Colorado Office of the State Auditor

Division of Insurance Premium Tax Collections

Performance Audit
November 2005

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November 29, 2005

Members of the Legislative Audit Committee:

This report contains the results of a performance audit of the premium tax collection function at the Colorado Division of Insurance, within the Department of Regulatory Agencies. The audit was conducted pursuant to Section 2-3-103, C.R.S., which authorizes the State Auditor to conduct audits of all departments, institutions, and agencies of state government. The State Auditor contracted with Clifton Gunderson LLP to conduct this performance audit in accordance with Generally Accepted Government Auditing Standards. The report presents our observations, findings, and recommendations.

Very truly yours,

Clifton Gunderson LLP

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Report Summary
Division of Insurance Premium Tax Audit

Authority, Purpose, and Scope

Clifton Gunderson LLP conducted this performance audit under contract with the Office of the State Auditor pursuant to Section 2-3-103, Colorado Revised Statutes (C.R.S). This audit reviewed the Division of Insurance's oversight of premium tax collection in Colorado. The audit was conducted in accordance with Generally Accepted Government Auditing Standards. Audit work was conducted from June through November 2005. We acknowledge the assistance and cooperation extended by management and staff at the Division of Insurance, the Department of Regulatory Agencies, and the Surplus Lines Association of Colorado, Inc.

Overview

The Colorado Division of Insurance (Division), within the Department of Regulatory Agencies, is responsible for regulating all aspects of the insurance business in Colorado. The Division regulates about 1,500 insurance companies, including life, health, title, property, and casualty insurance companies and collects taxes from about 1,200 companies. The Division's regulatory activities are aimed at protecting the public from financially troubled insurance companies and illegitimate insurance products. The Division is primarily cash-funded through taxes on insurance premiums and fees from business registrations and licenses. In Fiscal Year 2005 the Division had expenditures of about $8.1 million.

One of the Division's responsibilities is to assess and collect premium taxes. Statute (Section 10-3-209, C.R.S.) requires insurance companies that conduct business in Colorado to pay a tax on the gross amount of all premiums collected or owed on insurance policies covering property or risks in the State of Colorado (State). Insurance companies subject to the premium tax include insurers writing: (1) traditional policies for life, health, title, property, and casualty coverage, (2) non-traditional policies to protect against unusual risks or exposures, and (3) bail bonds policies issued to individuals awaiting trial for criminal offenses. The Division is responsible for the assessment and collection of all premium taxes other than those for non-traditional policies, also known as surplus lines coverage. The Division has delegated the responsibility for the assessment and collection of premium taxes on surplus lines insurance to the Surplus Lines Association of Colorado, Inc.

The premium tax rate is 1 percent for companies maintaining a home or regional home office in Colorado and writing bail bonds, 2 percent for companies that do not have a home or regional home office in Colorado, and 3 percent for surplus lines insurance companies. Premium taxes are due March 1st of each tax year. The Division collected $182 million in premium taxes from 1,200 insurance companies, surplus lines insurance brokers, and cash bail bonds agents during Fiscal Year 2004.

Summary of Audit Findings

We reviewed the Division's assessment and collection of premium taxes and identified the following issues:

Premium Tax Administration

- **Penalties are not consistently assessed and received on a timely basis.** We reviewed 2002 and 2003 tax payment information and found that penalties were assessed for only three of the 73 late tax payments. Penalties for these three totaled about $8,200. In addition, we reviewed the timeliness of penalty payments made during 2002, 2003, and 2004 and found that seven of the 16 penalties assessed during this time period were paid late. These seven penalties totaled about $37,600. None of the 16 penalties was assessed the maximum amount allowed by statute. By failing to consistently and timely assess and collect penalties, the Division reduces the effectiveness of penalties as an enforcement mechanism.

- **Home and regional home office designation approvals are not always sufficiently documented.** We reviewed the home and regional home office designation process and found that some application files do not contain sufficient documentation to support the designations. For example, we found that seven of the 11 applications reviewed contained no evidence that on-site reviews were conducted, as required by Division policy. Maintaining sufficient documentation to support the home or regional home office designation is an important control to ensure that companies do not inappropriately receive the 50 percent tax break that accompanies this designation.

