

**INSURANCE
DEPARTMENT OF BANKING AND INSURANCE
OFFICE OF SOLVENCY REGULATION**

Annual Audited Financial Reports

Proposed Amendments: N.J.A.C. 11:2-26.1 through 26.6 and 26.9 through 26.14

Proposed New Rules: N.J.A.C. 11:2-26.14, 26.15 and 26.16.

Authorized By: Neil N. Jasey, Commissioner, Department of Banking and Insurance.

Authority: N.J.S.A. 17:1-8.1, 17:1-15e and 17:23-20 et seq.

Calendar Reference: See Summary below for explanation of exception to calendar requirement.

Proposal Number: PRN 2009-296

Submit written comments by November 20, 2009 to:

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The agency proposal follows:

Summary

N.J.A.C. 11:2-26, originally effective December 18, 1989 and subsequently amended in 1993, 1996, 2001 and 2008, is intended to improve the oversight by the Department of Banking and Insurance (Department) of the financial condition of insurers by requiring an annual audit by independent certified public accountants (CPAs) of the financial statements that report the financial position and the results of operations of

insurers. The rules are based on a model rule adopted by the National Association of Insurance Commissioners (NAIC), and are required for state insurance departments to obtain and maintain accreditation by the NAIC. The Department historically has amended the rules to reflect the most recent NAIC Model. In 2006, the NAIC adopted amendments to the model rule related to auditor independence, corporate governance and internal control over financial reporting.

The 2006 NAIC model rule revisions reduce the number of consecutive years an audit partner may participate on the audit of an insurer and also lists various non-audit services that auditors may not provide to an insurer in order to maintain its independence. Realizing that it may be difficult for small insurers to comply with the prohibited services requirement, a small company exemption is included that indicates that those insurance companies with less than \$100 million in direct written and assumed premium may request an exemption from this requirement.

The 2006 NAIC adopted revisions also require that insurance companies have an audit committee that is solely responsible for the appointment, compensation and oversight of the company's auditor. Insurers with less than \$500 million in direct and assumed premium may apply for a waiver from this requirement based on hardship. Based on various premium thresholds, a certain percentage of the audit committee members must be independent from the insurer. However, if domiciliary law requires board participation by otherwise non-independent members, such law shall prevail and such members may participate in the audit committee. The effective date in the revised NAIC model is January 1, 2010.

Finally, the adopted NAIC revisions require that management of insurance companies with \$500 million or more in direct and assumed premium file a report with the state insurance department regarding its assessment of internal control over financial reporting. This report will include a statement by management whether these controls are effective to provide reasonable assurance regarding the reliability of the statutory financial statements and disclosure of any unremediated material weaknesses in internal control over financial reporting. The independent certified public accountant should consider this report during the planning and performance of the annual audit. In addition, the adopted revisions require the insurer to file with the state insurance department the independent certified public accountant's communication regarding any unremediated material weaknesses noted during the course of an audit. The effective date of these revisions to the model is December 31, 2010.

In addition to the adopted revisions to the model rule, the NAIC also adopted an Implementation Guide designed to assist insurers in complying with the new requirements included in the model rule regarding auditor independence, corporate governance and internal control over financial reporting. The guide is intended to be interpretative guidance only and is included as an appendix to the Accounting Practices and Procedures Manual and is available on the NAIC's website at

http://www.naic.org/documents/committees_e_naic_aicpa_implementation_guide_exposed-Final_0314.pdf.

Accordingly, in order to reflect the national standard set forth in the current NAIC model annual financial reporting rule, the Department proposes the amendments discussed below.

N.J.A.C. 11:2-26.1 is proposed to be amended by replacing the current annual examination requirement with an annual audit requirement by an independent certified public accountant of financial statements reporting the financial position and the results of operations of insurers. The amendments also require communication of internal control related matters noted in an audit and management's report of internal control over financial reporting.

N.J.A.C. 11:2-26.2 is proposed to be amended to reflect the proposed recodification of N.J.A.C. 11:2-26.14 to 26.17.

N.J.A.C. 11:2-26.3 is proposed to be amended to include definitions of "affiliate," "audit committee," "controlling person," "independent board member," "group of insurers," "internal control over financial reporting," "SEC," "Section 404," "Section 404 Report" and "SOX compliant entity" and to amend the definition of "workpapers."

