

INSURANCE  
DEPARTMENT OF BANKING AND INSURANCE  
OFFICE OF SOLVENCY REGULATION

Annual Audited Financial Reports  
Qualifications of Independent Certified Public Accountants

Proposed Amendments: N.J.AC. 11:2-26.3 and 26.6

Authorized By: Steven M. Goldman, Commissioner, Department of Banking and  
Insurance

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

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

Proposal Number: PRN 2008-100

Submit written comments by June 6, 2008 to:

Robert J. Melillo, Chief  
Office of Legislative and Regulatory Affairs  
Department of Banking and Insurance  
20 West State Street  
P.O. Box 325  
Trenton, NJ 08625-0325  
Fax: (609) 292-0896  
E-mail: [legsregs@dobi.state.nj.us](mailto:legsregs@dobi.state.nj.us)

The agency proposal follows:

Summary

N.J.A.C. 11:2-26, originally effective December 18, 1989, and subsequently amended in 1993, 1996 and 2001, is intended to improve the oversight by the Department of Banking and Insurance (Department) of the financial condition of insurers by requiring an annual examination by independent certified public accountants (CPAs) of the financial statements that report the financial position and the results of operations of insurers. The rules are based on a model rule adopted by the National Association of Insurance Commissioners (NAIC), and are required for

state insurance departments to obtain and maintain accreditation by the NAIC. The Department has historically amended the rules to reflect the most recent NAIC Model. In 2001, the NAIC adopted amendments to the model rule related to limiting the qualification of independent CPAs who enter into indemnification agreements with respect to audits of insurers. The NAIC adopted these changes in response to concerns expressed by regulators that indemnification provisions could preclude a receiver from taking action against an auditor for professional negligence if the problem was the failure to find or disclose erroneous or fraudulent information put forth by the management of the insurer. In addition, there were concerns that an indemnification agreement could give the auditor an opportunity to deny responsibility for management's misrepresentations. Consequently, the NAIC adopted amendments to the model rule precluding the use of indemnity agreements by CPAs.

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

N.J.A.C. 11:2-26.3 is proposed to be amended to include a definition of "indemnification" to mean 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 or other misrepresentations made by the insurer or its representatives.

N.J.A.C. 11:2-26.6(a) is proposed to be amended to provide that the Commissioner shall not recognize any person or firm as a qualified independent CPA if the person or firm has either directly or indirectly entered into an agreement of indemnity or release from liability with respect to the audit of the insurer. The Department also proposes other technical amendments to reflect

the recodification of this provision as paragraph (a)2, and to codify as paragraph (a)1 the existing requirement that the person or firm performing the audit must be in good standing with the American Institute of Certified Public Accountants and in all states in which he or it is licensed to practice or, for alien insurers, that the person or firm is a chartered or similarly certified accountant. Other technical amendments are proposed as a matter of form.

Further, N.J.A.C. 11:2-26.6(b) is proposed to be revised to make technical amendments as a matter of form. Finally, a new subsection (c) is proposed to provide that a qualified CPA may enter into an agreement with an insurer to have disputes related to an audit resolved by mediation or arbitration. However, the proposed amendment further provides that in the event that a delinquency proceeding is commenced against the insurer under N.J.S.A. 17:3C-1 et seq. or 17B:32-31 et seq., as applicable, the mediation or arbitration provisions shall operate at the option of the Commissioner, who is the statutory successor. This also reflects the NAIC model and continues the effect of mediation or arbitration clauses, except in cases of delinquency proceedings.

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

#### Social Impact

The proposed amendments reflect the national standards set forth in the current NAIC Annual Audited Financial Reporting Model Rule to prohibit the use of indemnification provisions for independent CPAs providing reports pursuant to N.J.A.C. 11:2-26, and to confirm that arbitration provisions may be used to settle disputes, except that such use is at the option of

the statutory successor in the case of delinquency proceedings. The proposed amendments thus will further implement the intent of the rule to ensure that independent CPAs properly perform the duties for which they are engaged and provide a report on the insurer's method of conducting business and its financial statements, while preserving the rights of the Commissioner to take actions under delinquency proceedings commenced under applicable statutes. In addition, the proposed amendments will help ensure that statutory receivers appointed in the case of insurer insolvency will continue to have the option to take action against CPA firms for professional negligence.

