

BILL ANALYSIS

H.B. 2752
By: Eiland
Insurance
Committee Report (Unamended)

BACKGROUND AND PURPOSE

Currently, insurance companies and health maintenance organizations (HMOs) with more than \$1 million in premiums in Texas are required to have an audit of their financial statements performed by an independent certified public accountant. The Texas requirements are based on model audit requirements developed by the National Association of Insurance Commissioners (NAIC). Recently, the NAIC revised the model audit requirements to incorporate provisions regarding corporate governance, accounting, and auditing requirements that will primarily impact large, non-public insurers and HMOs. The revised model requirements were designed to obtain the greatest public benefit at the lowest cost of compliance. As a result, small and medium insurance carriers and large carriers with less than \$500 million in premiums were exempt from many of the revised model requirements. These revised requirements will be required for state insurance departments to maintain their accreditation, which is necessary to ensure uniform financial regulation.

Currently, large non-public insurance companies and HMOs are not required to comply with best practices for corporate governance. Requiring such compliance would improve the oversight and internal controls for these insurers, who have substantial market share in Texas. Additionally, public insurers who already are required to comply with best practices for corporate governance under federal law are not required to file reports with insurance regulators.

H.B. 2752 improves Texas' surveillance of the financial condition of insurers and HMOs by incorporating NAIC model requirements for corporate governance and best practices. Consideration should be given regarding the costs of compliance to insurance companies and HMOs, including lessening the requirements for smaller companies.

RULEMAKING AUTHORITY

It is the committee's opinion that this bill does not expressly grant any additional rulemaking authority to a state officer, department, agency, or institution.

ANALYSIS

H.B. 2752 amends the Insurance Code to include in the purpose of the provisions relating to an independent audit of an insurer's financial statements that the provisions require communication of internal control related matters noted in an audit and require management to report on internal control over financial reporting. The bill establishes that an extension granted by the commissioner of insurance for filing an audited financial report also applies to the filing of management's report on internal control over financial reporting. The bill requires an insurer required to file an annual audited financial report to designate a group of individuals to serve as its audit committee. The bill authorizes the audit committee of an entity that controls an insurer to be the insurer's audit committee at the election of the controlling person. The bill adds a health maintenance organization to the definition of "insurer" and makes conforming changes.

H.B. 2752 requires the accountant who audits the insurer's financial reports, in accordance with the section "Consideration of Internal Control in a Financial Statement Audit" in the Professional Standards of the American Institute of Certified Public Accountants, to obtain an understanding of internal control sufficient to plan the audit. The bill requires the accountant, for those insurers required to file a management's report of internal control over financial reporting, to consider the most recently available report in planning and performing the audit of the statutory financial statements, to the extent required by those standards. The bill specifies that, for the purposes of this provision, the term "consider" has the meaning assigned by Statement on Auditing Standards No. 102, "Defining Professional Requirements in Statements on Auditing Standards," or a successor document.

H.B. 2752 prohibits a partner or other person responsible for rendering a report for an insurer for five, rather than seven, consecutive years from rendering a report for the insurer or for a subsidiary or affiliate of the insurer that is engaged in the business of insurance, during the five-year, rather than two-year, period after that fifth year and specifies that the partner is a lead partner. The bill establishes that a provision authorizing the commissioner to determine that this limitation does not apply to an accountant for a particular insurer under certain conditions is on application made at least 30 days before the end of the calendar year. The bill makes these provisions effective January 1, 2010.