N.J.A.C. 11:2-26.4 is proposed to be amended to reflect the proposed recodification of N.J.A.C. 11:2-26.14 to 26.17. The section is also proposed to be amended to add a subsection stating that if an extension for filing an annual audit is granted by the Commissioner, a similar extension of 30 days is granted for the filing of management's report of internal control over financial reporting. The section is further proposed to be amended to add a subsection stating that all insurers required to file an annual audited financial report are required to designate an audit committee, and that an audit committee

of an entity that controls an insurer may be deemed to be the insurer's audit committee for purposes of this subchapter at the election of the controlling person.

N.J.A.C. 11:2-26.5 is proposed to be amended to clarify that the notes to financial statements required to be included in the annual audited financial report are those required by the appropriate NAIC Annual Statement Instructions and the NAIC Accounting Practices and Procedures Manual.

N.J.A.C. 11:2-26.6 is proposed to be amended to include the acronym AICPA for the American Institute of Certified Public Accountants used throughout the section. Rather than proposing to adopt the NAIC model term "statutory successor" at subsection (c), the Department is retaining the term "Commissioner" because, pursuant to N.J.S.A. 17:30C-4, the Commissioner is required to commence all delinquency proceedings. Subsection (d) is proposed to be amended to change from seven to five the number of consecutive years that a partner or other person responsible for rendering a report may act in that capacity, and to change from two to five years the amount of time during which any person who acted in that capacity is disqualified from acting in that or a similar capacity for the same company or its insurance subsidiaries or affiliates. If an insurer has obtained relief from this rotation schedule pursuant to the rules, an additional requirement is being proposed that the insurer file with its annual statement filing the approval for relief granted with the states in which it is licensed or doing business and with the NAIC; if the nondomestic state accepts electronic filing with the NAIC, the insurer is required to file the approval in an electronic format acceptable to the NAIC.

This section is further proposed to be amended to add a new subsection (g) that requires the Commissioner to disqualify an accountant as an "independent certified public accountant" who provides to an insurer, contemporaneously with the audit, certain non-audit services listed in the section. Proposed subsection (h) sets forth the principles of independence with respect to services provided by the qualified independent certified public accountant. Proposed subsection (i) permits insurers having direct written and assumed premiums of less than \$100,000,000 in any calendar year to request an exemption from the disqualification criteria set forth at proposed subsection (g). Proposed subsection (j) permits a qualified independent certified public accountant who performs an audit to engage in other non-audit services that are not described in proposed subsection (g) or that do not conflict with proposed subsection (g), but only if the activity is approved in advance by the audit committee. Proposed subsection (k) sets forth the preapproval procedures for all auditing services and non-audit services provided to an insurer by a qualified independent certification public accountant. Proposed subsection (k) further establishes the criteria and procedure for waiving the preapproval requirement regarding non-audit services. Proposed subsection (l) permits the audit committee to delegate to one or more designated members of the audit committee the authority to grant preapprovals, and requires such member(s) to present their decisions to the full audit committee at each of its scheduled meetings. Proposed subsection (m) lists the criteria and procedure for disqualifying an independent certified public accountant for a particular insurer, and also permits an insurer to apply to the Commissioner for relief from this requirement on the basis of unusual circumstances.

N.J.A.C. 11:2-26.9 is proposed to be amended to change the heading of the section from "Scope of examination and report" to "Scope of audit and report." The section is further proposed to be amended to add language recommending that, pursuant to certain professional standards identified in this section, the independent certified public accountant gain an understanding of internal control sufficient to plan an audit and consider the most recently available report in planning and performing the audit of the statutory financial statements.

N.J.A.C. 11:2-26.10 is proposed to be amended with minor editorial changes.

N.J.A.C. 11:2-26.11 is proposed to be amended by changing the section's heading from "Report on significant deficiencies in internal controls" to "Communication of internal control related matters noted in an audit." The proposed amended section replaces the current procedure for reporting "reportable conditions" in the insurer's internal control structure with a new procedure requiring the insurer to file with the Commissioner a written communication as to any unremediated material weaknesses in its internal control over financial reporting noted during an audit. The communication must describe any unremediated material weaknesses or state that no unremediated material weaknesses were noted. The communication must be prepared by the accountant within 60 days after the filing of the annual audited financial report. 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.