- **Some companies that reported collecting premiums in Colorado may not have paid premium taxes as required by law.** We identified 95 companies that collected premiums in Colorado in 2003, but did not pay premium taxes. The 95 companies wrote non-traditional policies and were licensed in other states, and were not required to be licensed in Colorado. The premiums written by the 95 companies totaled about $5.8 million and taxes due on these premiums could be as much as $116,000. At the time of the audit, the Division had not reviewed the companies to determine if taxes were due on the collected premiums.

- **The Division does not adequately monitor cash and professional cash bail bond agents to ensure that all appropriate premium taxes are paid.** We found the Division does not follow up with agents to ensure they correctly report bail premiums. We reviewed the premium tax records for 10 different cash and professional cash bail agents and identified several inconsistencies that indicate the premiums reported may not be accurate. For example, one bail agent wrote 38 bonds totaling about $817,700 but reported not charging a fee on any of these bonds. Thus, the agent paid no premium taxes. The Division did not review these bonds.

Collection of Taxes on Surplus Lines Policies

As provided in statute, the Division uses the Surplus Lines Association's services to administer the surplus lines premium tax process. We reviewed the Division's practices with respect to this process and identified the following issues:

- **The reconciliation process does not identify brokers who may misreport premium amounts for tax purposes.** The Surplus Lines Association is required to conduct an annual reconciliation of the premium amounts reported by insurance companies to the premiums reported by brokers to ensure that brokers report all premiums and pay their corresponding taxes to the State. We identified the following issues related to this process: (1) the Association is not reconciling reported premiums in accordance with their agreement with the Division; (2) the agreed-upon amount used to identify the specific premiums reviewed may be too high; (3) the Association does not actually reconcile the differences in reported premiums; (4) no documentation is collected to support a determination that a premium is or is not taxable in Colorado; and (5) the Association does not follow up when adjustments are made to premium schedules by insurance companies that could result in additional taxes due to the State.

- **The surplus lines courtesy filing process does not ensure the State receives all tax payments.** The Surplus Lines Association is authorized to receive premium taxes due from non-resident brokers (courtesy filings). The Association forwards taxes received to the Division. We reviewed the courtesy filing process and found the Division does not verify that the Association forwards all courtesy filing tax payments to the State. Further, the State does not receive the interest earned by the Association on courtesy filing tax payments.

- **Examination fees for surplus lines filers may be set too high.** The Surplus Lines Association is authorized to charge brokers an examination fee to reimburse the Association for the cost of activities conducted on behalf of the Division. The Association is authorized to maintain a reasonable surplus of funds equal to two years of operating expenses. We found the Association is collecting more revenue than is necessary to cover its expenses and is maintaining a surplus higher than is allowable. The Association's 2003 financial statements indicate an accumulated cash surplus of about $2.0 million. A reasonable surplus would be about $600,000, based on the Association's financial statements, a $1.4 million difference.

- **Using the Surplus Lines Association's services may not be the most effective way to administer the premium tax process.** We found: (1) the use of an industry association to assist with tax collection is unique in the State; (2) there may be an inherent conflict

in having an association that represents the industry participate in the tax enforcement process over its members; (3) the Division has delegated all responsibility for the assessment and collection of taxes to the Association, even though statute only requires the Commissioner to rely on the advice and assistance of a broker association; (4) the Division has not used a binding contract to clarify the Association's responsibilities; and (5) the Division has provided limited oversight over the functions performed by the Association. We recommend the Division evaluate whether continuing to use the Association's services is the most effective way to administer the surplus lines premium tax process and is in the best interest of the State.

Our recommendations and the responses of the Division of Insurance can be found in the Recommendation Locator.

