

AGENDA
FINANCIAL SERVICES COMMISSION
Office of Insurance Regulation
Materials Available on the Web at:
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August 10, 2010

MEMBERS

Governor Charlie Crist
Attorney General Bill McCollum
Chief Financial Officer Alex Sink
Commissioner Charles Bronson

Contact: Monte Stevens
(850-413-2571)

9:00 A. M.
LL-03, The Capitol
Tallahassee, Florida

ITEM	SUBJECT	RECOMMENDATION
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| 1. | Minutes of the Financial Services Commission for April 13, 2010, May 11, 2010 and June 8, 2010. | |
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(ATTACHMENT 1)

FOR APPROVAL

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| 2. | Request for Approval for Adoption of Amendments to Proposed Rule 69O-137.002, Model Audit Rule | |
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Section 624.424(8)(e), F.S., provides that the Financial Services Commission must adopt rules in substantial conformity with the 1998 National Association of Insurance Commissioners (NAIC) Model Audit Rule or subsequent amendments. The NAIC has adopted subsequent amendments to the 1998 Model Audit Rule.

The proposed rule amends the existing rule to conform with the subsequent amendments adopted by NAIC. Interstate uniformity reduces the frictional cost of doing business in Florida. Substantial conformity to the model audit rule is also required for NAIC accreditation.

(ATTACHMENT 2)

APPROVAL FOR FINAL ADOPTION

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| 3. | Request for Approval for Adoption of Amendments to Proposed Rule 69O-167.024 | |
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The Legislature changed the numbering within Section 627.021, F.S. Consequently, this rule needs to be changed to reflect the renumbering. There is no substantive change in the proposed rule.

(ATTACHMENT 3)

APPROVAL FOR FINAL ADOPTION

4. Request for Approval for Publication of Amendments to Proposed Rule 69O-162.203, Adoption of 2001 Commissioners Standard Ordinary (CSO) Ultimate Mortality Tables for Determining Reserve Liabilities for Credit Life Insurance

This rule is being amended due to changes made to the NAIC Model Regulation. The amendment explains the conditions for use of the preferred class structure mortality tables, and permits use of the mortality tables for policies issued prior to the adoption date of the original rule.

(ATTACHMENT 4)

APPROVAL FOR PUBLICATION

5. Request for Approval for Publication of Amendments to Proposed Rule 69O-164.020, Valuation of Life Insurance Policies

This rule is being amended to adopt changes made to the NAIC Model Regulations. The amendment reduces the minimum premium deficiency reserve requirement, subject to certain conditions, to ensure adequacy of reserves.

(ATTACHMENT 5)

APPROVAL FOR PUBLICATION

6. Request for Approval for Publication of Amendments to Proposed Rule 69O-138.047, Description of Actuarial Memorandum

This rule is being amended due to changes made to the NAIC Model Regulations. The amendment adds an additional requirement to the Regulatory Asset Adequacy Issues Summary as a result of changes to Rules 69O-162.203 and 69O-164.020, F.A.C.

The new requirement relates to actuarial principles for the calculation of statutory assets.

(ATTACHMENT 6)

APPROVAL FOR PUBLICATION

**Minutes of the Financial Services Commission
April 13, 2010**

<i>Members</i> Charlie Crist, Governor Alex Sink, Chief Financial Officer Bill McCollum, Attorney General Charles Bronson, Agriculture Commissioner	Presented by: Kevin McCarty Cabinet Meeting Room, Lower Level, The Capitol Tallahassee, Florida 32399
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Item 1: Presentation on Citizens Property Insurance Corporation by Sharon Binnun, Chief Financial Officer and John Forney, Financial Advisor

**Minutes of the Financial Services Commission
May 11, 2010**

<i>Members</i> Charlie Crist, Governor Alex Sink, Chief Financial Officer Bill McCollum, Attorney General Charles Bronson, Agriculture Commissioner	Presented by: Kevin McCarty Cabinet Meeting Room, Lower Level, The Capitol Tallahassee, Florida 32399
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Item 1: Property Insurance Update by Commissioner Kevin McCarty

**Minutes of the Financial Services Commission
June 8, 2010**

<i>Members</i> Charlie Crist, Governor Alex Sink, Chief Financial Officer Bill McCollum, Attorney General Charles Bronson, Agriculture Commissioner	Presented by: Kevin McCarty Cabinet Meeting Room, Lower Level, The Capitol Tallahassee, Florida 32399
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Item 1: Minutes of the Financial Services Commission for March 9, 2010 and March 23, 2010

Upon motion by Agriculture Commissioner Charles Bronson and seconded by Attorney General Bill McCollum, the item was approved.

Item 2: Request for Approval for Adoption of Amendments to Proposed Rule 690-157, .302, .303, .304; Long Term Care, New Business Rates

Upon motion by Chief Financial Officer Alex Sink and seconded by Agriculture Commissioner Charles Bronson, the item was approved.

Item 3: Request for Approval for Publication of Amendments to Proposed Rule 690-137.001; Annual and Quarterly Financial Reporting Requirements

Upon motion by Agriculture Commissioner Charles Bronson and seconded by Attorney General Bill McCollum, the item was approved.

Item 4: Request for Approval for Publication of Amendments to Proposed Rule 690-138.001; NAIC Financial Condition Examiners Handbook

Upon motion by Attorney General Bill McCollum and seconded by Agriculture Commissioner Charles Bronson, the item was approved.

Item 5: Request for Approval for Publication of Amendments to Proposed Rule 690-200.004, .005, .006, .009, .014, .015, .016; Motor Vehicles Manufacturers

Upon motion by Agriculture Commissioner Charles Bronson and seconded by Attorney General Bill McCollum, the item was approved.

Item 6: Request for Approval for Publication of Amendments to Proposed Rule 690-167.024; Rate Filings for Inland Marine Insurance

Upon motion by Attorney General Bill McCollum and seconded by Agriculture Commissioner Charles Bronson, the item was approved.

M E M O R A N D U M

DATE: July 8, 2010
TO: Kevin M. McCarty, Commissioner, Office of Insurance Regulation
THROUGH: Steven H. Parton, General Counsel
FROM: Dennis Threadgill *SKT*
Bob Prentiss *BP*
SUBJECT: Cabinet Agenda for August 10, 2010
Request for Final Approval to Adopt Amendments to
Rule 69O-137.002
Assmt. 44303

The Office of Insurance Regulation requests that these proposed rule amendments be presented to the Cabinet aides on or before August 4, 2010 and to the Financial Services Commission on August 10, 2010, with a request for Final Approval to Adopt the proposed rules. A notice of the Commission Final Rule Hearing was published in the *Florida Administrative Weekly* May 7, 2010.

The notice of proposed rules was published March 26, 2010 in Volume 36, No. 12, of the *Weekly*. The hearing was not requested, therefore, the hearing was not held.

Section 624.424(8)(e) provides that the Financial Services Commission must adopt rules in substantial conformity with the 1998 NAIC Model Audit Rule or subsequent amendments. The NAIC has adopted subsequent amendments to the 1998 Model Audit Rule. The rule being proposed amends the existing rule to conform with the subsequent amendments adopted by NAIC.

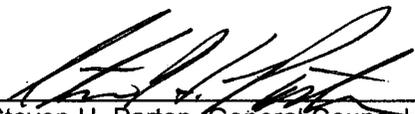
Sections 624.308(1), 624.424(8)(e), 624.307(1), 624.324, 624.424(8), F.S., provide rulemaking authority and laws implemented for this rule.

The Legal Services Office has communicated with the Joint Administrative Procedures Committee, and ascertained that their review of the rules has been completed.

Marc Ito is the attorney handling this rule. Attached are: 1) the proposed rule(s); 2) any incorporated materials, such as forms; 3) copies of the rulemaking statutory authority and law implemented.

MI

Approved for signature:



Steven H. Parton, General Counsel

Approved for submission to Financial Services
Commission:

Kevin M. McCarty, Commissioner
Office of Insurance Regulation

690-137.002 Annual Audited Financial Reports.

(1) The purpose of this rule is to improve the Office's surveillance of the financial condition of insurers by requiring an annual audit examination ~~by independent Certified Public Accountants~~ of the financial statements reporting the financial position and the results of operations of insurers by: (a) independent certified public accountants (b) Communication of Internal Control Related Matters Noted in an audit, and (c) Management's Report of Internal Control over Financial Reporting.

(2)(a) Every authorized insurer, as defined in subsection (3), below, shall be subject to this rule. Insurers having direct premiums written in this state of less than \$1,000,000 in any calendar year and fewer than 1,000 policyholders or certificateholders of directly written policies nationwide at the end of the calendar year shall be exempt from this rule for the ~~that~~-year (unless the Office makes a specific finding that compliance is necessary for the Office to carry out statutory responsibilities), except that insurers having assumed premiums pursuant to contracts and/or treaties of reinsurance of \$1,000,000 or more will not be so exempt. Any insurer subject to an exemption must submit by March 1 following the year to which the exemption applies an affidavit sworn to by a responsible officer of the insurer specifying the amount of direct premiums written in this state and number of policyholders or certificateholders. Form OIR-DO-1431, (Rev. 7/01), "Audited Financial Statements Exemption Affidavit", is hereby incorporated by reference to be the form specified in Section 624.424(8)(b), Florida Statutes, for exemptions from compliance with the filing of an annual audited financial statement. This form is available from Life & Health Financial Oversight or Property &

Casualty Financial Oversight at 200 East Gaines Street, Tallahassee, Florida 32399.
The form is also available from the Office of Insurance Regulation's website located at
the following address: www.floir.com.

(b) Foreign or alien insurers filing Audited Financial Reports in another state, pursuant to ~~that the other state's requirement for filing of Audited Financial Reports~~ which has been found by the Office to be substantially similar to the requirements herein, may, in lieu of the other requirements herein, be exempt from Sections (4) through (13) of this rule if: ~~requirements of this rule, file the following with the Office in accordance with the filing dates referenced below:~~

1. A copy of the Audited Financial Report, Communications of Internal Control Related Matters Noted in an Audit, Report on Significant Deficiencies in Internal Controls, and the Accountant's Letter of Qualifications which are filed with the other state are made available to the Office upon request in accordance with the filing dates specified in Sections (4), (11) and (12), respectively (Canadian insurers may submit accountants' reports as filed with the Office of the Superintendent of Financial Institutions, Canada); and the Canadian Dominion Office.

2. A copy of any Notification of Adverse Financial Condition Report filed with the other state are made available to the Office upon request within the time specified in Section (10).

(c) This rule shall not prohibit, preclude, or in any way limit the Office from ordering and/or conducting and/or performing examinations of insurers under its rules.

(3) Definitions.

~~(a) Audited Financial Report" means and includes those items specified in~~

~~subsection (5), below.~~

~~(a)(b) “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) licensing authority or accrediting authority for Certified Public Accountants and in all states in which he or she is licensed to the accountant practices. For Canadian and British companies, it means a Canadian-chartered or British-chartered accountant.~~

~~(b) “Affiliate” of, or person “affiliated” with, a specific person, is a person that directly or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified.~~

~~(c) “Audit committee” means a committee (or equivalent body) established by the board of directors of an entity for the purpose of overseeing the accounting and financial reporting processes of an insurer or Group of insurers, 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 regulation at the election of the controlling person. Refer to Section (14)(e) for exercising this election. If an Audit committee is not designated by the insurer, the insurer’s entire board of directors shall constitute the Audit committee. “Office” means the Office of Insurance Regulation.~~

~~(d) “Audited Financial Report” means and includes those items specified in Section (5), below. “Insurer” means an authorized insurer as defined in Section 624.09, Florida Statutes.~~

(e) "Indemnification" means an agreement of indemnity or a release from liability where the intent or effect is to shift or limit in any manner the potential liability of the person or firm for failure to adhere to applicable auditing or professional standards, whether or not resulting in part from knowing of other misrepresentations made by the insurer or its representatives.

(f) "Independent board member" has the same meaning as described in Section (14)(c).

(g) "Insurer" means an authorized insurer as defined in Section 624.09, Florida Statutes.

(h) "Group of insurers" means those licensed insurers included in the reporting requirements of Chapter 628, Part IV, Florida Statutes or a set of insurers as identified by management, for the purpose of assessing the effectiveness of Internal control over financial reporting.

(i) "Internal control over financial reporting" means a process effected by an entity's board of directors, management and other personnel designed to provide reasonable assurance regarding the reliability of the financial statements, i.e., those items specified in Section (5)(b) 2. through 7. of this regulation, and includes those policies and procedures that:

1. Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflects the transactions and dispositions of assets;

2. Provide reasonable assurance that transactions are recorded as necessary to permit preparation of the financial statements, i.e., those items specified in Section

(5)(b) 2. through 7. of this regulation, and that receipts and expenditures are being made only in accordance with authorizations of management and directors; and

3. Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of assets that could have a material effect on the financial statements, i.e., those items specified in Section (5)(b) 2. through 7. of this regulation.

(j) "Office" means the Office of Insurance Regulation.

(k) "SEC" means the United States Securities and Exchange Commission.

(l) "Section 404" means Section 404 of the Sarbanes-Oxley Act of 2002 and the SEC's rules and regulations promulgated thereunder.

(m) "Section 404 Report" means management's report on "internal control over financial reporting" as defined by the SEC and the related attestation report of the independent certified public accountant as described in Section (3)(a).

(n) "SOX Compliant Entity" means an entity that either is required to be compliant with, or voluntarily is compliant with, all of the following provisions of the Sarbanes-Oxley Act of 2002: (i) the preapproval requirements of Section 201 (Section 10A(i) of the Securities Exchange Act of 1934); (ii) the Audit committee independence requirements of Section 301 (Section 10A(m)(3) of the Securities Exchange Act of 1934); and (iii) the Internal control over financial reporting requirements of Section 404 (Item 308 of SEC Regulation S-K).

(o) "Section 16 Report" means a Management's Report of Internal Control over Financial Reporting provided in Section (16) of this rule.

(4) General Requirements Related to Filing and Extensions for Filing of Annual

Audited Financial Reports- and Audit Committee Appointment.

(a) All insurers shall have an annual audit by an independent Certified Public Accountant and shall file an Audited Financial Report with the Office on or before June 1 for the year ended December 31 immediately preceding. The Office may require an insurer to file an Audited Financial Report earlier than June 1 with ninety (90) days advance notice to the insurer.

(b) Every insurer required to file an annual Audited Financial Report pursuant to this regulation shall designate a group of individuals as constituting its Audit committee, as defined in Section (3). The Audit committee of an entity that controls an insurer may be deemed to be the insurer's Audit committee for purposes of this regulation at the election of the controlling person.

(5) Contents of Annual Audited Financial Report.

(a) The Annual Audited Financial Report shall report the financial position of the insurer as of the end of the most recent calendar year and the results of its operations, cash flows, and changes in capital and surplus for the year then ended in conformity with statutory accounting practices prescribed, or otherwise permitted, by the ~~Office of~~ the state of domicile.

(b) The Annual Audited Financial Report shall include the following:

1. Report of independent Certified Public Accountant.
2. Balance sheet reporting admitted assets, liabilities, capital and surplus.
3. Statement of operations.
4. Statement of cash flows.

5. Statement of changes in capital and surplus.

6. Notes to financial statements. These notes shall be those required by the appropriate NAIC Annual Statement Instructions (incorporated by reference in Rule 69O-137.001(4), F.A.C.) and the NAIC Accounting Practices and Procedures Manual (incorporated by reference in Rule 69O-137.001(4), F.A.C.) and any other notes required by generally accepted accounting principles and shall also include: ~~a~~ ~~a~~ A Reconciliation of differences, if any, between the audited statutory financial statements and the Annual Statement filed pursuant to Section 624.424(1), Florida Statutes, with a written description of the nature of these differences.

~~b. A summary of ownership and relationships of the insurer and all affiliated companies.~~

7. The financial statements included in the Audited Financial Report shall be prepared in a form and using language and groupings substantially the same as the relevant sections of the Annual Statement of the insurer filed with the Office, and the financial statement shall be comparative, presenting the amounts as of December 31 of the current year and the amounts as of the immediately preceding December 31. However, in the first year in which an insurer is required to file an Audited Financial Report, the comparative data may be omitted.

(6) Designation of Independent Certified Public Accountant.

(a) Each insurer required by this rule to file an annual Audited Financial Report must, by December 31 of the year subject to audit, register with the Office in writing the name and address of the independent Certified Public Accountant or accounting firm (~~generally referred to in this rule as the "accountant"~~) retained to conduct the annual

audit set forth in this rule.

(b) The insurer shall obtain a letter from the accountant, and file a copy with the Office, stating that the accountant is aware of the provisions of the Insurance Code and the Rules and Regulations of the ~~Insurance Office of the~~ state of domicile that relate to accounting and financial matters, and affirming that the accountant ~~he~~ will express his or her opinion on the financial statements in terms of their conformity to the statutory accounting practices prescribed or otherwise permitted by that Insurance Department Office, specifying the exceptions as he or she may believe appropriate.

(c) If an accountant who was the accountant for the immediately preceding filed Audited Financial Report is dismissed or resigns, the insurer shall within five (5) business days notify the Office of this event. The insurer shall also furnish the Office with a separate letter within ten (10) business days of the above notification stating whether in the twenty-four (24) months preceding that event there were any disagreements with the former accountant on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure; which disagreements, if not resolved to the satisfaction of the former accountant, would have caused him or her to make reference to the subject matter of the disagreement in connection with his or her opinion. The disagreements required to be reported in response to this paragraph include both those resolved to the former accountant's satisfaction and those not resolved to the former accountant's satisfaction. ~~(d)~~ Disagreements contemplated by this subsection are those that occur at the decision-making level, i.e., between personnel of the insurer responsible for presentation of its financial statements and personnel of the accounting firm responsible for rendering its

report. The insurer shall also in writing request the former accountant to furnish a letter addressed to the insurer stating whether the accountant agrees with the statements contained in the insurer's letter, and if not, stating the reasons for which he or she does not agree; and the insurer shall furnish the responsive letter from the former accountant to the Office together with its own.

(7) Qualifications of Independent Certified Public Accountant.

(a) The Office shall not recognize any person or firm as a qualified independent Certified Public Accountant if the person or firm that is

1. Is not in good standing with the American Institute of Certified Public Accountants (AICPA) licensing authority or accrediting authority for Certified Public Accountants and in all states in which the accountant is licensed to practices, or for a Canadian or British company, that is not a chartered accountant; or

2. Has either directly or indirectly entered into an agreement of indemnity or release from liability (collectively referred to as indemnification) with respect to the audit of the insurer.

(b) Except as otherwise provided in this rule herein, the Office shall recognize an independent Certified Public Accountant shall be recognized as qualified as long as he or she prepares reports, filings, and statements as required by the Florida Insurance Code, and conforms to the standards of his or her profession as contained in the Rules and Regulations and Code of Ethics and Rules of Professional Conduct of the Florida Board of Public Accountancy, or similar code.

(c) 1. A The lead (or coordinating) audit partner (having primary responsibility for the audit) or other person responsible for rendering a report may not act in that capacity

for more than five (5) ~~seven (7)~~ consecutive years. ~~Following any period of service that~~
The person shall be disqualified from acting in that or a similar capacity for the same
company or its insurance subsidiaries or affiliates for a period of five (5) consecutive two
(2) years. An insurer may make application to the Office for relief from the above
rotation requirement based on an unusual hardship to the insurer and a determination
by the Office that the accountant is exercising independent judgement that is not unduly
influenced by the insurer. This application should be made at least thirty (30) days
before the end of the calendar year. The Office shall consider ~~considering~~ the following
factors in determining if the relief should be granted:

a.~~1.~~ Number of partners, expertise of the partners, or the number of insurance
clients in the currently registered firm;

b.~~2.~~ Premium volume of the insurer; and

c.~~3.~~ Number of jurisdictions in which the insurer transacts business.

2. The insurer shall file, with its annual statement filing, the approval for relief from
Subsection (7) (c) with the states that it is licensed in or doing business in and with the
NAIC. If the nondomestic state accepts electronic filing with the NAIC, the insurer shall
file the approval in an electronic form acceptable to the NAIC.

(d) The Office shall neither ~~not~~ recognize as a qualified independent Certified Public
Accountant, nor accept any annual Audited Financial Report prepared in whole or in
part by any natural person who:

1. Has been found guilty of, or has pleaded guilty or nolo contendere to, any felony
or crime punishable by imprisonment of one year or more under the law of the United
States or any state thereof or under the law of any other country, which involves moral

turpitude, without regard to whether a judgement of conviction has been entered by the court having jurisdiction in such case;

2. Has been found to have violated the insurance laws of this state with respect to any previous reports submitted under this rule; or

3. Has failed to detect or disclose material information in previous reports filed under the provisions of this rule.

(e) In accordance with the provisions of Sections 624.307 and 624.324, Florida Statutes, and in its own rules of departmental practice, the Office shall conduct a hearing to determine whether an independent a-Certified Public Accountant is qualified if Office records do not contain sufficient information to demonstrate that the Certified Public Accountant is qualified. Considering the evidence presented, the Office shall conclude that the accountant is not qualified for purposes of expressing his or her opinion on the financial statements in the annual Audited Financial Report made pursuant to this rule, if the accountant fails to meet the qualifications and other requirements of this rule. If the accountant is found to be not qualified, the Office shall require the insurer to replace the accountant with another whose relationship with the insurer is qualified within the meaning of this rule. Upon determination by the Office that the accountant is not qualified to express an opinion on the financial statements in the annual Audited Financial Report made pursuant to this rule the insurer may request a hearing pursuant to Section 120.57, Florida Statutes.

(f) A qualified independent certified accountant may enter into an agreement with an insurer to have disputes relating to an audit resolved by mediation or arbitration. However, in the event of a delinquency proceeding commenced against the insurer

under Chapter 631, Florida Statutes, the mediation or arbitration provisions shall operate at the option of the statutory successor.

(g) 1. The Office shall not recognize as a qualified independent certified public accountant, nor accept an annual Audited Financial Report, prepared in whole or in part by an accountant who provides to an insurer, contemporaneously with the audit, the following non-audit services:

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

b. Financial information systems design and implementation;

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

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

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

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

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

e. Internal audit outsourcing services;

f. Management functions or human resources;

g. Broker or dealer, investment adviser, or investment banking services; or

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

2. In general, the principles of independence with respect to services provided by the qualified independent certified public accountant are largely predicated on three basic principles, violations of which would impair the accountant's independence. The principles are that the accountant cannot function in the role of management, cannot audit his own work, and cannot serve in an advocacy role for the insurer.

(h) Insurers having direct written and assumed premiums of less than \$100,000,000 in any calendar year may request an exemption from Subsection (g) 1. The insurer shall file with the Office a written statement discussing the reasons why the insurer should be exempt from these provisions. If the Office finds, upon review of this statement, that compliance with this regulation would constitute an undue financial or organizational hardship upon the insurer, an exemption shall be granted.

(i) A qualified independent certified public accountant who performs the audit may engage in other non-audit services, including tax services that are not described in Subsection (g)1. or that do not conflict with Subsection (g)2. only if the activity is approved in advance by the Audit committee, in accordance with Subsection (j).

(j) All auditing services and non-audit services provided to an insurer by the qualified independent certified public accountant of the insurer shall be preapproved by the Audit

committee. The preapproval requirement is waived with respect to non-audit services if the insurer is a SOX Compliant Entity or a direct or indirect wholly-owned subsidiary of a SOX Compliant Entity or:

1. The aggregate amount of all such non-audit services provided to the insurer constitutes not more than five percent (5%) of the total amount of fees paid by the insurer to its qualified independent certified public accountant during the fiscal year in which the non-audit services are provided;

2. The services were not recognized by the insurer at the time of the engagement to be non-audit services; and

3. The services are promptly brought to the attention of the Audit committee of the insurer and approved prior to the completion of the audit by the Audit committee or by one or more members of the Audit committee who are the members of the board of directors to whom authority to grant such approvals has been delegated by the Audit committee.

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

(l) 1. The Office 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 subsection shall only apply to partners and senior managers involved in the audit.

2. The insurer shall file, with its annual statement filing, the approval for relief from Subsection (l)(1) with the states that it is licensed in or doing business in and the NAIC. If the nondomestic state accepts electronic filing with the NAIC, the insurer shall file the approval in an electronic format acceptable to the NAIC.

(8) Consolidated or Combined Audits.

(a) An insurer may make written application to the Office for approval to file audited consolidated or combined financial statements in lieu of separate annual audited financial statements if the insurer is part of a group of insurance companies which utilizes a pooling or one hundred percent reinsurance agreement that affects the solvency and integrity of the insurer's reserves, and the insurer cedes all of its direct and assumed business to the pool. In these cases, a columnar consolidating or combining worksheet shall be filed with the report, as follows:

1. Amounts shown on the consolidated or combined Audited Financial Report shall be shown on the worksheet.

2. Amounts for each insurer subject to this section shall be stated separately.

3. Noninsurance operations may be shown on the worksheet on a combined or individual basis.

4. Explanations of consolidating and eliminating entries shall be included: and

5. A reconciliation shall be included of any differences between the amounts shown in the individual insurer columns of the worksheet and comparable amounts shown on the Annual Statements of the insurers.

(b) 1. The application for approval to consolidate is required each year, and must be filed with the Office prior to the end of the calendar year for which the approval is being granted, except that applications for approval will be accepted after the end of such calendar year subject to the imposition of an administrative fine on each insurer involved in such application as provided for in Section 624.4211(2), Florida Statutes.

2. The amount of the fine shall be \$50 per day for each day beyond the end of the calendar year, not to exceed an aggregate amount of \$10,000 for the group of insurers requesting permission to file on a consolidated basis.

(c) Approval to consolidate or combine statements shall be granted unless the Office makes a specific finding that approval would prevent the Office from carrying out its statutory responsibilities.

(9) ~~Scope of Audit Examination and Report of Independent Certified Public Accountant. Financial statements furnished pursuant to Section subsection (5), above, shall be examined by the an independent certified public accountant Certified Public Accountant. The audit examination of the insurer's financial statements shall be conducted in accordance with generally accepted auditing standards. In accordance with AU Section 319 of the Professional Standards of the AICPA, *Consideration of Internal Control in a Financial Statement Audit*, the independent certified public accountant should obtain an understanding of internal control sufficient to plan the audit. To the extent required by AU 319, for those insurers required to file a Management's Report of Internal Control over Financial Reporting pursuant to Section (16), the independent certified public accountant should consider (as that term is defined in AU Section 120 of the Professional Standards of the AICPA, *Defining Professional*~~

Requirements in Statements on Auditing Standards) the most recently available report in planning and performing the audit of the statutory financial statements. Consideration should also be given to the other procedures illustrated in the Financial Condition Examiner's Handbook promulgated by the National Association of Insurance Commissioners (incorporated by reference in Rule 69O-138.001, F.A.C.) as the independent Certified Public Accountant deems necessary.

(10) Notification of Adverse Financial Condition.

(a) The insurer required to furnish the annual Audited Financial Report shall require the independent Certified Public Accountant to report, in writing, within five (5) business days to the board of directors or its Audit audit committee any determination by the independent Certified Public Accountant that the insurer has materially misstated its financial condition as reported to the Office as of the balance sheet date currently under audit examination, or that the insurer does not meet the minimum capital and surplus requirement of the Florida Insurance Code as of that date. An insurer who has received a report pursuant to this paragraph shall forward a copy of the report to the Office within five (5) business days of receipt of said report and shall provide the independent Certified Public Accountant making the report with evidence of the report being furnished to the Office. If the independent Certified Public Accountant fails to receive the evidence within the required five (5) business day period, the independent Certified Public Accountant shall furnish to the Office a copy of its report within the next five (5) business days.

(b) An independent certified public accountant shall not be liable in any manner to any person for any statement made in connection with the above paragraph if the

statement is made in good faith in compliance with the above paragraph.

(c) If the accountant, subsequent to the date of the Audited Financial Report filed pursuant to this rule, becomes aware of facts which might have affected his report, the Office notes the obligation of the accountant to take such action as prescribed in Volume 1, Section AU 561 of the Professional Standards of the AICPA. ~~shall report those facts to the Office and the insurer within ten (10) calendar days of discovery.~~

(11) Communication of Internal Control Related Matters Noted in an Audit Report on Significant Deficiencies in Internal Controls

(a) In addition to the annual Audited Financial Report Statement, each insurer shall furnish the Office with a written communication as to any unremediated material weaknesses in its Internal control over financial reporting noted during the audit. Such communication shall be prepared by the accountant within sixty (60) days after the filing of the annual Audited Financial Report, and shall contain a description of any unremediated material weakness (as the term material weakness is defined by AU Section 325 of the Professional Standards of the AICPA, *Communicating Internal Control Related Matters Identified in an Audit*) as of December 31 immediately preceding (so as to coincide with the Audited Financial Report discussed in Section (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. ~~report prepared by the accountant describing significant deficiencies in the insurer's internal control structure noted by the accountant during the audit. The Report on Internal Controls Systems of~~

~~the insurer shall be filed with the annual Audited Financial Report as required in subsection (4), above.~~

(b) The insurer is required to provide a description of remedial actions taken or proposed to correct unremediated material weaknesses if the said actions are not described in the accountant's communication report.

(12) Accountant's Letter of Qualifications.

(a) The accountant shall furnish a letter to the insurer in connection with, and for inclusion in, the filing of the annual Audited Financial Report.

(b) The letter shall state:

1. That the accountant is independent with respect to the insurer and conforms to the standards of his or her profession as contained in the Code of Professional Ethics and pronouncements of the AICPA and the Rules of Professional Conduct of the Florida Board of Public Accountancy, or similar code;

2. The background and experience in general, and the experience in audits of insurers, of the staff assigned to the engagement and whether each is an independent Certified Public Accountant. Nothing within this rule shall be construed as prohibiting the accountant from utilizing his or her staff as he or she deems appropriate where use is consistent with the standards prescribed by generally accepted auditing standards.

3. That the accountant understands the annual Audited Financial Report, and his or her opinion thereon will be filed in compliance with this rule, and that the Office will be relying on this information in the monitoring and regulation of the financial position of insurers;

4. That the accountant consents to the requirements of subsection (13), below, and

that the accountant consents and agrees to make the workpapers as defined in subsection (13), below, available for review by the Office.

5. A representation that the accountant is properly licensed by an appropriate state licensing authority and is a member in good standing in the AICPA; and

6. A representation that the accountant is in compliance with the requirements of subsection (7) of this Rule, above.

(13) Definition, Availability, and Maintenance of Independent Certified Public Accountants. ~~CPA Workpapers.~~

(a) Workpapers are the records kept by the independent Certified Public Accountant of the procedures followed, the tests performed, the information obtained, and the conclusions reached pertinent to the accountant's audit ~~his examination~~ of the financial statements of an insurer. Workpapers, accordingly, may include audit planning documentation, work programs, analyses, memoranda, letters of confirmation and representation, abstracts of company documents and schedules, or commentaries prepared or obtained by the independent Certified Public Accountant in the course of his or her audit ~~examination~~ of the financial statements of an insurer, and which support the accountant's ~~his~~ opinion thereof.

(b) Every insurer required to file an Audited Financial Report pursuant to this rule shall require the accountant to make available for review by Office examiners all workpapers prepared in the conduct of the accountant's audit ~~his examination~~, and any communications related to the audit between the accountant and the insurer, at the offices of the insurer, at the Office or at any other reasonable place designated by the Office. The insurer shall require that the accountant retain the audit workpapers and

communications until the Office has filed a Report on Examination covering the period of the audit, but no less than seven (7) years from the date of the audit report.

(c) In the conduct of the aforementioned periodic review by the Office examiners, it shall be agreed that photocopies of pertinent audit workpapers may be made and retained by the Office. The reviews by the Office examiners shall be considered investigations, and all working papers and communications obtained during the course of the investigations shall be afforded the same confidentiality as other examination workpapers generated by the Office until the Report of Examination is filed by the Office.

(14) Requirements for Audit Committee

This section shall not apply to foreign or alien insurers licensed in this state or an insurer that is a SOX Compliant Entity or a direct or indirect wholly-owned subsidiary of a SOX Compliant Entity.

(a) The Audit committee shall be directly responsible for the appointment, compensation and oversight of the work of any accountant (including resolution of disagreements between management and the accountant regarding financial reporting) for the purpose of preparing or issuing the Audited Financial Report or related work pursuant to this rule. Each accountant shall report directly to the Audit committee.

(b) Each member of the Audit committee shall be a member of the board of directors of the insurer or a member of the board of directors of an entity elected pursuant to Subsection (e) and Section (3)(c).

(c) 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.

(d) 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.

(e) To exercise the election of the controlling person to designate the Audit committee for purposes of this regulation, the ultimate controlling person shall provide written notice to the Office of the affected insurers. Notification shall be made timely prior to the issuance of the statutory audit report and include a description of the basis for the election. The election can be changed through notice to the Office by the insurer, which shall include a description of the basis for the change. The election shall remain in effect for perpetuity, until rescinded.

(f) 1. The Audit committee shall require the accountant that performs for an insurer any audit required by this regulation to timely report to the Audit committee in accordance with the requirements of AU Section 380 of the Professional Standards of the AICPA, *Communication with Audit Committees*, including:

a. All significant accounting policies and material permitted practices;

b All material alternative treatments of financial information within statutory accounting principles that have been discussed with management officials of the

insurer, ramifications of the use of the alternative disclosures and treatments, and the treatment preferred by the accountant; and

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

2. If an insurer is a member of an insurance holding company system, the reports required by Subsection (f) 1. may be provided to the Audit committee on an aggregate basis for insurers in the holding company system, provided that any substantial differences among insurers in the system are identified to the Audit committee.

(g) The proportion of independent Audit committee members shall meet or exceed the following criteria:

<u>Prior Calendar Year Direct Written and Assumed Premiums</u>		
<u>\$0 – 300,000,000</u>	<u>Over \$300,000,000 – 500,000,000</u>	<u>Over 500,000,000</u>
<u>No minimum requirements.</u> <u>See also Notes A and B.</u>	<u>Majority (50% or more) of members shall be independent. See also Notes A and B.</u>	<u>Supermajority of members (75% or more) shall be independent. See also Note A.</u>

Note A: The Office has authority afforded by Section 624.4085, F.S., to require the entity'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 deemed to be in hazardous financial condition, or otherwise exhibits qualities of a troubled insurer.

Note B: All insurers with less than \$500,000,000 in prior year direct written and assumed premiums are encouraged to structure their Audit committees with at least a supermajority of independent Audit committee members.

Note C: Prior calendar year direct written and assumed premiums shall be the combined total of direct premiums and assumed premiums from non-affiliates for the reporting entities.

(h) An insurer with direct written and assumed premium, excluding premiums reinsured with the Federal Crop Insurance Corporation and Federal Flood Program, less than \$500,000,000 may make application to the Office for a waiver from the Section (14) requirements based upon hardship. The insurer shall file, with its annual statement filing, the approval for relief from Section (14) with the states that it is licensed in or doing business in and the NAIC. If the non-domestic state accepts electronic filing with the NAIC, the insurer shall file the approval in an electronic format acceptable to the NAIC.

(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 regulation; or

2. Omit to state, or cause another person to omit to state, any material fact necessary in order to make statements made, in light of the circumstances under which the statements were made, not misleading to an accountant in connection with any audit, review or communication required under this regulation.

(b) No officer or director of an insurer, or any other person acting under the direction thereof, shall directly or indirectly take any action to coerce, manipulate, mislead or fraudulently influence any accountant engaged in the performance of an audit pursuant to this regulation if that person knew or should have known that the action, if successful, could result in rendering the insurer's financial statements materially misleading.