#### Economic Impact

Under the proposed amendments, CPAs would not be qualified to render reports under N.J.A.C. 11:2-26 if they have entered into an indemnification agreement. As a result, such CPAs may be subject to direct liability for their actions. However, the additional costs associated with such liability would be voluntarily assumed and CPAs may adjust the fees they charge to reflect any additional risks or costs to them.

Other than the higher fees CPAs may charge for audits as a result of the bar upon indemnification agreements they would impose, insurers should experience little or no additional costs as a result of the proposed amendments. No additional professional services should be required in order to comply with the proposed amendments. Ultimately, by helping to avoid potential situations where management may be more likely to conceal certain actions from CPAs due to indemnification clauses, the Department will be more fully informed regarding an insurer's financial position, furthering the intent of N.J.A.C. 11:2-26. In addition, the Department will be in a better position to take action prior to an insurer's financial position

deteriorating to the point where delinquency proceedings would have to be instituted, thereby reducing costs associated with such actions to policyholders and the market generally.

#### Federal Standards Statement

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

#### Jobs Impact

The Department does not anticipate that any jobs will be generated or lost as a result of the proposed amendments.

The Department invites commenters to submit any data or studies regarding the jobs impact of this proposal together with any written comments on any other aspects of the proposal.

#### Agriculture Industry Impact

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

#### Regulatory Flexibility Analysis

The proposed amendments will apply to “small businesses,” as that term defined in the Regulatory Flexibility Act, N.J.S.A. 52:14B-16 et seq. These small businesses will be insurers domiciled in New Jersey and CPA firms incorporated in New Jersey seeking to become an independent CPA for purposes of filing audited financial reports under N.J.A.C. 11:2-26. The potential costs are outlined in the Economic Impact above. The Department does not believe that

any additional professional services will be required in order to comply with the proposed amendments.

The proposed amendments provide no differentiation in compliance requirements based on business size. First, the Department notes that pursuant to N.J.A.C. 11:2-26.14, insurers having direct premiums written in this State of less than \$1 million in any calendar year and less than 1,000 policyholders or certificate holders at the end of such calendar year are exempt from the subchapter for such year, except under limited circumstances. Direct premiums written and number of policyholders is indicative of insurer size.

The proposed amendments provide no differentiation based on CPA size in that the proposed amendments are intended to ensure that the reports provided under the rule accurately reflect an insurer's operations and financial condition, so as to enable the Department to take appropriate action to reduce the likelihood that an insurer will lapse into a hazardous financial condition. These goals do not vary based on business size.

#### Smart Growth Impact

The proposed amendments will not have any impact on the achievement of smart growth or the implementation of the State Development and Redevelopment Plan.

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

## 11:2-26.3 Definitions

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

...

**“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 or other misrepresentations made by the insurer or its representatives.**

...

## 11:2-26.6 Qualifications of independent certified public accountants

(a) The Commissioner shall not recognize any person or firm as a qualified independent certified public accountant [unless they are] **if the person or firm:**

**1. Is not** in good standing with the American Institute of Certified Public Accountants and in all states in which the accountant is licensed to practice or, for alien insurers, [that] **if the person or firm** is not a chartered or similarly certified 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 herein, **the Commissioner shall recognize** an independent certified public accountant [shall be recognized] as qualified as long as he or she conforms to the standards of his or her profession, as contained in the Code of Professional

Ethics of the American Institute of Certified Public Accountants and Rules and Regulations, Code of Ethics and Rules of Professional Conduct of the New Jersey Board of Public Accountancy or similar code.

**(c) A qualified independent certified public accountant may enter into an agreement with an insurer to have disputes relating to an audit of the insurer resolved by mediation or arbitration. However, in the event of a delinquency proceeding commenced against the insurer under N.J.S.A. 17:30C-1 et seq. or 17B:32-31 et seq., as applicable, the mediation or arbitration provisions shall operate at the option of the Commissioner.**

Recodify existing (c) - (e) as **(d) - (f)** (No change in text.)