Recommendation Locator
Agency Addressed: Division of Insurance

Rec. No.	Page No.	Recommendation Summary	Agency Response	Implementation Date
1	12	Establish criteria to use when determining if penalties should be assessed and procedures for management review of penalties and waivers; use data in the Premium Tax Database to identify companies that have not submitted their quarterly tax payments; include penalty due dates and the amount due in the penalty tracking spreadsheet; and establish procedures to increase penalties up to the maximum amount allowed by statute when payments are late.	Agree	March 1, 2006
2	15	Establish management oversight procedures to ensure on-site reviews are conducted for home and regional home office designations; specify what documentation should be included in application files and train staff; develop a standard application denial letter that includes instructions for the appeals process.	Agree	Implemented
3	17	Develop and implement procedures for identifying non-licensed insurance companies collecting premiums in Colorado and determine if taxes are due; consult with the Office of the Attorney General, as needed, to establish criteria to use when determining if a non-licensed company should pay premium taxes.	Agree	March 1, 2006
4	21	Examine a sample of records for cash and professional cash bail agents annually; establish procedures to reconcile premium fee amounts itemized in the premium tax records to the total dollar amount of fees charged; and explore the use of third-party data to track bond transactions.	Partially Agree	March 1, 2006
5	23	Implement procedures for staff to separate checks and supporting documentation when tax payments are received and forward to appropriate sections; limit staff ability to change the payment log; and investigate alternatives to manually processing cash payments.	Agree	March 1, 2006
6	29	Evaluate whether the Surplus Lines Association should continue to perform the reconciliation function; reassess whether the $250,000 and $25,000 thresholds are still effective; develop procedures to be used during the reconciliation process and follow up on policies not reconciled to determine if additional taxes are due.	Agree	July 1, 2006
7	32	Establish procedures for Division staff to review the Association's records and bank accounts; ensure the Association implements proper cash management controls over courtesy filings; and require the Association to remit all courtesy filing tax payments to the State within 15 days or alternatively, require the Association to forward interest earned on courtesy filings to the State.	Partially Agree	July 1, 2006

Rec. No.	Page No.	Recommendation Summary	Agency Response	Implementation Date
8	**35**	If the Association continues to provide services, evaluate the examination fee and the Association's excess surplus, adjust the fee when necessary, and establish monitoring procedures for reviewing the Association's financial activities. If the Division no longer uses the Association's services eliminate the examination fee and evaluate the Association's accumulated surplus to determine who should retain the funds, pursuing statutory change as necessary.	Agree	July 1, 2006
9	**37**	Periodically perform data reliability procedures to verify the integrity of data in the surplus lines database.	Agree	January 1, 2006
10	**38**	Evaluate whether continuing to use the Association's services is the most effective way to administer the surplus lines premium tax collection process.	Agree	July 1, 2006
11	**39**	If the Division continues to use the Association's services, clarify and document the Association's responsibilities in a contract and establish comprehensive oversight procedures to monitor the Association's performance.	Agree	January 1, 2006

Description of the Division of Insurance

The Colorado Division of Insurance (Division), within the Department of Regulatory Agencies, is responsible for regulating all aspects of the insurance business in Colorado. The Division regulates about 1,500 insurance companies, including life, health, title, property, and casualty insurance companies and collects taxes from about 1,200 companies. The Division's mission is consumer protection and its regulatory activities are aimed at protecting the public from unstable insurance companies and illegitimate insurance products. The Commissioner of Insurance is appointed by the Governor and is the head of the Division. According to statute (Section 10-1-108, C.R.S.), the Commissioner's responsibilities include, but are not limited to, the following:

- Supervising the business of insurance in Colorado to assure that it is conducted in accordance with Colorado laws and in such a manner as to protect policyholders and the general public.
- Issuing certificates of authority to transact insurance business to any insurance companies that fully comply with the laws of Colorado.
- Examining insurance companies' annual statements to ascertain whether the companies are solvent and have complied with the law.
- Examining all requests and applications for licenses.
- Transmitting all surcharges, costs, taxes, penalties, and fines collected by the Division to the Department of the Treasury.
- Determining whether rates are excessive, inadequate, or unfairly discriminatory.

Fiscal Overview

The Division is primarily cash-funded through a portion of the premium taxes and fees collected from business registrations and licenses. The following table shows the Division's revenues and expenditures for Fiscal Years 2003 through 2005. As the table shows, revenues have decreased by 8 percent and expenditures by 6.9 percent since Fiscal Year 2003.

**DIVISION OF INSURANCE
REVENUES AND EXPENDITURES
FISCAL YEARS 2003 THROUGH 2005
(IN MILLIONS)**

	Fiscal Year 2003	Fiscal Year 2004	Fiscal Year 2005	Percent Change 2003-2005
Revenues	$8.8	$8.0	$8.1	- 8.0%
Expenditures	$8.7	$7.9	$8.1	- 6.9%
FTE	90.1	78.0	78.5	-12.9%

Source: Division of Insurance data and Department of Regulatory Agencies Budget Request.