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

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 Office or generally accepted auditing standards);

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

3. Not to withdraw an issued report; or

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

(16) Management's Report of Internal Control over Financial Reporting

(a) Every insurer required to file an Audited Financial Report pursuant to this regulation that has annual direct written and assumed premiums, excluding premiums

reinsured with the Federal Crop Insurance Corporation and Federal Flood Program, of \$500,000,000 or more shall prepare a report of the insurer's or Group of insurers' Internal control over financial reporting, as these terms are defined in Section (3). The report shall be filed with the Office along with the Communication of Internal Control Related Matters Noted in an Audit described under Section (11). Management's Report of Internal Control over Financial Reporting shall be as of December 31 immediately preceding.

(b) Notwithstanding the premium threshold in Subsection (a), the Office shall require an insurer to file Management's Report of Internal Control over Financial Reporting if the insurer is in any Risk Based Capital level event, or meets any one or more of the standards of an insurer deemed to be in hazardous financial condition. "Hazardous financial condition" shall mean any of the conditions that subject an insurer to suspension or revocation of its certificate of authority as provided in Section 624.418, F.S.

(c) An insurer or a Group of insurers that is

1. directly subject to Section 404;

2. part of a holding company system whose parent is directly subject to Section 404;

3. not directly subject to Section 404 but is a SOX Compliant Entity; or,

4. a member of a holding company system whose parent is not directly subject to

Section 404 but is a SOX Compliant Entity;

may file its or its parent's Section 404 Report and an addendum in satisfaction of this

Section'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 Section (5) (b) 2. through (5) (b) 7. of this regulation) were included in the scope of the Section 404 Report. The addendum shall be a positive statement by management that there are no material processes with respect to the preparation of the insurer's or Group of insurers' audited statutory financial statements (those items included in Section (5)(b) 2. through (5)(b) 7. of this rule) excluded from the Section 404 Report. If there are internal controls of the insurer or Group of insurers that have a material impact on the preparation of the insurer's or Group of insurers' audited statutory financial statements and those internal controls were not included in the scope of the Section 404 Report, the insurer or Group of insurers may either file (i) a Section (16) report, or (ii) the Section 404 Report and a Section (16) report for those internal controls that have a material impact on the preparation of the insurer's or Group of insurers' audited statutory financial statements not covered by the Section 404 Report.

(d). Management's Report of Internal Control over Financial Reporting shall include:

1. A statement that management is responsible for establishing and maintaining adequate Internal control over financial reporting;

2. A statement that management has established Internal control over financial reporting and an assertion, to the best of management's knowledge and belief, after diligent inquiry, as to whether its Internal control over financial reporting is effective to provide reasonable assurance regarding the reliability of financial statements in accordance with statutory accounting principles;

3. A statement that briefly describes the approach or processes by which management evaluated the effectiveness of its Internal control over financial reporting;

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, after the effective date of this rule. 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 controls over financial reporting;

6. A statement regarding the inherent limitations of internal control systems; and

7. Signatures of the chief executive officer and the chief financial officer (or equivalent position/title).

(e) Management shall document and make available upon financial condition examination the basis upon which its assertions, required in Subsection (d) above, are made. Management may base its assertions, in part, upon its review, monitoring and testing of internal controls undertaken in the normal course of its activities.

1. Management shall have discretion as to the nature of the internal control framework used, and the nature and extent of documentation, in order to make its assertion in a cost effective manner and, as such, may include assembly of or reference to existing documentation.

2. Management's Report on Internal Control over Financial Reporting, required by Subsection (a) above, and any documentation provided in support thereof during the course of a financial condition examination, shall be kept confidential by the Office.

(17) ~~(14)~~ Exemptions and Effective Dates

(a) Upon written application of any insurer, the Office shall grant an exemption from compliance with ~~the filing of an annual audited financial report received by the Office by March 1 of the year following the calendar year to which the application applies~~ any and all provisions of this rule if the Office finds, upon review of the application, that compliance with this regulation would constitute an undue financial or organizational hardship upon the insurer. ~~the insurer is under an order of receivership, conservatorship, rehabilitation, or is in another delinquency proceeding by the public insurance supervising official of any state, and the insurer has been granted an exemption from filing an annual audited financial report by its state of domicile. An exemption shall be granted for one year only. Exemptions for future years require additional applications.~~

(b) Domestic insurers shall comply with this rule for the year ending December 31, 2010 and each year thereafter. ~~All authorized insurers shall comply with this rule for the year ending December 31, 1991, and each year thereafter unless the Office permits otherwise.~~

(c) Foreign insurers shall comply with this rule for the year ending December 31, 2010 and each year thereafter. ~~Form OIR-DO 1431, (Rev. 10/04), "Audited Financial Statements Exemption Affidavit", is hereby incorporated by reference to be the form specified in Section 624.424(8)(b), Florida Statutes, for exemptions from compliance with the filing of an annual audited financial statement. This form is available from Life & Health Financial Oversight or Property & Casualty Financial Oversight at 200 East Gaines Street, Tallahassee, Florida 32399. The form is also available from the Office of~~

Insurance Regulation's website located at the following address:
www.fldfs.com/companies/.

(d) The requirements of section (7)(c) shall be in effect for audits of the year ending December 31, 2010 and thereafter.

(e) The requirements of section (14) are to be in effect for audits of the year ending December 31, 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 discussed in this paragraph due to changes in premium shall have one (1) year following the year the threshold is exceeded (but not earlier than January 1, 2010) to comply with the independence requirements discussed in this paragraph. Likewise, an insurer that becomes subject to one of the independence requirements discussed in this paragraph as a result of a business combination shall have one (1) calendar year following the date of acquisition or combination to comply with the independence requirements.

(f) The requirements of Section (16) and other modified sections, except for Section (14) covered above, are effective beginning with the reporting period ending December 31, 2010 and each year thereafter. An insurer or Group of insurers that is not required to file a report because the total written premium is below the threshold and subsequently becomes subject to the reporting requirements shall have two (2) years following the year the threshold is exceeded (but not earlier than December 31, 2010) to file a report. Likewise, an insurer acquired in a business combination shall have two (2)

calendar years following the date of acquisition or combination to comply with the reporting requirements.

(18) (15) Canadian and British Companies.

(a) In the case of Canadian and British insurers, the annual Audited Financial Report shall be defined as the annual statement of total business on the form filed by the companies with their ~~domiciliary~~ supervision authority duly audited by an independent chartered accountant.

(b) For these insurers, the letter required in subsection (6)(b), above, shall state that the accountant is aware of the requirements relating to the annual aAudited statement Financial Report filed with the Office pursuant to subsection (4), above, and shall affirm that the opinion expressed is in conformity with these requirements.

(19) Severability Provision

If any section or portion of this rule or its applicability to any person or circumstance is held invalid by a court, the remainder of the rule or the applicability of the provision to other persons or circumstances shall not be affected.

(20) Standards Incorporated by Reference

(a) The following standards are hereby incorporated by reference:

1. AU Section 319 of the Professional Standards of the AICPA, Consideration of Internal Control in a Financial Statement Audit

2. AU Section 120 of the Professional Standards of the AICPA, *Defining Professional Requirements in Statements on Auditing Standards*

3. Volume 1, Section AU 561 of the Professional Standards of the AICPA

4. AU Section 325 of the Professional Standards of the AICPA, *Communicating*

Internal Control Related Matters Identified in an Audit

5. AU Section 380 of the Professional Standards of the AICPA, Communication with Audit Committees

(b) The standards incorporated in this section are available at the American Institute of CPAs (AICPA) website at:

<http://www.aicpa.org/Publications>

Rulemaking Specific Authority 624.308(1), 624.424(8)(e) FS. Law Implemented 624.307(1), 624.324, 624.424(8) FS. History—New 3-31-92, Amended 3-14-94

**AUDITED FINANCIAL STATEMENTS
EXEMPTION AFFIDAVIT**

Section 624.424(8)(b), Florida Statutes
(Filing Deadline - **MARCH 1**)

I, the undersigned, hereby certify that

(Name of Company)

(Address)

(City, State, Zip)

(Federal ID Number)

is automatically exempt from filing audited financial statements as permitted by Section 624.424(8)(b), Florida Statutes.

I further certify the amount of direct premiums written during the calendar year in the State of Florida for _____ (year ending December 31 prior to March 1 filing due date) was \$ _____ and the number of policyholders or certificate holders of directly written policies nationwide at the end of the calendar year was _____.

Signature Date

Officer's Name/Title (print or type)

Notary Public

the Act and appropriate consideration is not given to the violation, the auditor should consider withdrawing from the current engagement or disassociating himself from any future relationship with the client (See section 317.92).

.06 A violation of the internal accounting control provision of the Act would not, in and of itself, have a direct effect on amounts presented in audited financial statements. However, the contingent monetary effect on an entity ultimately determined to have willfully violated the internal accounting control provision of the Act could be fines of up to \$10,000 for the violation. The auditor should consider the materiality of such contingent monetary effect in relation to the audited financial statements taken as a whole. Other loss contingencies, as defined by FASB Statement No. 5 [AC section 059], ordinarily would not result from a weakness in internal control which gives rise to such a violation of the Act.

[Issue Date: October, 1978.]

[The next page is 321.]

AU Section 319

Consideration of Internal Control in a Financial Statement Audit¹

Source: SAS No. 55; SAS No. 78; SAS No. 94.

Effective for audits of financial statements for periods beginning on or after January 1, 1990, unless otherwise indicated.

Introduction

.01 This section provides guidance on the independent auditor's consideration of an entity's internal control in an audit of financial statements in accordance with generally accepted auditing standards. It defines internal control,² describes the objectives and components of internal control, and explains how an auditor should consider internal control in planning and performing the audit. In particular, this section provides guidance about implementing the second standard of field work: "A sufficient understanding of internal control is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed."

.02 In all audits, the auditor should obtain an understanding of internal control sufficient to plan the audit by performing procedures to understand the design of controls relevant to an audit of financial statements and determining whether they have been placed in operation. In obtaining this understanding, the auditor considers how an entity's use of information technology (IT)³ and manual procedures may affect controls relevant to the audit. The auditor then assesses control risk for the assertions embodied in the account balance, transaction class, and disclosure components of the financial statements.

¹ This section has been superseded by Statements on Auditing Standards No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, and No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*. This section will be superseded closer to the effective date of Statements on Auditing Standards No. 109 and No. 110, which are effective for audits of financial statements for periods beginning on or after December 15, 2006. Earlier application is permitted. Statements on Auditing Standards No. 109 and No. 110 are included in the "AU Risk Assessment Standards: SAS No. 104-SAS No. 111" section, following the "AU Section 900—Special Reports of the Committee on Auditing Procedure" section, of this publication.

² This section has been revised to reflect the amendments and conforming changes necessary due to the issuance of Statement on Auditing Standards No. 78, effective for audits of financial statements for periods beginning on or after January 1, 1997. The amendments are made to recognize the definition and description of internal control contained in *Internal Control—Integrated Framework*, published by the Committee of Sponsoring Organizations of the Treadway Commission (COSO Report). This section has also been amended to reflect the issuance of Statement on Auditing Standards No. 94, effective for audits of financial statements for periods beginning on or after June 1, 2001. Further application is permissible.

³ Internal control also may be referred to as *internal control structure*.

⁴ Information technology (IT) encompasses automated means of originating, processing, storing, and communicating information, and includes recording devices, communication systems, computer systems (including hardware and software components and data), and other electronic devices. An entity's use of IT may be extensive; however, the auditor is primarily interested in the entity's use of IT to initiate, record, process, and report transactions or other financial data.

.03 The auditor may determine that assessing control risk below the maximum level³ for certain assertions would be effective and more efficient than performing only substantive tests. In addition, the auditor may determine that it is not practical or possible to restrict detection risk to an acceptable level by performing only substantive tests for one or more financial statement assertions. In such circumstances, the auditor should obtain evidential matter about the effectiveness of both the design and operation of controls to reduce the assessed level of control risk. Such evidential matter may be obtained from tests of controls planned and performed concurrent with or subsequent to obtaining the understanding.⁴ Such evidential matter also may be obtained from procedures that were not specifically planned as tests of controls but that nevertheless provide evidential matter about the effectiveness of the design and operation of the controls. For certain assertions, the auditor may desire to further reduce the assessed level of control risk. In such cases, the auditor considers whether evidential matter sufficient to support a further reduction is likely to be available and whether performing additional tests of controls to obtain such evidential matter would be efficient.

.04 Alternatively, the auditor may assess control risk at the maximum level because he or she believes controls are unlikely to pertain to an assertion or are unlikely to be effective, or because evaluating the effectiveness of controls would be inefficient. However, the auditor needs to be satisfied that performing only substantive tests would be effective in restricting detection risk to an acceptable level. When evidence of an entity's initiation, recording, or processing of financial data exists only in electronic form, the auditor's ability to obtain the desired assurance only from substantive tests would significantly diminish.

.05 The auditor uses the understanding of internal control and the assessed level of control risk in determining the nature, timing, and extent of substantive tests for financial statement assertions.

Definition of Internal Control

.06 *Internal control* is a process—effected by an entity's board of directors, management, and other personnel—designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (a) reliability of financial reporting, (b) effectiveness and efficiency of operations, and (c) compliance with applicable laws and regulations.

- .07 Internal control consists of five interrelated components:
- a. *Control environment* sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure.
 - b. *Risk assessment* is the entity's identification and analysis of relevant risks to achievement of its objectives, forming a basis for determining how the risks should be managed.
 - c. *Control activities* are the policies and procedures that help ensure that management directives are carried out.

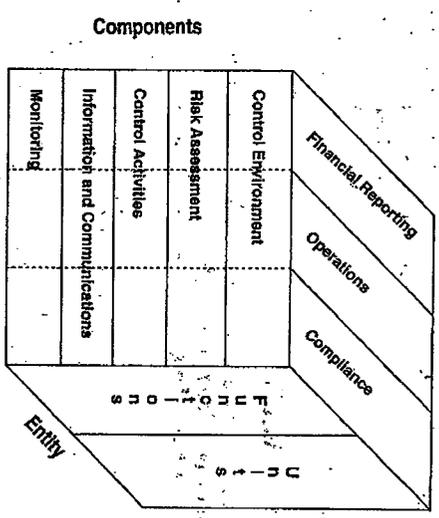
³ Control risk may be assessed in quantitative terms, such as percentages, or in nonquantitative terms that range, for example, from a maximum to a minimum. The term *maximum level* is used in this section to mean the greatest probability that a material misstatement that could occur in financial statement assertion will not be prevented or detected on a timely basis by an entity's internal control.

⁴ If the auditor is unable to obtain such evidential matter, he or she should consider the guidance in *one* *Practical Matter*, paragraphs 14 and 25.

- d. *Information and communication* systems support the identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities.
- e. *Monitoring* is a process that assesses the quality of internal control performance over time.

Relationship Between Objectives and Components

.08 There is a direct relationship between objectives, which are what an entity strives to achieve, and components, which represent what is needed to achieve the objectives. In addition, internal control is relevant to the entire entity, or to any of its operating units or business functions. This relationship is depicted as follows:



.09 Although an entity's internal control addresses objectives in each of the categories referred to in paragraph .06, not all of these objectives and related controls are relevant to an audit of the entity's financial statements. Also, although internal control is relevant to the entire entity or to any of its operating units or business functions, an understanding of internal control relevant to each of the entity's operating units and business functions may not be necessary to plan and perform an effective audit.

Financial Reporting Objective

.10 Generally, controls that are relevant to an audit pertain to the entity's objective of preparing financial statements for external purposes that are fairly presented in conformity with generally accepted accounting principles or a comprehensive basis of accounting other than generally accepted accounting principles.⁵

⁵ The term *comprehensive basis of accounting other than generally accepted accounting principles* is defined in section 623, *Special Reports*, paragraph .04. Hereafter, reference to generally accepted accounting principles in this section includes, where applicable, an other comprehensive basis of accounting.

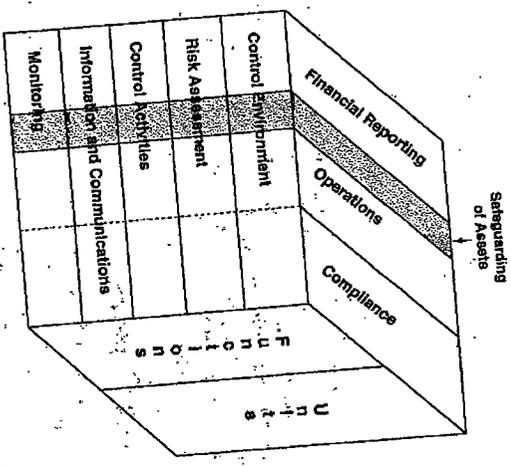
Operations and Compliance Objectives

11 The controls relating to operations and compliance⁶ objectives may be relevant to an audit if they pertain to data the auditor evaluates or uses in applying auditing procedures. For example, controls pertaining to nonfinancial data that the auditor uses in analytical procedures, such as production statistics, or pertaining to detecting noncompliance with laws and regulations such as controls over compliance with income tax laws and regulations used to determine the income tax provision, may be relevant to an audit.

12 An entity generally has controls relating to objectives that are not relevant to an audit and therefore need not be considered. For example, controls concerning compliance with health and safety regulations or concerning the effectiveness and efficiency of certain management decision-making processes (such as the appropriate price to charge for its products or whether to make expenditures for certain research and development or advertising activities), although important to the entity, ordinarily do not relate to a financial statement audit. Similarly, an entity may rely on a sophisticated system of automated controls to provide efficient and effective operations (such as a commercial airline's system of automated controls to maintain flight schedules), but these controls ordinarily would not be relevant to the financial statement audit and therefore need not be considered.

Safeguarding of Assets

13 Internal control over safeguarding of assets against unauthorized acquisition, use, or disposition may include controls relating to financial reporting and operations objectives. This relationship is depicted as follows:



In obtaining an understanding of each of the components of internal control to plan the audit, the auditor's consideration of safeguarding controls is generally

⁶ An auditor may need to consider controls relevant to compliance objectives when performing an audit in accordance with section 801, *Compliance Auditing Considerations in Audits of Governmental Financial Assistance*.

limited to those relevant to the reliability of financial reporting. For example, use of a lockbox system for collecting cash or access controls, such as passwords, that limit access to the data and programs that process cash disbursements may be relevant to a financial statement audit. Conversely, controls to prevent the excess use of materials in production generally are not relevant to a financial statement audit.

Application of Components to a Financial Statement Audit

14 The division of internal control into five components provides a useful framework for auditors to consider the impact of an entity's internal control in an audit. However, it does not necessarily reflect how an entity considers and implements internal control. Also, the auditor's primary consideration is whether a specific control affects financial statement assertions rather than its classification into any particular component. Controls relevant to the audit are those that individually or in combination with others are likely to prevent or detect material misstatements in financial statement assertions. Such controls may exist in any of the five components.

- 15 The five components of internal control are applicable to the audit of every entity. The components should be considered in the context of—
- The entity's size.
 - The entity's organization and ownership characteristics.
 - The nature of the entity's business.
 - The diversity and complexity of the entity's operations.
 - Applicable legal and regulatory requirements.
 - The nature and complexity of the systems that are part of the entity's internal control, including the use of service organizations.⁷

Effect of Information Technology on Internal Control

16 An entity's use of IT may affect any of the five components of internal control relevant to the achievement of the entity's financial reporting, operations, or compliance objectives, and its operating units or business functions. For example, an entity may use IT as part of discrete systems that support only particular business units, functions, or activities, such as a unique accounts receivable system for a particular business unit or a system that controls the operation of factory equipment. Alternatively, an entity may have complex, highly integrated systems that share data and that are used to support all aspects of the entity's financial reporting, operations, and compliance objectives.

17 The use of IT also affects the fundamental manner in which transactions are initiated, recorded, processed, and reported.⁸ In a manual system, an entity uses manual procedures and records in paper format (for example, individuals may manually record sales orders on paper forms or journals, authorize credit, prepare shipping reports and invoices, and maintain accounts receivable

⁷ See section 324, *Service Organizations*, for guidance if an entity obtains services that are part of its information system from another organization.
⁸ Paragraph 12 of the Appendix (paragraph 110) defines *initiation, recording, processing, and reporting* as used throughout this section.

records). Controls in such a system also are manual and may include such procedures as approvals and reviews of activities, and reconciliations and follow-up of reconciling items. Alternatively, an entity may have information systems that use automated procedures to initiate, record, process, and report transactions, in which case records in electronic format replace such paper documents as purchase orders, invoices, shipping documents, and related accounting records. Controls in systems that use IT consist of a combination of automated controls (for example, controls embedded in computer programs) and manual controls. Further, manual controls may be independent of IT, may use information produced by IT, or may be limited to monitoring the effective functioning of IT and of automated controls, and to handling exceptions. An entity's mix of manual and automated controls varies with the nature and complexity of the entity's use of IT.

18 IT provides potential benefits of effectiveness and efficiency for an entity's internal control because it enables an entity to—

- Consistently apply predefined business rules and perform complex calculations in processing large volumes of transactions or data.
- Enhance the timeliness, availability, and accuracy of information.
- Facilitate the additional analysis of information.
- Enhance the ability to monitor the performance of the entity's activities and its policies and procedures.
- Reduce the risk that controls will be circumvented.
- Enhance the ability to achieve effective segregation of duties by implementing security controls in applications, databases, and operating systems.

19 IT also poses specific risks to an entity's internal control, including—

- Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both.
- Unauthorized access to data that may result in destruction of data or improper changes to data, including the recording of unauthorized or nonexistent transactions or inaccurate recording of transactions.
- Unauthorized changes to data in master files.
- Unauthorized changes to systems or programs.
- Failure to make necessary changes to systems or programs.
- Inappropriate manual intervention.
- Potential loss of data.

20 The extent and nature of these risks to internal control vary depending on the nature and characteristics of the entity's information system. For example, multiple users, either external or internal, may access a common database of information that affects financial reporting. In such circumstances, a lack of control at a single user entry point might compromise the security of the entire database, potentially resulting in improper changes to or destruction of data. When IT personnel or users are given, or can gain, access privileges beyond those necessary to perform their assigned duties, a breakdown in segregation of duties can occur. This could result in unauthorized transactions or changes to programs or data that affect the financial statements. Therefore, the nature and characteristics of an entity's use of IT in its information system affect the entity's internal control.

Limitations of an Entity's Internal Control

21 Internal control, no matter how well designed and operated, can provide only reasonable assurance of achieving an entity's control objectives. The likelihood of achievement is affected by limitations inherent to internal control. These include the realities that human judgment in decision-making can be faulty and that breakdowns in internal control can occur because of human failures such as simple errors or mistakes. For example, errors may occur in designing, maintaining, or monitoring automated controls. If an entity's IT personnel do not completely understand how an order entry system processes sales transactions, they may erroneously design changes to the system to process sales for a new line of products. On the other hand, such changes may be correctly designed but misunderstood by individuals who translate the design into program code. Errors also may occur in the use of information produced by IT. For example, automated controls may be designed to report transactions over a specified dollar limit for management review, but individuals responsible for conducting the review may not understand the purpose of such reports and, accordingly, may fail to review them or investigate unusual items.

22 Additionally, controls, whether manual or automated, can be circumvented by the collusion of two or more people or inappropriate management override of internal control. For example, management may enter into side agreements with customers that alter the terms and conditions of the entity's standard sales contract in ways that would preclude revenue recognition. Also, edit routines in a software program that are designed to identify and report transactions that exceed specified credit limits may be overridden or disabled.

23 Internal control is influenced by the quantitative and qualitative estimates and judgments made by management in evaluating the cost-benefit relationship of an entity's internal control. The cost of an entity's internal control should not exceed the benefits that are expected to be derived. Although the cost-benefit relationship is a primary criterion that should be considered in designing internal control, the precise measurement of costs and benefits usually is not possible.

24 Custom, culture, and the corporate governance system may inhibit fraud, but they are not absolute deterrents. An effective control environment, too, may help reduce the risk of fraud. For example, an effective board of directors, audit committee, and internal audit function may constrain improper conduct by management. Alternatively, the control environment may reduce the effectiveness of other components. For example, when the nature of management incentives increases the risk of material misstatement of financial statements, the effectiveness of control activities may be reduced.

Obtaining an Understanding of Internal Control

25 In all audits, the auditor should obtain an understanding of each of the five components of internal control sufficient to plan the audit. A sufficient understanding is obtained by performing procedures to understand the design of controls relevant to an audit of financial statements and determining whether they have been placed in operation. In planning the audit, such knowledge should be used to—

- Identify types of potential misstatement.
- Consider factors that affect the risk of material misstatement.

components of internal control, providing discipline and structure. Control environment factors include the following:

- a. Integrity and ethical values
- b. Commitment to competence
- c. Board of directors or audit committee participation
- d. Management's philosophy and operating style
- e. Organizational structure
- f. Assignment of authority and responsibility
- g. Human resource policies and practices

35 The auditor should obtain sufficient knowledge of the control environment to understand management's and the board of directors' attitude, awareness, and actions concerning the control environment, considering both the substance of controls and their collective effect. The auditor should concentrate on the substance of controls rather than their form, because controls may be established but not acted upon. For example, management may establish a formal code of conduct but act in a manner that condones violations of that code.

36 When obtaining an understanding of the control environment, the auditor considers the collective effect on the control environment of strengths and weaknesses in various control environment factors. Management's strengths and weaknesses may have a pervasive effect on internal control. For example, owner-manager controls may mitigate a lack of segregation of duties in a small business, or an active and independent board of directors may influence the philosophy and operating style of senior management in larger entities. Alternatively, management's failure to commit sufficient resources to address security risks presented by IT may adversely affect internal control by allowing improper changes to be made to computer programs or to data, or by allowing unauthorized transactions to be processed. Similarly, human resource policies and practices directed toward hiring competent financial, accounting, and IT personnel may not mitigate a strong bias by top management to overstate earnings.

Risk Assessment

37 An entity's risk assessment for financial reporting purposes is its identification, analysis, and management of risks relevant to the preparation of financial statements that are fairly presented in conformity with generally accepted accounting principles. For example, risk assessment may address how the entity considers the possibility of unrecorded transactions or identities and analyzes significant estimates recorded in the financial statements. Risks relevant to reliable financial reporting also relate to specific events or transactions.

38 Risks relevant to financial reporting include external and internal events and circumstances that may occur and adversely affect an entity's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements.¹⁰ Risks can arise or change due to circumstances such as the following:

- Changes in operating environment
- New personnel
- New or revamped information systems
- Rapid growth

¹⁰ These assertions are discussed in section 326.

- New technology
- New business models, products, or activities
- Corporate restructurings
- Expanded foreign operations
- New accounting pronouncements

39 The auditor should obtain sufficient knowledge of the entity's risk assessment process to understand how management considers risks relevant to financial reporting objectives and decides about actions to address those risks. This knowledge might include understanding how management identifies risks, estimates the significance of the risks, assesses the likelihood of their occurrence, and relates them to financial reporting. The use of IT may be an important element in an entity's risk assessment process, including providing timely information to facilitate the identification and management of risks.

40 An entity's risk assessment differs from the auditor's consideration of audit risk in a financial statement audit. The purpose of an entity's risk assessment is to identify, analyze, and manage risks that affect entity objectives. In a financial statement audit, the auditor assesses inherent and control risks to evaluate the likelihood that material misstatements could occur in the financial statements.

Control Activities

41 Control activities are the policies and procedures that help ensure that management directives are carried out. They help ensure that necessary actions are taken to address risks to achievement of the entity's objectives. Control activities, whether automated or manual, have various objectives and are applied at various organizational and functional levels. Generally, control activities that may be relevant to an audit may be categorized as policies and procedures that pertain to the following:

- Performance reviews
- Information processing
- Physical controls
- Segregation of duties

42 The auditor should obtain an understanding of those control activities relevant to planning the audit. As the auditor obtains an understanding of the other components, he or she is also likely to obtain knowledge about some control activities. For example, in obtaining an understanding of the documents, records, and processing steps in the financial reporting information system that pertain to cash, the auditor is likely to become aware of whether bank accounts are reconciled. The auditor should consider the knowledge about the presence or absence of control activities obtained from the understanding of the other components in determining whether it is necessary to devote additional attention to obtaining an understanding of control activities to plan the audit. Ordinarily, audit planning does not require an understanding of the control activities related to each account balance, transaction class, and disclosure component in the financial statements or to every assertion relevant to them.

43 The auditor should obtain an understanding of how IT affects control activities that are relevant to planning the audit. Some entities and auditors may view the IT control activities in terms of application controls and general controls. Application controls apply to the processing of individual applications. Accordingly, application controls relate to the use of IT to initiate, record, process, and report transactions or other financial data. These controls help ensure

54 Monitoring is a process that assesses the quality of internal control performance over time. It involves assessing the design and operation of controls on a timely basis and taking necessary corrective actions. This process is accomplished through ongoing activities, separate evaluations, or a combination of the two. In many entities, internal auditors or personnel performing similar functions contribute to the monitoring of an entity's activities. Monitoring activities may include using information from communications from external parties such as customer complaints and regulator comments that may indicate problems or highlight areas in need of improvement. In many entities, much of the information used in monitoring may be produced by the entity's information system. If management assumes that data used for monitoring are accurate without having a basis for that assumption, errors may exist in the information, potentially leading management to incorrect conclusions from its monitoring activities.

55 The auditor should obtain sufficient knowledge of the major types of activities the entity uses to monitor internal control over financial reporting, including the source of the information related to those activities, and how those activities are used to initiate corrective actions. When obtaining an understanding of the internal audit function, the auditor should follow the guidance in section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, paragraphs .04 through .08.

Application to Small and Mid-sized Entities

56 The way in which the objectives of internal control are achieved will vary based on an entity's size and complexity, among other considerations. Specifically, small and mid-sized entities may use less formal means to ensure that internal control objectives are achieved. For example, smaller entities with active management involvement in the financial reporting process may not have extensive descriptions of accounting procedures, sophisticated information systems, or written policies. Smaller entities may not have a written code of conduct but, instead, develop a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example. Similarly, smaller entities may not have an independent or outside member on their board of directors.

57 When small or mid-sized entities are involved in complex transactions or are subject to legal and regulatory requirements also found in larger entities, more formal means of ensuring that internal control objectives are achieved may be present. Also, small and mid-sized entities may use IT in various ways to achieve their objectives. For example, a small entity may use sophisticated applications of IT as part of its information system. The impact of IT on an entity's internal control is related more to the nature and complexity of the systems in use than to the entity's size.

Procedures to Obtain Understanding

58 In obtaining an understanding of controls that are relevant to audit planning, the auditor should perform procedures to obtain sufficient knowledge about the design of the relevant controls pertaining to each of the five internal control components and determine whether they have been placed in operation. This knowledge is ordinarily obtained through previous experience with the entity and procedures such as inquiries of appropriate management, supervisory, and staff personnel, inspection of entity documents and records, and observation of entity activities and operations. The nature and extent of

the procedures performed generally vary from entity to entity and are influenced by the size and complexity of the entity, the auditor's previous experience with the entity, the nature of the particular control, and the nature of the entity's documentation of specific controls.

59 For example, the auditor's prior experience with the entity may provide an understanding of its classes of transactions. Inquiries of appropriate entity personnel and inspection of documents and records, such as source documents, journals, and ledgers, may provide an understanding of the accounting records. Similarly, in obtaining an understanding of the design of automated controls and determining whether they have been placed in operation, the auditor may make inquiries of appropriate entity personnel and inspect relevant systems documentation, reports (for example, exception reports or reports evidencing the processing of transactions or application of other controls), or other documents.

60 The auditor's assessments of inherent risk and judgments about materiality for various account balances and transaction classes also affect the nature and extent of the procedures performed to obtain the understanding. For example, the auditor may conclude that planning the audit of the prepaid insurance account does not require specific procedures to be included in obtaining the understanding of internal control.

Documenting the Understanding

61 The auditor should document the understanding of the entity's internal control components obtained to plan the audit. The form and extent of this documentation is influenced by the nature and complexity of the entity's controls. For example, documentation of the understanding of internal control of a complex information system in which a large volume of transactions are electronically initiated, recorded, processed, or reported may include flowcharts, questionnaires, or decision tables. For an information system making limited or no use of IT or for which few transactions are processed (for example, long-term debt), documentation in the form of a memorandum may be sufficient. Generally, the more complex the entity's internal control and the more extensive the procedures performed by the auditor, the more extensive the auditor's documentation should be.

Assessing Control Risk

62 Section 326, *Evidential Matter*, states that most of the independent auditor's work in forming an opinion on financial statements consists of obtaining and evaluating evidential matter concerning the assertions in such financial statements. These assertions are embodied in the account balance, transaction class, and disclosure components of financial statements and are classified according to the following broad categories:

- Existence or occurrence
- Completeness
- Rights and obligations
- Valuation or allocation
- Presentation and disclosure

In planning and performing an audit, an auditor considers these assertions in the context of their relationship to a specific account balance or class of transactions.

63 The risk of material misstatement¹¹ in financial statement assertions consists of inherent risk, control risk, and detection risk. Inherent risk is the susceptibility of an assertion to a material misstatement assuming there are no related controls. Control risk is the risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by the entity's internal control. Detection risk is the risk that the auditor will not detect a material misstatement that exists in an assertion.

64 Assessing control risk is the process of evaluating the effectiveness of an entity's internal control in preventing or detecting material misstatements in the financial statements. Control risk should be assessed in terms of financial statement assertions:

65 After obtaining the understanding of internal control, the auditor may assess control risk at the maximum level¹² for some or all assertions because he or she believes controls are unlikely to pertain to an assertion or are unlikely to be effective, or because evaluating the effectiveness of controls would be inefficient. However, the auditor needs to be satisfied that performing only substantive tests would be effective in restricting detection risk to an acceptable level. For example, the auditor may determine that performing only substantive tests would be effective and more efficient than performing tests of controls for assertions related to fixed assets and to long-term debt in an entity where a limited number of transactions are related to those financial statement components, and when the auditor can readily obtain corroborating evidence in the form of documents and confirmations. In circumstances where the auditor is performing only substantive tests in restricting detection risk to an acceptable level and where the information used by the auditor to perform such substantive tests is produced by the entity's information system, the auditor should obtain evidence about the accuracy and completeness of the information.

66 In other circumstances, the auditor may determine that assessing control risk below the maximum level for certain assertions would be effective and more efficient than performing only substantive tests. In addition, the auditor may determine that it is not practical or possible to restrict detection risk to an acceptable level by performing only substantive tests for one or more financial statement assertions. In such circumstances, the auditor should obtain evidential matter about the effectiveness of both the design and operation of controls to reduce the assessed level of control risk.¹³

67 In determining whether assessing control risk at the maximum level or at a lower level would be an effective approach for specific assertions, the auditor should consider—

- The nature of the assertion.
- The volume of transactions or data related to the assertion.

11 For purposes of this section, a material misstatement in a financial statement assertion is a misstatement whether caused by error or fraud as discussed in section 312, *Audit Risk and Materiality in Conducting an Audit*, that either individually or when aggregated with other misstatements in other assertions would be material to the financial statements taken as a whole.

12 footnote 3.
13 footnote 4.

- The nature and complexity of the systems, including the use of IT, by which the entity processes and controls information supporting the assertion.
- The nature of the available evidential matter, including audit evidence that is available only in electronic form.

68 In circumstances where a significant amount of information supporting one or more financial statement assertions is electronically initiated, recorded, processed, or reported, the auditor may determine that it is not possible to design effective substantive tests that by themselves would provide sufficient evidence that the assertions are not materially misstated. For such assertions, significant audit evidence may be available only in electronic form. In such cases, its competence and sufficiency as evidential matter usually depend on the effectiveness of controls over its accuracy and completeness. Furthermore, the potential for improper initiation or alteration of information to occur and not be detected may be greater if information is initiated, recorded, processed, or reported only in electronic form and appropriate controls are not operating effectively. In such circumstances, the auditor should perform tests of controls to gather evidential matter to use in assessing control risk.

