

## **BILL ANALYSIS**

Senate Research Center  
81R11262 TJS-F

H.B. 2752  
By: Eiland (Averitt)  
Business & Commerce  
5/11/2009  
Engrossed

### **AUTHOR'S / SPONSOR'S STATEMENT OF INTENT**

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, 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 amends current law relating to independent audits of insurer financial statements and insurer internal controls.

### **RULEMAKING AUTHORITY**

This bill does not expressly grant any additional rulemaking authority to a state officer, institution, or agency.

### **SECTION BY SECTION ANALYSIS**

SECTION 1. Amends Section 401.001, Insurance Code, by adding Subdivisions (2-a), (2-b), (4-a), (4-b), (6), (7), (8), and (9) and amending Subdivision (4), to define "audit committee," "group of insurers," "internal control over financial reporting," "management," "SEC," "Section 404," "Section 404 report," and "SOX-compliant entity" and redefine "insurer."

SECTION 2. Amends Sections 401.002, 401.003, and 401.004, Insurance Code, as follows:

Sec. 401.002. PURPOSE OF SUBCHAPTER. Provides that the purpose of this subchapter is to require an annual audit by an independent certified public accountant of the financial statements reporting the financial condition and the results of operations of each insurer, rather than require an annual audit of the results of operations of each insurer or health maintenance organization; require communication of internal control related matters noted in an audit; and require management to report on internal control over financial reporting.

Sec. 401.003. EFFECT OF SUBCHAPTER ON AUTHORITY TO EXAMINE. Makes a conforming change.

Sec. 401.004. FILING AND EXTENSIONS FOR FILING OF AUDITED FINANCIAL REPORT. (a) Makes a conforming change.

(b) Makes conforming changes.

(c) Makes conforming changes. Provides that an extension granted under this subsection also applies to the filing of management's report on internal control over financial reporting.

(d) Requires an insurer required to file an annual audited financial report under this subchapter to designate a group of individuals to serve as its audit committee. Authorizes the audit committee of an entity that controls an insurer to, at the election of the controlling person, be the insurer's audit committee for purposes of this subchapter.

SECTION 3. Amends the heading to Section 401.005, Insurance Code, to read as follows:

Sec. 401.005. ALTERNATIVE FILING FOR CANADIAN OR BRITISH INSURERS.

SECTION 4. Amends Section 401.005(a), Insurance Code, to make conforming changes.

SECTION 5. Amends Section 401.006, Insurance Code, as follows:

Sec. 401.006. New heading: EXEMPTION FOR CERTAIN SMALL INSURERS. (a)-(c) Makes conforming changes.

SECTION 6. Amends the heading to Section 401.007, Insurance Code, to read as follows:

Sec. 401.007. EXEMPTION FOR CERTAIN FOREIGN OR ALIEN INSURERS.

SECTION 7. Amends Sections 401.007(a) and (b), Insurance Code, to make conforming changes.

SECTION 8. Amends Section 401.008, Insurance Code, as follows:

Sec. 401.008. HARDSHIP EXEMPTION. (a)-(c) Makes conforming changes.

SECTION 9. Amends Sections 401.009(a), (b), and (c), Insurance Code, to make conforming changes.

SECTION 10. Amends Section 401.010, Insurance Code, as follows:

Sec. 401.010. REQUIREMENTS FOR FINANCIAL STATEMENTS IN AUDITED FINANCIAL REPORT. (a) Makes a conforming change.

(a-1) Requires the accountant, in accordance with "Consideration of Internal Control in a Financial Statement Audit," AU Section 319, Professional Standards of the American Institute of Certified Public Accountants, to obtain an understanding of internal control sufficient to plan the audit. Requires the accountant, to the extent required by AU Section 319, for those insurers required to file a management's report of internal control over financial reporting under Section 401.024, to consider the most recently available report in planning and performing the audit of the statutory financial statements. Defines "consider."

(b) Makes conforming changes.

SECTION 11. Amends Section 401.011, Insurance Code, by amending Subsections (a), (b), and (c) and adding Subsections (c-1), (e), (f), (g), (h), (i), (j), (k), (l), and (m), as follows:

(a) Requires the commissioner of insurance (commissioner), except as provided by Subsections (c), (d) (relating to prohibiting the commissioner from accepting a certain report), (e), (f), (g), and (l), to accept an audited financial report from a certain independent certified public accountant or accounting firm.

(b) Makes conforming changes.

