annual audited financial statement must not only be licensed in all states where the accountant practices but will also need to be in good standing with the American Institute of Certified Public Accountants (rather than a licensing authority or accrediting authority for Certified Public Accountants), and may not have, either directly or indirectly, entered into an agreement of indemnity or release from liability with respect to the audit of the insurer. Disputes with the Qualified CPA can be resolved by mediation or arbitration pursuant to an agreement between the insurer and the Qualified CPA; however, in the event of a delinquency proceeding commenced against the insurer, the mediation or arbitration requirement will be at the option of the statutory successor.

In addition, unless an insurer requests an exemption, the Qualified CPA cannot provide contemporaneously with the audit, (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 contributions in-kind reports, (d) actuarially-oriented advisory services involving the determination of amounts recorded in the financial statements, (e) internal audit outsourcing services, (f) management functions or human resources, (g) broker, dealer, investment adviser, or investment banking services, (h) legal services or



expert services unrelated to the audit, or (i) any other services that the OIR determines, by regulation, to be impermissible. An accountant's actuary can issue an actuarial opinion or certification on an insurer's reserves if certain conditions are met: the accountant and the accountant's actuary have not performed any management functions or made any management decisions, the insurer has competent personnel or engages a third party actuary to estimate the reserves for which management is responsible and the accountant's actuary tests the reasonableness of the reserves after management of the insurer has determined the amount of the reserves.

Only insurers having direct written and assumed premium of less than \$100,000,000 in any calendar year may request an exemption from the foregoing provisions. An exemption will be granted by the OIR upon a showing that compliance would constitute a financial or organizational hardship on the insurer.

All services of the Qualified CPA must be pre-approved by the audit committee. Preapproval by the audit committee is waived for non-audit services if the insurer is a SOX Compliant Entity or a direct or indirect subsidiary of a SOX Compliant Entity or (a) the aggregate amount of all the non-audit services is not more than 5% of the total fees paid by the insurer to its CPA during the fiscal year in which the non-audit services are provided, (b) the services were not recognized by the insurer to be non-audit services at the time of the engagement, and (c) the services were promptly brought to the attention of the audit committee or one or more of its members who are members of the Board of Directors to whom the audit committee has granted such authority.

An insurer's independent Certified Public Accountant will not be considered to be a Qualified CPA if a Board member, President, CEO, Controller, CFO, Chief Accounting Officer, or any person serving in an equivalent position with the insurer was employed by that independent Certified Public Accountant and participated in the insurer's audit, as a partner or senior manager, during the one-year period preceding the date that the most current statutory opinion is due.

7. **Lead (Coordinating) Audit Partner Requirements.** The time period for which the lead (coordinating) audit partner having primary responsibility for the audit may serve in that capacity is reduced from 7 consecutive years to 5 consecutive years. Thereafter, the partner 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 5 (rather than 2) consecutive years. The application for exemption of the lead audit partner from these criteria based upon hardship to the insurer must be filed with OIR by the insurer at least 30 days prior to the end of the calendar year and the relief from the requirements will be granted only if it can be shown that the accountant is exercising independent



judgment and is not unduly influenced by the insurer. The insurer will be obligated to file with its annual statement the approval of relief from the lead audit partner requirement with all states where it is licensed or does business and with the NAIC.

**8. Management's Report of Internal Control over Financial Reporting.**

Every insurer that is required to file an audited financial report that has annual direct written and assumed premium of \$500,000,000 or more, excluding premiums reinsured with the Federal Crop Insurance Corporation and Federal Flood Program, must prepare a management's report of internal control over financial reporting. In addition, the OIR 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 one or more of the standards of an insurer deemed to be in hazardous financial condition as prescribed by statute.

The management's report of internal control over financial reporting is confidential and any documentation provided in support thereof during the course of a financial examination must be kept confidential by the OIR.

An insurer or group of insurers that is (a) directly subject to Section 404, (b) part of a holding company system whose parent is directly subject to Section 404, (c) not directly subject to Section 404 but is a SOX Compliant Entity, or (d) 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 the requirement for management's report of internal control over financial reporting, provided the internal controls of the insurer or group of insurers having a material impact on the preparation of audited statutory financial statements of the insurer or group of insurers were included in the scope of the Section 404 Report. The addendum represents a positive management statement that there are no material processes with respect to the preparation of the insurer's or group of insurers' audited statutory financial statements excluded from the Section 404 Report.

If there is an insurer or group of insurers not included in the scope of the Section 404 Report, the insurer or group of insurers may file (a) management's report of internal control over financial reporting or (b) the Section 404 Report and management's report of internal control over financial reporting applicable to the insurer's or group of insurers' audited statutory financial statements not covered by the Section 404 Report.

Management reports of internal control over financial reporting must include certain information, including disclosure of unremediated material weaknesses in internal control identified by management as of preceding December 31, a statement regarding inherent limitations of internal control systems, 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 controls are effective to provide reasonable assurance regarding the reliability of financial statements in accordance with statutory accounting principles.

An insurer or group of insurers that is not required to file a management report because its premium volume is below the required threshold but subsequently meets the threshold for the report (including by reason of a business combination) has 2 years following the year the threshold is met to comply with the reporting provision, but no later than December 31, 2010.