69 Examples of situations where the auditor may find it impossible to design effective substantive tests that by themselves would provide sufficient evidence that certain assertions are not materially misstated include the following:

- An entity that conducts business using IT to initiate orders for goods based on predetermined decision rules and to pay the related payables based on system-generated information regarding receipt of goods. No other documentation of orders or goods received is produced or maintained.
- An entity that provides electronic services to customers (for example, an Internet service provider or a telephone company) and uses IT to log services provided to users, initiate bills for the services, process the billing transactions, and automatically record such amounts in electronic accounting records that are used to produce the financial statements.

Assessing Control Risk Below the Maximum Level

- 70 Assessing control risk below the maximum level involves¹⁴—
 - Identifying specific controls relevant to specific assertions.
 - Performing tests of controls.
 - Concluding on the assessed level of control risk.

Identifying Specific Controls Relevant to Specific Assertions

71 The auditor's understanding about internal control should be used to identify the types of potential misstatements that could occur and to consider factors that affect the risk of material misstatement. In assessing control risk,

14 Section 324 describes reports that an auditor may obtain that may assist in identifying controls relevant to specific assertions and obtaining evidential matter regarding their operating effectiveness when an entity uses a service organization.

the auditor should identify the controls that are likely to prevent or detect material misstatement in specific assertions. In identifying controls relevant to specific financial statement assertions, the auditor should consider that the controls can have either a pervasive effect on many assertions or a specific effect on an individual assertion, depending on the nature of the particular internal control component involved. For example, the conclusion that an entity's control environment is highly effective may influence the auditor's decision about the number of an entity's locations at which auditing procedures are to be performed or whether to perform certain auditing procedures for some account balances or transaction classes at an interim date. Either decision affects the way in which auditing procedures are applied to specific assertions, even though the auditor may not have specifically considered each individual assertion that is affected by such decisions.

72 Conversely, some control activities may have a specific effect on an individual assertion embodied in a particular account balance or transaction class. For example, the control activities that an entity established to ensure that its personnel are properly counting and recording the annual physical inventory relate directly to the existence assertion for the inventory account balance.

73 Controls can be either directly or indirectly related to an assertion. The more indirect the relationship, the less effective that control may be in reducing control risk for that assertion. For example, a sales manager's review of a summary of sales activity for specific stores by region ordinarily is indirectly related to the completeness assertion for sales revenue. Accordingly, it may be less effective in reducing control risk for that assertion than controls more directly related to that assertion, such as matching shipping documents with billing documents.

74 General controls relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems. The auditor should consider the need to identify not only application controls directly related to one or more assertions, but also relevant general controls.

Performing Tests of Controls

75 Procedures directed toward evaluating the effectiveness of the design of a control are concerned with whether that control is suitably designed to prevent or detect material misstatements in specific financial statement assertions. Procedures to obtain such evidential matter ordinarily include inquiries of appropriate entity personnel, inspection of documents, reports, or electronic files; and observation of the application of specific controls. For entities with complex internal control, the auditor should consider the use of flowcharts, questionnaires, or decision tables to facilitate the application of procedures directed toward evaluating the effectiveness of the design of a control.

76 Procedures to obtain evidential matter about the effectiveness of the operation of a control are referred to as tests of controls (paragraphs .90 through .104 of this section discuss characteristics of evidential matter to consider when performing tests of controls). Tests of controls directed toward the operating effectiveness of a control are concerned with how the control (whether manual or automated) was applied, the consistency with which it was applied during the audit period, and by whom it was applied. These tests ordinarily include procedures such as inquiries of appropriate entity personnel, inspection of documents, reports, or electronic files, indicating performance

of the control; observation of the application of the control; and reperformance of the application of the control by the auditor. In some circumstances, a specific procedure may address the effectiveness of both design and operation. However, a combination of procedures may be necessary to evaluate the effectiveness of the design or operation of a control.

77 In designing tests of automated controls, the auditor should consider the need to obtain evidence supporting the effective operation of controls directly related to the assertions as well as other indirect controls on which these controls depend. For example, the auditor may identify a "user review of an exception report of credit sales over a customer's authorized credit limit" as a direct control related to an assertion. In such cases, the auditor should consider the effectiveness of the user review of the report and also the controls related to the accuracy of the information in the report (for example, the general controls).

78 Because of the inherent consistency of IT processing, the auditor may be able to reduce the extent of testing of an automated control. For example, a programmed application control should function consistently unless the program (including the tables, files, or other permanent data used by the program) is changed. Once the auditor determines that an automated control is functioning as intended (which could be done at the time the control is initially implemented or at some other date), the auditor should consider performing tests to determine that the control continues to function effectively. Such tests might include determining that changes to the program are not made without being subject to the appropriate program change controls, that the authorized version of the program is used for processing transactions, and that other relevant general controls are effective. Such tests also might include determining that changes to the programs have not been made, as may be the case when the entity uses packaged software applications without modifying or maintaining them.

79 To test automated controls, the auditor may need to use techniques that are different from those used to test manual controls. For example, computer-assisted audit techniques may be used to test automated controls or data related to assertions. Also, the auditor may use other automated tools or reports produced by IT to test the operating effectiveness of general controls, such as program change controls, access controls, and system software controls. The auditor should consider whether specialized skills are needed to design and perform such tests of controls.

Concluding on the Assessed Level of Control Risk

80 The conclusion reached as a result of assessing control risk is referred to as the assessed level of control risk. In determining the evidential matter necessary to support an assessed level of control risk below the maximum level, the auditor should consider the characteristics of evidential matter about control risk discussed in paragraphs .90 through .104. Generally, however, the lower the assessed level of control risk, the greater the assurance the evidential matter must provide that the controls relevant to an assertion are designed and operating effectively.

81 The auditor uses the assessed level of control risk (together with the assessed level of inherent risk) to determine the acceptable level of detection risk for financial statement assertions. The auditor uses the acceptable level of detection risk to determine the nature, timing, and extent of the auditing procedures

to be applied to the account balance or class of transactions to detect material misstatements in the financial statement assertions. Auditing procedures designed to detect such misstatements are referred to in this section as substantive tests.

82 As the acceptable level of detection risk decreases, the assurance provided from substantive tests should increase. Consequently, the auditor may do one or more of the following:

- Change the nature of substantive tests from a less effective to a more effective procedure, such as using tests directed toward independent parties outside the entity rather than tests directed toward parties or documentation within the entity.
- Change the timing of substantive tests, such as performing them at year end rather than at an interim date.
- Change the extent of substantive tests, such as using a larger sample size.

Documenting the Assessed Level of Control Risk

83 In addition to the documentation of the understanding of internal control discussed in paragraph 61, the auditor should document his or her conclusions about the assessed level of control risk. Conclusions about the assessed level of control risk may differ as they relate to various account balances or classes of transactions. For those financial statement assertions where control risk is assessed at the maximum level, the auditor should document his or her conclusion that control risk is at the maximum level but need not document the basis for that conclusion. For those assertions where the assessed level of control risk is below the maximum level, the auditor should document the basis for his or her conclusion that the effectiveness of the design and operation of controls supports that assessed level. The nature and extent of the auditor's documentation are influenced by the assessed level of control risk, the nature of the entity's internal control, and the nature of the entity's documentation of internal control.

Relationship of Understanding to Assessing Control Risk

84 Although understanding internal control and assessing control risk are discussed separately in this section, they may be performed concurrently in an audit. The objective of procedures performed to obtain an understanding of internal control (discussed in paragraphs 58 through 60) is to provide the auditor with knowledge necessary for audit planning. The objective of tests of controls (discussed in paragraphs 75 through 79) is to provide the auditor with evidential matter to use in assessing control risk. However, procedures performed to achieve one objective may also pertain to the other objective.

85 Based on the assessed level of control risk the auditor expects to support and audit efficiency considerations, the auditor often plans to perform some tests of controls concurrently with obtaining the understanding of internal control. In addition, even though some of the procedures performed to obtain the understanding were not specifically planned as tests of controls, they may nevertheless provide evidential matter about the effectiveness of both the design and operation of the controls relevant to certain assertions. For

example, because of the inherent consistency of IT processing, performing procedures to determine whether an automated control has been placed in operation may serve as a test of that control's operating effectiveness, depending on such factors as whether the program has been changed or whether there is a significant risk of unauthorized change or other improper intervention. Also, in obtaining an understanding of the control environment, the auditor may have made inquiries about management's use of budgets, observed management's comparison of monthly budgeted and actual expenses, and inspected reports pertaining to these procedures provide knowledge about the design of the entity's budgeting policies and whether they have been placed in operation, they may also provide evidential matter about the effectiveness of the operation of budgeting policies in preventing or detecting material misstatements in the classification of expenses. In some circumstances, that evidential matter may be sufficient to support an assessed level of control risk that is below the maximum level for the presentation and disclosure assertions pertaining to expenses in the income statement.

86 When the auditor concludes that procedures performed to obtain the understanding of internal control also provide evidential matter for assessing control risk, he or she should consider the guidance in paragraphs 90 through 104 in judging the degree of assurance provided by that evidential matter. Although such evidential matter may not provide sufficient assurance to support an assessed level of control risk that is below the maximum level for certain assertions, it may do so for other assertions and thus provide a basis for modifying the nature, timing, or extent of the substantive tests that the auditor plans for those assertions. However, such procedures are not sufficient to support an assessed level of control risk below the maximum level if they do not provide sufficient evidential matter to evaluate the effectiveness of both the design and operation of a control relevant to an assertion.

Further Reduction in the Assessed Level of Control Risk

87 After obtaining the understanding of internal control and assessing control risk, the auditor may desire to further reduce the assessed level of control risk for certain assertions. In such cases, the auditor considers whether additional evidential matter sufficient to support a further reduction is likely to be available, and whether it would be efficient to perform tests of controls to obtain that evidential matter. The results of the procedures performed to obtain the understanding of internal control, as well as pertinent information from other sources, help the auditor to evaluate those two factors.

88 In considering efficiency, the auditor recognizes that additional evidential matter that supports a further reduction in the assessed level of control risk for an assertion would result in less audit effort for the substantive tests of that assertion. The auditor weighs the increase in audit effort associated with the additional tests of controls that is necessary to obtain such evidential matter against the resulting decrease in audit effort associated with the reduced substantive tests.

89 For those assertions for which the auditor performs additional tests of controls, the auditor determines the assessed level of control risk that the results of those tests will support. This assessed level of control risk is used in determining the appropriate detection risk to accept for those assertions and, accordingly, in determining the nature, timing, and extent of substantive tests for such assertions.

Evidential Matter to Support the Assessed Level of Control Risk

.90 When the auditor assesses control risk below the maximum level, he or she should obtain sufficient evidential matter to support that assessed level. The evidential matters that is sufficient to support a specific assessed level of control risk is a matter of judgment. Evidential matter varies substantially in the assurance it provides to the auditor as he or she develops an assessed level of control risk. The type of evidential matter, its source, its timeliness, and the existence of other evidential matter related to the conclusion to which it leads all bear on the degree of assurance evidential matter provides.

.91 These characteristics influence the nature, timing, and extent of the tests of controls that the auditor applies to obtain evidential matter about control risk. The auditor selects such tests from a variety of techniques such as inquiry, observation, inspection, and performance of a control that pertains to an assertion. No one specific test of controls is always necessary, applicable, or equally effective in every circumstance.

Type of Evidential Matter

.92 The nature of the particular controls that pertain to an assertion influences the type of evidential matter that is available to evaluate the effectiveness of the design or operation of those controls. For some controls, documentation of design or operation may exist. In such circumstances, the auditor may decide to inspect the documentation to obtain evidential matter about the effectiveness of design or operation.

.93 For other controls, however, such documentation may not be available or relevant. For example, documentation of design or operation may not exist for some factors in the control environment, such as assignment of authority and responsibility, or for some types of control activities, such as undocumented monitoring controls or control activities performed by a computer. In such circumstances, evidential matter about the effectiveness of design or operation may be obtained through such methods as observation, inquiry, or the use of computer-assisted audit techniques.

Source of Evidential Matter

.94 Generally, evidential matter about the effectiveness of the design and operation of controls obtained directly by the auditor, such as through observation, provides more assurance than evidential matter obtained indirectly or by inference, such as through inquiry. For example, evidential matter that is obtained by the auditor's direct personal observation of the individual who applies a control generally provides more assurance than making inquiries about the application of the control. The auditor should consider, however, that the observed application of a control might not be performed in the same manner when the auditor is not present.

.95 Inquiry alone generally will not provide sufficient evidential matter to support a conclusion about the effectiveness of design or operation of a specific control. When the auditor determines that a specific control may have

15 See also section 326 for guidance on evidential matter.

a significant effect in reducing control risk to a low level for a specific assertion, he or she ordinarily needs to perform additional tests to obtain sufficient evidential matter to support the conclusion about the effectiveness of the design or operation of that control.

Timeliness of Evidential Matter

.96 The timeliness of the evidential matter concerns when it was obtained and the portion of the audit period to which it applies. In evaluating the degree of assurance that is provided by evidential matter, the auditor should consider that the evidential matter obtained, by some tests of controls, such as observation, pertains only to the point in time at which the auditing procedure was applied. Consequently, such evidential matter may be insufficient to evaluate the effectiveness of the design or operation of controls for periods not subjected to such tests. In such circumstances, the auditor may decide to supplement those tests with other tests of controls that are capable of providing evidential matter about the entire audit period. For example, for an application control performed by a computer program, the auditor may test the operation of the control at a particular point in time to obtain evidential matter about whether the control is operating effectively at that point in time. The auditor may then perform tests of controls directed toward obtaining evidential matter about whether the application control operated consistently during the audit period, such as tests of general controls pertaining to the modification and use of that computer program during the audit period.

.97 Evidential matter about the effective design or operation of controls that was obtained in prior audits may be considered by the auditor in assessing control risk in the current audit. To evaluate the use of such evidential matter for the current audit, the auditor should consider the significance of the assertion involved, the specific controls that were evaluated during the prior audits, the degree to which the effective design and operation of those controls were evaluated, the results of the tests of controls used to make those evaluations, and the evidential matter about design or operation that may result from substantive tests performed in the current audit. The auditor should also consider that the longer the time elapsed since tests of controls were performed to obtain evidential matter about control risk, the less assurance they may provide.

.98 When considering evidential matter obtained from prior audits, the auditor should obtain evidential matter in the current period about whether changes have occurred in internal control, including its policies, procedures, and personnel, subsequent to the prior audits, as well as the nature and extent of any such changes. For example, in performing the prior audit, the auditor may have determined that an automated control was functioning as intended. The auditor should obtain evidence to determine whether changes to the automated control have been made that would affect its continued effective functioning. Consideration of evidential matter about these changes, together with the considerations in the preceding paragraph, may support either increasing or decreasing the evidential matter about the effectiveness of design and operation to be obtained in the current period.

.99 When the auditor obtains evidential matter about the design or operation of controls during an interim period, he or she should determine what additional evidential matter should be obtained for the remaining period. In making that determination, the auditor should consider the significance of the assertion involved, the specific controls that were evaluated during the interim period, the degree to which the effective design and operation of those

controls were evaluated, the results of the tests of controls used to make that valuation, the length of the remaining period, and the evidential matter about design or operation that may result from the substantive tests performed in the remaining period. The auditor should obtain evidential matter about the nature and extent of any significant changes in internal control, including its policies, procedures, and personnel, that occur subsequent to the interim period.

Interrelationship of Evidential Matter

100 The auditor should consider the combined effect of various types of evidential matter relating to the same assertion in evaluating the degree of assurance that evidential matter provides. In some circumstances, a single type of evidential matter may not be sufficient to evaluate the effective design or operation of a control. To obtain sufficient evidential matter in such circumstances, the auditor may perform other tests of controls pertaining to that control. For example, an auditor may observe the procedures for opening the mail and processing cash receipts to evaluate the operating effectiveness of controls over cash receipts. Because an observation is pertinent only at the point in time at which it is made, the auditor may supplement the observation with inquiries of entity personnel and inspection of documentation about the operation of such controls at other times during the audit period.

101 In addition, when evaluating the degree of assurance provided by evidential matter, the auditor should consider the interrelationship of an entity's control environment, risk assessment, control activities, information and communication, and monitoring. Although an individual internal control component may affect the nature, timing, or extent of substantive tests for a specific financial statement assertion, the auditor should consider the evidential matter about an individual component in relation to the evidential matter about the other components in assessing control risk for a specific assertion.

102 Generally, when various types of evidential matter support the same conclusion about the design or operation of a control, the degree of assurance provided increases. Conversely, if various types of evidential matter lead to different conclusions about the design or operation of a control, the assurance provided decreases. For example, based on the evidential matter that the control provided is effective, the auditor may have reduced the number of locations at which auditing procedures will be performed. If, however, when evaluating specific control activities, the auditor obtains evidential matter that such activities are ineffective, he or she may re-evaluate his or her conclusion about the control environment and, among other things, decide to perform auditing procedures at additional locations.

103 Similarly, evidential matter indicating that the control environment is ineffective may adversely affect an otherwise effective control for a particular assertion. For example, a control environment that is likely to permit unauthorized changes in a computer program may reduce the assurance provided by evidential matter obtained from evaluating the effectiveness of the program at a particular point in time. In such circumstances, the auditor may decide to obtain additional evidential matter about the design and operation of that program during the audit period. For example, the auditor might obtain and control a copy of the program and use computer-assisted audit techniques to compare that copy with the program that the entity uses to process data.

104 An audit of financial statements is a cumulative process; as the auditor assesses control risk, the information obtained may cause him or her to modify the nature, timing, or extent of the other planned tests of controls for

assessing control risk. In addition, information may come to the auditor's attention as a result of performing substantive tests or from other sources during the audit that differs significantly from the information on which his or her planned tests of controls for assessing control risk were based. For example, the extent of misstatements that the auditor detects by performing substantive tests may alter his or her judgment about the assessed level of control risk. In such circumstances, the auditor may need to re-evaluate the planned substantive procedures, based on a revised consideration of the assessed level of control risk for all or some of the financial statement assertions.

Correlation of Control Risk With Detection Risk

105 The ultimate purpose of assessing control risk is to contribute to the auditor's evaluation of the risk that material misstatements exist in the financial statements. The process of assessing control risk (together with assessing inherent risk) provides evidential matter about the risk that such misstatements may exist in the financial statements. The auditor uses this evidential matter as part of the reasonable basis for an opinion referred to in the third standard of field work, which follows:

Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.

106 After considering the level to which he or she seeks to restrict the risk of a material misstatement in the financial statements and the assessed levels of inherent risk and control risk, the auditor performs substantive tests to restrict detection risk to an acceptable level. As the assessed level of control risk decreases, the acceptable level of detection risk increases. Accordingly, the auditor may alter the nature, timing, and extent of the substantive tests performed.

107 Although the inverse relationship between control risk and detection risk may permit the auditor to change the nature or the timing of substantive tests or limit their extent, ordinarily the assessed level of control risk cannot be sufficiently low to eliminate the need to perform any substantive tests to restrict detection risk for all of the assertions relevant to significant account balances or transaction classes. Consequently, regardless of the assessed level of control risk the auditor should perform substantive tests for significant account balances and transaction classes.

108 The substantive tests that the auditor performs consist of tests of details of transactions and balances, and analytical procedures. In assessing control risk, the auditor also may use tests of details of transactions as substantive tests. The objective of tests of details of transactions performed as substantive tests is to detect material misstatements in the financial statements. The objective of tests of details of transactions performed as tests of controls are different, both may be accomplished concurrently through performance of a test of details on the same transaction. The auditor should recognize, however, that careful consideration should be given to the design and evaluation of such tests to ensure that both objectives will be accomplished.

Effective Date

109 This amendment is effective for audits of financial statements for periods beginning on or after June 1, 2001. Earlier application is permissible.

Appendix

Internal Control Components

1. This appendix discusses the five internal control components set forth in paragraph .07 and further described in paragraphs .34 through .57 as they relate to a financial statement audit.

Control Environment

2. The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure.
3. The control environment encompasses the following factors:
 - a. *Integrity and ethical values.* The effectiveness of controls cannot rise above the integrity and ethical values of the people who create, administer, and monitor them. Integrity and ethical values are essential elements of the control environment, affecting the design, administration, and monitoring of other components. Integrity and ethical behavior are the product of the entity's ethical and behavioral standards, how they are communicated, and how they are reinforced in practice. They include management's actions to remove or reduce incentives and temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts. They also include the communication of entity values and behavioral standards to personnel through policy statements and codes of conduct and by example.
 - b. *Commitment to competence.* Competence is the knowledge and skills necessary to accomplish tasks that define the individual's job. Commitment to competence includes management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.
 - c. *Board of directors or audit committee participation.* An entity's control consciousness is influenced significantly by the entity's board of directors or audit committee. Attributes include the board or audit committee's independence from management, the experience and stature of its members, the extent of its involvement and scrutiny of activities, the appropriateness of its actions, the degree to which difficult questions are raised and pursued with management, and its interaction with internal and external auditors.
 - d. *Management's philosophy and operating style.* Management's philosophy and operating style encompass a broad range of characteristics. Such characteristics may include the following: management's approach to taking and monitoring business risks; management's attitudes and actions toward financial reporting (conservative or aggressive selection from available alternative accounting principles, and conscientiousness and conservatism with which accounting estimates are developed); and management's attitudes toward information processing and accounting functions and personnel.

- e. *Organizational structure.* An entity's organizational structure provides the framework within which its activities for achieving entity-wide objectives are planned, executed, controlled, and monitored. Establishing a relevant organizational structure includes considering key areas of authority and responsibility and appropriate lines of reporting. An entity develops an organizational structure suited to its needs. The appropriateness of an entity's organizational structure depends, in part, on its size and the nature of its activities.

- f. *Assignment of authority and responsibility.* This factor includes how authority and responsibility for operating activities are assigned and how reporting relationships and authorization hierarchies are established. It also includes policies relating to appropriate business practices, knowledge and experience of key personnel, and resources provided for carrying out duties. In addition, it includes policies and communications directed at ensuring that all personnel understand the entity's objectives, know how their individual actions interrelate and contribute to those objectives, and recognize how and for what they will be held accountable.

- g. *Human resource policies and practices.* Human resource policies and practices relate to hiring, orientation, training, evaluating, counseling, promoting, compensating, and remedial actions. For example, standards for hiring the most qualified individuals—with emphasis on educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behavior—demonstrate an entity's commitment to competent and trustworthy people. Training policies that communicate prospective roles and responsibilities and include practices such as training schools and seminars illustrate expected levels of performance and behavior. Promotions driven by periodic performance appraisals demonstrate the entity's commitment to the advancement of qualified personnel to higher levels of responsibility.

Application to Small and Mid-sized Entities

4. Small and mid-sized entities may implement the control environment factors differently than larger entities. For example, smaller entities might not have a written code of conduct but, instead, develop a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example. Similarly, smaller entities may not have an independent or outside member on their board of directors.

Risk Assessment

5. An entity's risk assessment for financial reporting purposes is its identification, analysis, and management of risks relevant to the preparation of financial statements that are fairly presented in conformity with generally accepted accounting principles. For example, risk assessment may address how the entity considers the possibility of unrecorded transactions or identifies and analyzes significant estimates recorded in the financial statements. Risks relevant to reliable financial reporting also relate to specific events or transactions.

6. Risks relevant to financial reporting include external and internal events and circumstances that may occur and adversely affect an entity's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. Once risks are identified, management considers their significance, the likelihood of their occurrence, and how they should be managed. Management may initiate plans, programs, or actions to address specific risks or it may decide to accept a risk because of cost or other considerations. Risks can arise or change due to circumstances such as the following:

- *Changes in operating environment.* Changes in the regulatory or operating environment can result in changes in competitive pressures and significantly different risks.
- *New personnel.* New personnel may have a different focus on or understanding of internal control.
- *New or revamped information systems.* Significant and rapid changes in information systems can change the risk relating to internal control.
- *Rapid growth.* Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls.
- *New technology.* Incorporating new technologies into production processes or information systems may change the risk associated with internal control.
- *New business models, products, or activities.* Entering into business areas or transactions with which an entity has little experience may introduce new risks associated with internal control.
- *Corporate restructurings.* Restructurings may be accompanied by staff reductions and changes in supervision and segregation of duties that may change the risk associated with internal control.
- *Expanded foreign operations.* The expansion or acquisition of foreign operations carries new and often-unique risks that may affect internal control, for example, additional or changed risks from foreign currency transactions.
- *New accounting pronouncements.* Adoption of new accounting principles or changing accounting principles may affect risks in preparing financial statements.

Application to Small and Midsized Entities

7. The basic concepts of the risk assessment process should be present in every entity, regardless of size, but the risk assessment process is likely to be less formal and less structured in small and midsized entities than in larger ones. All entities should have established financial reporting objectives, but they may be recognized implicitly rather than explicitly in smaller entities. Management may be able to learn about risks related to these objectives through direct personal involvement with employees and outside parties.

Control Activities

8. Control activities are the policies and procedures that help ensure that necessary actions are taken to address risks to achievement of the entity's objectives. Control activities, whether automated or manual, have various objectives and are applied at various organizational and functional levels.

9. Generally, control activities that may be relevant to an audit may be categorized as policies and procedures that pertain to the following:

- *Performance reviews.* These control activities include reviews of actual performance versus budgets, forecasts, and prior period performance; relating different sets of data—operating or financial—to one another, together with analyses of the relationships and investigative and corrective actions; and review of functional or activity performance, such as a bank's consumer loan manager's review of reports by branch, region, and loan type for loan approvals and collections.
- *Information processing.* A variety of controls are performed to check accuracy, completeness, and authorization of transactions. The two broad groupings of information systems control activities are application controls and general controls. Application controls apply to the processing of individual applications. These controls help ensure that transactions occurred and processed, and are completely and accurately recorded and processed. General controls commonly include controls over data center and network operations; system software acquisition and maintenance; access security; and application system acquisition, development, and maintenance. These controls apply to mainframe, miniframe, and end-user environments. Examples of such general controls are program change controls, controls that restrict access to programs or data, controls over the implementation of new releases of packaged software applications, and controls over system software that restrict access to or monitor the use of system utilities that could change financial data or records without leaving an audit trail.
- *Physical controls.* These activities encompass the physical security of assets, including adequate safeguards such as secured facilities, over access to assets and records; authorization for access to computer programs and data files; and periodic counting and comparison with amounts shown on control records. The extent to which physical controls intended to prevent theft of assets are relevant to the reliability of financial statement preparation, and therefore the audit, depends on circumstances such as when assets are highly susceptible to misappropriation. For example, these controls would ordinarily not be relevant when any inventory losses would be detected pursuant to periodic physical inspection and recorded in the financial statements. However, if for financial reporting purposes management relies solely on perpetual inventory records, the physical security controls would be relevant to the audit.
- *Segregation of duties.* Assigning different people the responsibilities of authorizing transactions, recording transactions, and

maintaining custody of assets is intended to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or fraud in the normal course of his or her duties.

Application to Small and Midsized Entities

10. The concepts underlying control activities in small or midsized organizations are likely to be similar to those in larger entities, but the formality with which they operate varies. Further, smaller entities may find that certain types of control activities are not relevant because of controls applied by management. For example, management's retention of authority for approving credit sales, significant purchases, and draw-downs on lines of credit can provide strong control over those activities, lessening or removing the need for more detailed control activities. An appropriate segregation of duties often appears to present difficulties in smaller organizations. Even companies that have only a few employees, however, may be able to assign their responsibilities to achieve appropriate segregation or, if that is not possible, to use management oversight of the incompatible activities to achieve control objectives.

Information and Communication

11. An information system consists of infrastructure (physical and hardware components), software, people, procedures (manual and automated), and data. Infrastructure and software will be absent, or have less significance, in systems that are exclusively or primarily manual. Many information systems make extensive use of information technology.
12. The information system relevant to financial reporting objectives, which includes the accounting system, consists of the procedures, whether automated or manual, and records established to initiate, record, process, and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities, and equity. Transactions may be initiated manually or automatically by programmed procedures. Recording includes identifying and capturing the relevant information for transactions or events. Processing includes functions such as edit and validation, calculation, measurement, valuation, summarization, and reconciliation, whether performed by automated or manual procedures. Reporting relates to the preparation of financial reports as well as other information, in electronic or printed format, that the entity uses in monitoring and other functions. The quality of system-generated information affects management's ability to make appropriate decisions in managing and controlling the entity's activities and to prepare reliable financial reports.
13. Accordingly, an information system encompasses methods and records that—
 - Identify and record all valid transactions.
 - Describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions for financial reporting.

- Measure the value of transactions in a manner that permits recording their proper monetary value in the financial statements.
- Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.
- Present properly the transactions and related disclosures in the financial statements.

Application to Small and Midsized Entities

14. Communication involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting. It includes the extent to which personnel understand how their activities in the financial reporting information system relate to the work of others and the means of reporting exceptions to an appropriate higher level within the entity. Open communication channels help ensure that exceptions are reported and acted on.
15. Communication takes such forms as policy manuals, accounting and financial reporting manuals, and memoranda. Communication also can be made electronically, orally, and through the actions of management.
16. Information systems in small or midsized organizations are likely to be less formal than in larger organizations, but their role is just as significant. Smaller entities with active management involvement may not need extensive descriptions of accounting procedures, sophisticated accounting records, or written policies. Communication may be less formal and easier to achieve in a small or midsized company than in a larger enterprise due to the smaller organization's size and fewer levels as well as management's greater visibility and availability.

Monitoring

17. Monitoring is a process that assesses the quality of internal control performance over time. It involves assessing the design and operation of controls on a timely basis and taking necessary corrective actions. This process is accomplished through ongoing monitoring activities, separate evaluations, or a combination of the two.
18. Ongoing monitoring activities are built into the normal recurring activities of an entity and include regular management and supervisory activities. Managers of sales, purchasing, and production at divisional and corporate levels are in touch with operations and may question reports that differ significantly from their knowledge of operations.
19. In many entities, internal auditors or personnel performing similar functions contribute to the monitoring of an entity's activities through separate evaluations. They regularly provide information about the functioning of internal control, focusing considerable attention on evaluating the design and operation of internal control. They communicate information about strengths and weaknesses and recommendations for improving internal control.

20. Monitoring activities may include using information from communications from external parties. Customers implicitly corroborate billing data by paying their invoices or complaining about their charges. In addition, regulators may communicate with the entity concerning matters that affect the functioning of internal control, for example, communications concerning examinations by bank regulatory agencies. Also, management may consider communications relating to internal control from external auditors in performing monitoring activities.

Application to Small and Mid-sized Entities

21. Ongoing monitoring activities of small and mid-sized entities are more likely to be informal and are typically performed as a part of the overall management of the entity's operations. Management's close involvement in operations often will identify significant variances from expectations and inaccuracies in financial data.

[The next page is 371.]

**AU Section 9319
Consideration of Internal Control in a
Financial Statement Audit: Auditing
Interpretations of Section 319**

[1.] Audit Considerations for the Year 2000 Issue [Withdrawn July, 2000]

[The next page is 381.]

examine all of the items that comprise an account balance or class of transactions that exceed a given amount or that have an unusual characteristic and either apply other auditing procedures (e.g., analytical procedures) to those items that do not exceed the given amount or possess the unusual characteristic or apply no auditing procedures to them because of their insignificance. Again, the auditor is not using audit sampling. Rather, he has broken the account balance or class of transactions into two groups. One group is tested 100 percent, the other group is either tested by analytical procedures or considered insignificant. The auditor would be using audit sampling only if he applied an auditing procedure to less than all of the items in the second group to form a conclusion about that group. For the same reason, cutoff tests often do not involve audit sampling applications. In performing cutoff tests auditors often examine all significant transactions for a period surrounding the cutoff date and, as a result, such tests do not involve the application of audit sampling.

The auditor is testing controls that are not documented. Auditors choose from a variety of methods including inquiry, observation, and examination of documentary evidence in testing controls. For example, observation of a client's physical inventory count procedures is a test that is performed primarily through the auditor's observation of controls over such things as inventory movement, counting procedures and other procedures used by the client to control the count of the inventory. The auditor generally does not require use of audit sampling. However, audit sampling may be used in certain tests of controls or substantive tests of details of inventory, for example, in tracing selected test counts into inventory records.

The auditor is not performing a substantive test of details. Substantive tests consist of tests of details of transactions and balances, analytical review and/or from a combination of both. In performing substantive tests, audit sampling is generally used only in testing details of transactions and balances.

[Issue Date: January, 1985.]

[The next page is 675.]

AU Section 380

Communication With Audit Committees

Source: SAS No. 61; SAS No. 89; SAS No. 90.

See section 9380 for interpretations of this section.

Effective for audits of financial statements for periods beginning on or after January 1, 1989, unless otherwise indicated.

01 This section establishes a requirement for the auditor to determine that certain matters related to the conduct of an audit are communicated to those who have responsibility for oversight of the financial reporting process.¹ For purposes of this document, the recipient of the communications is referred to as the *audit committee*. The communications required by this section are applicable to (1) entities that either have an audit committee or that have otherwise formally designated oversight of the financial reporting process to a group equivalent to an audit committee (such as a finance committee or budget committee) and (2) all Securities and Exchange Commission (SEC) engagements.²

02 This section requires the auditor to ensure that the audit committee receives additional information regarding the scope and results of the audit that may assist the audit committee in overseeing the financial reporting and

1 Communication with the audit committee by the independent auditor on certain specified matters when they arise in the conduct of an audit is required by other standards, including—

- Section 326A, *Communication of Internal Control Related Matters Noted in an Audit*.
- Section 316, *Consideration of Fraud in a Financial Statement Audit*.
- Section 317, *Illegal Acts by Clients*.
- Section 801, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*.

In addition, section 722, *Interim Financial Information*, requires that certain information be communicated to audit committees as a result of performing a review of interim financial information. (Footnote revised, November 2002, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 100.)

2 For purposes of this section, an SEC engagement is defined as one that involves the audit of the financial statements of—

1. An issuer making an initial filing, including amendments, under the Securities Act of 1933 and the Securities Exchange Act of 1934.
2. A registrant that files periodic reports with the SEC under the Investment Company Act of 1940 or the Securities Exchange Act of 1934 (except a broker or dealer registered only because of section 15(c) of the 1934 Act).
3. A bank or other lending institution that files periodic reports with the Comptroller of the Currency, the Federal Reserve System, the Federal Deposit Insurance Corporation, or the Federal Home Loan Bank Board because the powers, functions, and duties of the SEC to enforce its periodic reporting provisions are vested, pursuant to section 12(f) of the 1934 Act, in those agencies. (Section 12(f) of the Securities Exchange Act of 1934 provides an exemption from periodic reporting to the SEC to [1] entities with less than \$5 million in total assets on the last day of each of the entity's three most recent fiscal years and fewer than 500 shareholders and [2] entities with fewer than 300 shareholders. Accordingly, such entities are not encompassed within the scope of this definition.)
4. A company whose financial statements appear in the annual report or proxy statement of any investment fund because it is a sponsor or manager of such a fund, but which is not itself a registrant required to file periodic reports under the 1940 Act or section 13 or 15(d) of the Securities Exchange Act of 1934.

disclosure process for which management is responsible. This section does not require communications with management; however, it does not preclude communications with management or other individuals within the entity who may, in the auditor's judgment, benefit from the communications.

03 The communications may be oral or written. If information is communicated orally, the auditor should document the communication by appropriate memoranda or notations in the working papers.³ When the auditor communicates in writing, the report should indicate that it is intended solely for the information and use of the audit committee or the board of directors and, if appropriate, management, and is not intended to be and should not be used by anyone other than these specified parties.

04 The communications specified by this section are incidental to the audit. Accordingly, they are not required to occur before the issuance of the auditor's report on the entity's financial statements so long as the communications occur on a timely basis. There may be occasions, however, when discussion of certain of the matters (specified by paragraphs .06 through .14 below) with the audit committee prior to the issuance of the report may, in the auditor's judgment, be desirable.