H.B. 2752 requires an insurer for which the commissioner has approved an exception as described above, on filing its annual statement, to file the approval with the states in which it is doing or is authorized to do business and with the National Association of Insurance Commissioners (NAIC). The bill requires the insurer to file the approval in an electronic format acceptable to NAIC, if a state other than Texas accepts electronic filing with NAIC. The bill prohibits the accountant, in providing services, from functioning in the role of management, auditing the accountant's own work, or serving in an advocacy role for the insurer. The bill prohibits the commissioner from recognizing as qualified an accountant, or from accepting an annual audited financial report that was prepared wholly or partly by an accountant, who provides an insurer at the time of the audit with certain specified services. The bill authorizes an accountant to assist an insurer in understanding the methods, assumptions, and inputs used in the determination of amounts recorded in the financial statement if it is reasonable to believe that the advisory service will not be the subject of audit procedures during an audit of the insurer's financial statements. The bill authorizes an accountant's actuary to also issue an actuarial opinion or certification on an insurer's reserves if those individuals have not performed 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 takes responsibility; and the accountant's actuary tests the reasonableness of the reserves after the insurer's management has determined the amount of the reserves. The bill authorizes an insurer that has direct written and assumed premiums of less than \$100 million in any calendar year to request an exemption from the requirements that prohibit the commissioner recognizing as a qualified accountant or accepting a report prepared by an accountant who at the time of the audit provides an insurer with certain services by filing with the commissioner a written statement explaining why the insurer should be exempt. The bill authorizes the commissioner to grant the exemption if the commissioner finds that compliance with the requirements would impose an undue financial or organizational hardship on the insurer. The bill authorizes an accountant who performs an audit to perform certain nonaudit services only if the activity is approved in advance by the audit committee in accordance with these provisions. The bill requires the audit committee to approve in advance all auditing services and nonaudit services that an insurer's accountant provides to the insurer. The bill establishes that the prior approval requirement is waived with respect to nonaudit services if the insurer is a SOX-compliant entity or a direct or indirect wholly owned subsidiary of such an entity or satisfies certain other criteria. The bill defines the term "SOX-compliant entity" to mean an entity that is required to comply with or voluntarily complies with certain preapproval requirements and audit committee independence requirements provided by federal law, and internal control over financial reporting requirements provided by federal law and by a regulation of the U.S. Securities and Exchange Commission. The bill authorizes the

audit committee to delegate to one or more designated members of the audit committee the authority to grant the prior approval. The bill requires the decisions of any member to whom this authority is delegated to be presented to the full audit committee at each of its scheduled meetings. The bill prohibits the commissioner from recognizing an accountant as qualified for a particular insurer if a member of the board, the president, chief executive officer, controller, chief financial officer, chief accounting officer, or any person serving in an equivalent position for the insurer was employed by the accountant and participated in the audit of that insurer during the one-year period preceding the date on which the most current statutory opinion is due. The bill applies this prohibition only to partners and senior managers involved in the audit. The bill authorizes an insurer to apply to the commissioner for an exemption from these requirements on the basis of unusual circumstances. The bill requires the insurer to file, with its annual statement filing, the approval of a granted exemption with the states in which it does or in which it is authorized to do business and NAIC. The bill requires the insurer to file the approval in an electronic format acceptable to NAIC if a state other than Texas in which the insurer does or in which it is authorized to do business accepts electronic filing.

H.B. 2752 specifies that the document each insurer is required to provide to the commissioner in addition to the audited financial report is a written communication prepared by an accountant that describes any unremediated material weaknesses in its internal controls over financial reporting noted during the audit in accordance with the Professional Standards of the American Institute of Certified Public Accountants, rather than a report of significant deficiencies required and prepared by an accountant in accordance with those standards. The bill requires the communication to contain a description of any unremediated material weaknesses, as defined by Statement on Auditing Standards No. 60, "Communication of Internal Control Related Matters Noted in an Audit," or a successor document, as of the immediately preceding December 31, in the insurer's internal control over financial reporting that was noted by the accountant during the course of the audit of the financial statements. The bill requires the communication to affirmatively state if unremediated material weaknesses were not noted by the accountant.

H.B. 2752 requires an insurer, effective January 1, 2010, to establish an audit committee and establishes criteria for committee membership based on the insurer's direct written and assumed premiums for the preceding calendar year. The bill specifies that this requirement does not apply to foreign or alien insurers authorized in Texas or to an insurer that is a SOX-compliant entity or a direct or indirect wholly owned subsidiary of a SOX-compliant entity. The bill authorizes the commissioner to require the insurer's board to enact improvements to the independence of the audit committee membership if the insurer meets certain criteria. The bill authorizes an insurer with direct written and assumed premiums, with certain exclusions, of less than \$500 million to apply to the commissioner for a waiver from the requirement to establish an audit committee based on hardship. The bill requires the insurer to file, with its annual statement filing, the approval of a waiver with the states in which it does or is authorized to do business and with NAIC. The bill requires the insurer to file the approval in an electronic format acceptable to NAIC if a state other than Texas accepts electronic filing. The bill establishes, for the purpose of these provisions, that premiums assumed from affiliates in the same group of insurers are excluded in determining whether an insurer has less than \$500 million in direct written premiums and assumed premiums. The bill provides that the audit committee is directly responsible for the appointment, compensation, and oversight of the work of any accountant, including the resolution of disagreements between the management of the insurer and the accountant regarding financial reporting, for the purpose of preparing or issuing the audited financial report or related work under these provisions. The bill requires each accountant to report directly to the audit committee. The bill sets out the requirements for committee membership and the procedures for the election of the committee's controlling person. The bill requires the audit committee to require the accountant who performs an audit required by this subchapter to report to the audit committee in accordance with the requirements of Statement on Auditing Standards No. 61, "Communication with Audit Committees," or a successor document, and specifies the types of information the report must include. The bill authorizes the report, if the insurer is a member of an insurance holding company, to be provided to the audit committee