N.J.A.C. 11:2-26.12 is proposed to be amended to change references to the American Institute of Certified Public Accountants to AICPA.

N.J.A.C. 11:2-26.13 is proposed to be amended to change the heading from "Availability and maintenance of workpapers" to "Availability and maintenance of independent certified public accountants' workpapers." Also proposed is to change a reference to "examination" to "audit," and change from 10 to seven years the maximum period for the accountant to retain the audit workpapers and communications from the date the accountant submits the audit report to the insurer.

A new N.J.A.C. 11:2-26.14 is being proposed headed "Requirements for audit committees." The proposed section does 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. However, unlike the NAIC model, this proposal excludes from this exemption those entities that are statutorily required to comply with audit committee requirements pursuant to N.J.S.A. 17:27A-4(d) (domestic members of a holding company system) and entities required to comply with N.J.A.C. 11:27-12.1, which imposes specific audit committee requirements on medical malpractice insurers. The proposed section sets forth the responsibilities of audit committees, establishes the criteria for membership on an audit committee and sets forth the procedure for designating audit committees. The proposed section further requires that audit committees require accountants that perform audits for insurers and for insurers that are members of an insurance holding company system to timely report to the audit committee pursuant to certain established professional standards described in the proposed section. The proposed section additionally sets forth criteria that must be met or exceeded for

establishing permissible proportions of independent directors, committee members or audit committee members.

A new N.J.A.C. 11:2-26.15 is being proposed headed "Conduct of insurer in connection with the preparation of required reports and documents." The proposed section sets forth specific conduct in which directors and officers of an insurer are prohibited from engaging relating to an accountant's preparation of reports and documents.

A new N.J.A.C. 11:2-26.16 is being proposed headed "Management's report of internal control over financial reporting." This proposed section requires insurers who must file an audited financial report and who have annual direct written and assumed premiums of \$500,000,000 or more, excluding premiums reinsured with the Federal Crop Insurance corporation and Federal Flood Program, to file a report with the Commissioner describing the insurer's or group of insurers' internal control over financial reporting. The proposed section sets forth the standards and procedures for filing the report.

N.J.A.C. 11:2-26.17, currently N.J.A.C. 11:2-26.14, is proposed to be amended by changing the heading from "Exemptions" to "Exemptions and effective dates." This proposed section changes the reference to "report on any significant deficiencies in internal controls" to "communication of internal control related matters noted in an audit." The proposed section adds new subsections that exempt foreign or alien insurers required to file management's report of internal control over financial reporting in another state 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. The proposed section establishes the timeframes for domestic and foreign insurers to comply with this subchapter, for independent certified public accountants to comply with the qualification requirements set forth at N.J.A.C. 11:2-26.6, for insurers to comply with the management's report of internal control over financial reporting requirements set forth at N.J.A.C. 11:2-26.16, and for audit committees to comply with the requirements of N.J.A.C. 11:2-26.14.

N.J.A.C. 11:2-26.15 through 26.18 are being recodified as N.J.A.C. 11:2-26.18 through 26.21.

This rule proposal provides for a comment period of 60 days; therefore, pursuant to N.J.A.C. 1:30-3.3(a)5 it is not subject to the provisions of N.J.A.C. 1:30-3.1 and 3.2 governing rulemaking calendars.

Social Impact

The proposed amendments and new rules reflect the national standards set forth in the current NAIC Annual Financial Reporting Model Rule to improve a state's surveillance of the financial condition of insurers by addressing auditor independence, corporate governance and internal control over financial reporting. The amendments and new rules favorably impact consumers and insurers required to comply with its requirements. Improved surveillance of the financial condition of insurers benefits consumers and the industry at large.