05 It may be appropriate for management to communicate to the audit committee certain of the matters specified in this section. In such circumstances, the auditor should be satisfied that such communications have, in fact, occurred. Generally, it is not necessary to repeat the communication of recurring matters each year. Periodically, however, the auditor should consider whether, because of changes in the audit committee or simply because of the passage of time, it is appropriate and timely to report such matters. Finally, this section is not intended to restrict the communication of other matters.

Matters to Be Communicated

The Auditor's Responsibility Under Generally Accepted Auditing Standards

06 An audit performed in accordance with generally accepted auditing standards may address many matters of interest to an audit committee. For example, an audit committee is usually interested in internal control and in whether the financial statements are free of material misstatement. In order for the audit committee to understand the nature of the assurance provided by an audit, the auditor should communicate the level of responsibility assumed for these matters under generally accepted auditing standards. It is also important for the audit committee to understand that an audit conducted in accordance with generally accepted auditing standards is designed to obtain reasonable, rather than absolute, assurance about the financial statements.

Significant Accounting Policies

07 The auditor should determine that the audit committee is informed about the initial selection of and changes in significant accounting policies or

³ The auditor may wish to review the minutes, if any prepared by the audit committee for consistency with the auditor's understanding of the communications. [Footnote added, effective for audits of financial statements for periods ending on or after December 15, 2000, by Statement on Auditing Standards No. 90.]

their application. The auditor should also determine that the audit committee is informed about the methods used to account for significant unusual transactions and the effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus. For example, significant accounting issues may exist in areas such as revenue recognition, off-balance-sheet financing, and accounting for equity investments.

Management Judgments and Accounting Estimates

08 Accounting estimates are an integral part of the financial statements prepared by management and are based upon management's current judgments. Those judgments are normally based on knowledge and experience about past and current events and assumptions about future events. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ markedly from management's current judgments. The auditor should determine that the audit committee is informed about the process used by management in formulating particularly sensitive accounting estimates and about the basis for the auditor's conclusions regarding the reasonableness of those estimates.

Audit Adjustments

09 The auditor should inform the audit committee about adjustments arising from the audit that could, in his judgment, either individually or in the aggregate, have a significant effect on the entity's financial reporting process. For purposes of this section, an audit adjustment, whether or not recorded by the entity, is a proposed correction of the financial statements that, in the auditor's judgment, may not have been detected except through the auditing procedures performed. Matters underlying adjustments proposed by the auditor but not recorded by the entity could potentially cause future financial statements to be materially misstated, even though the auditor has concluded that the adjustments are not material to the current financial statements. [As amended, effective for audits of financial statements for periods beginning on or after December 15, 1999, by Statement on Auditing Standards No. 89.]

10 The auditor also should inform the audit committee⁴ about uncorrected misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole.⁵ [Paragraph added, effective for audits of financial statements for periods beginning on or after December 15, 1999, by Statement on Auditing Standards No. 89.]

⁴ The presentation to the audit committee should be similar to the summary of uncorrected misstatements included in or attached to the management representation letter. See footnote 6 of section 639, *Management Representations*. [Footnote added, effective for audits of financial statements for periods beginning on or after December 15, 1999, by Statement on Auditing Standards No. 89.]

⁵ The communication to management and the audit committee of immaterial misstatements aggregated by the auditor does not constitute a communication pursuant to section 317.17, Section 10A of the Securities Exchange Act of 1934, or section 316.79-82. The auditor may have additional communication responsibilities pursuant to section 317, Section 10A of the Securities Exchange Act of 1934, or section 316. [Footnote added, effective for audits of financial statements for periods beginning on or after December 15, 1999, by Statement on Auditing Standards No. 89. Footnote revised, January 2004, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 99.]

Difficulties Encountered in Performing the Audit

16 The auditor should inform the audit committee of any serious difficulties he encountered in dealing with management related to the performance of the audit. This may include, among other things, unreasonable delays by management in permitting the commencement of the audit or in providing needed information, and whether the timetable set by management was unreasonably under the circumstances. Other matters that the auditor may encounter include the unavailability of client personnel and the failure of client personnel to complete client-prepared schedules on a timely basis. If the auditor considers these matters significant, he should inform the audit committee. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 89, December 1999. Paragraph subsequently renumbered by the issuance of Statement on Auditing Standards No. 90, December 1999.]

Effective Date

17 This section is effective for audits of financial statements for periods beginning on or after January 1, 1989. Early application of the provisions of this section is permissible.

AU Section 9380

Communication With Audit Committees: Auditing Interpretations of Section 380

1. Applicability of Section 380

01 *Question*—Section 380, *Communication With Audit Committees*, requires the auditor to determine that certain matters related to the conduct of an audit are communicated to those who have responsibility for oversight of the financial reporting process. Paragraph .01 indicates that the section is applicable to "(1) entities that either have an audit committee or that have otherwise formally designated oversight of the financial reporting process to a group equivalent to an audit committee (such as a finance committee or budget committee) and (2) all Securities and Exchange Commission (SEC) engagements."¹

02 When a non-SEC client has no designated group equivalent to an audit committee with formal responsibility for the financial reporting process, does the auditor have a responsibility to communicate section 380 matters to the governing or oversight body or person(s)?

03 *Interpretation*—No. If a governing or oversight body, such as a board of directors or a board of trustees, has not established an audit committee or formally designated a group with equivalent responsibility for the financial reporting process, the auditor is not required to make the communications. Similarly, the auditor has no responsibility to communicate section 380 matters if the client has no governing or oversight body (for example, a small owner-managed entity). However, the auditor is not precluded from communicating any or all matters described in section 380 in such cases.

[Issue Date: August, 1993.]

[The next page is 686.]

¹ See section 380.01, footnote 2.

to future periods any evaluation of the description. Section 324.44 goes on to state that the report also should refer to the risk of projecting to the future "any conclusions about the effectiveness of controls in achieving control objectives." The sample service auditor's reports in section 324.38 and .54 include illustrative paragraphs that illustrate this caveat. The following excerpt is from section 324.54:

The description of controls at XYZ Service Organization is as of _____ and information about tests of the operating effectiveness of specific controls covers the period from _____ to _____. Any projection of such information to the future is subject to the risk that, because of change, the description may no longer portray the controls in existence. The potential effectiveness of specific controls at the Service Organization is subject to inherent limitations and, accordingly, errors or fraud may occur and not be detected. Furthermore, the projection of any conclusions, based on our findings, to future periods is subject to the risk that changes may alter the validity of such conclusions.

The validity of projections to the future about the effectiveness of controls may be affected by changes made to the system and the controls, and also by the failure to make needed changes, for example, changes to accommodate new processing requirements. May a service auditor's report be expanded to describe the risk of projecting to the future conclusions about the effectiveness of controls?

39 Interpretation—The sample reports in section 324.38 and .54 may be expanded to describe this risk. The first and second sentences of the illustrative paragraph above address the potential effect of change on the description of controls as of a specified date; accordingly, they do not require modification because new processing requirements would not affect the description as of the specified date. However, the last sentence in the sample report paragraph above could be expanded to describe the risk of projecting an evaluation of the controls to future periods because of changes to the system or controls, or the failure to make needed changes to the system or controls.

40 Suggested additions to the paragraph in the illustrative service auditor's reports in section 324.38 and .54 are the following (new language is shown in italics):

The description of controls at XYZ Service Organization is as of _____ and information about tests of the operating effectiveness of specific controls covers the period from _____ to _____. Any projection of such information to the future is subject to the risk that, because of change, the description may no longer portray the controls in existence. The potential effectiveness of specific controls at the Service Organization is subject to inherent limitations and, accordingly, errors or fraud may occur and not be detected. Furthermore, the projection of any conclusions, based on our findings, to future periods is subject to the risk that changes made to the system or controls, or the failure to make needed changes to the system or controls, may alter the validity of such conclusions.

[Issue Date: February, 2002.]

[6.] Responsibilities of Service Organizations and Service Auditors With Respect to Subsequent Events in a Service Auditor's Engagement

[41-42] [Rescinded September, 2002, by Statement on Auditing Standards No. 98.]

[The next page is 431.]

AU Section 325

Communicating Internal Control Related Matters Identified in an Audit

(Supersedes SAS No. 60.)

Source: SAS No. 112.

Effective for audits of financial statements for periods ending on or after December 15, 2006.

Introduction

.01 This section establishes standards and provides guidance on communicating matters related to an entity's internal control over financial reporting identified in an audit of financial statements. It is applicable whenever an auditor expresses an opinion on financial statements (including a disclaimer of opinion). In particular, this section:

- Defines the terms *significant deficiency* and *material weakness*.
- Provides guidance on evaluating the severity of control deficiencies identified in an audit of financial statements.
- Requires the auditor to communicate, in writing, to management and those charged with governance, significant deficiencies and material weaknesses identified in an audit.

.02 The term *those charged with governance* is defined in footnote 5 of section 330, *Audit Documentation*, as "the person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting and disclosure process." In most entities, governance is a collective responsibility that may be carried out by a board of directors, a committee of the board of directors (for example, an audit or legislative oversight committee), a committee of management (for example, a finance, budget, or governmental agency executive committee), partners, equivalent persons, or some combination of these parties. In some smaller entities, management and those charged with governance may be the same people, for example, the owner in an owner-managed entity or a sole trustee.

.03 Internal control is a process—effected by those charged with governance, management, and other personnel—designed to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. Internal control over the safeguarding of assets against unauthorized acquisition, use, or disposition may include controls related to financial reporting and operations objectives. Generally, controls that are relevant to an audit of financial statements are those that pertain to the entity's objective of reliable financial reporting. In this section, the term *financial reporting* relates to the preparation of reliable financial statements that are fairly presented in conformity with generally accepted

- The subjectivity and complexity of the amount involved, and the extent of judgment needed to determine that amount.
 - The cause and frequency of any known or detected exceptions related to the operating effectiveness of a control.
 - The interaction or relationship of the control with other controls.
 - The interaction of the control deficiency with other control deficiencies.
 - The possible future consequences of the deficiency.
- 12 Several factors affect the magnitude of a misstatement that could result from a deficiency or deficiencies in controls. The factors include, but are not limited to, the following:
- The financial statement amounts or total of transactions exposed to the deficiency.
 - The volume of activity in the account balance or class of transactions exposed to the deficiency in the current period or expected in future periods.
- The maximum amount by which an account balance or total of transactions can be overstated generally is the recorded amount. However, because of the potential for unrecorded amounts, the recorded amount is not a limitation on the amount of potential understatement.

13 Multiple control deficiencies that affect the same financial statement account balance or disclosure increase the likelihood of misstatement and may, in combination, constitute a significant deficiency or material weakness, even though such deficiencies are individually insignificant. Therefore, the auditor should evaluate individual control deficiencies that affect the same account balance, disclosure, relevant assertion, or component of internal control, to determine whether they collectively result in a significant deficiency or material weakness.

14 In determining whether a control deficiency or combination of control deficiencies is a significant deficiency or material weakness, the auditor also should evaluate the possible mitigating effects of effective compensating controls that have been tested and evaluated as part of the financial statement audit. A compensating control is a control that limits the severity of a control deficiency and prevents it from rising to the level of a significant deficiency or, in some cases, a material weakness. Compensating controls operate at a level of precision, considering the possibility of further undetected misstatements, that would result in the prevention or detection of a misstatement that is more than inconsequential or material to the financial statements. Although compensating controls mitigate the effects of a control deficiency, they do not eliminate the control deficiency.

15 The auditor's evaluation of the possible mitigating effects of compensating controls can be illustrated by the following example, in which an owner-managed entity does not segregate duties within the accounts payable function. As a compensating control, the owner reviews the supporting documentation for all disbursements exceeding \$1,000. The auditor could evaluate the effect of this compensating control and determine whether it operates effectively for the purpose of mitigating the effects of the control deficiency in the accounts payable function (the lack of segregation of duties).

16 In an audit in which the auditor has decided to test the operating effectiveness of controls, the auditor may encounter deviations in the operation of those controls. A control that has an observed nonnegligible deviation rate is a deficiency regardless of the reason for the deviation. For example, if the auditor

designs a test in which he or she selects a sample and expects no deviations, the finding of one deviation is a nonnegligible deviation rate because, based on the results of the auditor's test of the sample, the desired level of confidence was not obtained.

17 The auditor should conclude whether prudent officials, having knowledge of the same facts and circumstances, would agree with the auditor's classification of the deficiency.

18 Deficiencies in the following areas ordinarily are at least significant deficiencies in internal control:

- Controls over the selection and application of accounting principles that are in conformity with generally accepted accounting principles. Having sufficient expertise in selecting and applying accounting principles is an aspect of such controls.
- Antifraud programs and controls.
- Controls over nonroutine and nonsystematic transactions.
- Controls over the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; initiate, authorize, record, and process journal entries into the general ledger; and record recurring and nonrecurring adjustments to the financial statements.

19 Each of the following is an indicator of a control deficiency that should be regarded as at least a significant deficiency and a strong indicator of a material weakness in internal control:

- Ineffective oversight of the entity's financial reporting and internal control by those charged with governance.
- Restatement of previously issued financial statements to reflect the correction of a material misstatement. (The correction of a misstatement includes misstatements due to error or fraud; it does not include restatements to reflect a change in accounting principle to comply with a new accounting principle or a voluntary change from one generally accepted accounting principle to another generally accepted accounting principle.)
- Identification by the auditor of a material misstatement in the financial statements for the period under audit that was not initially identified by the entity's internal control. This includes misstatements involving estimation and judgment for which the auditor identifies likely material adjustments and corrections of the recorded amounts. (This is a strong indicator of a material weakness even if management subsequently corrects the misstatement.)
- An ineffective internal audit function or risk assessment function at an entity for which such functions are important to the monitoring or risk assessment component of internal control, such as for very large or highly complex entities.
- For complex entities in highly regulated industries, an ineffective regulatory compliance function. This relates solely to those aspects of the ineffective regulatory compliance function for which associated violations of laws and regulations could have a material effect on the reliability of financial reporting.

- Identification of fraud of any magnitude on the part of senior management. (The auditor has a responsibility to plan and perform procedures to obtain reasonable assurance about whether the financial statements are free of material misstatement caused by error or fraud.⁷ However, for the purposes of evaluating and communicating deficiencies in internal control, the auditor should evaluate fraud of any magnitude—including fraud resulting in immaterial misstatements—on the part of senior management, of which he or she is aware.)
- Failure by management or those charged with governance to assess the effect of a significant deficiency previously communicated to them and either correct it or conclude that it will not be corrected. See paragraph .20 for communication requirements in these circumstances.
- An ineffective control environment. Control deficiencies in various other components of internal control could lead the auditor to conclude that a significant deficiency or material weakness exists in the control environment.

See the Appendix [paragraph .32] of this section for examples of circumstances that may be control deficiencies, significant deficiencies, or material weaknesses.

Communication—Form, Content, and Timing

.20 Control deficiencies identified during the audit that upon evaluation are considered significant deficiencies or material weaknesses under this section must be communicated in writing to management and those charged with governance as a part of each audit, including significant deficiencies and material weaknesses that were communicated to management and those charged with governance in previous audits, and have not yet been remediated. (Significant deficiencies and material weaknesses that previously were communicated and have not yet been remediated may be communicated in writing by referring to the previously issued written communication and the date of that communication.)

.21 The written communication referred to in paragraph .20 is best made by the report release date, which is the date the auditor grants the entity permission to use the auditor's report in connection with the financial statements, but should be made no later than 60 days following the report release date. See section 339.23 for additional guidance related to the report release date.

.22 For some matters, early communication to management or those charged with governance may be important. Accordingly, the auditor may decide to communicate certain identified significant deficiencies and material weaknesses during the audit. If the communication is made during the audit, the form of interim communication would be affected by the relative significance of the identified control deficiencies and the urgency for corrective follow-up action. Such early communication is not required to be in writing. However, regardless of how the early communication is delivered, the auditor must communicate all significant deficiencies and material weaknesses in

⁷ Section 316, *Consideration of Fraud in a Financial Statement Audit*, provides guidance on the auditor's responsibilities for planning and performing the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement whether caused by error or fraud.

writing to management and those charged with governance in accordance with paragraphs .20 and .21.

.23 The existence of significant deficiencies or material weaknesses may already be known to management and may represent a conscious decision by management or those charged with governance to accept that degree of risk because of cost or other considerations. Management is responsible for making decisions concerning costs to be incurred and related benefits. The auditor's responsibility to communicate significant deficiencies and material weaknesses in accordance with paragraph .20 exists regardless of management's decisions.

.24 Nothing precludes the auditor from communicating to management and those charged with governance other matters that the auditor:

- Believes to be of potential benefit to the entity, such as recommendations for operational or administrative efficiency, or for improving internal control.
- Has been requested to communicate, for example, control deficiencies that are not significant deficiencies or material weaknesses.

Such matters may be communicated either orally or in writing. If the information is communicated orally, the auditor should document the communication.

.25 The written communication regarding significant deficiencies and material weaknesses identified during an audit of financial statements should:

- State that the purpose of the audit was to express an opinion on the financial statements, but not to express an opinion on the effectiveness of the entity's internal control over financial reporting.
- State that the auditor is not expressing an opinion on the effectiveness of internal control.
- Include the definition of the terms *significant deficiency* and, where relevant, *material weakness*.
- Identify the matters that are considered to be significant deficiencies and, if applicable, those that are considered to be material weaknesses.
- State that the communication is intended solely for the information and use of management, those charged with governance, and others within the organization and is not intended to be and should not be used by anyone other than these specified parties. If an entity is required to furnish such auditor communications to a governmental authority, specific reference to such governmental authorities may be made.

.26 The following is an illustrative written communication encompassing the requirements in paragraph .25.

In planning and performing our audit of the financial statements of ABC Company as of and for the year ended December 31, 20XX, in accordance with auditing standards generally accepted in the United States of America, we considered ABC Company's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing an opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies in internal control that we consider to be significant deficiencies [and other deficiencies that we consider to be material weaknesses].

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control. We consider the following deficiencies to be significant deficiencies in internal control:

[Describe the significant deficiencies that were identified.]

[A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control. We believe that the following deficiencies constitute material weaknesses.]

[Describe the material weaknesses that were identified.]

This communication is intended solely for the information and use of management, [identify the body or individuals charged with governance], others within the organization, and [identify any specified governmental authorities] and is not intended to be and should not be used by anyone other than these specified parties.

27 If the auditor wishes, he or she may include additional statements in the communication regarding the general inherent limitations of internal control, including the possibility of management override of controls, or the specific nature and extent of the auditor's consideration of internal control during the audit.

28 A client may ask the auditor to issue a communication indicating that no material weaknesses were identified during the audit of the financial statements for the client to submit to governmental authorities. The following is an illustrative communication that may be used when the auditor has not identified any material weaknesses and wishes, or has been requested, to advise management and those charged with governance that no material weaknesses were identified.⁸

In planning and performing our audit of the financial statements of ABC Company as of and for the year ended December 31, 20XX, in accordance with auditing standards generally accepted in the United States of America, we considered ABC Company's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.

⁸ If an examination of internal control under AT section 501 was performed for the same period or "as of" date as the audit of the financial statements, the issuance of a report indicating that no material weaknesses had been identified during the audit of the financial statements would not be appropriate.

Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of internal control was for the limited purpose described in the first paragraph and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control that we consider to be material weaknesses, as defined above.

This communication is intended solely for the information and use of management, [identify the body or individuals charged with governance], others within the organization, and [identify any specified governmental authorities] and is not intended to be and should not be used by anyone other than these specified parties.

If one or more significant deficiencies have been identified, the auditor may add the following sentence to the fourth paragraph of the communication:

However, we identified certain deficiencies in internal control that we consider to be significant deficiencies, and communicated them in writing to management and those charged with governance on [date].

29 The auditor should not issue a written communication stating that no significant deficiencies were identified during the audit because of the potential for misinterpretation of the limited degree of assurance provided by such a communication.

30 Management may wish to, or may be required by a regulator to, prepare a written response to the auditor's communication regarding significant deficiencies or material weaknesses identified in the audit. Such management communications may include a description of corrective actions taken by the entity, the entity's plans to implement new controls, or a statement indicating that management believes the cost of correcting a significant deficiency or material weakness would exceed the benefits to be derived from doing so. If such a written response is included in a document containing the auditor's written communication to management and those charged with governance concerning identified significant deficiencies or material weaknesses, the auditor should add a paragraph to his or her written communication disclaiming an opinion on such information. Following is an example of such a paragraph.

ABC Company's written response to the significant deficiencies [and material weaknesses] identified in our audit has not been subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

.31 This section is effective for audits of financial statements for periods ending on or after December 15, 2006. Earlier implementation is permitted.

Appendix

Examples of Circumstances That May Be Control Deficiencies, Significant Deficiencies, or Material Weaknesses

Paragraph .18 of this section identifies areas in which control deficiencies ordinarily are at least significant deficiencies, and paragraph .19 identifies indicators that a control deficiency should be regarded as at least a significant deficiency and a strong indicator of a material weakness. The following are examples of circumstances that may be control deficiencies, significant deficiencies, or material weaknesses.

Deficiencies in the Design of Controls

- Inadequate design of internal control over the preparation of the financial statements being audited.
- Inadequate design of internal control over a significant account or process.
- Inadequate documentation of the components of internal control.
- Insufficient control consciousness within the organization, for example, the tone at the top and the control environment.
- Absent or inadequate segregation of duties within a significant account or process.
- Absent or inadequate controls over the safeguarding of assets (this applies to controls that the auditor determines would be necessary for effective internal control over financial reporting).
- Inadequate design of information technology (IT) general and application controls that prevent the information system from providing complete and accurate information consistent with financial reporting objectives and current needs.
- Employees or management who lack the qualifications and training to fulfill their assigned functions. For example, in an entity that prepares financial statements in accordance with generally accepted accounting principles, the person responsible for the accounting and reporting function lacks the skills and knowledge to apply generally accepted accounting principles in recording the entity's financial transactions or preparing its financial statements.
- Inadequate design of monitoring controls used to assess the design and operating effectiveness of the entity's internal control over time.
- The absence of an internal process to report deficiencies in internal control to management on a timely basis.

Failures in the Operation of Internal Control

- Failure in the operation of effectively designed controls over a significant account or process, for example, the failure of a control such as dual authorization for significant disbursements within the purchasing process.

- Failure of the information and communication component of internal control to provide complete and accurate output because of deficiencies in timeliness, completeness, or accuracy; for example, the failing to obtain timely and accurate consolidating information from remote locations that is needed to prepare the financial statements.
- Failure of controls designed to safeguard assets from loss, damage, or misappropriation. This circumstance may need careful consideration before it is evaluated as a significant deficiency or material weakness. For example, assume that a company uses security devices to safeguard its inventory (preventive controls) and also performs periodic physical inventory counts (detective controls) timely in relation to its financial reporting. Although the physical inventory count does not safeguard the inventory from theft or loss, it prevents a material misstatement of the financial statements if performed effectively and timely. Therefore, given that the definitions of material weakness and significant deficiency relate to likelihood of misstatement of the financial statements, the failure of a preventive control such as inventory tags will not result in a significant deficiency or material weakness if the detective control (physical inventory) prevents a misstatement of the financial statements. Material weaknesses relating to controls over the safeguarding of assets would only exist if the company does not have effective controls (considering both safeguarding and other controls) to prevent or detect a material misstatement of the financial statements.
- Failure to perform reconciliations of significant accounts. For example, accounts receivable subsidiary ledgers are not reconciled to the general ledger account in a timely or accurate manner.
- Undue bias or lack of objectivity by those responsible for accounting decisions, for example, consistent understatement of expenses or overstatement of allowances at the direction of management.
- Misrepresentation by client personnel to the auditor (an indicator of fraud).
- Management override of controls.
- Failure of an application control caused by a deficiency in the design or operation of an IT general control.

[The next page is 444-21.]

AU Section 325A Communication of Internal Control Related Matters Noted in an Audit¹

(Supersedes AU sections 323 and 642.47-.53)

Source: SAS No. 60; SAS No. 79; SAS No. 87.

See section 9325A for interpretations of this section.

Effective for audits of financial statements for periods beginning on or after January 1, 1989, unless otherwise indicated.

01. This section provides guidance in identifying and reporting conditions that relate to an entity's internal control observed during an audit of financial statements. It is contemplated that the communication would generally be to the audit committee or to individuals with a level of authority and responsibility equivalent to an audit committee in organizations that do not have one, such as the board of directors, the board of trustees, an owner in an owner-managed enterprise, or others who may have engaged the auditor. For the purpose of this section, the term *audit committee* is used to refer to the appropriate recipient of the communication. This section also provides guidance on establishing, between the auditor and client, agreed-upon criteria for identifying and reporting additional matters beyond those required by this section.

Reportable Conditions

02. During the course of an audit, the auditor may become aware of matters relating to internal control that may be of interest to the audit committee. The matters that this section requires for reporting to the audit committee are referred to as *reportable conditions*.¹ Specifically, these are matters coming to the auditor's attention that, in his judgment, should be communicated to the audit committee because they represent significant deficiencies in the design or operation of internal control, which could adversely affect the organization's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements.² Such deficiencies may involve aspects of the five internal control components³ of (a) the control environment, (b) risk assessment, (c) control

¹ This section has been revised to reflect the amendments and conforming changes necessary due to the issuance of Statement on Auditing Standards No. 79, effective for audits of financial statements for periods beginning on or after January 1, 1997.

² This section supersedes section 323, *Required Communication of Material Weaknesses in Internal Accounting Control*, and section 642, *Reporting on Internal Accounting Control*, paragraphs .47 through .53, and related auditing interpretations. This section does not affect the reporting of material weaknesses noted in an engagement to report on an entity's internal control.

³ The auditor should also consider matters coming to his attention that relate to internal financial reporting outside the entity in the communication contemplated by this section.

⁴ *Internal control* refers to the controls established to provide reasonable assurance that specific entity objectives will be achieved. (See section 319, *Consideration of Internal Control in a Financial Statement Audit*, for additional key definitions.) [Footnote transferred from paragraph .04 to paragraph .02, February 1997.]

activities, (d) information and communication, and (e) monitoring. (See paragraph .21 for examples of reportable conditions.) [As amended, effective for audits of financial statements for periods beginning on or after January 1, 1997, by Statement on Auditing Standards No. 78, Revised, April 2002, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 94.]

.03 The auditor may also identify matters that, in his judgment, are not reportable conditions as defined in paragraph .02; however, the auditor may choose to communicate such matters for the benefit of management and other recipients, as appropriate.

Identifying Reportable Conditions

.04 The auditor's objective in an audit of financial statements is to form an opinion on the entity's financial statements taken as a whole. The auditor is not obligated to search for reportable conditions. However, the auditor may become aware of possible reportable conditions through consideration of the components of internal control, application of audit procedures to balances and transactions, or otherwise during the course of the audit. The auditor's awareness of reportable conditions varies with each audit and is influenced by the nature, timing, and extent of audit procedures and numerous other factors, such as an entity's size, its complexity, and the nature and diversity of its business activities. [As amended, effective for audits of financial statements for periods beginning on or after January 1, 1997, by Statement on Auditing Standards No. 78.]

.05 In making the judgment as to which matters are reportable conditions, the auditor should take into consideration various factors relating to the entity, such as its size, complexity and diversity of activities, organizational structure, and ownership characteristics.

.06 The existence of reportable conditions related to internal control design or operation may already be known and, in fact, may represent a conscious decision by management—a decision of which the audit committee is aware—to accept that degree of risk because of cost or other considerations. It is the responsibility of management to make the decisions concerning costs to be incurred and related benefits. Provided the audit committee has acknowledged its understanding and consideration of such deficiencies and the associated risks, the auditor may decide the matter does not need to be reported. Periodically, the auditor should consider whether, because of changes in management, the audit committee, or simply because of the passage of time, it is appropriate and timely to report such matters.

Agreed-Upon Criteria

.07 The auditor and client may discuss internal control and concerns regarding its functioning when making arrangements for the audit. Clients may request the auditor to be alert to matters and to report conditions that go beyond those contemplated by this section. The auditor is not precluded from reporting matters that he views to be of value to management in the absence of any specific request to do so.

.08 Agreed-upon arrangements between the auditor and the client to report conditions noted may include, for example, the reporting of matters of less significance than provided for by this section, the existence of conditions

specified by the client, or the results of further investigation of matters noted to identify underlying causes. Under these arrangements, it is possible that the auditor may be requested to visit specific locations, assess specific controls, or undertake specific procedures not otherwise planned.

Reporting—Form and Content

.09 Conditions noted by the auditor that are considered reportable under this section or that are the result of agreement with the client should be reported, preferably in writing. If information is communicated orally, the auditor should document the communication by appropriate memoranda or notations in the working papers.

.10 The report should state that the communication is intended solely for the information and the use of the audit committee, management, and others within the organization and is not intended to be and should not be used by anyone other than these specified parties. When there are requirements established by governmental authorities to furnish such reports, specific reference to such regulatory authorities may be made.

- .11 Any report issued on reportable conditions should—
- Indicate that the purpose of the audit was to report on the financial statements and not to provide assurance on internal control.
 - Include the definition of reportable conditions.
 - Include the restriction on use as discussed in paragraph .10.

.12 The following is an illustration of the sections of a report encompassing the above requirements.

In planning and performing our audit of the financial statements of the ABC Corporation for the year ended December 31, 19XX, we considered its internal control in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control. However, we noted certain matters involving the internal control and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control that, in our judgment, could adversely affect the organization's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements.

[Include paragraphs to describe the reportable conditions noted.]

This report is intended solely for the information and use of the audit committee (board of directors, board of trustees, or owners in owner-managed enterprises), management, and others within the organization (or specified regulatory agency) and is not intended to be and should not be used by anyone other than these specified parties.

[As amended, effective for reports issued after December 31, 1998, by Statement on Auditing Standards No. 87, Revised, April 2002, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 94.]

13. In some circumstances, the auditor may wish to include additional statements in the report regarding the inherent limitations of internal control in general, the specific extent and nature of his consideration of internal control during the audit, or other matters regarding the basis for the comments made.

14. In a communication that contains both observations deemed by the auditor to be reportable conditions, as defined, and other comments, it may be appropriate to indicate which comments are in each category.

15. A reportable condition may be of such magnitude as to be considered a material weakness. A material weakness in internal control is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Although this section does not require that the auditor separately identify and communicate material weaknesses, the auditor may choose or the client may request the auditor to separately identify and communicate as material weaknesses those reportable conditions that, in the auditor's judgment, are considered to be material weaknesses. [As modified, June, 1990, by the Audit Issues Task Force.]

16. The following is an illustration of the sections of a report that may be used when the auditor wishes, or has been requested, to advise the audit committee in writing that one or more reportable conditions have been identified, but none is deemed to be a material weakness.

[Include the first paragraph in the report illustrated in paragraph 12.]

[Include paragraphs to describe the reportable conditions noted.]

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of internal control would not necessarily disclose all matters in internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, none of the reportable conditions described above is believed to be a material weakness.

[Include the final paragraph in the report illustrated in paragraph 12.]

17. Because of the potential for misinterpretation of the limited degree of assurance associated with the auditor issuing a written report representing that no reportable conditions were noted during an audit, the auditor should not issue such representations.

18. Because timely communication may be important, the auditor may choose to communicate significant matters during the course of the audit rather than after the audit is concluded. The decision on whether an interim communication should be issued would be influenced by the relative significance of the matters noted and the urgency of corrective follow-up action.

19. The provisions in this section should not be viewed as precluding an auditor from communicating to a client a variety of observations and suggestions regarding its activities that go beyond internal control related matters. Such matters may deal with operational or administrative efficiencies, business strategies, and other items of perceived benefit to the client.

Effective Date

20. This section is effective for audits of financial statements for periods beginning on or after January 1, 1989, with early application permissible.

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Appendix

Examples of Possible Reportable Conditions

1. As indicated in paragraph .02 of this section reportable conditions involve matters coming to the auditor's attention that relate to significant deficiencies in the design or operation of internal control that, in the auditor's judgment, could adversely affect the organization's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements.

2. The following are examples of matters that may be reportable conditions. They are grouped by categories of conditions and within categories by specific examples of conditions. Certain of these matters may also require communications under the provisions of other statements on auditing standards.

Deficiencies in internal control design

- Inadequate overall internal control design
- Absence of appropriate segregation of duties consistent with appropriate control objectives
- Absence of appropriate reviews and approvals of transactions, accounting entries, or systems output
- Inadequate procedures for appropriately assessing and applying accounting principles
- Inadequate provisions for the safeguarding of assets
- Absence of other controls considered appropriate for the type and level of transaction activity
- Evidence that a system fails to provide complete and accurate output that is consistent with objectives and current needs because of design flaws

Failures in the operation of internal control

- Evidence of failure of identified controls in preventing or detecting misstatements of accounting information
- Evidence that a system fails to provide complete and accurate output consistent with the entity's control objectives because of the misapplication of controls
- Evidence of failure to safeguard assets from loss, damage or misappropriation
- Evidence of intentional override of internal control by those in authority to the detriment of the overall objectives of the system
- Evidence of failure to perform tasks that are part of internal control, such as reconciliations not prepared or not timely prepared
- Evidence of willful wrongdoing by employees or management

Others

- Evidence of manipulation, falsification, or alteration of accounting records or supporting documents
 - Evidence of intentional misapplication of accounting principles
 - Evidence of misrepresentation by client personnel to the auditor
 - Evidence that employees or management lack the qualifications and training to fulfill their assigned functions
 - Absence of a sufficient level of control consciousness within the organization
 - Failure to follow up and correct previously identified internal control deficiencies
 - Evidence of significant or extensive undisclosed related party transactions
 - Evidence of undue bias or lack of objectivity by those responsible for accounting decisions
- [Revised, April 2002, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 94.]

[The next page is 444-41.]

AU Section 9325A

Communication of Internal Control Related Matters Noted in an Audit: Auditing Interpretations of Section 325A

1. Reporting on the Existence of Material Weaknesses

.01 Question—Section 325A requires the auditor to report to the audit committee or to individuals with equivalent authority and responsibility reportable conditions noted during an audit of financial statements. If permits the issuance of reports that include a statement about whether any of the reportable conditions identified are material weaknesses. In connection with an audit, may the auditor issue a written report on material weaknesses separate from the report on reportable conditions?

.02 Interpretation—Yes. Section 325A does not preclude the auditor from issuing a separate report stating whether he or she noted any material weaknesses during the audit. Reports on material weaknesses should—

- Indicate that the purpose of the audit was to report on the financial statements and not to provide assurance on internal control.
- Include the definition of a material weakness.
- State that the communication is intended solely for the information and the use of the audit committee, management, and others within the organization and is not intended to be and should not be used by anyone other than these specified parties. When there are requirements established by governmental agencies to furnish such reports, specific reference to such regulatory authorities may be made.

.03 Section 325A prohibits the auditor from issuing a written report representing that no reportable conditions were noted during the audit. Therefore, in issuing a report stating that no material weaknesses were noted, the auditor should not imply that no reportable conditions were noted.

.04 The following is an illustration of a report encompassing the above requirements:

In planning and performing our audit of the financial statements of ABC Corporation for the year ended December 31, 19XX, we considered its internal control in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control. Our consideration of the internal control would not necessarily disclose all matters in the internal control that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. However, we noted no matters involving the internal control and its operation that we consider to be material weaknesses as defined above.

This report is intended solely for the information and use of the audit committee (board of directors, board of trustees, or owners in owner-managed enterprises), management, and others within the organization (or specified regulatory agency) and is not intended to be and should not be used by anyone other than these specified parties.

