

AUDIT COMMITTEES

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The National Association of Insurance Commissioners (“NAIC”) has adopted model laws and regulations:

- requiring insurers to have annual audits of their financial statements that are prepared in accordance with statutory accounting principles by independent certified public accountants;¹
- authorizing insurers to publish financial statements to shareholders in any manner acceptable to the insurer’s domiciliary Commissioner,² i.e., financial statements prepared on the basis of generally accepted accounting principles; and
- requiring insurers with 300 or more shareholders that do not file periodic reports with the Securities and Exchange Commission to send financial statements, proxy statements, consents and authorizations to their shareholders.³

The NAIC has never adopted a model act or regulation requiring insurers, other than producer controlled insurers,⁴ to have audit committees. However, the Sarbanes-Oxley Act of 2002 (the “Act”)⁵ requires all issuers of securities that file periodic reports with the Securities and Exchange Commission (“SEC”), including stock insurance companies that have voluntarily registered with the SEC under Section 12 of the Securities Exchange Act of 1934, as amended,⁶ to have audit committees.

In addition to requiring audit committees, the Act (i) creates a public company accounting oversight board, (ii) requires chief executive and financial officers to certify financial statements and reports, (iii) establishes professional responsibility standards for attorneys, (iv) requires enhanced disclosure and accelerated filings, (v) prohibits loans to officers and directors, (vi) requires the establishment of internal accounting and reporting controls, (vii) requires issuers to adopt a code of ethics for their principal accounting officers, (viii) lengthens statutes of limitations, and (ix) increases criminal penalties.

Section 2 of the Act defines “audit committee” as meaning a committee established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer.

Section 301 of the Act makes audit committees directly responsible for the appointment, compensation, and oversight of the auditors for the purpose of preparing or issuing an audit report or related work, and requires auditors to report directly to the audit committee.

Each member of an audit committee must be an independent member of the board of directors within the meaning of both the Act and any stock exchange on which the issuer’s shares are listed for trading, including NASDAQ. In order to be independent for the purposes of the Act, a member of the audit committee may not, other than in his capacity as a director or as a member of the audit or other committee of the board of directors: (i) accept any consulting, advisory, or other compensatory fee from the issuer, or (ii) be an affiliated person of the issuer or any subsidiary of the issuer.

Audit committees are required to establish procedures for (i) the receipt, retention, and treatment of complaints by the issuer regarding accounting, internal accounting controls, or auditing matters, and (ii) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.

Audit committees are empowered to engage independent counsel and other advisers they determine to be necessary to carry out their duties, and issuers are required to pay the fees of the auditors and advisers chosen by the audit committees.

Section 407 of the Act requires the SEC to issue rules requiring issuers to disclose in their periodic reports to the SEC, including their proxy statements, if at least one member of the committee is a financial expert as defined by the SEC. Otherwise, the issuer must disclose why it does not have a financial expert on its audit committee.

The Rule⁷ adopted by the SEC defines financial expert to mean a person who has all of the following attributes:

- an understanding of financial statements and generally accepted accounting principles;
- an ability to assess the general application of such principles in connection with the accounting for estimates, accruals, and reserves;
- experience preparing, auditing, analyzing, or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant's financial statements, or experience actively supervising one or more persons engaged in such activities;
- an understanding of internal controls and procedures for financial reporting; and
- an understanding of audit committee functions.

The Rule⁸ provides that a person can acquire the above attributes through one or more of the following means:

- education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor, or experience in one or more positions that involve the performance of similar functions;
- experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions, or experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements; or
- other relevant experience.

Pursuant to the requirements of Section 406 of the Act, the SEC also adopted a Rule⁹ requiring issuers to disclose in their annual reports whether they have a code of ethics that applies to the issuer's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions. The Rule defines code of ethics as written standards that are reasonably necessary to deter wrongdoing and to promote:

- honest and ethical conduct, including ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
- full, fair, accurate, timely, and understandable disclosure in reports and documents that the issuer filed with, or submits to, the SEC and in other public communications made by it;
- compliance with applicable governmental laws, rules and regulations;
- prompt internal reporting of code violations to an appropriate person or persons identified in the code; and

- accountability for adherence to the code.

It may only be a matter of time before the NAIC adopts some of the standards set forth in the Act, including the requirement that insurers have audit committees that are responsible for the appointment, compensation and oversight of the work of the insurer's outside auditors.

Endnotes

1. Model Regulation Requiring Annual Audited Financial Reports, NAIC Model Regulation Laws, Regulations, and Guidelines, 205-1.
2. Regulation Regarding Proxies, Consents and Authorizations of Domestic Stock Insurers, NAIC Model Laws, Regulations, and Guidelines, 490-1, Section 4. B. (2).
3. Regulation Regarding Proxies, Consents and Authorizations of Domestic Stock Insurers, NAIC Model Laws, Regulations, and Guidelines, 490-1, Sections 1.A and 4.B
4. Business Transacted with Producer Controlled Property/Casualty Insurer Act, NAIC Model Laws, Regulations, and Guidelines, 325-1. Section 4. C. provides, "Every controlled insurer shall have an audit committee of the board of directors composed of independent directors. The audit committee shall annually meet with management, the insurer's independent certified public accountants, and an independent casualty actuary or other independent loss reserve specialist acceptable to the Commissioner to review the adequacy of the insurer's loss reserves."
5. The Sarbanes-Oxley Act of 2002 was adopted by Congress and signed by President Bush on July 30, 2002 to address the issues arising out of the Enron/Worldcom debacle.
6. Section 12 (g) of the Securities Exchange Act of 1934, as amended (the "34 Act") and Rule 12g-1 under the 34 Act requires issuers that have at least \$10,000,000 in assets and 500 shareholders to register with the SEC. However, Section 12(g)G of the 34 Act exempts insurance companies from registering if (i) they file annual statements with their domiciliary Commissioners of Insurance that conform to the requirements of the National Association of Insurance Commissioners (NAIC), (ii) they are subject to regulation by their domiciliary states with respect to proxies, consents and authorizations that conform to those prescribed by the NAIC, and (iii) the purchases and sales of securities issued by the insurance company by its officers and directors and 10% beneficial owners are subject to regulation in their domiciliary state in a manner that substantially conforms with Section 16 of the 34 Act. Since most, if not all, states permit insurers to prepare their financial statements to shareholders on the basis of generally accepted accounting principles, it is not unusual for stock insurers to voluntarily register with the SEC.
7. SEC Release Nos. 33-8138; 34-46701; IC 25775; File No. S7-40-02.
8. *Id.* Note 7.
9. *Id.* Note 7. 