Economic Impact

The proposed amendments and new rules reduce the number of consecutive years that an audit partner may participate on the audit of an insurer and prohibits auditors who

provide certain non-audit services to insurers from being considered an independent auditor. However, the amendments and new rules permit insurers with less than \$100 million in direct written and assumed premium in any calendar year to request an exemption from this requirement. Further, all insurers that are required to file an annual audited financial report with the Commissioner are also required to have an audit committee and, depending on various premium thresholds, a certain percentage of the audit committee members must be independent from the insurer. Insurers with less than \$500 million in direct and assumed premium, however, may apply for a waiver from the audit committee requirement. The amendments and new rules further require that management of insurance companies with \$500 million or more in direct and assumed premium file a report with the Commissioner regarding its assessment of internal control over financial reporting. Insurers are also required to file with the Commissioner a written communication regarding any unremediated material weaknesses in its internal control over financial reporting noted during an audit. Insurers may be negatively impacted to the extent they incur additional costs in complying with the proposed requirements. However, the long-term benefits of enhanced industry oversight and consumer protection outweigh any additional costs.

Federal Standards Statement

A Federal standards analysis is not required because the proposed amendments and new rules are not subject to any Federal requirements or standards.

Jobs Impact

The Department does not anticipate that any jobs will be generated or lost as a result of the proposed amendments and new rules. The Department invites commenters to submit any data or studies regarding the jobs impact of this proposal, together with any written comments on any other aspects of the proposal.

Agriculture Industry Impact

The proposed amendments and new rules will not have any impact on the agriculture industry in New Jersey.

Regulatory Flexibility Analysis

The proposed amendments and new rules may apply to “small businesses” as that term is defined in the Regulatory Flexibility Act, N.J.S.A. 52:14B-16 et seq. These small businesses would be insurers required to conduct annual audits and file a communication of internal control related matters noted in an audit and management’s report of internal control over financial reporting. The potential costs of complying with these requirements are outlined in the Economic Impact above. The Department notes that, pursuant to N.J.A.C. 11:2-26.14, insurers having direct premiums written in this State of less than \$1 million in any calendar year and less than 1,000 policyholders or certificate holders at the end of such calendar year are exempt from the subchapter for such year, except under limited circumstances. Direct premiums written and number of policyholders are indicative of insurer size. Additionally, as stated in the Economic Impact above, the proposed amendments and new rules permit certain exemptions from the proposed amendments and new rules dependent on insurer size, thereby minimizing any adverse economic impact on small business insurers meeting the exemption criteria.

The proposed amendments and new rules do not necessitate additional professional services because they do not expand the criteria that prescribe which insurers must retain an independent CPA and file results of an annual audit.

Smart Growth Impact

The proposed amendments and new rules have no impact on the achievement of smart growth and implementation of the State Development and Redevelopment Plan.

Housing Affordability Impact

The proposed amendments and new rules have no impact on housing affordability. The proposed amendments and new rules affect the State's surveillance of the financial condition of insurers.

Smart Growth Development Impact

The proposed amendments and new rules have no impact on housing production in Planning Areas 1 and 2, or within designated centers, under the State Plan. The proposed amendments and new rules affect the State's surveillance of the financial condition of insurers.

Full text of the proposal follows (additions indicated in boldface **thus**; deletions indicated in brackets [thus]):

SUBCHAPTER 26. ANNUAL [AUDITED] FINANCIAL REPORT[S]ING

11:2-26.1 Purpose

(a) The purpose of this subchapter is to improve the Department's surveillance of the financial position of insurers by requiring [an]: **1. An annual [examination] audit** by independent certified public accountants of the financial statements reporting the financial position and the results of operations of insurers; **2. Communication of internal control related matters noted in an audit;** and **3. Management's report of internal control over financial reporting.**

(b) (No change.)

11:2-26.2 Scope

This subchapter shall apply to all insurers transacting business in the State of New Jersey except as provided at N.J.A.C. 11:2-[26. 14] **26.17**.

11:2-26.3 Definitions

The following words and terms, when used in this subchapter, shall have the following meanings, unless the context clearly indicates otherwise.

"Accountant" and "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 they are licensed to practice; for alien insurers, it means a chartered or similarly certified accountant.

"Affiliate" of, or person "affiliated" with, a specific person, means 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.

...

"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, and 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 subchapter at the election of the controlling person if it meets the requirements of N.J.S.A. 17:27A-4d(5).

...

"Controlling person" means the same as that term is defined in N.J.S.A. 17:27A-1.