.05 If conditions believed to be material weaknesses are disclosed, the report should describe the weaknesses that have come to the auditor's attention. The last sentence of the first paragraph of the report illustrated in paragraph .04 should be modified as follows and paragraphs describing the material weaknesses should follow the first paragraph:

However, we noted the following matters involving internal control and its operation that we consider to be material weaknesses as defined above.

.06 In some cases reports on material weaknesses may include comments on specific aspects of internal control or on additional matters. For example, a regulatory agency may require comments on the accounting system and controls (but not on the control environment) or on compliance with certain provisions in contracts or regulations. In such cases the language in paragraph .04 should be modified to:

- a. identify clearly the specific aspects of internal controls or the additional matters covered by the report
- b. distinguish any additional matters from internal control
- c. describe in reasonable detail the scope of the review and tests concerning the additional matters.
- d. express conclusions in language comparable to that in paragraph .04 or .05, as appropriate

.07 The identification of the specific aspects of internal control or additional matters covered in the report should be as specific as the auditor considers necessary to prevent misunderstanding in this respect. Such identification can be made in some cases by reference to specific portions of other documents such as contracts or regulations.

[Issue Date: February, 1989; Revised: February, 1999.]

[2.] Audit Considerations for the Year 2000 Issue

[.08-17] [Withdrawn, July, 2000, by the Audit Issues Task Force.]

[The next page is 44b.]

AU Section 326

Evidential Matters⁵

(Supersedes section 330, "Evidential Matter")

Source: SAS No. 31; SAS No. 48; SAS No. 80.

See section 9326 for interpretations of this section.

Issue date, unless otherwise indicated: August, 1980.

.01 The third standard of field work is:

Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.

.02 Most of the independent auditor's work in forming his or her opinion on financial statements consists of obtaining and evaluating evidential matter¹ concerning the assertions in such financial statements. The measure of the validity of such evidence for audit purposes lies in the judgment of the auditor; in this respect audit evidence differs from legal evidence, which is circumscribed by rigid rules. Evidential matter varies substantially in its influence on the auditor as he or she develops an opinion with respect to financial statements under audit. The pertinence of the evidence, its objectivity, its timeliness, and the existence of other evidential matter corroborating the conclusions to which it leads all bear on its competence.

Nature of Assertions

.03 Assertions are representations by management that are embodied in financial statement components. They can be either explicit or implicit and can be classified according to the following broad categories:

- Existence or occurrence
- Completeness
- Rights and obligations
- Valuation or allocation
- Presentation and disclosure

.04 Assertions about existence or occurrence address whether assets or liabilities of the entity exist at a given date and whether recorded transactions have occurred during a given period. For example, management asserts that

⁵ This section has been superseded by Statement on Auditing Standards No. 106, *Audit Evidence*. This section will be superseded closer to the effective date of Statement on Auditing Standards No. 106, which is effective for audits of financial statements for periods beginning on or after December 15, 2006. Earlier application is permitted. Statement on Auditing Standards No. 106 is published in SAS No. 104-SAS No. 111 section, following the "AU Section 900—Special Reports of the Committee on Auditing Procedures" section of this publication.

¹ See section 319, *Consideration of Internal Control in a Financial Statement Audit*, paragraphs 30 through 104, for further guidance on evidential matter. [Footnote added, May 1994, to cross-reference guidance on evidential matter to section 319. Footnote revised, May 2001, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 94.]

AU Section 561 Subsequent Discovery of Facts Existing at the Date of the Auditor's Report

Source: SAS No. 1, section 561; SAS No. 98.

See section 9561 for interpretations of this section.

Issue date, unless otherwise indicated: November, 1972.

.01 The procedures described in this section should be followed by the auditor who, subsequent to the date of the report upon audited financial statements, becomes aware that facts may have existed at that date which might have affected the report had he or she then been aware of such facts.¹ [As amended, effective September 2002, by Statement on Auditing Standards No. 98.]

.02 Because of the variety of conditions which might be encountered, some of these procedures are necessarily set out only in general terms; the specific actions to be taken in a particular case may vary somewhat in the light of the circumstances. The auditor would be well advised to consult with an attorney when he or she encounters the circumstances to which this section may apply because of legal implications that may be involved in actions contemplated herein, including, for example, the possible effect of state statutes regarding confidentiality of auditor-client communications. [As amended, effective September 2002, by Statement on Auditing Standards No. 98.]

.03 After the date of the report, the auditor has no obligation² to make any further or continuing inquiry or perform any other auditing procedures with respect to the audited financial statements covered by that report, unless new information which may affect the report comes to his or her attention. [As amended, effective September 2002, by Statement on Auditing Standards No. 98.]

.04 When the auditor becomes aware of information which relates to financial statements previously reported on by him, but which was not known to him at the date of his report, and which is of such a nature and from such a source that he would have investigated it had it come to his attention during the course of his audit, he should, as soon as practicable, undertake to determine whether the information is reliable and whether the facts existed at the date of his report. In this connection, the auditor should discuss the matter with his client at whatever management levels he deems appropriate, including the board of directors, and request cooperation in whatever investigation may be necessary.

¹ If the financial statements have not yet been issued, see the guidance found in section 560, *Subsequent Events*. [Footnote added, effective September 2002, by Statement on Auditing Standards No. 98.]

² However, see section 711.10-.13 as to an auditor's obligation with respect to audited financial statements included in registration statements filed under the Securities Act of 1933 between the date of the auditor's report and the effective date of the registration statement. [Footnote revised by the issuance of Statement on Auditing Standards No. 37, April 1981. Footnote renumbered by the issuance of Statement on Auditing Standards No. 98, September 2002.]

.05 When the subsequently discovered information is found both to be reliable and to have existed at the date of the auditor's report, the auditor should take action in accordance with the procedures set out in subsequent paragraphs if the nature and effect of the matter are such that (a) his report would have been affected if the information had been known to him at the date of his report and had not been reflected in the financial statements and (b) he believes there are persons currently relying or likely to rely on the financial statements who would attach importance to the information. With respect to (b), consideration should be given, among other things, to the time elapsed since the financial statements were issued.

.06 When the auditor has concluded, after considering (a) and (b) in paragraph .05, that action should be taken to prevent future reliance on his report, he should advise his client to make appropriate disclosure of the newly discovered facts and their impact on the financial statements to persons who are known to be currently relying or who are likely to rely on the financial statements and the related auditor's report. When the client undertakes to make appropriate disclosure, the method used and the disclosure made will depend on the circumstances.

a. If the effect on the financial statements or auditor's report of the subsequently discovered information can promptly be determined, disclosure should consist of issuing, as soon as practicable, revised financial statements and auditor's report. The reasons for the revision usually should be described in a note to the financial statements and referred to in the auditor's report. Generally, only the most recently issued audited financial statements would need to be revised, even though the revision resulted from events that had occurred in prior years.³

b. When issuance of financial statements accompanied by the auditor's report for a subsequent period is imminent, so that disclosure is not delayed, appropriate disclosure of the revision can be made in such statements instead of reissuing the earlier statements pursuant to subparagraph (a).⁴

c. When the effect on the financial statements of the subsequently discovered information cannot be determined without a prolonged investigation, the issuance of revised financial statements and auditor's report would necessarily be delayed. In this circumstance, when it appears that the information will require a revision of the statements, appropriate disclosure would consist of notification by the client to persons who are known to be relying or who are likely to rely on the financial statements and the related report that they should not be relied upon, and that revised financial statements and auditor's report will be issued upon completion of an investigation. If applicable, the client should be advised to discuss with the Securities and Exchange Commission, stock exchanges, and appropriate regulatory agencies the disclosure to be made or other measures to be taken in the circumstances.

.07 The auditor should take whatever steps he deems necessary to satisfy himself that the client has made the disclosures specified in paragraph .06.

.08 If the client refuses to make the disclosures specified in paragraph .06, the auditor should notify each member of the board of directors of such refusal and of the fact that, in the absence of disclosure by the client, the auditor will take steps as outlined below to prevent future reliance upon his report. The steps that can appropriately be taken will depend upon the degree of certainty of the auditor's knowledge that there are persons who are currently relying or who will rely on the financial statements and the auditor's report, and who would attach importance to the information, and the auditor's ability as a practical matter to communicate with them. Unless the auditor's attorney recommends a different course of action, the auditor should take the following steps to the extent applicable:

a. Notification to the client that the auditor's report must no longer be associated with the financial statements.

b. Notification to regulatory agencies having jurisdiction over the client that the auditor's report should no longer be relied upon.

c. Notification to each person known to the auditor to be relying on the financial statements that his report should no longer be relied upon. In many instances, it will not be practicable for the auditor to give appropriate individual notification to stockholders or investors at large, whose identities ordinarily are unknown to him; notification to a regulatory agency having jurisdiction over the client will usually be the only practicable way for the auditor to provide appropriate disclosure. Such notification should be accompanied by a request that the agency take whatever steps it may deem appropriate to accomplish the necessary disclosure. The Securities and Exchange Commission and the stock exchanges are appropriate agencies for this purpose as to corporations within their jurisdictions.

.09 The following guidelines should govern the content of any disclosure made by the auditor in accordance with paragraph .08 to persons other than his client:

a. If the auditor has been able to make a satisfactory investigation of the information and has determined that the information is reliable:

(i) The disclosure should describe the effect the subsequently acquired information would have had on the auditor's report if it had been known to him at the date of his report and had not been reflected in the financial statements. The disclosure should include a description of the nature of the subsequently acquired information and of its effect on the financial statements.

(ii) The information disclosed should be as precise and factual as possible and should not go beyond that which is reasonably necessary to accomplish the purpose mentioned in the preceding subparagraph (i). Comments concerning the conduct or motives of any person should be avoided.

b. If the client has not cooperated and as a result the auditor is unable to conduct a satisfactory investigation of the information, his disclosure need not detail the specific information but can merely indicate that information has come to his attention which his client has not

³ See paragraphs 26 and 27 of Accounting Principles Board Opinion No. 9 [AC section A35.107E-108I and paragraphs 36 and 37 of Opinion No. 20 [AC section A35.105] regarding disclosure of adjustments applicable to prior periods. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 98, September 2002.]

⁴ Ibid. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 98, September 2002.]

cooperated in attempting to substantiate that, if the information is true, the auditor believes that his report must no longer be relied upon or be associated with the financial statements. No such disclosure should be made unless the auditor believes that the financial statements are likely to be misleading and that his report should not be relied on.

10 The concepts embodied in this section are not limited solely to corporations but apply in all cases where financial statements have been audited and reported on by independent auditors.

[The next page is 981.]

AU Section 9561

Subsequent Discovery of Facts Existing at the Date of the Auditor's Report: Auditing Interpretations of Section 561

1. Auditor Association With Subsequently Discovered Information When the Auditor Has Resigned or Been Discharged

.01 *Question*—New information may come to an auditor's attention subsequent to the date of his report on audited financial statements that might affect the previously issued audit report. Is the auditor's responsibility with respect to that information different if the auditor has resigned or been discharged prior to undertaking or completing his investigation than if he were the continuing auditor?

.02 *Interpretation*—No. Section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*, requires the auditor to undertake to determine whether the information is reliable and whether the facts existed at the date of his report. This undertaking must be performed even when the auditor has resigned or been discharged.

[Issue Date: February, 1989.]

[The next page is 1051.]

AU Section 120

Defining Professional Requirements in Statements on Auditing Standards

Source: SAS No. 102.

Effective December 2005.

Introduction

.01 This section sets forth the meaning of certain terms used in Statements on Auditing Standards (SASs) issued by the Auditing Standards Board in describing the professional requirements imposed on auditors.

Professional Requirements

.02 SASs contain professional requirements together with related guidance in the form of explanatory material. Auditors have a responsibility to consider the entire text of a SAS in carrying out their work on an engagement and in understanding and applying the professional requirements of the relevant SASs.

.03 Not every paragraph of a SAS carries a professional requirement that the auditor is expected to fulfill. Rather, the professional requirements are communicated by the language and the meaning of the words used in the SASs.

.04 SASs use two categories of professional requirements, identified by specific terms, to describe the degree of responsibility they impose on auditors, as follows:

- *Unconditional requirements.* The auditor is required to comply with an unconditional requirement in all cases in which the circumstances exist to which the unconditional requirement applies. SASs use the words *must* or *is required* to indicate an unconditional requirement.
- *Presumptively mandatory requirements.* The auditor is also required to comply with a presumptively mandatory requirement in all cases in which the circumstances exist to which the requirement applies; however, in rare circumstances, the auditor may depart from a presumptively mandatory requirement provided the auditor documents his or her justification for the departure and how the alternative procedures performed in the circumstances were sufficient to achieve the objectives of the presumptively mandatory requirement. SASs use the word *should* to indicate a presumptively mandatory requirement.

If a SAS provides that a procedure or action is one that the auditor "should consider," the consideration of the procedure or action is presumptively required, whereas carrying out the procedure or action is not. The professional requirements of a SAS are to be understood and applied in the context of the explanatory material that provides guidance for their application. Section 389, *Audit Documentation*, establishes standards and provides guidance on the form, content, and extent of audit documentation.

Explanatory Material

.05 Explanatory material is defined as the text within a SAS (excluding any related appendices or interpretations¹) that may:

- Provide further explanation and guidance on the professional requirements; or
- Identify and describe other procedures or actions relating to the activities of the auditor.

.06 Explanatory material that provides further explanation and guidance on the professional requirements is intended to be descriptive rather than interpretive. That is, it explains the objective of the professional requirements (where not otherwise self-evident); it explains why the auditor might consider or employ particular procedures, depending on the circumstances; and it provides additional information for the auditor to consider in exercising professional judgment in performing the engagement.

.07 Explanatory material that identifies and describes other procedures or actions relating to the activities of the auditor is not intended to impose a professional requirement for the auditor to perform the suggested procedures or actions. Rather, these procedures or actions require the auditor's attention and understanding; how and whether the auditor carries out such procedures or actions in the engagement depends on the exercise of professional judgment in the circumstances consistent with the objective of the standard. The words *may*, *might*, and *could* are used to describe these actions and procedures.

Application

.08 The provisions of this section are effective upon issuance.²

[The next page is 81.]

¹ Auditing interpretations and certain appendices represent interpretive publications, which differ from explanatory material. Interpretive publications, as defined in paragraph .06 and .06 of section 150, *Generally Accepted Auditing Standards*, as amended, reside outside of the standards section of a SAS and are recommendations on the application of the SAS in specific circumstances, including engagements for entities in specialized industries. In contrast, explanatory material is all ways contained within the standards sections of the SAS and is meant to be more descriptive in nature. Interpretive publications are issued under the authority of the Auditing Standards Board (ASB) and consist of original interpretations of the SASs, appendices to the SASs (except for previously issued appendices to original pronouncements that when adopted modified other SASs), auditing guidance included in AICPA Audit and Accounting Guides, and AICPA auditing Statements of Position.

² The specific terms used to define professional requirements in this section are not intended to apply to interpretive publications issued under the authority of the ASB, since interpretive publications are not auditing standards. (See footnote 1.) It is the ASB's intention to make conforming changes to the interpretive publications over the next several years to remove any language that would imply a professional requirement where none exists. It is the ASB's intention that such language would only be used in the standards sections of the SASs.

AU Section 150

Generally Accepted Auditing Standards

(Supersedes SAS No. 1, section 150)

Source: SAS No. 95; SAS No. 98; SAS No. 102.

Effective for audits of financial statements for periods beginning on or after December 15, 2001, unless otherwise indicated.

.01 An independent auditor plans, conducts, and reports the results of an audit in accordance with generally accepted auditing standards (GAAS). Auditing standards provide a measure of audit quality and the objectives to be achieved in an audit. Auditing procedures differ from auditing standards. Auditing procedures are acts that the auditor performs during the course of an audit to comply with auditing standards.

Auditing Standards

.02 The general field work and reporting standards (the 10 standards) approved and adopted by the membership of the AICPA, as amended by the AICPA Auditing Standards Board (ASB), are as follows:

General Standards

1. The audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.
3. Due professional care is to be exercised in the performance of the audit and the preparation of the report.

Standards of Field Work

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.
2. A sufficient understanding of internal control is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.
3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.

Standards of Reporting

¹ This section has been amended by Statement on Auditing Standards No. 105, *Amendment to Statement on Auditing Standards No. 95, Generally Accepted Auditing Standards*. This section will be amended closer to the effective date of Statement on Auditing Standards No. 105, which is effective for audits of financial statements for periods beginning on or after December 15, 2006. Earlier application is permitted. Statement on Auditing Standards No. 105 is included in the "AU Risk Assessment Standards: SAS No. 104-SAS No. 111" section, following the "AU Section 900—Special Reports of the Committee on Auditing Procedure" section, of this publication.

624.308 Rules.--

- (1) The department and the commission may each adopt rules pursuant to ss. 120.536(1) and 120.54 to implement provisions of law conferring duties upon the department or the commission, respectively.

624.424 Annual statement and other information.—

(8) (e) The commission shall adopt rules to implement this subsection, which rules must be in substantial conformity with the 1998 Model Rule Requiring Annual Audited Financial Reports adopted by the National Association of Insurance Commissioners or subsequent amendments, except where inconsistent with the requirements of this subsection. Any exception to, waiver of, or interpretation of accounting requirements of the commission must be in writing and signed by an authorized representative of the office. No insurer may raise as a defense in any action, any exception to, waiver of, or interpretation of accounting requirements, unless previously issued in writing by an authorized representative of the office.

624.307 General powers; duties.--

- (1) The department and office shall enforce the provisions of this code and shall execute the duties imposed upon them by this code, within the respective jurisdiction of each, as provided by law.

624.424 Annual statement and other information.--

- (8)(a) All authorized insurers must have conducted an annual audit by an independent certified public accountant and must file an audited financial report with the office on or before June 1 for the preceding year ending December 31. The office may require an insurer to file an audited financial report earlier than June 1 upon 90 days' advance notice to the insurer. The office may immediately suspend an insurer's certificate of authority by order if an insurer's failure to file required reports, financial statements, or information required by this subsection or rule adopted pursuant thereto creates a significant uncertainty as to the insurer's continuing eligibility for a certificate of authority.
- (b) Any authorized insurer otherwise subject to this section having direct premiums written in this state of less than \$1 million in any calendar year and fewer than 1,000 policyholders or certificateholders of directly written policies nationwide at the end of such calendar year is exempt from this section for such year unless the office makes a specific finding that compliance is necessary in order for the office to carry out its statutory responsibilities. However, any insurer having assumed premiums pursuant to contracts or treaties or reinsurance of \$1 million or more is not exempt. Any insurer subject to an exemption must submit by March 1 following the year to which the exemption applies an affidavit sworn to by a responsible officer of the insurer specifying the amount of direct premiums written in this state and number of policyholders or certificateholders.
- (c) The board of directors of an insurer shall hire the certified public accountant that prepares the audit required by this subsection and the board shall establish an audit committee of three or more directors of the insurer or an affiliated company. The audit committee shall be responsible for discussing audit findings and interacting with the certified public accountant with regard to her or his findings. The audit committee shall be comprised solely of members who are free from any relationship that, in the opinion of its board of directors, would interfere with the exercise of independent judgment as a committee member. The audit committee shall report to the board any findings of adverse financial conditions or significant deficiencies in internal controls that have been noted by the accountant. The insurer may request the office to waive this requirement of the audit committee membership based upon unusual hardship to the insurer.

(d) An insurer may not use the same accountant or partner of an accounting firm responsible for preparing the report required by this subsection for more than 7 consecutive years. Following this period, the insurer may not use such accountant or partner for a period of 2 years, but may use another accountant or partner of the same firm. An insurer may request the office to waive this prohibition based upon an unusual hardship to the insurer and a determination that the accountant is exercising independent judgment that is not unduly influenced by the insurer considering such factors as the number of partners, expertise of the partners or the number of insurance clients of the accounting firm; the premium volume of the insurer; and the number of jurisdictions in which the insurer transacts business.

(e) The commission shall adopt rules to implement this subsection, which rules must be in substantial conformity with the 1998 Model Rule Requiring Annual Audited Financial Reports adopted by the National Association of Insurance Commissioners or subsequent amendments, except where inconsistent with the requirements of this subsection. Any exception to, waiver of, or interpretation of accounting requirements of the commission must be in writing and signed by an authorized representative of the office. No insurer may raise as a defense in any action, any exception to, waiver of, or interpretation of accounting requirements, unless previously issued in writing by an authorized representative of the office.

M E M O R A N D U M

DATE: July 13, 2010
TO: Kevin M. McCarty, Commissioner, Office of Insurance Regulation
THROUGH: Steven H. Parton, General Counsel *SH*
FROM: Dennis Threadgill *DT*
Bob Prentiss *BP*
SUBJECT: Cabinet Agenda for August 10, 2010
Request for Final Approval to Adopt Amendments to
Rule 69O-167.024
Assmt. 44307

The Office of Insurance Regulation requests that these proposed rule amendments be presented to the Cabinet aides on or before August 4, 2010 and to the Financial Services Commission on August 10, 2010, with a request for Final Approval to Adopt the proposed rules. A notice of the Commission Final Rule Hearing will be published in the *Florida Administrative Weekly* on July 23, 2010.

The notice of proposed rules was published June 18, 2010 in Volume 36, No. 24, of the *Weekly*. The hearing was not requested, therefore, the hearing was not held. No changes were made.

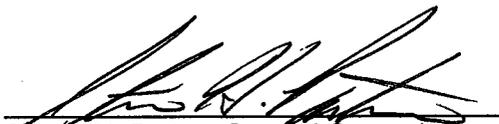
The Legislature changed the numbering within Section 627.021, Florida Statutes. Consequently, this rule needs to be changed to reflect the renumbering. There is no substantive change in the proposed rule.

Sections 624.308, 627.021, 627.607, 627.062, 627.0651, F.S., provide rulemaking authority and laws implemented for this rule.

The Legal Services Office has communicated with the Joint Administrative Procedures Committee, and ascertained that their review of the rules has been completed.

Bob Prentiss is the attorney handling this rule. Attached are: 1) the proposed rule(s); 2) any incorporated materials, such as forms; 3) copies of the rulemaking statutory authority and law implemented.

Approved for signature:



Steven H. Parton, General Counsel

Approved for submission to Financial Services
Commission:

Kevin M. McCarty, Commissioner
Office of Insurance Regulation

690-167.024 Rate Filings for Inland Marine Insurance.

(1) This rule applies to marine insurance that is subject to Chapter 627, Florida Statutes.

(2) Section 627.021(2)(c), Florida Statutes, states that Chapter 627, Florida Statutes, does not apply to ocean marine insurance as distinguished from inland marine insurance.

(a) Section 627.021(d) ~~627.0651(13)(e)~~, Florida Statutes, states that rates and rules are not required to be filed for commercial inland marine risks.

(b) The specific exclusion of commercial inland marine risks indicates that rates and rules for personal inland marine risks must continue to be filed with the Office.

(c) For purposes of this rule, personal inland marine is defined as insurance covering non-business property of a portable or movable nature that would typically be included in or with a homeowner's policy or a separate policy insuring one or more articles of property, including, but not limited to, jewelry, furs, art objects, silverware, glassware, small boats, sports equipment.

(d) For purposes of this rule, commercial inland marine is defined as commercial or industrial property, often but not always of a portable or movable nature or instrumentalities of transportation or communication, that would typically be included in or with a commercial lines policy or written in a separate policy insuring one or more such items of property, including, but not limited to, commercial goods in transit, traffic signals, bridges, tunnels.

Rulemaking-Specific Authority 624.308(1) FS. Law Implemented 624.607, 627.021, 627.062, ~~627.0651~~ FS. History-New 1-27-92, Formerly 4-167.024.

624.308 Rules.--

(1) The department and the commission may each adopt rules pursuant to ss. 120.536(1) and 120.54 to implement provisions of law conferring duties upon the department or the commission, respectively.

624.607 "Marine insurance," "wet marine and transportation insurance," and "inland marine insurance" defined.--

(1) "Marine insurance" includes:

(a) Insurance against any kinds of loss or damage to:

1. Vessels, craft, aircraft, cars, automobiles, and vehicles of every kind, as well as all goods, freights, cargoes, merchandise, effects, disbursements, profits, moneys, bullion, precious stones, securities, choses in action, evidences of debt, valuable papers, bottomry and respondentia interests and all other kinds of property and interests therein, in respect to, appertaining to, or in connection with any and all risks or perils of navigation, transit, or transportation, including war risks, on or under any seas or other waters, on land or in the air, or while being assembled, packed, crated, baled, compressed, or similarly prepared for shipment or while awaiting the same or during any delays, storage, transshipment, or reshipment incident thereto, including marine builder's risks and all personal property floater risks; and
2. Person or property in connection with or appertaining to a marine, inland marine, transit, or transportation insurance, including liability for loss of or damage to either, arising out of or in connection with the construction, repair, operation, maintenance, or use of the subject matter of such insurance, but not including life insurance or surety bonds nor insurance against loss by reason of bodily injury to the person arising out of the ownership, maintenance, or use of automobiles; and
3. Precious stones, jewels, jewelry, gold, silver, and other precious metals, whether used in business or trade or otherwise and whether the same be in course of transportation or otherwise; and
4. Bridges, tunnels, and other instrumentalities of transportation and communication (excluding buildings, their furniture and furnishings, fixed contents, and supplies held in storage) unless fire, tornado, sprinkler leakage, hail, explosion, earthquake, riot, and/or civil commotion are the only hazards to be covered; piers, wharves, docks, and slips, excluding the risks of fire, tornado, sprinkler leakage, hail, explosion, earthquake, riot, and/or civil commotion; and other aids to navigation and transportation, including dry docks and marine railways, against all risks.

(b) Marine protection and indemnity insurance, meaning insurance against, or against legal liability of the insured for, loss, damage, or expense arising out of, or incident to, the ownership, operation, chartering, maintenance, use, repair, or construction of any vessel, craft, or instrumentality in use in ocean or inland waterways, including liability of the insured for personal injury, illness, or death or for loss of or damage to the property of another person.

(2) For the purposes of this code, "wet marine and transportation insurance" is that part of marine insurance which includes only:

(a) Insurance upon vessels, crafts, and hulls and of interests therein or with relation thereto;

(b) Insurance of marine builders' risks, marine war risks, and contracts of marine protection and indemnity insurance;

- (c) Insurance of freights and disbursements pertaining to a subject of insurance coming within this definition; and
 - (d) Insurance of personal property and interests therein, in course of exportation from or importation into any country, or in course of transportation coastwise or on inland waters, including transportation by land, water, or air from point of origin to final destination, in respect to, appertaining to, or in connection with any and all risks or perils of navigation, transit, or transportation, and while being prepared for and while awaiting shipment, and during any delays, storage, transshipment, or reshipment incident thereto.
- (3) For the purposes of this code, "inland marine insurance" is as established by general custom of the insurance business and promulgated by rule of the commission.

627.021 Scope of this part.--

- (1) This part of this chapter applies only to property, casualty, and surety insurances on subjects of insurance resident, located, or to be performed in this state.
- (2) This chapter does not apply to:
 - (a) Reinsurance, except joint reinsurance as provided in s. 627.311.
 - (b) Insurance against loss of or damage to aircraft, their hulls, accessories, or equipment, or against liability, other than workers' compensation and employer's liability, arising out of the ownership, maintenance, or use of aircraft.
 - (c) Insurance of vessels or craft, their cargoes, marine builders' risks, marine protection and indemnity, or other risks commonly insured under marine insurance policies.
 - (d) Commercial inland marine insurance.
 - (e) Surplus lines insurance placed under the provisions of ss. 626.913-626.937.
- (3) For the purposes of this chapter, all motor vehicle insurance shall be deemed to be casualty insurance only.
- (4) This part does not apply to health insurance.

627.062 Rate standards.--

- (1) The rates for all classes of insurance to which the provisions of this part are applicable shall not be excessive, inadequate, or unfairly discriminatory.
- (2) As to all such classes of insurance:
 - (a) Insurers or rating organizations shall establish and use rates, rating schedules, or rating manuals to allow the insurer a reasonable rate of return on such classes of insurance written in this state. A copy of rates, rating schedules, rating manuals, premium credits or discount schedules, and surcharge schedules, and changes thereto, shall be filed with the office under one of the following procedures except as provided in subparagraph 3.:

1. If the filing is made at least 90 days before the proposed effective date and the filing is not implemented during the office's review of the filing and any proceeding and judicial review, then such filing shall be considered a "file and use" filing. In such case, the office shall finalize its review by issuance of a notice of intent to approve or a notice of intent to disapprove within 90 days after receipt of the filing. The notice of intent to approve and the notice of intent to disapprove constitute agency action for purposes of the Administrative Procedure Act. Requests for supporting information, requests for mathematical or mechanical corrections, or notification to the insurer by the office of its preliminary findings shall not toll the 90-day period during any such proceedings and subsequent judicial review. The rate shall be deemed approved if the office does not issue a notice of intent to approve or a notice of intent to disapprove within 90 days after receipt of the filing.

2. If the filing is not made in accordance with the provisions of subparagraph 1., such filing shall be made as soon as practicable, but no later than 30 days after the effective date, and shall be considered a "use and file" filing. An insurer making a "use and file" filing is potentially subject to an order by the office to return to policyholders portions of rates found to be excessive, as provided in paragraph (h).

3. For all property insurance filings made or submitted after January 25, 2007, but before December 31, 2010, an insurer seeking a rate that is greater than the rate most recently approved by the office shall make a "file and use" filing. For purposes of this subparagraph, motor vehicle collision and comprehensive coverages are not considered to be property coverages.

(b) Upon receiving a rate filing, the office shall review the rate filing to determine if a rate is excessive, inadequate, or unfairly discriminatory. In making that determination, the office shall, in accordance with generally accepted and reasonable actuarial techniques, consider the following factors:

1. Past and prospective loss experience within and without this state.

2. Past and prospective expenses.

3. The degree of competition among insurers for the risk insured.

4. Investment income reasonably expected by the insurer, consistent with the insurer's investment practices, from investable premiums anticipated in the filing, plus any other expected income from currently invested assets representing the amount expected on unearned premium reserves and loss reserves. The commission may adopt rules using reasonable techniques of actuarial science and economics to specify the manner in which insurers shall calculate investment income attributable to such classes of insurance written in this state and the manner in which such investment income shall be used to calculate insurance rates. Such manner shall contemplate allowances for an underwriting profit factor and full consideration of investment income which produce a reasonable rate of return; however, investment income from invested surplus may not be considered.

5. The reasonableness of the judgment reflected in the filing.

6. Dividends, savings, or unabsorbed premium deposits allowed or returned to Florida policyholders, members, or subscribers.

7. The adequacy of loss reserves.

8. The cost of reinsurance. The office shall not disapprove a rate as excessive solely due to the insurer having obtained catastrophic reinsurance to cover the insurer's estimated 250-year probable maximum loss or any lower level of loss.

9. Trend factors, including trends in actual losses per insured unit for the insurer making the filing.
 10. Conflagration and catastrophe hazards, if applicable.
 11. Projected hurricane losses, if applicable, which must be estimated using a model or method found to be acceptable or reliable by the Florida Commission on Hurricane Loss Projection Methodology, and as further provided in s. 627.0628.
 12. A reasonable margin for underwriting profit and contingencies.
 13. The cost of medical services, if applicable.
 14. Other relevant factors which impact upon the frequency or severity of claims or upon expenses.
- (c) In the case of fire insurance rates, consideration shall be given to the availability of water supplies and the experience of the fire insurance business during a period of not less than the most recent 5-year period for which such experience is available.
- (d) If conflagration or catastrophe hazards are given consideration by an insurer in its rates or rating plan, including surcharges and discounts, the insurer shall establish a reserve for that portion of the premium allocated to such hazard and shall maintain the premium in a catastrophe reserve. Any removal of such premiums from the reserve for purposes other than paying claims associated with a catastrophe or purchasing reinsurance for catastrophes shall be subject to approval of the office. Any ceding commission received by an insurer purchasing reinsurance for catastrophes shall be placed in the catastrophe reserve.
- (e) After consideration of the rate factors provided in paragraphs (b), (c), and (d), a rate may be found by the office to be excessive, inadequate, or unfairly discriminatory based upon the following standards:
 1. Rates shall be deemed excessive if they are likely to produce a profit from Florida business that is unreasonably high in relation to the risk involved in the class of business or if expenses are unreasonably high in relation to services rendered.
 2. Rates shall be deemed excessive if, among other things, the rate structure established by a stock insurance company provides for replenishment of surpluses from premiums, when the replenishment is attributable to investment losses.
 3. Rates shall be deemed inadequate if they are clearly insufficient, together with the investment income attributable to them, to sustain projected losses and expenses in the class of business to which they apply.
 4. A rating plan, including discounts, credits, or surcharges, shall be deemed unfairly discriminatory if it fails to clearly and equitably reflect consideration of the policyholder's participation in a risk management program adopted pursuant to s. 627.0625.
 5. A rate shall be deemed inadequate as to the premium charged to a risk or group of risks if discounts or credits are allowed which exceed a reasonable reflection of expense savings and reasonably expected loss experience from the risk or group of risks.

6. A rate shall be deemed unfairly discriminatory as to a risk or group of risks if the application of premium discounts, credits, or surcharges among such risks does not bear a reasonable relationship to the expected loss and expense experience among the various risks.

(f) In reviewing a rate filing, the office may require the insurer to provide at the insurer's expense all information necessary to evaluate the condition of the company and the reasonableness of the filing according to the criteria enumerated in this section.

(g) The office may at any time review a rate, rating schedule, rating manual, or rate change; the pertinent records of the insurer; and market conditions. If the office finds on a preliminary basis that a rate may be excessive, inadequate, or unfairly discriminatory, the office shall initiate proceedings to disapprove the rate and shall so notify the insurer. However, the office may not disapprove as excessive any rate for which it has given final approval or which has been deemed approved for a period of 1 year after the effective date of the filing unless the office finds that a material misrepresentation or material error was made by the insurer or was contained in the filing. Upon being so notified, the insurer or rating organization shall, within 60 days, file with the office all information which, in the belief of the insurer or organization, proves the reasonableness, adequacy, and fairness of the rate or rate change. The office shall issue a notice of intent to approve or a notice of intent to disapprove pursuant to the procedures of paragraph (a) within 90 days after receipt of the insurer's initial response. In such instances and in any administrative proceeding relating to the legality of the rate, the insurer or rating organization shall carry the burden of proof by a preponderance of the evidence to show that the rate is not excessive, inadequate, or unfairly discriminatory. After the office notifies an insurer that a rate may be excessive, inadequate, or unfairly discriminatory, unless the office withdraws the notification, the insurer shall not alter the rate except to conform with the office's notice until the earlier of 120 days after the date the notification was provided or 180 days after the date of the implementation of the rate. The office may, subject to chapter 120, disapprove without the 60-day notification any rate increase filed by an insurer within the prohibited time period or during the time that the legality of the increased rate is being contested.

(h) In the event the office finds that a rate or rate change is excessive, inadequate, or unfairly discriminatory, the office shall issue an order of disapproval specifying that a new rate or rate schedule which responds to the findings of the office be filed by the insurer. The office shall further order, for any "use and file" filing made in accordance with subparagraph (a)2., that premiums charged each policyholder constituting the portion of the rate above that which was actuarially justified be returned to such policyholder in the form of a credit or refund. If the office finds that an insurer's rate or rate change is inadequate, the new rate or rate schedule filed with the office in response to such a finding shall be applicable only to new or renewal business of the insurer written on or after the effective date of the responsive filing.

(i) Except as otherwise specifically provided in this chapter, the office shall not prohibit any insurer, including any residual market plan or joint underwriting association, from paying acquisition costs based on the full amount of premium, as defined in s. 627.403, applicable to any policy, or prohibit any such insurer from including the full amount of acquisition costs in a rate filing.