(c) Prohibits a lead partner or other person responsible for rendering a report for an insurer for five consecutive years, during the five-year period after that fifth year, rather than for seven consecutive years, during the two-year period after that seventh year, render a report for the insurer or for a subsidiary or affiliate of the insurer that is engaged in the business of insurance. Authorizes the commissioner, on application made at least 30 days before the end of the calendar year, to determine that the limitation provided by this subsection does not apply to an accountant for particular insurer if the insurer meets certain conditions. Makes nonsubstantive and conforming changes.

(c-1) Requires an insurer for which the commissioner has approved an exception under Subsection (c), 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). Requires the insurer, if a state other than this state accepts electronic filing with the (NAIC), to file the approval in an electronic format acceptable to the (NAIC).

(e) 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.

(f) Prohibits the commissioner from recognizing as qualified an accountant, or 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 certain services.

(g) Authorizes an accountant, notwithstanding Subsection (f)(4) (relating to actuarially oriented advisory services involving the determination of amounts recorded in the financial statements), 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. Authorizes an accountant's actuary to also issue an actuarial opinion or certification on an insurer's reserves if the accountant or the accountant's actuary has 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.

(h) 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 of Subsection (f) by filing with the commissioner a written statement explaining why the insurer should be exempt. Authorizes the commissioner to grant the exemption if the commissioner finds that compliance with Subsection (f) would impose an undue financial or organizational hardship on the insurer.

(i) Authorizes an accountant who performs an audit to perform nonaudit services, including tax services, that are not described in Subsection (f) or that do not conflict with Subsection (e) only if the activity is approved in advance by the audit committee in accordance with Subsection (j).

(j) Requires the audit committee to approve in advance all auditing services and nonaudit services that an insurer's accountant provides to the insurer. Provides 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 a SOX-compliant entity or the aggregate amount of all nonaudit services provided to the insurer is not more than five percent of the total amount of fees paid by the insurer to its accountant during the fiscal year in which the nonaudit services are provided; the services were not recognized by the insurer at the time of the engagement to be nonaudit services; and the services are promptly brought to the attention of the audit committee and approved before

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 the audit committee has delegated authority to grant approvals.

(k) Authorizes the audit committee to delegate to one or more designated members of the audit committee the authority to grant the prior approval required by Subsection (i). Requires that the decisions of any member to whom this authority is delegated be presented to the full audit committee at each of its scheduled meetings.

(l) 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. Provides that this subsection applies only to partners and senior managers involved in the audit. Authorizes an insurer to apply to the commissioner for an exemption from the requirements of this subsection on the basis of unusual circumstances.

(m) Requires the insurer to file, with its annual statement filing, the approval of an exemption granted under Subsection (h) or (l) with the states in which it does or in which it is authorized to do business and NAIC. Requires the insurer, if a state other than this state in which the insurer does or in which it is authorized to do business accepts electronic filing, to file the approval in an electronic format acceptable to NAIC.

SECTION 12. Amends Section 401.012, Insurance Code, as follows:

Sec. 401.012. HEARING ON ACCOUNTANT QUALIFICATIONS; REPLACEMENT OF ACCOUNTANT. Makes a conforming change.

SECTION 13. Amends Section 401.013(a), Insurance Code, to make conforming changes.

SECTION 14. Amends Section 401.014(a) and (b), Insurance Code, to makes conforming changes.

SECTION 15. Amends Sections 401.015(a), (b), and (d), Insurance Code, to make conforming changes.

SECTION 16. Amends Sections 401.016 and 401.017, Insurance Code, as follows:

Sec. 401.016. AUDITED COMBINED OR CONSOLIDATED FINANCIAL STATEMENTS. (a) Authorizes an insurer described by Section 401.001, rather than Section 401.001(3) or (4), that is required to file an audited financial report under this subchapter to apply in writing to the commissioner for approval to file audited combined or consolidated financial statements instead of separate audited financial reports if the insurer meets certain conditions. Makes conforming changes.

(b)-(d) Makes conforming changes.

Sec. 401.017. NOTICE OF ADVERSE FINANCIAL CONDITION OR MISSTATEMENT OF FINANCIAL CONDITION. (a)-(d) Makes conforming changes.

SECTION 17. Amends Section 401.019, Insurance Code, as follows:

Sec. 401.019. New heading: COMMUNICATION OF INTERNAL CONTROL MATTERS NOTED IN AUDIT. (a) Requires each insurer, in addition to the audited financial report required by this subchapter, to provide the commissioner a written communication prepared by an accountant in accordance with the Professional Standards of the American Institute of Certified Public Accountants that describes any unremediated material weaknesses in its internal controls over financial reporting noted during the audit, rather than a written report of significant deficiencies required and

prepared by an accountant in accordance with the Professional Standards of the American Institute of Certified Public Accountants. Makes a conforming change.