...

"Group of insurers" means those licensed insurers included in the reporting requirements of N.J.S.A. 17:27A-1 et seq. or a set of insurers as identified by management, for the purpose of assessing the effectiveness of internal controls over financial reporting.

...

"Independent board member" has the same meaning as described in N.J.A.C. 11:2-26.14(c).

...

“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, that is, those items specified in N.J.A.C. 11:2-26.5(b), 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, that is, those items specified in N.J.A.C. 11:2-26.5(b); 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, that is, those items specified in N.J.A.C. 11:2-26.5(b).

“SEC” means the United States Securities and Exchange Commission.

“Section 404” means Section 404 of the Sarbanes-Oxley Act of 2002, 15 U.S.C. §7262, and the SEC’s rules and regulations promulgated thereunder.

“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 N.J.A.C. 11:2-26.3.

“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: 1. The preapproval requirements of Section

201 (Section 10A(i) of the Securities Exchange Act of 1934), 15 U.S.C. §78j-1(g) and (h); 2. The Audit committee independence requirements of Section 301 (Section 10A(m)(3) of the Securities Exchange Act of 1934) 15 U.S.C. §78j-1(m); and 3. The internal control over financial reporting requirements of Section 404 (Item 308 of SEC Regulation S-K), 15 U.S.C. §7262.

"Workpapers" means 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 his or her [examination] **audit** of the financial statements of an insurer. Workpapers 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 [examination] **audit** of the financial statements of an insurer and which support his or her opinion thereof.

11:2-26.4 Filing of annual audited financial reports; extensions for filing of annual audited financial reports and audit committee appointment

(a) All insurers (unless exempted pursuant to N.J.A.C. 11:2-[26. 14] **26.17**) 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 upon 90 days advance written notice to the insurer.

(b) (No change.)

(c) If an extension is granted in accordance with the provisions in (b) above, a similar extension of 30 days is granted for 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 subchapter shall designate a group of individuals as constituting its audit committee as that term is defined in N.J.A.C. 11:2-26. 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 subchapter at the election of the controlling person.

11:2-26.5 Contents of annual audited financial report

(a) (No change).

(b) The annual audited financial report shall include:

1. – 5. (No change.)

6. Notes to financial statements. These notes shall be those required by the appropriate **National Association of Insurance Commissioners (NAIC)** Annual Statement Instructions and the NAIC Accounting Practices and Procedures Manual. The notes shall also include a reconciliation of differences, if any, between the audited statutory financial statements and the annual statement filed pursuant to N.J.S.A. 17:23-1 and 17B:21-1 with a written description of the nature of these differences.

(c) (No change).

11:2-26.6 Qualifications of independent certified public accountants

(a) The Commissioner shall not recognize any person or firm as a qualified independent certified public accountant if the person or firm:

1. Is not in good standing with the American Institute of Certified Public Accountants (**AICPA**) and in all states in which the accountant is licensed to practice or, for alien insurers, if the person or firm is not a chartered or similarly certified accountant; or

2. (No change.)

(b) Except as otherwise provided herein, 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 [American Institute of Certified Public Accountants] **AICPA** and **the** Rules and Regulations, Code of Ethics and Rules of Professional Conduct of the New Jersey Board of Public Accountancy or similar code.

(c) (No change.)

(d) No partner or other person responsible for rendering a report may act in that capacity for more than [seven] **five** consecutive years. Following any period of service such 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 [two] **five** years. An insurer may make application to the Commissioner for relief from the above rotation requirement on the basis of unusual circumstances. The Commissioner may consider the

following factors in determining if the relief should be granted: [1. The] **the** number of partners, expertise of the partners or the number of insurance clients in the currently registered firm; [2. The] **the** premium volume of the insurer; [or] **and** [3. The] **the** number of jurisdictions in which the insurer transacts business. **If such relief is granted, the insurer shall file, with its annual statement filing, the approval for relief from this subsection with the states in which it is licensed or doing business and with the National Association of Insurance Commissioners (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) – (f) (No change.)