(j) With respect to residential property insurance rate filings, the rate filing must account for mitigation measures undertaken by policyholders to reduce hurricane losses.

(k)1. An insurer may make a separate filing limited solely to an adjustment of its rates for reinsurance or financing costs incurred in the purchase of reinsurance or financing products to replace or finance the payment of the amount covered by the Temporary Increase in Coverage Limits (TICL) portion of the Florida Hurricane Catastrophe Fund including replacement reinsurance for the TICL reductions made pursuant to s. 215.555(17)(e); the actual cost paid due to the application of the TICL premium factor pursuant to s. 215.555(17)(f); and the actual cost paid due to the application of the cash build-up factor pursuant to s. 215.555(5)(b) if the insurer:

- a. Elects to purchase financing products such as a liquidity instrument or line of credit, in which case the cost included in the filing for the liquidity instrument or line of credit may not result in a premium increase exceeding 3 percent for any individual policyholder. All costs contained in the filing may not result in an overall premium increase of more than 10 percent for any individual policyholder.
- b. Includes in the filing a copy of all of its reinsurance, liquidity instrument, or line of credit contracts; proof of the billing or payment for the contracts; and the calculation upon which the proposed rate change is based demonstrates that the costs meet the criteria of this section and are not loaded for expenses or profit for the insurer making the filing.
- c. Includes no other changes to its rates in the filing.
- d. Has not implemented a rate increase within the 6 months immediately preceding the filing.
- e. Does not file for a rate increase under any other paragraph within 6 months after making a filing under this paragraph.
- f. That purchases reinsurance or financing products from an affiliated company in compliance with this paragraph does so only if the costs for such reinsurance or financing products are charged at or below charges made for comparable coverage by nonaffiliated reinsurers or financial entities making such coverage or financing products available in this state.

2. An insurer may only make one filing in any 12-month period under this paragraph.

3. An insurer that elects to implement a rate change under this paragraph must file its rate filing with the office at least 45 days before the effective date of the rate change. After an insurer submits a complete filing that meets all of the requirements of this paragraph, the office has 45 days after the date of the filing to review the rate filing and determine if the rate is excessive, inadequate, or unfairly discriminatory.

The provisions of this subsection ¹shall not apply to workers' compensation and employer's liability insurance and to motor vehicle insurance.

(3)(a) For individual risks that are not rated in accordance with the insurer's rates, rating schedules, rating manuals, and underwriting rules filed with the office and which have been submitted to the insurer for individual rating, the insurer must maintain documentation on each risk subject to individual risk rating. The documentation must identify the named insured and specify the characteristics and classification of the risk supporting the reason for the risk being individually risk rated, including any modifications to existing approved forms to be used on the risk. The insurer must maintain these records for a period of at least 5 years after the effective date of the policy.

(b) Individual risk rates and modifications to existing approved forms are not subject to this part or part II, except for paragraph (a) and ss. 627.402, 627.403, 627.4035, 627.404, 627.405, 627.406, 627.407, 627.4085, 627.409, 627.4132, 627.4133, 627.415, 627.416, 627.417, 627.419, 627.425, 627.426, 627.4265, 627.427, and 627.428, but are subject to all other applicable provisions of this code and rules adopted thereunder.

(c) This subsection does not apply to private passenger motor vehicle insurance.

(4) The establishment of any rate, rating classification, rating plan or schedule, or variation thereof in violation of part IX of chapter 626 is also in violation of this section. In order to enhance the ability of consumers to compare premiums and to increase the accuracy and usefulness of rate-comparison information provided by the office to the public, the office shall develop a proposed standard rating

territory plan to be used by all authorized property and casualty insurers for residential property insurance. In adopting the proposed plan, the office may consider geographical characteristics relevant to risk, county lines, major roadways, existing rating territories used by a significant segment of the market, and other relevant factors. Such plan shall be submitted to the President of the Senate and the Speaker of the House of Representatives by January 15, 2006. The plan may not be implemented unless authorized by further act of the Legislature.

(5) With respect to a rate filing involving coverage of the type for which the insurer is required to pay a reimbursement premium to the Florida Hurricane Catastrophe Fund, the insurer may fully recoup in its property insurance premiums any reimbursement premiums paid to the Florida Hurricane Catastrophe Fund, together with reasonable costs of other reinsurance, but except as otherwise provided in this section, may not recoup reinsurance costs that duplicate coverage provided by the Florida Hurricane Catastrophe Fund. An insurer may not recoup more than 1 year of reimbursement premium at a time. Any under-recoupment from the prior year may be added to the following year's reimbursement premium, and any over-recoupment shall be subtracted from the following year's reimbursement premium.

(6)(a) If an insurer requests an administrative hearing pursuant to s. 120.57 related to a rate filing under this section, the director of the Division of Administrative Hearings shall expedite the hearing and assign an administrative law judge who shall commence the hearing within 30 days after the receipt of the formal request and shall enter a recommended order within 30 days after the hearing or within 30 days after receipt of the hearing transcript by the administrative law judge, whichever is later. Each party shall be allowed 10 days in which to submit written exceptions to the recommended order. The office shall enter a final order within 30 days after the entry of the recommended order. The provisions of this paragraph may be waived upon stipulation of all parties.

(b) Upon entry of a final order, the insurer may request a expedited appellate review pursuant to the Florida Rules of Appellate Procedure. It is the intent of the Legislature that the First District Court of Appeal grant an insurer's request for an expedited appellate review.

(7)(a) The provisions of this subsection apply only with respect to rates for medical malpractice insurance and shall control to the extent of any conflict with other provisions of this section.

(b) Any portion of a judgment entered or settlement paid as a result of a statutory or common-law bad faith action and any portion of a judgment entered which awards punitive damages against an insurer may not be included in the insurer's rate base, and shall not be used to justify a rate or rate change. Any common-law bad faith action identified as such, any portion of a settlement entered as a result of a statutory or common-law action, or any portion of a settlement wherein an insurer agrees to pay specific punitive damages may not be used to justify a rate or rate change. The portion of the taxable costs and attorney's fees which is identified as being related to the bad faith and punitive damages in these judgments and settlements may not be included in the insurer's rate base and may not be utilized to justify a rate or rate change.

(c) Upon reviewing a rate filing and determining whether the rate is excessive, inadequate, or unfairly discriminatory, the office shall consider, in accordance with generally accepted and reasonable actuarial techniques, past and present prospective loss experience, either using loss experience solely for this state or giving greater credibility to this state's loss data after applying actuarially sound methods of assigning credibility to such data.

(d) Rates shall be deemed excessive if, among other standards established by this section, the rate structure provides for replenishment of reserves or surpluses from premiums when the replenishment is attributable to investment losses.

(e) The insurer must apply a discount or surcharge based on the health care provider's loss experience or shall establish an alternative method giving due consideration to the provider's loss experience. The insurer must include in the filing a copy of the surcharge or discount schedule or a description of the alternative method used, and must provide a copy of such schedule or description, as approved by the office, to policyholders at the time of renewal and to prospective policyholders at the time of application for coverage.

(f) Each medical malpractice insurer must make a rate filing under this section, sworn to by at least two executive officers of the insurer, at least once each calendar year.

(8)(a)1. No later than 60 days after the effective date of medical malpractice legislation enacted during the 2003 Special Session D of the Florida Legislature, the office shall calculate a presumed factor that reflects the impact that the changes contained in such legislation will have on rates for medical malpractice insurance and shall issue a notice informing all insurers writing medical malpractice coverage of such presumed factor. In determining the presumed factor, the office shall use generally accepted actuarial techniques and standards provided in this section in determining the expected impact on losses, expenses, and investment income of the insurer. To the extent that the operation of a provision of medical malpractice legislation enacted during the 2003 Special Session D of the Florida Legislature is stayed pending a constitutional challenge, the impact of that provision shall not be included in the calculation of a presumed factor under this subparagraph.

2. No later than 60 days after the office issues its notice of the presumed rate change factor under subparagraph 1., each insurer writing medical malpractice coverage in this state shall submit to the office a rate filing for medical malpractice insurance, which will take effect no later than January 1, 2004, and apply retroactively to policies issued or renewed on or after the effective date of medical malpractice legislation enacted during the 2003 Special Session D of the Florida Legislature. Except as authorized under paragraph (b), the filing shall reflect an overall rate reduction at least as great as the presumed factor determined under subparagraph 1. With respect to policies issued on or after the effective date of such legislation and prior to the effective date of the rate filing required by this subsection, the office shall order the insurer to make a refund of the amount that was charged in excess of the rate that is approved.

(b) Any insurer or rating organization that contends that the rate provided for in paragraph (a) is excessive, inadequate, or unfairly discriminatory shall separately state in its filing the rate it contends is appropriate and shall state with specificity the factors or data that it contends should be considered in order to produce such appropriate rate. The insurer or rating organization shall be permitted to use all of the generally accepted actuarial techniques provided in this section in making any filing pursuant to this subsection. The office shall review each such exception and approve or disapprove it prior to use. It shall be the insurer's burden to actuarially justify any deviations from the rates required to be filed under paragraph (a). The insurer making a filing under this paragraph shall include in the filing the expected impact of medical malpractice legislation enacted during the 2003 Special Session D of the Florida Legislature on losses, expenses, and rates.

(c) If any provision of medical malpractice legislation enacted during the 2003 Special Session D of the Florida Legislature is held invalid by a court of competent jurisdiction, the office shall permit an adjustment of all medical malpractice rates filed under this section to reflect the impact of such holding on such rates so as to ensure that the rates are not excessive, inadequate, or unfairly discriminatory.

(d) Rates approved on or before July 1, 2003, for medical malpractice insurance shall remain in effect until the effective date of a new rate filing approved under this subsection.

(e) The calculation and notice by the office of the presumed factor pursuant to paragraph (a) is not an order or rule that is subject to chapter 120. If the office enters into a contract with an independent

consultant to assist the office in calculating the presumed factor, such contract shall not be subject to the competitive solicitation requirements of s. 287.057.

(9)(a) The chief executive officer or chief financial officer of a property insurer and the chief actuary of a property insurer must certify under oath and subject to the penalty of perjury, on a form approved by the commission, the following information, which must accompany a rate filing:

1. The signing officer and actuary have reviewed the rate filing;
 2. Based on the signing officer's and actuary's knowledge, the rate filing does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading;
 3. Based on the signing officer's and actuary's knowledge, the information and other factors described in paragraph (2)(b), including, but not limited to, investment income, fairly present in all material respects the basis of the rate filing for the periods presented in the filing; and
 4. Based on the signing officer's and actuary's knowledge, the rate filing reflects all premium savings that are reasonably expected to result from legislative enactments and are in accordance with generally accepted and reasonable actuarial techniques.
- (b) A signing officer or actuary knowingly making a false certification under this subsection commits a violation of s. 626.9541(1)(e) and is subject to the penalties under s. 626.9521.
- (c) Failure to provide such certification by the officer and actuary shall result in the rate filing being disapproved without prejudice to be refiled.
- (d) The commission may adopt rules and forms pursuant to ss. 120.536(1) and 120.54 to administer this subsection.

(10) The burden is on the office to establish that rates are excessive for personal lines residential coverage with a dwelling replacement cost of \$1 million or more or for a single condominium unit with a combined dwelling and contents replacement cost of \$1 million or more. Upon request of the office, the insurer shall provide to the office such loss and expense information as the office reasonably needs to meet this burden.

(11) Any interest paid pursuant to s. 627.70131(5) may not be included in the insurer's rate base and may not be used to justify a rate or rate change.

M E M O R A N D U M

DATE: July 29, 2010
TO: Kevin M. McCarty, Commissioner, Office of Insurance Regulation
THROUGH: Steven H. Parton, General Counsel
FROM: Dennis Threadgill
Bob Prentiss
SUBJECT: Cabinet Agenda for August 10, 2010
Request for Approval to Publish Amendments to
Rule 69O-162.203
Assmt. # 44314

The Office of Insurance Regulation requests that these proposed rule amendments be presented to the Cabinet aides on or before August 4, 2010, and to the Financial Services Commission on August 10, 2010, with a request to approve for publication the proposed rules.

Section 625.121(5) provides that the Commission may adopt by rule the NAIC Model Regulations for valuation of life insurance policies. This rule does that. This rule is being amended due to changes made to the NAIC Model Regulation. The amendment explains the conditions for use of the preferred class structure mortality tables, and permits use of the mortality tables for policies issued prior to the adoption date of the original rule.

Sections 624.308(1), 624.307 (1), 625.121, F.S., provide rulemaking authority and laws implemented for this rule.

Amanda Hunter is the attorney handling this rule. Attached are: 1) the proposed rule(s), 2) any incorporated materials, such as forms; and 3) copies of the rulemaking statutory authority and law implemented.

Approved for signature:



Steven H. Parton, General Counsel

Approved for submission to Financial Services
Commission:

Kevin M. McCarty, Commissioner
Office of Insurance Regulation

THE FULL TEXT OF THE PROPOSED RULE IS:

69O-162.203 Adoption of 2001 Commissioners Standard Ordinary (CSO) Preferred Mortality Tables for Determining Reserve Liabilities for Ordinary Life Insurance.

(1) Scope. This rule shall govern mortality tables for use in reserves as set forth in Section 625.121, F.S.

(2) Purpose. The purpose of this rule is to recognize, permit and prescribe the use of mortality tables that reflect differences in mortality between Preferred and Standard lives in determining minimum reserve liabilities in accordance with Section 625.121(5)(a)3., F.S., and subsection 69O-164.020(5), F.A.C.

(3) Definitions.

(a) "2001 CSO Mortality Table" means that mortality table, consisting of separate rates of mortality for male and female lives, developed by the American Academy of Actuaries CSO Task Force from the Valuation Basic Mortality Table developed by the Society of Actuaries Individual Life Insurance Valuation Mortality Task Force, and adopted by the NAIC in December 2002. The 2001 CSO Mortality Table is included in the Proceedings of the NAIC (2nd Quarter 2002) and supplemented by the 2001 CSO Preferred Class Structure Mortality Table defined below in Subsection (b). Unless the context indicates otherwise, the "2001 CSO Mortality Table" includes both the ultimate form of that table and the select and ultimate form of that table and includes both the smoker and nonsmoker mortality tables and the composite mortality tables. It also includes both the age-nearest-birthday and age-last-birthday bases of the mortality tables. Mortality tables in the 2001 CSO Mortality Table include the following:

1. "2001 CSO Mortality Table (F)" means that mortality table consisting of the rates of mortality for female lives from the 2001 CSO Mortality Table.

2. "2001 CSO Mortality Table (M)" means that mortality table consisting of the rates of mortality for male lives from the 2001 CSO Mortality Table.

3. "Composite mortality tables" means mortality tables with rates of mortality that do not distinguish between smokers and nonsmokers.

4. "Smoker and nonsmoker mortality tables" means mortality tables with separate rates of mortality for smokers and nonsmokers.

(b) "2001 CSO Preferred Class Structure Mortality Table" means mortality tables with separate rates of mortality for Super Preferred Nonsmokers, Preferred Nonsmokers, Residual Standard Nonsmokers, Preferred Smokers, and Residual Standard Smoker splits of the 2001 CSO Nonsmoker and Smoker tables as adopted by the NAIC September 10, 2006, which is available in the NAIC Proceedings (3rd Quarter 2006) which is adopted herein and incorporated by reference. Unless the context indicates otherwise, the "2001 CSO Preferred Class Structure Mortality Table" includes both the ultimate form of that table and the select and ultimate form of that table. It includes both the smoker and nonsmoker mortality tables. It includes both the male and female mortality tables and the gender composite mortality tables. It also includes both the age-nearest-birthday and age-last-birthday bases of the mortality table.

(c) "Statistical agent" means an entity with proven systems for protecting the confidentiality of individual insured and insurer information; demonstrated resources for and history of ongoing electronic communications and data transfer ensuring data integrity with insurers, which are its members or subscribers; and a history of and

means for aggregation of data and accurate promulgation of the experience modifications in a timely manner.

(4) 2001 CSO Preferred Class Structure Table.

(a) At the election of the company, for each calendar year of issue, for any one or more specified plans of insurance and subject to satisfying the conditions stated in this rule, the 2001 CSO Preferred Class Structure Mortality Table may be substituted in place of the 2001 CSO Smoker or Nonsmoker Mortality Table as the minimum valuation standard for policies issued on or after January 1, 2007.

1. On valuation dates beginning with December 31, 2010, for policies issued on or after January 1, 2005 for policies not issued in this state, and on or after June 8, 2005, for policies issued in this state, and prior to January 1, 2007 wherever issued, these tables may be substituted with the consent of the commissioner and subject to the conditions of (5).

2. In determining such consent, the commissioner may rely on the consent of the commissioner of the company's state of domicile.

(b) No such election shall be made until the company demonstrates at least 20% of the business to be valued on this table is in one or more of the preferred classes.

(c) A table from the 2001 CSO Preferred Class Structure Mortality Table used in place of a 2001 CSO Mortality Table, pursuant to the requirements of this rule, will be treated as part of the 2001 CSO Mortality Table only for purposes of reserve valuation pursuant to the requirements of Rule 690-162.201, F.A.C., Adoption of 2001 Commissioners Standard Ordinary (CSO) Mortality Tables.

(5) Conditions.

(a) For each plan of insurance with separate rates for Preferred and Standard Nonsmoker lives, an insurer may use the Super Preferred Nonsmoker, Preferred Nonsmoker, and Residual Standard Nonsmoker tables to substitute for the Nonsmoker mortality table found in the 2001 CSO Mortality Table to determine minimum reserves. At the time of election and annually thereafter, except for business valued under the Residual Standard Nonsmoker Table, the appointed actuary shall certify that:

1. The present value of death benefits over the next ten years after the valuation date, using the anticipated mortality experience without recognition of mortality improvement beyond the valuation date for each class, is less than the present value of death benefits using the valuation basic table corresponding to the valuation table being used for that class.

2. The present value of death benefits over the future life of the contracts, using anticipated mortality experience without recognition of mortality improvement beyond the valuation date for each class, is less than the present value of death benefits using the valuation basic table corresponding to the valuation table being used for that class.

(b) For each plan of insurance with separate rates for Preferred and Standard Smoker lives, an insurer may use the Preferred Smoker and Residual Standard Smoker tables to substitute for the Smoker mortality table found in the 2001 CSO Mortality Table to determine minimum reserves. At the time of election and annually thereafter, for business valued under the Preferred Smoker Table, the appointed actuary shall certify that:

1. The present value of death benefits over the next ten years after the valuation date, using the anticipated mortality experience without recognition of mortality

improvement beyond the valuation date for each class, is less than the present value of death benefits using the Preferred Smoker valuation basic table corresponding to the valuation table being used for that class.

2. The present value of death benefits over the future life of the contracts, using anticipated mortality experience without recognition of mortality improvement beyond the valuation date for each class, is less than the present value of death benefits using the Preferred Smoker valuation basic table.

(c) The use of the 2001 CSO Preferred Class Structure Table for the valuation of policies issued prior to January 1, 2007 shall not be permitted in any statutory financial statement in which a company reports, with respect to any policy or portion of a policy coinsured, either of the following:

1. In cases where the mode of payment of the reinsurance premium is less frequent than the mode of payment of the policy premium, a reserve credit that exceeds, by more than the amount specified in this paragraph as Y, the gross reserve calculated before reinsurance. Y is the amount of the gross reinsurance premium that (a) provides coverage for the period from the next policy premium due date to the earlier of the end of the policy year and the next reinsurance premium due date, and (b) would be refunded to the ceding entity upon the termination of the policy.

2.a. In cases where the mode of payment of the reinsurance premium is more frequent than the mode of payment of the policy premium, a reserve credit that is less than the gross reserve, calculated before reinsurance, by an amount that is less than the amount specified in this paragraph as Z. Z is the amount of the gross reinsurance premium that the ceding entity would need to pay the assuming company to provide

reinsurance coverage from the period of the next reinsurance premium due date to the next policy premium due date minus any liability established for the proportionate amount not remitted to the reinsurer.

b. For purposes of this condition, the reserve (i) for the mean reserve method shall be defined as the mean reserve minus the deferred premium asset, and (ii) for the midterminal reserve method shall include the unearned premium reserve. A company may estimate and adjust its accounting on an aggregate basis in order to meet the conditions to use the 2001 CSO Preferred Class Structure Table.

(6) Effective Date. This rule shall be effective for policies issued on or after January 1, 2007, for valuation dates on or after the date this rule becomes effective.

Rulemaking Specific Authority 624.308(1), 625.121 FS. Law Implemented 624.307(1), 625.121 FS. History—New 1-16-08.

624.308 Rules.--

- (1) The department and the commission may each adopt rules pursuant to ss. 120.536(1) and 120.54 to implement provisions of law conferring duties upon the department or the commission, respectively.

625.121 Standard Valuation Law; life insurance.--

- (1) SHORT TITLE.--This section shall be known as the "Standard Valuation Law."
- (2) ANNUAL VALUATION.--The office shall annually value, or cause to be valued, the reserve liabilities, hereinafter called "reserves," for all outstanding life insurance policies and annuity and pure endowment contracts of every life insurer doing business in this state, and may certify the amount of any such reserves, specifying the mortality table or tables, rate or rates of interest, and methods, net-level premium method or others, used in the calculation of such reserves. In the case of an alien insurer, such valuation shall be limited to its insurance transactions in the United States. In calculating such reserves, the office may use group methods and approximate averages for fractions of a year or otherwise. It may accept in its discretion the insurer's calculation of such reserves. In lieu of the valuation of the reserves herein required of any foreign or alien insurer, it may accept any valuation made or caused to be made by the insurance supervisory official of any state or other jurisdiction when such valuation complies with the minimum standard herein provided and if the official of such state or jurisdiction accepts as sufficient and valid for all legal purposes the certificate of valuation of the office when such certificate states the valuation to have been made in a specified manner according to which the aggregate reserves would be at least as large as if they had been computed in the manner prescribed by the law of that state or jurisdiction. When any such valuation is made by the office, it may use the actuary of the office or employ an actuary for the purpose; and the reasonable compensation of the actuary, at a rate approved by the office, and reimbursement of travel expenses pursuant to s. 624.320 upon demand by the office, supported by an itemized statement of such compensation and expenses, shall be paid by the insurer. When a domestic insurer furnishes the office with a valuation of its outstanding policies as computed by its own actuary or by an actuary deemed satisfactory for the purpose by the office, the valuation shall be verified by the actuary of the office without cost to the insurer.

(3) ACTUARIAL OPINION OF RESERVES.--

- (a)1. Each life insurance company doing business in this state shall annually submit the opinion of a qualified actuary as to whether the reserves and related actuarial items held in support of the policies and contracts specified by the commission by rule are computed appropriately, are based on assumptions which satisfy contractual provisions, are consistent with prior reported amounts, and comply with applicable laws of this state. The commission by rule shall define the specifics of this opinion and add any other items determined to be necessary to its scope.
2. The opinion shall be submitted with the annual statement reflecting the valuation of such reserve liabilities for each year ending on or after December 31, 1992.
3. The opinion shall apply to all business in force, including individual and group health insurance plans, in the form and substance acceptable to the office as specified by rule of the commission.
4. The commission may adopt rules providing the standards of the actuarial opinion consistent with standards adopted by the Actuarial Standards Board on December 31, 2002, and subsequent revisions thereto, provided that the standards remain substantially consistent.
5. In the case of an opinion required to be submitted by a foreign or alien company, the office may accept the opinion filed by that company with the insurance supervisory official of another state if the

office determines that the opinion reasonably meets the requirements applicable to a company domiciled in this state.

6. For the purposes of this subsection, "qualified actuary" means a member in good standing of the American Academy of Actuaries who also meets the requirements specified by rule of the commission.

7. Disciplinary action by the office against the company or the qualified actuary shall be in accordance with the insurance code and related rules adopted by the commission.

8. A memorandum in the form and substance specified by rule shall be prepared to support each actuarial opinion.

9. If the insurance company fails to provide a supporting memorandum at the request of the office within a period specified by rule of the commission, or if the office determines that the supporting memorandum provided by the insurance company fails to meet the standards prescribed by rule of the commission, the office may engage a qualified actuary at the expense of the company to review the opinion and the basis for the opinion and prepare such supporting memorandum as is required by the office.

10. Except as otherwise provided in this paragraph, any memorandum or other material in support of the opinion is confidential and exempt from the provisions of s. 119.07(1); however, the memorandum or other material may be released by the office with the written consent of the company, or to the American Academy of Actuaries upon request stating that the memorandum or other material is required for the purpose of professional disciplinary proceedings and setting forth procedures satisfactory to the office for preserving the confidentiality of the memorandum or other material. If any portion of the confidential memorandum is cited by the company in its marketing or is cited before any governmental agency other than a state insurance department or is released by the company to the news media, no portion of the memorandum is confidential.

(b) In addition to the opinion required by subparagraph (a)1., the office may, pursuant to commission rule, require an opinion of the same qualified actuary as to whether the reserves and related actuarial items held in support of the policies and contracts specified by the commission by rule, when considered in light of the assets held by the company with respect to the reserves and related actuarial items, including but not limited to the investment earnings on the assets and considerations anticipated to be received and retained under the policies and contracts, make adequate provision for the company's obligations under the policies and contracts, including, but not limited to, the benefits under, and expenses associated with, the policies and contracts.

(c) The commission may provide by rule for a transition period for establishing any higher reserves which the qualified actuary may deem necessary in order to render the opinion required by this subsection.

(4) MINIMUM STANDARD FOR VALUATION OF POLICIES AND CONTRACTS ISSUED BEFORE OPERATIVE DATE OF STANDARD NONFORFEITURE LAW.--The minimum standard for the valuation of all such policies and contracts issued prior to the operative date of s. 627.476 (Standard Nonforfeiture Law) shall be any basis satisfactory to the office. Any basis satisfactory to the former Department of Insurance on the effective date of this code shall be deemed to meet such minimum standards.

(5) MINIMUM STANDARD FOR VALUATION OF POLICIES AND CONTRACTS ISSUED ON OR AFTER OPERATIVE DATE OF STANDARD NONFORFEITURE LAW.--Except as otherwise provided in paragraph (h) and subsections (6), (11), and (14), the minimum standard for the valuation of all such policies and contracts issued on or after the operative date of s. 627.476 (Standard Nonforfeiture Law for Life Insurance) shall be the commissioners' reserve valuation method defined in subsections (7), (11), and

(14); 5 percent interest for group annuity and pure endowment contracts and 3.5 percent interest for all other such policies and contracts, or in the case of life insurance policies and contracts, other than annuity and pure endowment contracts, issued on or after July 1, 1973, 4 percent interest for such policies issued prior to October 1, 1979, and 4.5 percent interest for such policies issued on or after October 1, 1979; and the following tables:

(a) For all ordinary policies of life insurance issued on the standard basis, excluding any disability and accidental death benefits in such policies:

1. For policies issued prior to the operative date of s. 627.476(9), the commissioners' 1958 Standard Ordinary Mortality Table; except that, for any category of such policies issued on female risks, modified net premiums and present values, referred to in subsection (7), may be calculated according to an age not more than 6 years younger than the actual age of the insured.

2. For policies issued on or after the operative date of s. 627.476(9), the commissioners' 1980 Standard Ordinary Mortality Table or, at the election of the insurer for any one or more specified plans of life insurance, the commissioners' 1980 Standard Ordinary Mortality Table with Ten-Year Select Mortality Factors.

3. For policies issued on or after July 1, 2004, ordinary mortality tables, adopted after 1980 by the National Association of Insurance Commissioners, adopted by rule by the commission for use in determining the minimum standard of valuation for such policies.

(b) For all industrial life insurance policies issued on the standard basis, excluding any disability and accidental death benefits in such policies:

1. For policies issued prior to the first date to which the commissioners' 1961 Standard Industrial Mortality Table is applicable according to s. 627.476, the 1941 Standard Industrial Mortality Table; and

2. For such policies issued on or after that date, the commissioners' 1961 Standard Industrial Mortality Table.

(c) For individual annuity and pure endowment contracts, excluding any disability and accidental death benefits in such policies, the 1937 Standard Annuity Mortality Table or, at the option of the insurer, the Annuity Mortality Table for 1949, Ultimate, or any modification of either of these tables approved by the office.

(d) For group annuity and pure endowment contracts, excluding any disability and accidental death benefits in such policies, the Group Annuity Mortality Table for 1951; any modification of such table approved by the office; or, at the option of the insurer, any of the tables or modifications of tables specified for individual annuity and pure endowment contracts.

(e) For total and permanent disability benefits in or supplementary to ordinary policies or contracts:

1. For policies or contracts issued on or after January 1, 1966, the tables of period 2 disablement rates and the 1930 to 1950 termination rates of the 1952 disability study of the Society of Actuaries, with due regard to the type of benefit;

2. For policies or contracts issued on or after January 1, 1961, and prior to January 1, 1966, either those tables or, at the option of the insurer, the class three disability table (1926);

3. For policies issued prior to January 1, 1961, the class three disability table (1926); and

4. For policies or contracts issued on or after July 1, 2004, tables of disablement rates and termination rates adopted after 1980 by the National Association of Insurance Commissioners, adopted by rule by the commission for use in determining the minimum standard of valuation for those policies or contracts.

Any such table for active lives shall be combined with a mortality table permitted for calculating the reserves for life insurance policies.

(f) For accidental death benefits in or supplementary to policies:

1. For policies issued on or after January 1, 1966, the 1959 Accidental Death Benefits Table;
2. For policies issued on or after January 1, 1961, and prior to January 1, 1966, either that table or, at the option of the insurer, the Intercompany Double Indemnity Mortality Table;
3. For policies issued prior to January 1, 1961, the Intercompany Double Indemnity Mortality Table;
and
4. For policies issued on or after July 1, 2004, tables of accidental death benefits adopted after 1980 by the National Association of Insurance Commissioners, adopted by rule by the commission for use in determining the minimum standard of valuation for those policies.

Either table shall be combined with a mortality table permitted for calculating the reserves for life insurance policies.

(g) For group life insurance, life insurance issued on the substandard basis, and other special benefits, such tables as may be approved by the office as being sufficient with relation to the benefits provided by such policies.

(h) Except as provided in subsection (6), the minimum standard for the valuation of all individual annuity and pure endowment contracts issued on or after the operative date of this paragraph and for all annuities and pure endowments purchased on or after such operative date under group annuity and pure endowment contracts shall be the commissioners' reserve valuation method defined in subsection (7) and the following tables and interest rates:

1. For individual annuity and pure endowment contracts issued prior to October 1, 1979, excluding any disability and accidental death benefits in such contracts, the 1971 Individual Annuity Mortality Table, or any modification of this table approved by the office, and 6 percent interest for single-premium immediate annuity contracts and 4 percent interest for all other individual annuity and pure endowment contracts.
2. For individual single-premium immediate annuity contracts issued on or after October 1, 1979, and prior to October 1, 1986, excluding any disability and accidental death benefits in such contracts, the 1971 Individual Annuity Mortality Table, or any modification of this table approved by the office, and 7.5 percent interest. For such contracts issued on or after October 1, 1986, the 1983 Individual Annual Mortality Table, or any modification of such table approved by the office, and the applicable calendar year statutory valuation interest rate as described in subsection (6).
3. For individual annuity and pure endowment contracts issued on or after October 1, 1979, and prior to October 1, 1986, other than single-premium immediate annuity contracts, excluding any disability and accidental death benefits in such contracts, the 1971 Individual Annuity Mortality Table, or any modification of this table approved by the office, and 5.5 percent interest for single-premium deferred annuity and pure endowment contracts and 4.5 percent interest for all other such individual annuity

and pure endowment contracts. For such contracts issued on or after October 1, 1986, the 1983 Individual Annual Mortality Table, or any modification of such table approved by the office, and the applicable calendar year statutory valuation interest rate as described in subsection (6).

4. For all annuities and pure endowments purchased prior to October 1, 1979, under group annuity and pure endowment contracts, excluding any disability and accidental death benefits purchased under such contracts, the 1971 Group Annuity Mortality Table, or any modification of this table approved by the office, and 6 percent interest.
5. For all annuities and pure endowments purchased on or after October 1, 1979, and prior to October 1, 1986, under group annuity and pure endowment contracts, excluding any disability and accidental death benefits purchased under such contracts, the 1971 Group Annuity Mortality Table, or any modification of this table approved by the office, and 7.5 percent interest. For such contracts purchased on or after October 1, 1986, the 1983 Group Annuity Mortality Table, or any modification of such table approved by the office, and the applicable calendar year statutory valuation interest rate as described in subsection (6).

After July 1, 1973, any insurer may have filed with the former Department of Insurance a written notice of its election to comply with the provisions of this paragraph after a specified date before January 1, 1979, which shall be the operative date of this paragraph for such insurer. However, an insurer may elect a different operative date for individual annuity and pure endowment contracts from that elected for group annuity and pure endowment contracts. If an insurer makes no such election, the operative date of this paragraph for such insurer shall be January 1, 1979.

(i) In lieu of the mortality tables specified in this subsection, and subject to rules previously adopted by the former Department of Insurance, the insurance company may, at its option:

1. Substitute the applicable 1958 CSO or CET Smoker and Nonsmoker Mortality Tables, in lieu of the 1980 CSO or CET mortality table standard, for policies issued on or after the operative date of s. 627.476(9) and before January 1, 1989.
2. Substitute the applicable 1980 CSO or CET Smoker and Nonsmoker Mortality Tables in lieu of the 1980 CSO or CET mortality table standard;
3. Use the Annuity 2000 Mortality Table for determining the minimum standard of valuation for individual annuity and pure endowment contracts issued on or after January 1, 1998, and before July 1, 1998.
4. Use the 1994 GAR Table for determining the minimum standard of valuation for annuities and pure endowments purchased on or after January 1, 1998, and before July 1, 1998, under group annuity and pure endowment contracts.

(j) The commission may adopt by rule the model regulation for valuation of life insurance policies as approved by the National Association of Insurance Commissioners in March 1999, including tables of select mortality factors, and may make the regulation effective for policies issued on or after January 1, 2000.

(k) For individual annuity and pure endowment contracts issued on or after July 1, 2004, excluding any disability and accidental death benefits purchased under those contracts, individual annuity mortality tables adopted after 1980 by the National Association of Insurance Commissioners, adopted by rule by the commission for use in determining the minimum standard of valuation for those contracts.

- (l) For all annuities and pure endowments purchased on or after July 1, 2004, under group annuity and pure endowment contracts, excluding any disability and accidental death benefits purchased under those contracts, group annuity mortality tables adopted after 1980 by the National Association of Insurance Commissioners, adopted by rule by the commission for use in determining the minimum standard of valuation for those contracts.

(6) MINIMUM STANDARD OF VALUATION.--

(a) The interest rates used in determining the minimum standard for the valuation of:

1. All life insurance policies issued in a particular calendar year on or after the operative date of s. 627.476(9);
2. All individual annuity and pure endowment contracts issued in a particular calendar year on or after January 1, 1982;
3. All annuities and pure endowments purchased in a particular calendar year on or after January 1, 1982, under group annuity and pure endowment contracts; and
4. The net increase, if any, in a particular calendar year after January 1, 1982, in amounts held under guaranteed interest contracts,

shall be the calendar year statutory valuation interest rates for the year-of-issue purchase or increase as defined in this subsection.

(b) The calendar year statutory valuation interest rates shall be determined as follows, and the results rounded to the nearest 0.25 percent:

1. For life insurance:

$$I = 0.03 + W(R1-0.03) + (W/2)(R2-0.09).$$

For purposes of this subparagraph, "R1" is the lesser of R and .09; "R2" is the greater of R and .09; "R" is the reference interest rate defined in this subsection; and "W" is the weighting factor defined in this subsection.