(b) Requires the insurer to annually file with the commissioner the communication, rather than the report, required by this section by a certain date. 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. Requires that the communication affirmatively state if unremediated material weaknesses were not noted by the accountant. Makes a conforming change.

(c) Requires the insurer to also provide a description of remedial actions taken or proposed to be taken to correct unremediated material weaknesses, rather than significant deficiencies, if the actions are not described in the accountant's communication. Makes conforming changes.

(d) Redesignates Subsection (c) as Subsection (d).

SECTION 18. Amends Sections 401.020(a) and (b), Insurance Code, as follows:

(a) Redefines "work papers."

(b) Makes conforming changes.

SECTION 19. Amends the heading to Section 401.021, Insurance Code, to read as follows:

Sec. 401.021. COMMISSIONER-ORDERED AUDIT.

SECTION 20. Amends Sections 401.021(a), (b), and (c), Insurance Code, to make conforming changes.

SECTION 21. Amends Subchapter A, Chapter 401, Insurance Code, by adding Sections 401.022, 401.023, 401.024, and 401.025, as follows:

Sec. 401.022. REQUIREMENTS FOR AUDIT COMMITTEES. (a) Provides that this section does not apply to foreign or alien insurers authorized in this state or to an insurer that is a SOX-compliant entity or a direct or indirect wholly owned subsidiary of a SOX-compliant entity.

(b) Requires an insurer to which this subchapter applies to establish an audit committee conforming to the following criteria: an insurer with over \$500 million in direct written and assumed premiums for the preceding calendar year is required to establish an audit committee with an independent membership of at least 75 percent; and an insurer with \$300 million to \$500 million in direct written and assumed premiums for the preceding calendar year is required to establish an audit committee with an independent membership of at least 50 percent.

(c) Authorizes the commissioner to require the insurer's board to enact improvements to the independence of the audit committee membership if the insurer is in a risk-based capital action level event, meets one or more of the standards of an insurer considered to be in hazardous financial condition, or otherwise exhibits qualities of a troubled insurer.

(d) Authorizes an insurer with direct written and assumed premiums, excluding premiums reinsured with the Federal Crop Insurance Corporation and the National Flood Insurance Program, of less than \$500 million to apply to the commissioner for a waiver from the requirements of this section based on hardship. Requires the insurer to file, with its annual statement filing, the

approval of a waiver under this subsection with the states in which it does or is authorized to do business and with NAIC. Requires the insurer, if a state other than this state accepts electronic filing, to file the approval in an electronic format acceptable to NAIC.

(e) Provides that in this section, premiums that are 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.

(f) 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 this subchapter. Requires each accountant to report directly to the audit committee.

(g) Requires each member of the audit committee to be a member of the board of directors of the insurer or a member of the board of directors of an entity elected under Subsection (j) and described under Section 401.001(2-a).

(h) Prohibits a member of the audit committee, to be independent for purposes of this section, other than in the person's capacity as a member of the audit committee, the board of directors, or any other board committee, from accepting any consulting, advisory, or other compensatory fee from the entity or being an affiliated person of the entity or any subsidiary of the entity. Provides that to the extent of any conflict with another statute requiring an otherwise nonindependent board member to participate in the audit committee, the other statute prevails and controls, and authorizes the member to participate in the audit committee unless the member is an officer or employee of the insurer or an affiliate of the insurer.

(i) Authorizes the member, if a member of the audit committee ceases to be independent for reasons outside the member's reasonable control, to remain an audit committee member of the responsible entity if the responsible entity gives notice to the commissioner until the earlier of: the next annual meeting of the responsible entity or the first anniversary of the occurrence of the event that caused the member to be no longer independent.

(j) Requires the ultimate controlling person, to exercise the election of the controlling person to designate the audit committee under this subchapter, to provide written notice of the affected insurers to the commissioner. Requires that notice be made before the issuance of the statutory audit report and include a description of the basis for the election. Authorizes that the election be changed through a notice to the commissioner by the insurer, which is required to include a description of the basis for the change. Provides that an election remains in effect until changed by later election.

(k) 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, including: all significant accounting policies and material permitted practices; all material alternative treatments of financial information in statutory accounting principles that have been discussed with the insurer's management officials; ramifications of the use of the alternative disclosures and treatments, if applicable, and the treatment preferred by the accountant; and other material written communications between the accountant and the management of the insurer, such as any management letter or schedule of unadjusted differences.

(l) Authorizes the report required by Subsection (k), if an insurer is a member of an insurance holding company system, 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.

Sec. 401.023. PROHIBITED CONDUCT IN CONNECTION WITH PREPARATION OF REQUIRED REPORTS AND DOCUMENTS. (a) 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 an audit, review, or communication required by this subchapter or 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 audit, review, or communication required under this subchapter.