on an aggregate basis for insurers in the holding company system if any substantial differences among insurers in the system are identified to the audit committee.

H.B. 2752 prohibits a director or officer of an insurer from directly or indirectly making or causing to be made a materially false or misleading statement to an accountant in connection with a required audit, review, or communication and from omitting to state, or causing 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 required audit, review, or communication. The bill prohibits an officer or director of an insurer, or another person acting under the direction of the officer or director from directly or indirectly coercing, manipulating, misleading, or fraudulently influencing an accountant performing an audit under these provisions if that person knew or should have known that the action, if successful, could result in rendering the insurer's financial statements materially misleading.

H.B. 2752 requires each insurer required to file an audited financial report that has annual direct written and assumed premiums, with certain exclusions of \$500 million or more to prepare a report, as of the immediately preceding December 31, of the insurer's or group of insurers' internal control over financial reporting and to file the report with the commissioner with the required communication described above. The bill authorizes the commissioner to require an insurer to file the management's report of internal control over financial reporting if the insurer is in any risk-based capital level event or meets one or more of the standards of an insurer considered to be in hazardous financial condition. The bill authorizes an insurer or group of insurers to file the insurer's or the insurer's parent's Section 404 report and an addendum if the insurer or group of insurers meets certain criteria. The bill requires the Section 404 report to include those 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 requires the addendum to 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. The bill authorizes the insurer or group of insurers, 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 are not included in the Section 404 report, to either file a report under these provisions or the Section 404 report and a 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. The bill defines "Section 404" to mean Section 404 of the federal Sarbanes-Oxley Act of 2002 and rules adopted under that section and "Section 404 report" to mean management's report on internal control over financial reporting as determined by the SEC and the related attestation report of an accountant. The bill specifies the information that must be included in the insurer's management report of internal control over financial reporting.

H.B. 2752 prohibits an insurer's management, for purposes relating to the disclosure of any unremediated material weaknesses in the internal control over financial reporting identified by management as of the immediately preceding December 31, from concluding 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. The bill requires management to document and make available on financial condition examination the basis of the opinions required for the insurer's management report of internal control over financial reporting and authorizes management to base opinions, in part, on its review, monitoring, and testing of internal controls undertaken in the normal course of its activities. The bill establishes that management has discretion as to the nature of the internal control framework used, and the nature and extent of documentation, in order to form its opinion in a cost-effective manner and authorizes management to include an assembly of or reference to existing documentation. The bill requires the department to maintain the confidentiality of the

management's report of internal control over financial reporting and any supporting documentation provided in the course of a financial condition examination.

H.B. 2752 provides that an insurer or group of insurers whose audit committee as of January 1, 2010, is not subject to the independence requirements under these provisions because the total written and assumed premium is below the established threshold, and that later becomes subject to one of the requirements because of changes in the amount of written and assumed premium, has one year following the year in which the written and assumed premium exceeds the threshold amount to comply with the requirements. The bill requires an insurer that becomes subject to one of the independence requirements as a result of a business combination to comply with these requirements not later than the first anniversary of the date of the acquisition or combination. The bill establishes that an insurer or group of insurers that is not required to file a management's report of internal control over financial reporting as of January 1, 2010, because the total written premium is below the threshold amount, and that later becomes subject to the reporting requirements, has two years after the year in which the written premium exceeds the threshold amount to file a report. The bill requires an insurer acquired in a business combination to comply with the reporting requirements not later than the second anniversary of the date of the acquisition or combination.

H.B. 2752 defines "audit committee," "group of insurers," "internal control over financial reporting," "management," and "SEC."

H.B. 2752 establishes that, except as otherwise provided, this bill's provisions take effect beginning with the reporting period ending December 31, 2010.

H.B. 2752 repeals Section 401.001(3), Insurance Code.

EFFECTIVE DATE

September 1, 2009, except as otherwise provided.