(g) 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:

1. Bookkeeping or other services related to the accounting records or financial statements of the insurer;

2. Financial information systems design and implementation;

3. Appraisal or valuation services, fairness opinions, or contribution-in-kind reports;

4. Actuarially-oriented advisory services involving the determination of amounts recorded in the financial statements. The accountant may assist an insurer in understanding the methods, assumptions

and inputs used in the determination of amounts recorded in the financial statement only if it is reasonable to conclude that the services provided will not be subject to audit procedures during an audit of the insurer's financial statements. An accountant's actuary may also issue an actuarial opinion or certification ("opinion") on an insurer's reserves if the following conditions have been met:

i. Neither the accountant nor the accountant's actuary has performed any management functions or made any management decisions;

ii. The insurer has competent personnel (or engages a third party actuary) to estimate the reserves for which management takes responsibility; and

iii. The accountant's actuary tests the reasonableness of the reserves after the insurer's management has determined the amount of the reserves;

5. Internal audit outsourcing services;

6. Management functions or human resources;

7. Broker or dealer, investment advisor, or investment banking services;

8. Legal services or expert services unrelated to the audit; or

9. Any other services that the Commissioner determines, by regulation, are impermissible.

(h) 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.

(i) Insurers having direct written and assumed premiums of less than \$100,000,000 in any calendar year may request an exemption from (g) above. 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 subchapter would constitute a financial or organizational hardship upon the insurer, an exemption may be granted.

(j) 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 (g) above or that do not conflict with (g) above, only if the activity is approved in advance by the audit committee in accordance with (k) below.

(k) 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 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.

(l) The audit committee may delegate to one or more designated members of the audit committee the authority to grant the preapprovals required by subsection (k) above. The decisions of any member(s) to whom this authority is delegated shall be presented to the full audit committee at each of its scheduled meetings.

(m) 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 prohibition shall only apply to partners and senior managers of the independent certified public accountant involved in the audit. An insurer may make application to the Commissioner for relief from the above requirement on the basis of unusual circumstances. The insurer shall file, with its annual statement filing, the approval for relief from the qualified independent certified public accountant requirements with the states in which it is licensed or doing business 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.

11:2-26.9 Scope of [examination] audit and report

Financial statements furnished pursuant to N.J.A.C. 11:2-26.5 shall be examined by [an] **the** independent certified public accountant. The [examination] **audit** of the insurer's financial statements shall be conducted in accordance with generally accepted auditing standards. **In accordance with 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 16 of this subchapter, 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 [should also] **shall** be given to [such other] **the** procedures illustrated in the Financial Condition Examiner's Handbook promulgated by the National Association of Insurance Commissioners as the independent certified public accountant deems necessary.

11:2-26.10 Notification of adverse financial condition

(a) An insurer required to furnish the annual audited financial report shall require the independent certified public accountant to report in writing within five 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 [examination] **audit** or that the insurer does not meet the minimum capital and surplus requirements as of that date. An insurer who has received a report pursuant to this section shall forward a copy of the report to the Commissioner within five business days of receipt of such 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 such evidence within the required five-business-day period, the independent certified public accountant shall furnish to the

Commissioner a copy of its report within the next five business days. No independent **certified** public accountant shall be liable in any manner to any person for any statement made in connection with this subsection if such statement is made in good faith in compliance with this subsection.

(b) (No change.)

11:2-26.11 [Report on significant deficiencies in internal controls]

Communication of internal control related matters noted in an audit

(a) In addition to the annual audited financial report, each insurer shall file with the Commissioner a written [report] **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 [describing any significant deficiencies known as "reportable conditions" in the insurer's internal control structure noted by the accountant during the audit which an accountant is required to report to appropriate parties within an entity pursuant to SAS No. 60, Communication of Internal Control Structure Matters Noted in an Audit (AU Section 325 of the Professional Standards of the American Institute of Certified Public Accountants.) **within 60 days after the filing of the annual audited financial report, and shall contain a description of any unremediated material weakness (as that term is defined by the 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 N.J.A.C. 11:2-26.4) 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.

(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.

[(b) No report should be issued if the accountant does not identify one or more significant deficiencies.

(c) If one or more significant deficiencies are noted, the written report shall be filed annually by the insurer with the Department within 60 days after the filing of the annual audited financial report. The insurer shall provide a description of remedial actions taken or proposed to correct significant deficiencies, if such actions are not described in the accountant's report.]