2. For single-premium immediate annuities and for annuity benefits involving life contingencies arising from other annuities with cash settlement options and from guaranteed interest contracts with cash settlement options:

$$I = 0.03 + W(R-0.03).$$

For purposes of this subparagraph, "R" is the reference interest rate defined in this subsection, and "W" is the weighting factor defined in this subsection.

3. For other annuities with cash settlement options and guaranteed interest contracts with cash settlement options, valued on an issue-year basis, except as stated in subparagraph 2., the formula for life insurance stated in subparagraph 1. shall apply to annuities and guaranteed interest contracts with

guarantee durations in excess of 10 years, and the formula for single-premium immediate annuities stated in subparagraph 2. shall apply to annuities and guaranteed interest contracts with guarantee durations of 10 years or less.

4. For other annuities with no cash settlement options and for guaranteed interest contracts with no cash settlement options, the formula for single-premium immediate annuities stated in subparagraph 2. shall apply.

5. For other annuities with cash settlement options and guaranteed interest contracts with cash settlement options, valued on a change-in-fund basis, the formula for single-premium immediate annuities stated in subparagraph 2. shall apply.

However, if the calendar year statutory valuation interest rate for any life insurance policies issued in any calendar year determined without reference to this sentence differs from the corresponding actual rate for similar policies issued in the immediately preceding calendar year by less than 0.5 percent, the calendar year statutory valuation interest rate for such life insurance policies shall be equal to the corresponding actual rate for the immediately preceding calendar year. For purposes of applying the immediately preceding sentence, the calendar year statutory valuation interest rate for life insurance policies issued in a calendar year shall be determined for 1980, the reference interest rate defined for 1979 being used, and shall be determined for each subsequent calendar year regardless of when s. 627.476(9) becomes operative.

(c) The weighting factors referred to in the formulas stated in paragraph (b) are given in the following tables:

1. Weighting factors for life insurance:

Guarantee Duration (Years)	Weighting Factors
10 or less:	0.50
More than 10, but not more than 20:	0.45
More than 20:	0.35

For life insurance, the "guarantee duration" is the maximum number of years the life insurance can remain in force on a basis guaranteed in the policy or under options to convert to plans of life insurance with premium rates or nonforfeiture values or both which are guaranteed in the original policy.

2. Weighting factor for single-premium immediate annuities and for annuity benefits involving life contingencies arising from other annuities with cash settlement options and guaranteed interest contracts with cash settlement options: 0.80.

3. Weighting factors for other annuities and for guaranteed interest contracts, except as stated in subparagraph 2., shall be as specified in sub-subparagraphs a., b., and c., according to the rules and definitions in sub-subparagraphs d., e., and f. and in paragraph (f):

a. For annuities and guaranteed interest contracts valued on an issue-year basis:

Guarantee Duration	Weighting Factor
(Years)	for Plan Type
5 or less:	A--0.80
	B--0.60
	C--0.50
More than 5, but not more than 10:	A--0.75
	B--0.60
	C--0.50
More than 10, but not more than 20:	A--0.65
	B--0.50
	C--0.45

More than 20: A--0.45

B--0.35

C--0.35

b. For annuities and guaranteed interest contracts valued on a change-in-fund basis, the factors shown in sub-subparagraph a. increased by: 0.15 for Plan Type A; 0.25 for Plan Type B; 0.05 for Plan Type C.

c. For annuities and guaranteed interest contracts valued on an issue-year basis, other than those with no cash settlement options, which do not guarantee interest on considerations received more than 1 year after issue or purchase and for annuities and guaranteed interest contracts valued on a change-in-fund basis which do not guarantee interest rates on considerations received more than 12 months beyond the valuation date, the factors shown in sub-subparagraph a. or derived in sub-subparagraph b. increased by: 0.05 for Plan Type A; 0.05 for Plan Type B; 0.05 for Plan Type C.

d. For other annuities with cash settlement options and guaranteed interest contracts with cash settlement options, the "guarantee duration" is the number of years for which the contract guarantees interest rates in excess of the calendar year statutory valuation interest rate for life insurance policies with guarantee duration in excess of 20 years. For other annuities with no cash settlement options and for guaranteed interest contracts with no cash settlement options, the guarantee duration is the number of years from the date of issue or date of purchase to the date annuity benefits are scheduled to commence.

e. "Plan type," as used in the tables above, is defined as follows:

(I) Plan Type A: At any time, the policyholder may withdraw funds only with an adjustment to reflect changes in interest rates or asset values since receipt of the funds by the insurer; the policyholder may withdraw funds only without such adjustment but in installments over 5 years or more; the policyholder may withdraw funds only as an immediate life annuity; or no withdrawal is permitted.

(II) Plan Type B: Before expiration of the interest rate guarantee, the policyholder may withdraw funds only with an adjustment to reflect changes in interest rates or asset values since receipt of the funds by the insurer; the policyholder may withdraw funds only without such adjustment but in installments over 5 years or more; or no withdrawal is permitted. At the end of interest rate guarantee, funds may be withdrawn without such adjustment in a single sum or installments over less than 5 years.

(III) Plan Type C: The policyholder may withdraw funds before expiration of interest rate guarantee in a single sum or installments over less than 5 years either without adjustment to reflect changes in interest rates or asset values since receipt of the funds by the insurer or subject only to a fixed surrender charge stipulated in the contract as a percentage of the fund.

f. An insurer may elect to value guaranteed interest contracts with cash settlement options and annuities with cash settlement options on either an issue-year basis or on a change-in-fund basis.

Guaranteed interest contracts with no cash settlement options and other annuities with no cash settlement options must be valued on an issue-year basis.

(d) The "reference interest rate" referred to in paragraph (b) is defined as follows:

1. For all life insurance, the lesser of the average over a period of 36 months and the average over a period of 12 months, ending on June 30 of the calendar year next preceding the year of issue, of the interest rate index.
2. For single-premium immediate annuities and for annuity benefits involving life contingencies arising from other annuities with cash settlement options and guaranteed interest contracts with cash settlement options, the average over a period of 12 months, ending on June 30 of the calendar year of issue or year of purchase, of the interest rate index.
3. For other annuities with cash settlement options and guaranteed interest contracts with cash settlement options, valued on a year-of-issue basis, except as stated in subparagraph 2., with guarantee duration in excess of 10 years, the lesser of the average over a period of 36 months and the average over a period of 12 months, ending on June 30 of the calendar year of issue or purchase, of the interest rate index.
4. For other annuities with cash settlement options and guaranteed interest contracts with cash settlement options, valued on a year-of-issue basis, except as stated in subparagraph 2., with guarantee duration of 10 years or less, the average over a period of 12 months, ending on June 30 of the calendar year of issue or purchase, of the interest rate index.
5. For other annuities with no cash settlement options and for guaranteed interest contracts with no cash settlement options, the average over a period of 12 months, ending on June 30 of the calendar year of issue or purchase, of the interest rate index.
6. For other annuities with cash settlement options and guaranteed interest contracts with cash settlement options, valued on a change-in-fund basis, except as stated in subparagraph 2., the average over a period of 12 months, ending on June 30 of the calendar year of the change in the fund, of the interest rate index.

(e) The interest rate index shall be the Moody's Corporate Bond Yield Average-Monthly Average Corporates as published by Moody's Investors Service, Inc., as long as this index is calculated by using substantially the same methodology as used by it on January 1, 1981. If Moody's corporate bond yield average ceases to be calculated in this manner, the interest rate index shall be the index approved by rule promulgated by the commission. The methodology used in determining the index approved by rule shall be substantially the same as the methodology employed on January 1, 1981, for determining Moody's Corporate Bond Yield Average-Monthly Average Corporates as published by Moody's Investors Service, Inc.

(f) As used in this subsection, an "issue-year basis" of valuation refers to a valuation basis under which the interest rate used to determine the minimum valuation standard for the entire duration of the annuity or guaranteed interest contract is the calendar year valuation interest rate for the year of purchase of the annuity or guaranteed interest contract; and the "change-in-fund" basis of valuation refers to a valuation basis under which the interest rate used to determine the minimum valuation standard applicable to each change in the fund held under the annuity or guaranteed interest contract is the calendar year valuation interest rate for the year of the change in the fund.

(7) COMMISSIONERS' RESERVE VALUATION METHOD.--

(a)1. Except as otherwise provided in this subsection and subsections (11) and (14), reserves according to the commissioners' reserve valuation method, for the life insurance and endowment benefits of policies providing for a uniform amount of insurance and requiring the payment of uniform premiums, shall be the excess, if any, of the present value, at the date of valuation, of such future guaranteed benefits provided for by such policies, over the then-present value of any future modified net premiums therefor. The modified net premiums for any such policy shall be such uniform percentage of the respective contract premiums for such benefits that the present value, at the date of issue of the policy, of all such modified net premiums shall be equal to the sum of the then-present value of such benefits provided for by the policy and the excess of sub-subparagraph a. over sub-subparagraph b. as follows:

a. A net-level annual premium equal to the present value, at the date of issue, of such benefits provided for after the first policy year, divided by the present value, at the date of issue, of an annuity of one per annum payable on the first and each subsequent anniversary of such policy on which a premium falls due; provided, however, that such net-level annual premium shall not exceed the net-level annual premium on the 19-year premium whole life plan for insurance of the same amount at an age 1 year higher than the age at issue of such policy.

b. A net-1-year-term premium for such benefits provided for in the first policy year.

2. For any life insurance policy which is issued on or after January 1, 1985, for which the contract premium in the first policy year exceeds that of the second year and for which no comparable additional benefit is provided in the first year for such excess, and which provides an endowment benefit, a cash surrender value, or a combination thereof in an amount greater than such excess premium, the reserve according to the commissioners' reserve valuation method as of any policy anniversary occurring on or before the assumed ending date, defined herein as the first policy anniversary on which the sum of any endowment benefit and any cash surrender value then available is greater than such excess premium, shall, except as otherwise provided in subsection (11), be the greater of the reserve as of such policy anniversary calculated as described in subparagraph 1. and the reserve as of such policy anniversary calculated as described in subparagraph 1. but with:

a. The value defined in subparagraph 1. being reduced by 15 percent of the amount of such excess first year premium;

b. All present values of benefits and premiums being determined without reference to premiums or benefits provided for by the policy after the assumed ending date;

c. The policy being assumed to mature on such date as an endowment; and

d. The cash surrender value provided on such date being considered as an endowment benefit.

In making the above comparison, the mortality and interest bases stated in subsections (5) and (6) shall be used.

(b) Reserves according to the commissioners' reserve valuation method for:

1. Life insurance policies providing for a varying amount of insurance or requiring the payment of varying premiums;

2. Group annuity and pure endowment contracts, purchased under a retirement plan or plan of deferred compensation, established or maintained by an employer, including a partnership or sole proprietorship, or by an employee organization, or by both, other than a plan providing individual

retirement accounts or individual retirement annuities under s. 408 of the Internal Revenue Code, as now or hereafter amended;

3. Disability and accidental death benefits in all policies and contracts; and

4. All other benefits, except life insurance and endowment benefits in life insurance policies, and benefits provided by all other annuity and pure endowment contracts,

shall be calculated by a method which is consistent with and yields results consistent with the principles of paragraph (a).

(c) This subsection shall apply to all annuity and pure endowment contracts other than group annuity and pure endowment contracts purchased under a retirement plan or plan of deferred compensation, established or maintained by an employer, including a partnership or sole proprietorship, or by an employee organization, or by both, other than a plan providing individual retirement accounts or individual retirement annuities under s. 408 of the Internal Revenue Code, as now or hereafter amended. Reserves according to the commissioners' annuity reserve method for benefits under annuity or pure endowment contracts, excluding any disability and accidental death benefits in such contracts, shall be the greatest of the respective excesses of the present values, at the date of valuation, of the future guaranteed benefits, including guaranteed nonforfeiture benefits, provided for by such contracts at the end of each respective contract year, over the present value, at the date of valuation, of any future valuation considerations derived from future gross considerations, required by the terms of such contract, that become payable prior to the end of such respective contract year. The future guaranteed benefits shall be determined by using the mortality table, if any, and the interest rate or rates specified in such contracts for determining guaranteed benefits. The valuation considerations are the portions of the respective gross considerations applied under the terms of such contracts to determine nonforfeiture values.

(8) MINIMUM AGGREGATE RESERVES.--

(a) In no event shall an insurer's aggregate reserves for all life insurance policies, excluding disability and accidental death benefits, issued on or after the operative date of s. 627.476, be less than the aggregate reserves calculated in accordance with the methods set forth in subsections (7), (11), and (12) and the mortality table or tables and rate or rates of interest used in calculating nonforfeiture benefits for such policies.

(b) In no event may the aggregate reserves for all policies, contracts, and benefits be less than the aggregate reserves determined by the qualified actuary to be necessary to render the opinion required by subsection (3).

(9) OPTIONAL RESERVE BASIS.--

(a) Reserves for all policies and contracts issued prior to the operative date of s. 627.476 may be calculated, at the option of the insurer, according to any standards which produce greater aggregate reserves for all such policies and contracts than the minimum reserves required by the laws in effect immediately prior to such date.

(b) For any category of policies, contracts, or benefits specified in subsections (5) and (6), issued on or after the operative date of s. 627.476 (the Standard Nonforfeiture Law for Life Insurance), reserves may be calculated, at the option of the insurer, according to any standard or standards which produce greater aggregate reserves for such category than those calculated according to the minimum standard herein provided; but the rate or rates of interest used for policies and contracts, other than annuity

and pure endowment contracts, shall not be higher than the corresponding rate or rates of interest used in calculating any nonforfeiture benefits provided for therein.

(10) LOWER VALUATIONS.--An insurer which at any time had adopted any standard of valuation producing greater aggregate reserves than those calculated according to the minimum standard herein provided may, with the approval of the office, adopt any lower standard of valuation, but not lower than the minimum herein provided; however, for the purposes of this subsection, the holding of additional reserves previously determined by a qualified actuary to be necessary to render the opinion required by subsection (3) shall not be deemed to be the adoption of a higher standard of valuation.

(11) DEFICIENCY RESERVE.--If in any contract year the gross premium charged by any life insurer on any policy or contract is less than the valuation net premium for the policy or contract calculated by the method used in calculating the reserve thereon but using the minimum valuation standards of mortality and rate of interest, there shall be maintained on such policy or contract a deficiency reserve in addition to the reserve defined by subsections (7) and (12). For each such policy or contract, the deficiency reserve shall be the present value, according to the minimum valuation standards of mortality and rate of interest, of the differences between all such valuation net premiums and the corresponding premiums charged for such policy or contract during the remainder of the premium-paying period. For any category of policies, contracts, or benefits specified in subsections (5) and (6), issued on or after the operative date of s. 627.476 (the Standard Nonforfeiture Law for Life Insurance), the aggregate deficiency reserves may be reduced by the amount, if any, by which the aggregate reserves actually calculated in accordance with subsection (9) exceed the minimum aggregate reserves prescribed by subsection (8). The minimum valuation standards of mortality and rate of interest referred to in this subsection are those standards stated in subsections (5) and (6). However, for any life insurance policy which is issued on or after January 1, 1985, for which the gross premium in the first policy year exceeds that of the second year and for which no comparable additional benefit is provided in the first year for such excess, and which provides an endowment benefit, a cash surrender value, or a combination thereof in an amount greater than such excess premium, the foregoing provisions of this subsection shall be applied as if the method actually used in calculating the reserve for such policy were the method described in subsection (7), the provisions of subparagraph (7)(a)2. being ignored. The amount of the deficiency reserve, if any, at each policy anniversary of such a policy shall be the excess, if any, of the amount determined by the foregoing provisions of this subsection plus the reserve calculated by the method described in subsection (7), the provisions of subparagraph (7)(a)2. being ignored, over the reserve actually calculated by the method described in subsection (7), the provisions of subparagraph (7)(a)2. being taken into account.

(12) ALTERNATE METHOD FOR DETERMINING RESERVES IN CERTAIN CASES.--In the case of any plan of life insurance which provides for future premium determination, the amounts of which are to be determined by the insurer based on then estimates of future experience, or in the case of any plan of life insurance or annuity which is of such a nature that the minimum reserves cannot be determined by the methods described in subsection (7), the reserves which are held under any such plan shall:

- (a) Be appropriate in relation to the benefits and the pattern of premiums for that plan; and
- (b) Be computed by a method which is consistent with the principles of this section, as determined by rules promulgated by the commission.

(13) CREDIT LIFE AND DISABILITY POLICIES.--

(a) For policies issued prior to January 1, 2004:

1. The minimum reserve for single-premium credit disability insurance, monthly premium credit life insurance, and monthly premium credit disability insurance shall be the unearned gross premium.

2. As to single-premium credit life insurance policies, the insurer shall establish and maintain reserves that are not less than the value, at the valuation date, of the risk for the unexpired portion of the period for which the premium has been paid as computed on the basis of the commissioners' 1980 Standard Ordinary Mortality Table and 3.5 percent interest. At the discretion of the office, the insurer may make a reasonable assumption as to the ages at which net premiums are to be determined. In lieu of the foregoing basis, reserves based upon unearned gross premiums may be used at the option of the insurer.

(b) For policies issued on or after January 1, 2004:

1. The minimum reserve for single-premium credit disability insurance shall be either:
 - a. The unearned gross premium, or
 - b. Based upon a morbidity table that is adopted by the National Association of Insurance Commissioners and is specified in a rule the commission adopts pursuant to subsection (14).
2. The minimum reserve for monthly premium credit disability insurance shall be the unearned gross premium.
3. The minimum reserve for monthly premium credit life insurance shall be the unearned gross premium.
4. As to single-premium credit life insurance policies, the insurer shall establish and maintain reserves that are not less than the value, at the valuation date, of the risk for the unexpired portion of the period for which the premium has been paid as computed on the basis of the commissioners' 1980 Standard Ordinary Mortality Table or any ordinary mortality table, adopted after 1980 by the National Association of Insurance Commissioners, that is approved by rule adopted by the commission for use in determining the minimum standard of valuation for such policies; and an interest rate determined in accordance with subsection (6). At the discretion of the office, the insurer may make a reasonable assumption as to the ages at which net premiums are to be determined. In lieu of the foregoing basis, reserves based upon unearned gross premiums may be used at the option of the insurer.

(14) MINIMUM STANDARDS FOR HEALTH PLANS.--The commission shall adopt a rule containing the minimum standards applicable to the valuation of health plans in accordance with sound actuarial principles.

624.307 General powers; duties.--

- (1) The department and office shall enforce the provisions of this code and shall execute the duties imposed upon them by this code, within the respective jurisdiction of each, as provided by law.

M E M O R A N D U M

DATE: July 29, 2010
TO: Kevin M. McCarty, Commissioner, Office of Insurance Regulation
THROUGH: Steven H. Parton, General Counsel
FROM: Dennis Threadgill
Bob Prentiss
SUBJECT: Cabinet Agenda for August 10, 2010
Request for Approval to Publish Amendments to
Rule 69O-164.020
Assmt. # 44315

The Office of Insurance Regulation requests that these proposed rule amendments be presented to the Cabinet aides on or before August 4, 2010, and to the Financial Services Commission on August 10, 2010, with a request to approve for publication the proposed rules.

Sections 625.121(5), F.S., provides the Commission may adopt by rule the NAIC Model Regulations related to valuation of life insurance policies. This rule does that.

This rule is being amended to adopt changes made to the NAIC Model Regulations. The amendment reduces the minimum premium deficiency reserve requirement, subject to certain conditions to ensure adequacy of reserves.

Sections 624.308(1), 624.307(1), 625.121(5), F.S., provide rulemaking authority and laws implemented for this rule.

Amanda Hunter is the attorney handling this rule. Attached are: 1) the proposed rule(s), 2) any incorporated materials, such as forms; and 3) copies of the rulemaking statutory authority and law implemented.

Approved for signature:



Steven H. Parton, General Counsel

Approved for submission to Financial Services
Commission:

Kevin M. McCarty, Commissioner
Office of Insurance Regulation

THE FULL TEXT OF THE PROPOSED RULE IS:

69O-164.020 Valuation of Life Insurance Policies.

(1) Purpose.

(a) The purpose of this rule is to provide:

1. Tables of select mortality factors, identified as Appendix to Rule 69O-164.020, F.A.C., which is hereby adopted and incorporated by reference, and rules for their use;

2. Rules concerning a minimum standard for the valuation of plans with nonlevel premiums or benefits; and

3. Rules concerning a minimum standard for the valuation of plans with secondary guarantees.

(b) The method for calculating basic reserves defined in this rule will constitute the Commissioners' Reserve Valuation Method for policies to which this rule is applicable.

(2)(a) This rule is consistent with Appendix A-830 of the NAIC Accounting Practices and Procedures Manual as adopted in Rule 69O-137.001, F.A.C.

(b) This rule applies to policies issued during calendar year 2000 in addition to those issued on or after January 1, 2001.

(3) Applicability. This rule shall apply to all life insurance policies, with or without nonforfeiture values, issued on or after January 1, 2000, subject to the following exceptions and conditions:

(a) Exceptions.

1. This rule shall not apply to any individual life insurance policy issued on or after the effective date of this rule if the policy is issued in accordance with and as a result of

the exercise of a reentry provision contained in the original life insurance policy of the same or greater face amount, issued before January 1, 2000, that guarantees the premium rates of the new policy. This rule also shall not apply to subsequent policies issued as a result of the exercise of such a provision, or a derivation of the provision, in the new policy.

2. This rule shall not apply to any universal life policy that meets all the following requirements:

a. Secondary guarantee period, if any, is 5 years or less;

b. Specified premium for the secondary guarantee period is not less than the net level reserve premium for the secondary guarantee period based on the CSO valuation tables as defined in paragraph (4)(f), or the ultimate mortality tables specified in subsection 69O-162.201(6), F.A.C., and the applicable valuation interest rate; and

c. The initial surrender charge is not less than 100 percent of the first year annualized specified premium for the secondary guarantee period.

3. This rule shall not apply to any variable life insurance policy that provides for life insurance the amount or duration of which varies according to the investment experience of any separate account or accounts.

4. This rule shall not apply to any variable universal life insurance policy that provides for life insurance the amount or duration of which varies according to the investment experience of any separate account or accounts.

5. This rule shall not apply to a group life insurance certificate unless the certificate provides for a stated or implied schedule of maximum gross premiums required in order to continue coverage in force for a period in excess of one year.

(b) Conditions.

1. Calculation of the minimum valuation standard for policies with guaranteed nonlevel gross premiums or guaranteed nonlevel benefits (other than universal life policies), or both, shall be in accordance with the provisions of subsection (6).

2. Calculation of the minimum valuation standard for flexible premium and fixed premium universal life insurance policies that contain provisions resulting in the ability of a policyholder to keep a policy in force over a secondary guarantee period shall be in accordance with the provisions of subsection (7).

(4) Definitions. For purposes of this rule:

(a) "Basic reserves" means reserves calculated in accordance with Section 625.121(7), Florida Statutes.

(b)1. "Contract segmentation method" means the method of dividing the period from issue to mandatory expiration of a policy into successive segments, with the length of each segment being defined as the period from the end of the prior segment (from policy inception for the first segment) to the end of the latest policy year as determined below. All calculations are made using the 1980 CSO valuation tables, as defined in paragraph (f), or the mortality tables specified in subsection 69O-162.201(6), F.A.C., and, if elected, the optional minimum mortality standard for deficiency reserves stipulated in paragraph (5)(b) of this rule.

2. The length of a particular contract segment shall be set equal to the minimum of the value t for which G_t is greater than R_t (if G_t never exceeds R_t the segment length is deemed to be the number of years from the beginning of the segment to the mandatory expiration date of the policy), where G_t and R_t are defined as follows:

$$G_t = \frac{GP_{x+k+t}}{GP_{x+k+t-1}}$$

where:

x = original issue age;

k = the number of years from the date of issue to the beginning of the segment;

t = 1, 2, ...; t is reset to 1 at the beginning of each segment;

$GP_{x+k+t-1}$ = Guaranteed gross premium per thousand of face amount for year t of the segment, ignoring policy fees only if level for the premium paying period of the policy.

q_{x+k+t}

$R_t = \underline{\hspace{2cm}}$; however, R_t may be increased or decreased by one

$q_{x+k+t-1}$ percent in any policy year, at the company's option, but R_t shall not be less than one;

where:

x, k and t are as defined above, and

$q_{x+k+t-1}$ = valuation mortality rate for deficiency reserves in policy year k+t but using the mortality of Section 5B(2) if Section 5B(3) is elected for deficiency reserves.

However, if GP_{x+k+t} is greater than 0 and $GP_{x+k+t-1}$ is equal to 0, G_t shall be deemed to be 1000. If GP_{x+k+t} and $GP_{x+k+t-1}$ are both equal to 0, G_t shall be deemed to be 0.

(c) "Deficiency reserves" means the excess, if greater than zero, of

1. Minimum reserves calculated in accordance with Section 625.121(11), Florida Statutes, over

2. Basic reserves.

(d) "Guaranteed gross premiums" means the premiums under a policy of life insurance that are guaranteed and determined at issue.

(e) "Maximum valuation interest rates" means the interest rates defined in Section 625.121(6), Florida Statutes, (Computation of Minimum Standard by Calendar Year of Issue) that are to be used in determining the minimum standard for the valuation of life insurance policies.

(f) "1980 CSO valuation tables" means the Commissioners' 1980 Standard Ordinary Mortality Table (1980 CSO Table) without 10-year selection factors, incorporated into the 1980 amendments to the NAIC Standard Valuation Law, and variations of the 1980 CSO Table approved by the NAIC, such as the smoker and nonsmoker versions approved in December 1983.

(g) "Scheduled gross premium" means the smallest illustrated gross premium at issue for other than universal life insurance policies. For universal life insurance policies, scheduled gross premium means the smallest specified premium described in subparagraph (7)(a)3., if any, or else the minimum premium described in subparagraph (7)(a)4.

(h)1. "Segmented reserves" means reserves, calculated using segments produced by the contract segmentation method, equal to the present value of all future guaranteed benefits less the present value of all future net premiums to the mandatory expiration of a policy, where the net premiums within each segment are a uniform percentage of the respective guaranteed gross premiums within the segment. The uniform percentage for each segment is such that, at the beginning of the segment, the present value of the net premiums within the segment equals:

- a. The present value of the death benefits within the segment, plus
- b. The present value of any unusual guaranteed cash value (see paragraph (6)(d))

occurring at the end of the segment, less

c. Any unusual guaranteed cash value occurring at the start of the segment, plus

d. For the first segment only, the excess of the Item (I) over Item (II), as follows:

(I) A net level annual premium equal to the present value at the date of issue of the benefits provided for in the first segment after the first policy year; divided by the present value at the date of issue of an annuity of 1 per year payable on the first and each subsequent anniversary within the first segment on which a premium falls due. However, the net level annual premium shall not exceed the net level annual premium on the 19 year premium whole life plan of insurance of the same renewal year equivalent level amount at an age one year higher than the age at issue of the policy.

(II) A net 1 year term premium for the benefits provided for in the first policy year.

2. The length of each segment is determined by the "contract segmentation method," as defined in this rule.

3. The interest rates used in the present value calculations for any policy shall not exceed the maximum valuation interest rate, determined with a guarantee duration equal to the sum of the lengths of all segments of the policy.

4. For both basic reserves and deficiency reserves computed by the segmented method, present values shall include future benefits and net premiums in the current segment and in all subsequent segments.

a. The segmentation requirement shall not be limited to plans with no cash surrender values; otherwise companies could avoid segmentation entirely by designing policies with minimal (positive) cash values.

b. Segmentation for plans with cash surrender values shall be based solely upon

gross premium levels.

c. Basing segmentation upon the level of cash surrender values introduces complications because of the inter-relationship between minimum cash surrender values and gross premium patterns.

d. The requirements of this rule relating to reserves for plans with unusual cash values and to reserves if cash values exceed calculated reserves serve to link required reserves and cash surrender values.

e. The calculation of segmented reserves shall not be linked to the occurrence of a positive unitary terminal reserve at the end of a segment.

f. The requirement of this rule to hold the greater of the segmented reserve or the unitary reserve eliminates the need for any linkage.

(i) "Tabular cost of insurance" means the net single premium at the beginning of a policy year for 1 year term insurance in the amount of the guaranteed death benefit in that policy year.

(j) "Ten-year select factors" means the select factors adopted with the 1980 amendments to the NAIC Standard Valuation Law.

(k)1. "Unitary reserves" means the present value of all future guaranteed benefits less the present value of all future modified net premiums, where:

a. Guaranteed benefits and modified net premiums are considered to the mandatory expiration of the policy; and

b. Modified net premiums are a uniform percentage of the respective guaranteed gross premiums, where the uniform percentage is such that at issue the present value of the net premiums equals the present value of all death benefits and pure

endowments, plus the excess of Item (I) over Item (II), as follows:

(I) A net level annual premium equal to the present value at the date of issue of the benefits provided for after the first policy year, divided by the present value, at the date of issue, of an annuity of one per year payable on the first and each subsequent anniversary of the policy on which a premium falls due. However, the net level annual premium shall not exceed the net level annual premium on the 19 year premium whole life plan of insurance of the same renewal year equivalent level amount at an age 1 year higher than the age at issue of the policy.

(II) A net 1 year term premium for the benefits provided for in the first policy year.

2. The interest rates used in the present value calculations for any policy shall not exceed the maximum valuation interest rate, determined with a guarantee duration equal to the length from issue to the mandatory expiration of the policy.

(I) "Universal life insurance policy" means any individual life insurance policy under the provisions of which separately identified interest credits (other than in connection with dividend accumulations, premium deposit funds, or other supplementary accounts) and mortality or expense charges are made to the policy.

(5) General Calculation Requirements for Basic Reserves and Premium Deficiency Reserves.

(a) At the election of the insurer for any one or more specified plans of life insurance, the minimum mortality standard for basic reserves may be calculated using the 1980 CSO valuation tables with select mortality factors or the mortality tables specified in subsection 69O-162.201(6), F.A.C. If select mortality factors are elected for use with the 1980 CSO valuation tables, they may be:

1. The 10 year select mortality factors incorporated into the 1980 amendments to the NAIC Standard Valuation Law; or

2. The select mortality factors in the Appendix.

(b) Deficiency reserves, if any, are calculated for each policy as the excess, if greater than zero, of the quantity A over the basic reserve.

1. The quantity A is obtained by recalculating the basic reserve for the policy using guaranteed gross premiums instead of net premiums when the guaranteed gross premiums are less than the corresponding net premiums.

2. At the election of the insurer for any one or more specified plans of insurance, the quantity A and the corresponding net premiums used in the determination of quantity A may be based upon the 1980 CSO valuation tables with select mortality factors or the mortality tables specified in subsection 69O-162.201(6), F.A.C. If select mortality factors are elected for use with the 1980 CSO valuation tables, they may be:

a. The 10 year select mortality factors incorporated into the 1980 amendments to the NAIC Standard Valuation Law;

b. The select mortality factors in the Appendix of this rule;

c. For durations in the first segment, X percent of the select mortality factors in the Appendix, subject to the following:

(I) X may vary by policy year, policy form, underwriting classification, issue age, or any other policy factor expected to affect mortality experience;

~~(II) X shall not be less than 20 percent;~~

~~(III) X shall not decrease in any successive policy years;~~

(II) ~~(IV)~~ X is such that, when using the valuation interest rate used for basic reserves,

item (A) is greater than or equal to Item (B);

(A) The actuarial present value of future death benefits, calculated using the mortality rates resulting from the application of X;

(B) The actuarial present value of future death benefits calculated using anticipated mortality experience without recognition of mortality improvement beyond the valuation date;

(III) ~~(V)~~ X is such that the mortality rates resulting from the application of X are at least as great as the anticipated mortality experience, without recognition of mortality improvement beyond the valuation date, in each of the first 5 years after the valuation date;

(IV) ~~(VI)~~ The appointed actuary shall increase X at any valuation date where it is necessary to continue to meet all the requirements of subparagraph (b)3.;

(V) ~~(VII)~~ The appointed actuary may decrease X at any valuation date as long as X does not decrease in any successive policy years and as long as it continues to meet all the requirements of subparagraph (b)3.; and

(VI) ~~(VIII)~~ The appointed actuary shall specifically take into account the adverse effect on expected mortality and lapsation of any anticipated or actual increase in gross premiums.

(VII) ~~(IX)~~ If X is less than 100 percent at any duration for any policy, the following requirements shall be met:

(A) The appointed actuary shall annually prepare an actuarial opinion and memorandum for the company in conformance with the requirements of Rule Chapter 69O-138, F.A.C.; and

(B) The appointed actuary shall annually opine for all policies subject to this rule as to whether the mortality rates resulting from the application of X meet the requirements of subparagraph (b)2.c.

I. The opinion shall be supported by an actuarial report, subject to appropriate Actuarial Standards of Practice promulgated by the Actuarial Standards Board of the American Academy of Actuaries.

II. The X factors shall reflect anticipated future mortality without recognition of mortality improvement beyond the valuation date, taking into account relevant emerging experience.

(C) The appointed actuary shall disclose, in the Regulatory Asset Adequacy Issues Summary, the impact of the insufficiency of assets to support the payment of benefits and expenses and the establishment of statutory reserves during one or more interim periods;

(c) This subsection applies to both basic reserves and deficiency reserves. Any set of select mortality factors may be used only for the first segment. However, if the first segment is less than 10 years, the appropriate 10 year select mortality factors incorporated into the 1980 amendments to the NAIC Standard Valuation Law may be used thereafter through the tenth policy year from the date of issue.

(d) In determining basic reserves or deficiency reserves, guaranteed gross premiums without policy fees may be used where the calculation involves the guaranteed gross premium, but only if the policy fee is a level dollar amount after the first policy year. In determining deficiency reserves, policy fees may be included in guaranteed gross premiums even if not included in the actual calculation of basic

reserves.

(e) Reserves for policies that have changes to guaranteed gross premiums, guaranteed benefits, guaranteed charges, or guaranteed credits that are unilaterally made by the insurer after issue and that are effective for more than 1 year after the date of the change shall be the greatest of the following:

1. Reserves calculated ignoring the guarantee;
2. Reserves assuming the guarantee was made at issue; and
3. Reserves assuming that the policy was issued on the date of the guarantee.

(f) The company shall document the extent of the adequacy of reserves for material blocks, including policies issued prior to the effective date of this rule. The documentation shall include:

1. A demonstration of the extent to which aggregation with immaterial blocks of business is relied upon in the formation of the appointed actuary opinion pursuant to and consistent with the requirements of Chapter 69O-138, F.A.C.; and
2. A definition of material.

(6) Calculation of Minimum Valuation Standard for Policies with Guaranteed Nonlevel Gross Premiums or Guaranteed Nonlevel Benefits (Other than Universal Life Policies).

(a) Basic Reserves. Basic reserves shall be calculated as the greater of the segmented reserves and the unitary reserves. Both the segmented reserves and the unitary reserves for any policy shall use the same valuation mortality table and selection factors. At the option of the insurer in calculating segmented reserves and net premiums either of the adjustments described in subparagraph 1. or 2. below may be made:

1. Treat the unitary reserve, if greater than zero, applicable at the end of each segment as a pure endowment and subtract the unitary reserve, if greater than zero, applicable at the beginning of each segment from the present value of guaranteed life insurance and endowment benefits for each segment.

2. Treat the guaranteed cash surrender value, if greater than zero, applicable at the end of each segment as a pure endowment; and subtract the guaranteed cash surrender value, if greater than zero, applicable at the beginning of each segment from the present value of guaranteed life insurance and endowment benefits for each segment.

(b) Deficiency Reserves.

1. The deficiency reserve at any duration shall be calculated:

a. On a unitary basis if the corresponding basic reserve determined by paragraph (a) is unitary;

b. On a segmented basis if the corresponding basic reserve determined by paragraph (a) is segmented; or

c. On the segmented basis if the corresponding basic reserve determined by paragraph (a) is equal to both the segmented reserve and the unitary reserve.