(b) Prohibits an officer or director of an insurer, or another person acting under the direction of an officer or director of an insurer, from directly or indirectly coercing, manipulating, misleading, or fraudulently influencing an accountant performing an audit under 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) Provides that, for purposes of Subsection (b), actions that could result in rendering the insurer's financial statements materially misleading include actions taken at any time with respect to the professional engagement period to coerce, manipulate, mislead, or fraudulently influence an accountant to issue or reissue a report on an insurer's financial statements that is not warranted and would result in material violations of statutory accounting principles prescribed by the commissioner, generally accepted auditing standards, or other professional or regulatory standards, not to perform an audit, review, or other procedure required by generally accepted auditing standards or other professional standards, not to withdraw an issued report, or not to communicate matters to an insurer's or health maintenance organization's audit committee.

Sec. 401.024. MANAGEMENT'S REPORT OF INTERNAL CONTROL OVER FINANCIAL REPORTING. (a) Requires each insurer required to file an audited financial report under this subchapter that has annual direct written and assumed premiums, excluding premiums reinsured with the Federal Crop Insurance Corporation and the National Flood Insurance Program, of \$500 million or more to prepare a report of the insurer's or group of insurers' internal control over financial reporting. Requires that the report be filed with the commissioner with the communication described by Section 401.019. Requires that the report of internal control over financial reporting be as of the immediately preceding December 31.

(b) Authorizes the commissioner, notwithstanding the premium threshold under Subsection (a), 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 as described by Chapter 404 (Financial Condition).

(c) Authorizes an insurer or a 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 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.

(d) Requires that a Section 404 report described by Subsection (c) 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, including those items listed in Sections 401.009(a)(3)(B)-(H) (relating to the inclusion of a balance sheet that reports admitted assets, liabilities, capital, and surplus; a statement of gain or loss from operations; a statement of cash

flows; a statement of changes in capital and surplus, any notes to financial statements; certain date and information; certain required information) and (b). Requires that the addendum 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, including those items listed in Sections 401.009(a)(3)(B)-(H) and (b), excluded from the Section 404 report. 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 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.

(e) Requires that the insurer's management report of internal control over financial reporting include a statement that management is responsible for establishing and maintaining adequate internal control over financial reporting; a statement that management has established internal control over financial reporting and an opinion concerning whether, to the best of management's knowledge and belief, after diligent inquiry, its internal control over financial reporting is effective to provide reasonable assurance regarding the reliability of financial statements in accordance with statutory accounting principles; a statement that briefly describes the approach or processes by which management evaluates the effectiveness of its internal control over financial reporting; a statement that briefly describes the scope of work that is included and whether any internal controls were excluded; disclosure of any unremediated material weaknesses in the internal control over financial reporting identified by management as of the immediately preceding December 31; a statement regarding the inherent limitations of internal control systems; and signatures of the chief executive officer and the chief financial officer or an equivalent position or title.

(f) Prohibits an insurer's management, for purposes of Subsection (e)(5) (relating to 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.

(g) Requires management to document, and make available on financial condition examination, the basis of the opinions required by Subsection (e). Authorizes management to base opinions, in part, on its review, monitoring, and testing of internal controls undertaken in the normal course of its activities.

(h) Provides 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 may include an assembly of or reference to existing documentation.

(i) Requires the Texas Department of Insurance to maintain the confidentiality of the management's report of internal control over financial reporting required by this section and any supporting documentation provided in the course of a financial condition examination.

Sec. 401.025. TRANSITION DATES. (a) Provides that an insurer or group of insurers whose audit committee as of January 1, 2010, is not subject to the independence requirements of Section 401.022 because the total written and assumed premium is below the threshold under that section, and that later becomes subject to one of the independence 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 independence requirements. Requires an insurer that becomes subject to one of the independence requirements as a result of a business combination to comply with the independence requirements not later than the first anniversary of the date of the acquisition or combination.

(b) Provides that an insurer or group of insurers that is not required by Section 401.024 to file a report 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. 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.

SECTION 22. Repealer: Section 401.001(3) (relating to the definition of health maintenance organization), Insurance Code.

SECTION 23. (a) Effective date, Section 401.011(c), Insurance Code, as amended by this Act: January 1, 2010.

(b) Effective date, Section 401.022, Insurance Code, as added by this Act: January 1, 2010.

(c) Provides that except as provided by Subsections (a) and (b) of this section, Chapter 401, Insurance Code, as amended by this Act, takes effect beginning with the reporting period ending December 31, 2010.

SECTION 24. Effective date, except as otherwise provided by this Act: September 1, 2009.