11:2-26.12 Accountant's letter of qualifications

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

1. That the accountant is independent with respect to the insurer and conforms to the standards of the profession as contained in the Code of Professional Ethics and pronouncements of the American Institute of Certified Public Accountants

(AICPA) and the Rules of Professional Conduct of the New Jersey Board of Public Accountancy, or similar code;

2. – 4. (No change.)

5. A representation that the accountant is properly licensed by an appropriate state licensing authority and that he is a member in good standing in the [American Institute of Certified Public Accountants] **AICPA**; and

6. (No change.)

11:2-26.13 Availability and maintenance of independent certified public accountants' workpapers

(a) Every insurer required to file an audited financial report pursuant to this subchapter shall require the accountant to make available for review by the Commissioner, all the workpapers prepared in the conduct of his or her [examination] **audit** and any communications related to the audit between the accountant and the insurer, at the offices of the insurer, at the Department or at any other reasonable place designated by the Commissioner. The insurer shall require that the accountant retain the audit workpapers and communications until the Department has filed a Report on Examination covering the period of the audit and determined that the audit workpapers and communications need no longer be retained or for no longer than [10] **seven** years from the date the accountant submits the audit report to the insurer, whichever occurs first.

(b) (No change.)

11:2-26.14 Requirements for audit committees

(a) 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 not otherwise required to establish a committee in accordance with N.J.S.A. 17:27A-4(d) and/or N.J.A.C. 11:27-12.1.

(b) 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 subchapter. Each accountant shall report directly to the audit committee.

(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 (f) below and the definition of "audit committee" as set forth in N.J.A.C. 11:2-26.3.

(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.

(e) If a member of the audit committee ceases to be independent for

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

(f) To exercise the election of the controlling person to designate the audit committee for purposes of this subchapter, the ultimate controlling person shall provide written notice to the state regulatory official of the affected insurer's state of domicile. Notification shall be made timely prior to the issuance of the statutory audit report and include a description of the basis for the election. The election can be changed through notice to the Commissioner by the insurer, which shall include a description of the basis for the change. The election shall remain in effect for perpetuity, until rescinded.

(g) The audit committee shall require the accountant that performs for an insurer any audit required by this subchapter to timely report to the audit committee in accordance with the requirements of SAS 61, Communication with Audit Committees, or its replacement, including:

1. All significant accounting policies and material permitted practices;
2. 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

3. Other material written communications between the accountant and the management of the insurer, such as any management letter or schedule of unadjusted differences.

(h) If an insurer is a member of an insurance holding company system, the reports required by (g) above 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.

(i) The proportion of independent directors, committee members or audit committee members shall meet or exceed the following criteria:

1. Not less than one-third of the directors of a domestic insurer, and not less than one-third of the members of each committee of the board of directors of any domestic insurer, shall be persons who are not officers or employees of that insurer or of any entity controlling, controlled by, or under common control with, that insurer and who are not beneficial owners of a controlling interest in the voting securities of that insurer or any such entity. At least one such person shall be included in any quorum for the transaction of business at any meeting of the board of directors or any committee thereof.

2. The board of directors of a domestic insurer shall establish one or more committees, including an audit committee, comprised solely of

directors who are not officers or employees of the insurer or of any entity controlling, controlled by, or under common control with, the insurer and who are not beneficial owners of a controlling interest in the voting securities of the insurer or any such entity. The committee shall be responsible for recommending the selection of independent certified public accountants, reviewing the insurer's financial condition, the scope and results of the independent audit and any internal audit, nominating candidates for director for election by shareholders or policyholders, evaluating the performance of officers deemed to be principal officers of the insurer and recommending to the board of directors the selection and compensation, including bonuses or other special payments, of the principal officers.

3. The provisions of (i)1 and 2 above shall not apply to a domestic insurer if the person controlling the insurer is an entity having a board of directors and committees thereof that substantially meet the requirements of those paragraphs.

11:2-26.15 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 subchapter; 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 subchapter.