2. This subsection shall apply to any policy for which the guaranteed gross premium at any duration is less than the corresponding modified net premium calculated by the method used in determining the basic reserves, but using the minimum valuation standards in paragraph (5)(b) and rate of interest.

3. Deficiency reserves, if any, shall be calculated for each policy as the excess if greater than zero, for the current and all remaining periods, of the quantity A over the

basic reserve, where A is obtained as indicated in paragraph (5)(b).

4. For deficiency reserves determined on a segmented basis, the quantity A is determined using segment lengths equal to those determined for segmented basic reserves.

(c) Minimum Value.

1. Basic reserves shall not be less than the tabular cost of insurance for the balance of the policy year if mean reserves are used.

2. Basic reserves shall not be less than the tabular cost of insurance for the balance of the current modal period or to the paid-to-date, if later, but not beyond the next policy anniversary, if mid-terminal reserves are used.

3. The tabular cost of insurance shall use the same valuation mortality table and interest rates as that used for the calculation of the segmented reserves.

4. Mortality tables specified in subsection 69O-162.201(6), F.A.C., may be used.

5. However, if select mortality factors are used with the 1980 CSO valuation tables, they shall be the 10 year select factors incorporated into the 1980 amendments of the NAIC Standard Valuation Law.

6. In no case may total reserves (including basic reserves, deficiency reserves and any reserves held for supplemental benefits that would expire upon contract termination) be less than the amount that the policyowner would receive (including the cash surrender value of the supplemental benefits, if any, referred to above), exclusive of any deduction for policy loans, upon termination of the policy.

(d) Unusual Pattern of Guaranteed Cash Surrender Values.

1. For any policy with an unusual pattern of guaranteed cash surrender values, the

reserves actually held prior to the first unusual guaranteed cash surrender value shall not be less than the reserves calculated by treating the first unusual guaranteed cash surrender value as a pure endowment and treating the policy as an n year policy providing term insurance plus a pure endowment equal to the unusual cash surrender value, where n is the number of years from the date of issue to the date the unusual cash surrender value is scheduled.

2. The reserves actually held subsequent to any unusual guaranteed cash surrender value shall not be less than the reserves calculated by treating the policy as an n year policy providing term insurance plus a pure endowment equal to the next unusual guaranteed cash surrender value, and treating any unusual guaranteed cash surrender value at the end of the prior segment as a net single premium, where

a. n is the number of years from the date of the last unusual guaranteed cash surrender value prior to the valuation date to the earlier of:

(I) The date of the next unusual guaranteed cash surrender value, if any, that is scheduled after the valuation date; or

(II) The mandatory expiration date of the policy; and

b. The net premium for a given year during the n year period is equal to the product of the net to gross ratio and the respective gross premium; and

c. The net to gross ratio is equal to Item I divided by Item II as follows:

(I)(A) The present value at the beginning of the n year period of death benefits payable during the n year period, plus

(B) The present value at the beginning of the n year period of the next unusual guaranteed cash surrender value, if any, minus

(C) The amount of the last unusual guaranteed cash surrender value, if any, scheduled at the beginning of the n year period.

(II) The present value at the beginning of the n year period of the scheduled gross premiums payable during the n year period.

3. For purposes of this subsection, a policy is considered to have an unusual pattern of guaranteed cash surrender values if any future guaranteed cash surrender value exceeds the prior year's guaranteed cash surrender value by more than the sum of:

a. 110 percent of the scheduled gross premium for that year;

b. 110 percent of one year's accrued interest on the sum of the prior year's guaranteed cash surrender value and the scheduled gross premium using the nonforfeiture interest rate used for calculating policy guaranteed cash surrender values; and

c. 5 percent of the first policy year surrender charge, if any.

(e) Optional Exemption for Yearly Renewable Term Reinsurance. At the option of the company, the following approach for reserves on YRT reinsurance may be used:

1. Calculate the valuation net premium for each future policy year as the tabular cost of insurance for that future year.

2. Basic reserves shall never be less than the tabular cost of insurance for the appropriate period, as defined in paragraph (c).

3. Deficiency reserves.

a. For each policy year, calculate the excess, if greater than zero, of the valuation net premium over the respective maximum guaranteed gross premium.

b. Deficiency reserves shall never be less than the sum of the present values, at the

date of valuation, of the excesses determined in accordance with paragraph (a) above.

4. For purposes of this subsection, the calculations use the maximum valuation interest rate and the 1980 CSO mortality tables with or without 10 year select mortality factors or the mortality tables specified in subsection 69O-162.201(6), F.A.C.

5. A reinsurance agreement shall be considered YRT reinsurance for purposes of this subsection if only the mortality risk is reinsured.

6. If the assuming company chooses this optional exemption, the ceding company's reinsurance reserve credit shall be limited to the amount of reserve held by the assuming company for the affected policies.

(f) Optional Exemption for Attained-Age-Based Yearly Renewable Term Life Insurance Policies. At the option of the company, the following approach for reserves for attained-age-based YRT life insurance policies may be used:

1. Calculate the valuation net premium for each future policy year as the tabular cost of insurance for that future year.

2. Basic reserves shall never be less than the tabular cost of insurance for the appropriate period, as defined in paragraph (6)(c).

3. Deficiency reserves.

a. For each policy year, calculate the excess, if greater than zero, of the valuation net premium over the respective maximum guaranteed gross premium.

b. Deficiency reserves shall never be less than the sum of the present values at the date of valuation of the excesses determined in accordance with sub-subparagraph a. above.

4. For purposes of this subsection, the calculations use the maximum valuation

interest rate and the 1980 CSO valuation tables with or without 10 year select mortality factors or the mortality tables specified in subsection 69O-162.201(6), F.A.C.

5. A policy shall be considered an attained-age-based YRT life insurance policy for purposes of this subsection if:

a. The premium rates on both the initial current premium scale and the guaranteed maximum premium scale are based upon the attained age of the insured such that the rate for any given policy at a given attained age of the insured is independent of the year the policy was issued; and

b. The premium rates on both the initial current premium scale and the guaranteed maximum premium scale are the same as the premium rates for policies covering all insureds of the same sex, risk class, plan of insurance, and attained age.

6. For policies that become attained-age-based YRT policies after an initial period of coverage, the approach of this subsection may be used after the initial period if:

a. The initial period is constant for all insureds of the same sex, risk class, and plan of insurance; or

b. The initial period runs to a common attained age for all insureds of the same sex, risk class, and plan of insurance; and

c. After the initial period of coverage, the policy meets the conditions of subparagraph 5. above.

7. If this election is made, this approach shall be applied in determining reserves for all attained-age-based YRT life insurance policies issued on or after the effective date of this rule.

(g) Exemption from Unitary Reserves for Certain n-Year Renewable Term Life

Insurance Policies. Unitary basic reserves and unitary deficiency reserves need not be calculated for a policy if the following conditions are met:

1. The policy consists of a series of n-year periods including the first period and all renewal periods where n is the same for each period, except that for the final renewal period, n may be truncated or extended to reach the expiry age, provided that:

a. This final renewal period is less than 10 years and less than twice the size of the earlier n-year periods, and

b. For each period, the premium rates on both the initial current premium scale and the guaranteed maximum premium scale are level;

2. The guaranteed gross premiums in all n-year periods are not less than the corresponding net premiums based upon the 1980 CSO Table with or without the 10 year select mortality factors or the mortality tables specified in subsection 69O-162.201(6), F.A.C.; and

3. There are no cash surrender values in any policy year.

(h) Exemption from Unitary Reserves for Certain Juvenile Policies. Unitary basic reserves and unitary deficiency reserves need not be calculated for a policy if the following conditions are met, based upon the initial current premium scale at issue:

1. At issue, the insured is age 24 or younger;

2. Until the insured reaches the end of the juvenile period, which shall occur at or before age 25, the gross premiums and death benefits are level, and there are no cash surrender values; and

3. After the end of the juvenile period, gross premiums are level for the remainder of the premium paying period, and death benefits are level for the remainder of the life of

the policy.

(7) Calculation of Minimum Valuation Standard for Flexible Premium and Fixed Premium Universal Life Insurance Policies that Contain Provisions Resulting in the Ability of a Policyowner to Keep a Policy in Force Over a Secondary Guarantee Period.

(a) General.

1. Policies with a secondary guarantee include:

a. A policy with a guarantee that the policy will remain in force at the original schedule of benefits, subject only to the payment of specified premiums;

b. A policy in which the minimum premium at any duration is less than the corresponding 1 year valuation premium, calculated using the maximum valuation interest rate and the 1980 CSO valuation tables with or without 10 year select mortality factors or the mortality tables specified in subsection 69O-162.201(6), F.A.C.; or

c. A policy with any combination of subparagraph a. and b.

2. A secondary guarantee period is the period for which the policy is guaranteed to remain in force subject only to a secondary guarantee.

a. When a policy contains more than one secondary guarantee, the minimum reserve shall be the greatest of the respective minimum reserves at that valuation date of each unexpired secondary guarantee, ignoring all other secondary guarantees.

b. Secondary guarantees that are unilaterally changed by the insurer after issue shall be considered to have been made at issue.

c. Reserves described in paragraphs (b) and (c) below shall be recalculated from issue to reflect these changes.

3. Specified premiums mean the premiums specified in the policy, the payment of

which guarantees that the policy will remain in force at the original schedule of benefits but which otherwise would be insufficient to keep the policy in force in the absence of the guarantee if maximum mortality and expense charges and minimum interest credits were made and any applicable surrender charges were assessed.

4.a. For purposes of this section, the minimum premium for any policy year is the premium that, when paid into a policy with a zero account value at the beginning of the policy year, produces a zero account value at the end of the policy year.

b. The minimum premium calculation shall use the policy cost factors (including mortality charges, loads, and expense charges) and the interest crediting rate which are all guaranteed at issue.

5.a. The 1 year valuation premium means the net 1 year premium based upon the original schedule of benefits for a given policy year.

b. The 1 year valuation premiums for all policy years are calculated at issue.

c. The select mortality factors defined in subparagraphs (5)(b)2., 3., and 4. shall not be used to calculate the 1 year valuation premiums.

6. The 1 year valuation premium shall reflect the frequency of fund processing, as well as the distribution of deaths assumption employed in the calculation of the monthly mortality charges to the fund.

(b) Basic Reserves for the Secondary Guarantees.

1. Basic reserves for the secondary guarantees shall be the segmented reserves for the secondary guarantee period.

2. In calculating the segments and the segmented reserves, the gross premiums shall be set equal to the specified premiums, if any, or otherwise to the minimum

premiums that keep the policy in force.

3. The segments will be determined according to the contract segmentation method as defined in paragraph (4)(b).

(c) Deficiency Reserves for the Secondary Guarantees. Deficiency reserves, if any, for the secondary guarantees shall be calculated for the secondary guarantee period in the same manner as described in paragraph (6)(b) with gross premiums set equal to the specified premiums, if any, or otherwise to the minimum premiums that keep the policy in force.

(d) Minimum Reserves. The minimum reserves during the secondary guarantee period are the greater of:

1. The basic reserves for the secondary guarantee plus the deficiency reserve, if any, for the secondary guarantees; or

2. The minimum reserves required by Rule 69O-164.010, F.A.C., governing universal life plans.

(9) Effective Date.

(a) This rule shall be effective for policies issued on or after January 1, 2000 for valuation dates on or after the date this rule is adopted.

(b) For valuation dates prior to the effective date of this rule, at the option of the company, the company may report reserves for policies issued in calendar year 2000 based upon this rule.

Rulemaking Specific Authority 624.308(1), 625.121(5) FS. Law Implemented 624.307(1), 625.121(5) FS. History—New 12-24-03, Formerly 4-164.020, Amended 6-8-05.

624.308 Rules.--

- (1) The department and the commission may each adopt rules pursuant to ss. 120.536(1) and 120.54 to implement provisions of law conferring duties upon the department or the commission, respectively.

625.121 Standard Valuation Law; life insurance.--

- (5) MINIMUM STANDARD FOR VALUATION OF POLICIES AND CONTRACTS ISSUED ON OR AFTER OPERATIVE DATE OF STANDARD NONFORFEITURE LAW.--Except as otherwise provided in paragraph (h) and subsections (6), (11), and (14), the minimum standard for the valuation of all such policies and contracts issued on or after the operative date of s. 627.476 (Standard Nonforfeiture Law for Life Insurance) shall be the commissioners' reserve valuation method defined in subsections (7), (11), and (14); 5 percent interest for group annuity and pure endowment contracts and 3.5 percent interest for all other such policies and contracts, or in the case of life insurance policies and contracts, other than annuity and pure endowment contracts, issued on or after July 1, 1973, 4 percent interest for such policies issued prior to October 1, 1979, and 4.5 percent interest for such policies issued on or after October 1, 1979; and the following tables:

- (a) For all ordinary policies of life insurance issued on the standard basis, excluding any disability and accidental death benefits in such policies:

1. For policies issued prior to the operative date of s. 627.476(9), the commissioners' 1958 Standard Ordinary Mortality Table; except that, for any category of such policies issued on female risks, modified net premiums and present values, referred to in subsection (7), may be calculated according to an age not more than 6 years younger than the actual age of the insured.
2. For policies issued on or after the operative date of s. 627.476(9), the commissioners' 1980 Standard Ordinary Mortality Table or, at the election of the insurer for any one or more specified plans of life insurance, the commissioners' 1980 Standard Ordinary Mortality Table with Ten-Year Select Mortality Factors.
3. For policies issued on or after July 1, 2004, ordinary mortality tables, adopted after 1980 by the National Association of Insurance Commissioners, adopted by rule by the commission for use in determining the minimum standard of valuation for such policies.

- (b) For all industrial life insurance policies issued on the standard basis, excluding any disability and accidental death benefits in such policies:

1. For policies issued prior to the first date to which the commissioners' 1961 Standard Industrial Mortality Table is applicable according to s. 627.476, the 1941 Standard Industrial Mortality Table; and
2. For such policies issued on or after that date, the commissioners' 1961 Standard Industrial Mortality Table.

- (c) For individual annuity and pure endowment contracts, excluding any disability and accidental death benefits in such policies, the 1937 Standard Annuity Mortality Table or, at the option of the insurer, the Annuity Mortality Table for 1949, Ultimate, or any modification of either of these tables approved by the office.

- (d) For group annuity and pure endowment contracts, excluding any disability and accidental death benefits in such policies, the Group Annuity Mortality Table for 1951; any modification of such table

approved by the office; or, at the option of the insurer, any of the tables or modifications of tables specified for individual annuity and pure endowment contracts.

(e) For total and permanent disability benefits in or supplementary to ordinary policies or contracts:

1. For policies or contracts issued on or after January 1, 1966, the tables of period 2 disablement rates and the 1930 to 1950 termination rates of the 1952 disability study of the Society of Actuaries, with due regard to the type of benefit;
2. For policies or contracts issued on or after January 1, 1961, and prior to January 1, 1966, either those tables or, at the option of the insurer, the class three disability table (1926);
3. For policies issued prior to January 1, 1961, the class three disability table (1926); and
4. For policies or contracts issued on or after July 1, 2004, tables of disablement rates and termination rates adopted after 1980 by the National Association of Insurance Commissioners, adopted by rule by the commission for use in determining the minimum standard of valuation for those policies or contracts.

Any such table for active lives shall be combined with a mortality table permitted for calculating the reserves for life insurance policies.

(f) For accidental death benefits in or supplementary to policies:

1. For policies issued on or after January 1, 1966, the 1959 Accidental Death Benefits Table;
2. For policies issued on or after January 1, 1961, and prior to January 1, 1966, either that table or, at the option of the insurer, the Intercompany Double Indemnity Mortality Table;
3. For policies issued prior to January 1, 1961, the Intercompany Double Indemnity Mortality Table;
and
4. For policies issued on or after July 1, 2004, tables of accidental death benefits adopted after 1980 by the National Association of Insurance Commissioners, adopted by rule by the commission for use in determining the minimum standard of valuation for those policies.

Either table shall be combined with a mortality table permitted for calculating the reserves for life insurance policies.

(g) For group life insurance, life insurance issued on the substandard basis, and other special benefits, such tables as may be approved by the office as being sufficient with relation to the benefits provided by such policies.

(h) Except as provided in subsection (6), the minimum standard for the valuation of all individual annuity and pure endowment contracts issued on or after the operative date of this paragraph and for all annuities and pure endowments purchased on or after such operative date under group annuity and pure endowment contracts shall be the commissioners' reserve valuation method defined in subsection (7) and the following tables and interest rates:

1. For individual annuity and pure endowment contracts issued prior to October 1, 1979, excluding any disability and accidental death benefits in such contracts, the 1971 Individual Annuity Mortality Table, or any modification of this table approved by the office, and 6 percent interest for single-premium

immediate annuity contracts and 4 percent interest for all other individual annuity and pure endowment contracts.

2. For individual single-premium immediate annuity contracts issued on or after October 1, 1979, and prior to October 1, 1986, excluding any disability and accidental death benefits in such contracts, the 1971 Individual Annuity Mortality Table, or any modification of this table approved by the office, and 7.5 percent interest. For such contracts issued on or after October 1, 1986, the 1983 Individual Annual Mortality Table, or any modification of such table approved by the office, and the applicable calendar year statutory valuation interest rate as described in subsection (6).
3. For individual annuity and pure endowment contracts issued on or after October 1, 1979, and prior to October 1, 1986, other than single-premium immediate annuity contracts, excluding any disability and accidental death benefits in such contracts, the 1971 Individual Annuity Mortality Table, or any modification of this table approved by the office, and 5.5 percent interest for single-premium deferred annuity and pure endowment contracts and 4.5 percent interest for all other such individual annuity and pure endowment contracts. For such contracts issued on or after October 1, 1986, the 1983 Individual Annual Mortality Table, or any modification of such table approved by the office, and the applicable calendar year statutory valuation interest rate as described in subsection (6).
4. For all annuities and pure endowments purchased prior to October 1, 1979, under group annuity and pure endowment contracts, excluding any disability and accidental death benefits purchased under such contracts, the 1971 Group Annuity Mortality Table, or any modification of this table approved by the office, and 6 percent interest.
5. For all annuities and pure endowments purchased on or after October 1, 1979, and prior to October 1, 1986, under group annuity and pure endowment contracts, excluding any disability and accidental death benefits purchased under such contracts, the 1971 Group Annuity Mortality Table, or any modification of this table approved by the office, and 7.5 percent interest. For such contracts purchased on or after October 1, 1986, the 1983 Group Annuity Mortality Table, or any modification of such table approved by the office, and the applicable calendar year statutory valuation interest rate as described in subsection (6).

After July 1, 1973, any insurer may have filed with the former Department of Insurance a written notice of its election to comply with the provisions of this paragraph after a specified date before January 1, 1979, which shall be the operative date of this paragraph for such insurer. However, an insurer may elect a different operative date for individual annuity and pure endowment contracts from that elected for group annuity and pure endowment contracts. If an insurer makes no such election, the operative date of this paragraph for such insurer shall be January 1, 1979.

- (i) In lieu of the mortality tables specified in this subsection, and subject to rules previously adopted by the former Department of Insurance, the insurance company may, at its option:
 1. Substitute the applicable 1958 CSO or CET Smoker and Nonsmoker Mortality Tables, in lieu of the 1980 CSO or CET mortality table standard, for policies issued on or after the operative date of s. 627.476(9) and before January 1, 1989.
 2. Substitute the applicable 1980 CSO or CET Smoker and Nonsmoker Mortality Tables in lieu of the 1980 CSO or CET mortality table standard;
 3. Use the Annuity 2000 Mortality Table for determining the minimum standard of valuation for individual annuity and pure endowment contracts issued on or after January 1, 1998, and before July 1, 1998.

4. Use the 1994 GAR Table for determining the minimum standard of valuation for annuities and pure endowments purchased on or after January 1, 1998, and before July 1, 1998, under group annuity and pure endowment contracts.

(j) The commission may adopt by rule the model regulation for valuation of life insurance policies as approved by the National Association of Insurance Commissioners in March 1999, including tables of select mortality factors, and may make the regulation effective for policies issued on or after January 1, 2000.

(k) For individual annuity and pure endowment contracts issued on or after July 1, 2004, excluding any disability and accidental death benefits purchased under those contracts, individual annuity mortality tables adopted after 1980 by the National Association of Insurance Commissioners, adopted by rule by the commission for use in determining the minimum standard of valuation for those contracts.

(l) For all annuities and pure endowments purchased on or after July 1, 2004, under group annuity and pure endowment contracts, excluding any disability and accidental death benefits purchased under those contracts, group annuity mortality tables adopted after 1980 by the National Association of Insurance Commissioners, adopted by rule by the commission for use in determining the minimum standard of valuation for those contracts.

624.307 General powers; duties.--

(1) The department and office shall enforce the provisions of this code and shall execute the duties imposed upon them by this code, within the respective jurisdiction of each, as provided by law.

M E M O R A N D U M

DATE: July 29, 2010
TO: Kevin M. McCarty, Commissioner, Office of Insurance Regulation
THROUGH: Steven H. Parton, General Counsel
FROM: Dennis Threadgill
Bob Prentiss
SUBJECT: Cabinet Agenda for August 10, 2010
Request for Approval to Publish Amendments to
Rule 69O-138.047 Description of Actuarial Memorandum including an Asset
Adequacy Analysis and Regulatory Asset Adequacy Issues Summary
Assmt. # 44313

The Office of Insurance Regulation requests that these proposed rule amendments be presented to the Cabinet aides on or before August 4, 2010, and to the Financial Services Commission on August 10, 2010, with a request to approve for publication the proposed rules.

Sections 625.121(3) provides that the Commission shall by rule establish procedures and specifications for the Actuarial Memorandum. This rule does that, by adopting the related NAIC Model Regulations.

This rule is being amended due to changes made to the NAIC Model Regulations. The amendment adds an additional requirement to the Regulatory Asset Adequacy Issues Summary as a result of changes to Rules 69O-162.203 and 69O-164.020, F.A.C.

Sections 625.121(3)(a) and 625.121(3), F.S., provide rulemaking authority and laws implemented for this rule.

Amanda Hunter is the attorney handling this rule. Attached are: 1) the proposed rule(s), 2) any incorporated materials, such as forms; and 3) copies of the rulemaking statutory authority and law implemented.

Approved for signature:


Steven H. Parton, General Counsel

Approved for submission to Financial Services
Commission:

Kevin M. McCarty, Commissioner
Office of Insurance Regulation

69O-138.047 Description of Actuarial Memorandum Including an Asset Adequacy Analysis and Regulatory Asset Adequacy Issues Summary.

(1) General.

(a)1. In accordance with subsection (3) of the Standard Valuation Law, the appointed actuary shall prepare a memorandum to the company describing the analysis done in support of his or her opinion regarding the reserves.

2. The memorandum shall be made available for examination by the Office upon its request. Any memorandum in support of the opinion, and any other material provided by the company to the Office in connection therewith, is confidential and exempt from the provisions of Section 119.07(1), F.S., as provided in Section 625.121(3)(a)10., Florida Statutes.

(b) In preparing the memorandum, the appointed actuary may include as a part of his or her own memorandum, memoranda prepared and signed by other actuaries who are qualified within the meaning of subsection 69O-138.043(2), F.A.C., with respect to the areas covered in the memoranda, and shall so state in their memoranda.

(c) If the Office requests a memorandum and no such memorandum exists, or if the Office finds that the analysis described in the memorandum fails to meet the standards of the Actuarial Standards Board or the standards and requirements of this part, the Office may designate a qualified actuary to review the opinion and prepare for review the required supporting memorandum. The reasonable and necessary expense of the independent review shall be paid by the company but shall be directed and controlled by the Office.

(d)1. The reviewing actuary shall have the same status as an examiner for purposes of obtaining data from the company.

2. The work papers and documentation of the reviewing actuary shall be retained by the Office.

3. Any information provided by the company to the reviewing actuary and included in the work papers shall be considered as material provided by the company to the Office and kept confidential to the same extent prescribed by law with respect to other material provided by the company to the Office pursuant to the statute governing this part.

4. The reviewing actuary shall not be an employee of a consulting firm involved with the preparation of any prior memorandum or opinion for the insurer pursuant to this part for the current year or any one of the preceding 3 years.

(e) In accordance with Section 625.121(3), Florida Statutes, the appointed actuary shall prepare a regulatory asset adequacy issues summary, the contents of which are specified in subsection 69O-138.047(3), F.A.C.

1. The regulatory asset adequacy issues summary shall be submitted no later than March 15 of the year following the year for which a statement of actuarial opinion based on asset adequacy is required.

2. The regulatory asset adequacy issues summary shall be kept confidential to the same extent and under the same conditions as the actuarial memorandum.

(2) Details of the Memorandum Section Documenting Asset Adequacy Analysis. When an actuarial opinion is provided, the memorandum shall demonstrate that the analysis has been done in accordance with the standards for asset adequacy referred to in subsection 69O-138.043(3), F.A.C., and any additional standards under this part. It

shall specify:

(a) For reserves:

1. Product descriptions, including market description, underwriting, and other aspects of a risk profile, and the specific risks the appointed actuary deems significant;
2. Source of liability in force;
3. Reserve method and basis;
4. Investment reserves;
5. Reinsurance arrangements.
6. Identification of any explicit or implied guarantees made by the general account in support of benefits provided through a separate account or under a separate account policy or contract and the methods used by the appointed actuary to provide for the guarantees in the asset adequacy analysis.

7.a. Documentation of assumptions to test reserves for the following:

- (I) Lapse rates (both base and excess);
- (II) Interest crediting rate strategy;
- (III) Mortality;
- (IV) Policyholder dividend strategy;
- (V) Competitor or market interest rate;
- (VI) Annuitization rates;
- (VII) Commissions and expenses; and
- (VIII) Morbidity.

b. The documentation of the assumptions shall be such that an actuary reviewing the actuarial memorandum can form a conclusion as to the reasonableness of the

assumptions.

(b) For assets:

1. Portfolio descriptions, including a risk profile disclosing the quality, distribution, and types of assets;

2. Investment and disinvestment assumptions;

3. Source of asset data;

4. Asset valuation bases; and

5.a. Documentation of assumptions made for:

(I) Default costs;

(II) Bond call function;

(III) Mortgage prepayment function;

(IV) Determining market value for assets sold due to disinvestment strategy; and

(V) Determining yield on assets acquired through the investment strategy.

b. The documentation of the assumptions shall be such that an actuary reviewing the actuarial memorandum can form a conclusion as to the reasonableness of the assumptions.

(c) For the analysis basis:

1. Methodology;

2. Rationale for inclusion/exclusion of different blocks of business, and how pertinent risks were analyzed;

3. Rationale for degree of rigor in analyzing different blocks of business (include in the rationale the level of "materiality" that was used in determining how rigorously to analyze different blocks of business);

4. Criteria for determining asset adequacy (include in the criteria the precise basis for determining if assets are adequate to cover reserves under “moderately adverse conditions” or other conditions as specified in relevant actuarial standards of practice); and

5. Whether the impact of federal income taxes was considered and the method of treating reinsurance in the asset adequacy analysis.

(d) Summary of material changes in methods, procedures, or assumptions from prior year’s asset adequacy analysis;

(e) Summary of Results; and

(f) Conclusion(s).

(3) Details of the Regulatory Asset Adequacy Issues Summary.

(a) The regulatory asset adequacy issues summary shall include:

1. Descriptions of the scenarios tested (including whether those scenarios are stochastic or deterministic) and the sensitivity testing done relative to those scenarios.

a. If negative ending surplus results under certain tests in the aggregate, the actuary should describe those tests and the amount of additional reserve as of the valuation date which, if held, would eliminate the negative aggregate surplus values.

b. Ending surplus values shall be determined by either extending the projection period until the in force and associated assets and liabilities at the end of the projection period are immaterial or by adjusting the surplus amount at the end of the projection period by an amount that appropriately estimates the value that can reasonably be expected to arise from the assets and liabilities remaining in force.

2. The extent to which the appointed actuary uses assumptions in the asset

adequacy analysis that are materially different than the assumptions used in the previous asset adequacy analysis;

3. The amount of reserves and the identity of the product lines that had been subjected to asset adequacy analysis in the prior opinion but were not subject to analysis for the current opinion;

4. Comments on any interim results that may be of significant concern to the appointed actuary; For example, the impact of the insufficiency of assets to support the payment of benefits and expenses and the establishment of statutory reserves during one or more interim periods;

5. The methods used by the actuary to recognize the impact of reinsurance on the company's cash flows, including both assets and liabilities, under each of the scenarios tested; and

6. Whether the actuary has been satisfied that all options whether explicit or embedded, in any asset or liability (including but not limited to those affecting cash flows embedded in fixed income securities) and equity-like features in any investments have been appropriately considered in the asset adequacy analysis.

(b) The regulatory asset adequacy issues summary shall contain the name of the company for which the regulatory asset adequacy issues summary is being supplied and shall be signed and dated by the appointed actuary rendering the actuarial opinion.

(4) Conformity to Standards of Practice. The memorandum shall include a statement:

“Actuarial methods, considerations, and analyses used in the preparation of this memorandum conform to the appropriate Standards of Practice as promulgated by the

Actuarial Standards Board which form the basis for this memorandum.”

(5) Use of Assets Supporting the Interest Maintenance Reserve and the Asset Valuation Reserve.

(a) An appropriate allocation of assets in the amount of the Interest Maintenance Reserve (IMR), whether positive or negative, shall be used in any asset adequacy analysis.

1. Analysis of risks regarding asset default may include an appropriate allocation of assets supporting the Asset Valuation Reserve (AVR); these AVR assets may not be applied for any other risks with respect to reserve adequacy.

2. Analysis of these and other risks may include assets supporting other mandatory or voluntary reserves available to the extent not used for risk analysis and reserve support.

(b)1. The amount of the assets used for the AVR shall be disclosed in the Table of Reserves and Liabilities of the opinion and in the memorandum.

2. The method used for selecting particular assets or allocated portions of assets shall be disclosed in the memorandum.

(6) Documentation. The appointed actuary shall retain on file for at least seven (7) years sufficient documentation so that it will be possible to determine the procedures followed, the analyses performed, the bases for assumptions and the results obtained.

Rulemaking Specific Authority 625.121(3)(a) FS. Law Implemented 625.121(3) FS. History—New 5-18-93, Amended 1-23-03, Formerly 4-138.047.

625.121 Standard Valuation Law; life insurance.--

(3) ACTUARIAL OPINION OF RESERVES.--

- (a)1. Each life insurance company doing business in this state shall annually submit the opinion of a qualified actuary as to whether the reserves and related actuarial items held in support of the policies and contracts specified by the commission by rule are computed appropriately, are based on assumptions which satisfy contractual provisions, are consistent with prior reported amounts, and comply with applicable laws of this state. The commission by rule shall define the specifics of this opinion and add any other items determined to be necessary to its scope.
2. The opinion shall be submitted with the annual statement reflecting the valuation of such reserve liabilities for each year ending on or after December 31, 1992.
3. The opinion shall apply to all business in force, including individual and group health insurance plans, in the form and substance acceptable to the office as specified by rule of the commission.
4. The commission may adopt rules providing the standards of the actuarial opinion consistent with standards adopted by the Actuarial Standards Board on December 31, 2002, and subsequent revisions thereto, provided that the standards remain substantially consistent.
5. In the case of an opinion required to be submitted by a foreign or alien company, the office may accept the opinion filed by that company with the insurance supervisory official of another state if the office determines that the opinion reasonably meets the requirements applicable to a company domiciled in this state.
6. For the purposes of this subsection, "qualified actuary" means a member in good standing of the American Academy of Actuaries who also meets the requirements specified by rule of the commission.
7. Disciplinary action by the office against the company or the qualified actuary shall be in accordance with the insurance code and related rules adopted by the commission.
8. A memorandum in the form and substance specified by rule shall be prepared to support each actuarial opinion.
9. If the insurance company fails to provide a supporting memorandum at the request of the office within a period specified by rule of the commission, or if the office determines that the supporting memorandum provided by the insurance company fails to meet the standards prescribed by rule of the commission, the office may engage a qualified actuary at the expense of the company to review the opinion and the basis for the opinion and prepare such supporting memorandum as is required by the office.
10. Except as otherwise provided in this paragraph, any memorandum or other material in support of the opinion is confidential and exempt from the provisions of s. 119.07(1); however, the memorandum or other material may be released by the office with the written consent of the company, or to the American Academy of Actuaries upon request stating that the memorandum or other material is required for the purpose of professional disciplinary proceedings and setting forth procedures satisfactory to the office for preserving the confidentiality of the memorandum or other material. If any portion of the confidential memorandum is cited by the company in its marketing or is cited before any governmental agency other than a state insurance department or is released by the company to the news media, no portion of the memorandum is confidential.

625.121 Standard Valuation Law; life insurance.--

(3) ACTUARIAL OPINION OF RESERVES.--

- (a)1. Each life insurance company doing business in this state shall annually submit the opinion of a qualified actuary as to whether the reserves and related actuarial items held in support of the policies and contracts specified by the commission by rule are computed appropriately, are based on assumptions which satisfy contractual provisions, are consistent with prior reported amounts, and comply with applicable laws of this state. The commission by rule shall define the specifics of this opinion and add any other items determined to be necessary to its scope.
2. The opinion shall be submitted with the annual statement reflecting the valuation of such reserve liabilities for each year ending on or after December 31, 1992.
3. The opinion shall apply to all business in force, including individual and group health insurance plans, in the form and substance acceptable to the office as specified by rule of the commission.
4. The commission may adopt rules providing the standards of the actuarial opinion consistent with standards adopted by the Actuarial Standards Board on December 31, 2002, and subsequent revisions thereto, provided that the standards remain substantially consistent.
5. In the case of an opinion required to be submitted by a foreign or alien company, the office may accept the opinion filed by that company with the insurance supervisory official of another state if the office determines that the opinion reasonably meets the requirements applicable to a company domiciled in this state.
6. For the purposes of this subsection, "qualified actuary" means a member in good standing of the American Academy of Actuaries who also meets the requirements specified by rule of the commission.
7. Disciplinary action by the office against the company or the qualified actuary shall be in accordance with the insurance code and related rules adopted by the commission.
8. A memorandum in the form and substance specified by rule shall be prepared to support each actuarial opinion.
9. If the insurance company fails to provide a supporting memorandum at the request of the office within a period specified by rule of the commission, or if the office determines that the supporting memorandum provided by the insurance company fails to meet the standards prescribed by rule of the commission, the office may engage a qualified actuary at the expense of the company to review the opinion and the basis for the opinion and prepare such supporting memorandum as is required by the office.
10. Except as otherwise provided in this paragraph, any memorandum or other material in support of the opinion is confidential and exempt from the provisions of s. 119.07(1); however, the memorandum or other material may be released by the office with the written consent of the company, or to the American Academy of Actuaries upon request stating that the memorandum or other material is required for the purpose of professional disciplinary proceedings and setting forth procedures satisfactory to the office for preserving the confidentiality of the memorandum or other material. If any portion of the confidential memorandum is cited by the company in its marketing or is cited before any governmental agency other than a state insurance department or is released by the company to the news media, no portion of the memorandum is confidential.

(b) In addition to the opinion required by subparagraph (a)1., the office may, pursuant to commission rule, require an opinion of the same qualified actuary as to whether the reserves and related actuarial items held in support of the policies and contracts specified by the commission by rule, when considered in light of the assets held by the company with respect to the reserves and related actuarial items, including but not limited to the investment earnings on the assets and considerations anticipated to be received and retained under the policies and contracts, make adequate provision for the company's obligations under the policies and contracts, including, but not limited to, the benefits under, and expenses associated with, the policies and contracts.

(c) The commission may provide by rule for a transition period for establishing any higher reserves which the qualified actuary may deem necessary in order to render the opinion required by this subsection.