(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 subchapter 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 (b) above, actions that "if successful, could result in rendering the insurer's financial statements materially misleading" include, but are not limited to, actions taken at any time with respect to the professional engagement period to coerce, manipulate, mislead or fraudulently influence an accountant:

1. To issue or reissue a report on an insurer's financial statements that is not warranted in the circumstances (due to material violations of statutory accounting principles prescribed by the Commissioner, generally accepted auditing standards, or other professional or regulatory standards);

2. Not to perform audit, review or other procedures required by generally accepted auditing standards or other professional standards;

3. Not to withdraw an issued report; or

4. Not to communicate matters to an insurer's audit committee.

11:2-26.16 Management's report of internal control over financial reporting

(a) Every insurer required to file an audited financial report pursuant to this subchapter that has annual direct written and assumed premiums of \$500,000,000 or more, excluding premiums reinsured with the Federal Crop Insurance Corporation and Federal Flood Program, shall prepare a report of the insurer's or group of insurers' internal control over financial reporting, as these terms are defined in N.J.A.C. 11:2-26.3. The report shall be filed with the Commissioner, along with the Communication of Internal Control Related Matters Noted in an Audit described in N.J.A.C. 11:2-26.11. Management's Report of Internal Control over Financial Reporting shall be as of December 31 of the immediately preceding year.

(b) Notwithstanding the premium threshold in (a) above, 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 as that term is defined in N.J.A.C. 11:2-39.2, or meets any one or more of the standards of an insurer deemed to be in hazardous financial condition as defined in N.J.S.A. 17:47A-2.

(c) An insurer or a group of insurers that is directly subject to Section 404, part of a holding company system whose parent is directly subject to

Section 404, not directly subject to Section 404 but is a SOX Compliant Entity or 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's 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 N.J.A.C. 11:2-26.5(b)2 through 6) 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 N.J.A.C. 11:2-26.5(b)2 through 6 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 a report under this section, or the Section 404 Report and a report under this section 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;

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 (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 (a) above, and any documentation provided in support thereof during the course of a financial condition examination, shall be deemed by the Department to be confidential information.

11:2-[26.14] 26.17 Exemptions and effective dates

(a) (No change.)

(b) **[Insurers] Foreign or alien insurers** filing audited financial reports in another state, pursuant to such other state's requirement of audited financial reports

which have been found by the Commissioner to be substantially similar to the requirements herein, are exempt from compliance with this subchapter if:

1. A copy of the audited financial report, **communication of internal control related matters noted in an audit**, [the report on any significant deficiencies in internal controls,] and the accountant's letter of qualifications which are filed with such other state are filed with the Commissioner in accordance with the filing dates specified in N.J.A.C. 11:2-26.4, 26.11 and 26.12 respectively (Canadian insurers may submit accountants' reports as filed with the Canadian Dominion Department of Insurance); and
2. (No change.)

(c) 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.

(d) Domestic insurers who have retained a certified public accountant on or before the effective date of this subchapter who qualifies as independent shall comply with this subchapter for the year ending December 31, 2010 and each year thereafter unless the Commissioner permits otherwise.

(e) Domestic insurers who have not retained a certified public accountant on or before the effective date of this subchapter who qualifies as independent may meet the following schedule for compliance unless the Commissioner permits otherwise:

1. As of December 31, 2010, file with the Commissioner an audited financial report; and

2. For the year ending December 31, 2011, and each year thereafter, such insurers shall file with the Commissioner all reports and communication required by this subchapter.

(f) Foreign insurers shall comply with this subchapter for the year ending December 31, 2010 and each year thereafter unless the Commissioner permits otherwise.

(g) The requirements for independent certified public accountants set forth at N.J.A.C. 11:2-26.6 shall be in effect for audits of the year beginning January 1, 2010 and each year thereafter.

(h) The requirements for management's report of internal control over financial reporting set forth at N.J.A.C. 11:2-26.16 of this subchapter 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 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 calendar years following the date of acquisition or combination to comply with the reporting requirements.

(i) The requirements for audit committees as set forth in N.J.A.C. 11:2-26.14 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 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 calendar year following the date of acquisition or combination to comply with the independence requirements.

[(c)] **(j)** (No change in text.)

Recodifying existing N.J.A.C. 11:2-26.15 through 26.18 as **26.18 through 26.21** (No change in text.)

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