Premium Taxes

One of the Division's responsibilities is to assess and collect premium taxes. Section 10-3-209, C.R.S., requires insurance companies that conduct business in Colorado to pay a tax on the gross amount of all premiums collected or owed on insurance policies covering property or risks in the State. The premium tax applies to most types of insurance. (Certain types of insurance such as health maintenance organizations, nonprofit corporations providing insurance, and companies writing annuities have been exempted by statute.) Insurance companies subject to the premium tax include insurers writing (1) traditional policies for life, health, title, property, and casualty coverage, (2) non-traditional policies to protect against unusual risks or exposures (also known as surplus lines coverage), and (3) bail bonds policies issued to individuals awaiting trial for criminal offenses.

Premium tax is the only state tax on insurance companies in Colorado; insurance companies are exempt from all other state taxes including the corporate tax on net profits. The premium tax rate is 1 percent for companies maintaining a home or regional home office in Colorado and writing bail bonds, 2 percent for companies that do not have a home or regional home office in Colorado, and 3 percent for surplus lines insurance companies. According to statute (Section 10-3-209(1)(b), C.R.S.), companies can apply to the Division for home or regional home office designation if they maintain an office in Colorado that substantially performs specific functions, such as issuing policies, approving or rejecting applications, and hiring. Statute also imposes a retaliatory tax on companies licensed in other states conducting business in Colorado. This retaliatory tax rate ensures that a non Colorado-based insurance company will pay a premium tax in Colorado at a rate at least equal to the rate their home state would charge a Colorado-based insurance company doing business in that state. Premium taxes are due March 1st of each tax year. Insurance companies that paid more than $5,000 in premium taxes in the preceding year are required to submit quarterly tax payments to cover their estimated current year tax liabilities. The Division collected $182 million in premium taxes from 1,200 insurance companies, surplus line insurance brokers, and cash bail bonds agents during Fiscal Year 2004.

Within the Division, the Premium Tax Section is responsible for assessing and collecting premium taxes from most traditional types of insurance companies. As discussed further in Chapter 1, the Investigations Section within the Division is responsible for collecting taxes on the premiums charged for bail bonds written in Colorado. Finally, as discussed in Chapter 2, the Division has utilized the services of the Surplus Lines Association of Colorado, Inc. to assist in the collection of premium taxes for surplus lines insurance.

Audit Scope & Methodology

The purpose of this performance audit was to evaluate the Division's oversight of premium tax collection in Colorado. Our audit reviewed premium taxes due for Calendar Years 2002, 2003, and 2004. We conducted

interviews with key staff, performed walkthroughs of activities conducted by the Division, reviewed policies and procedures, analyzed data, and tested supporting documentation. Detailed test work included review of annual tax returns, data analysis for the identification of required tax payments, reconciliation of tax payments to supporting documentation, and testing of posted payments into the Premium Tax Database, the Surplus Lines Database, and COFRS, the State's accounting system.

The audit was conducted in accordance with Generally Accepted Government Auditing Standards. Audit work was conducted from June through November 2005. We acknowledge the assistance and cooperation extended by the management and staff at the Division of Insurance, the Department of Regulatory Agencies, and the Executive Director of the Colorado Surplus Lines Association.

Chapter 1: Premium Tax Administration

Background

The Division of Insurance (Division) is responsible for the assessment and timely collection of premium taxes. As discussed previously, statute (Section 10-3-209, C.R.S.) requires insurance companies that conduct business in Colorado to pay a tax on the gross amount of all premiums collected or contracted for on policies covering property or risks in the State, unless specifically exempt by law. Within the Division, the Premium Tax Section is responsible for assessing and collecting premium taxes from most traditional types of insurance companies. This Section, which is comprised of one staff and one part-time assistant, maintains a database of premium tax data for all licensed insurance companies that pay premium taxes. In addition, staff conduct an annual desk review of tax returns to verify that the appropriate tax rate was used, the correct tax amounts were calculated based on reported premiums, and that all taxes have been paid by the appropriate due dates. This desk review also includes a review of quarterly tax returns to verify that the appropriate quarterly tax payments were made within the required time frames. The Division's Investigations Section is responsible for collecting taxes and monitoring the premium tax collection process for bail bond premiums written by cash and professional cash bail agents. Finally, the Division's Cash Management Section is responsible for processing and recording all premium tax payments paid directly to the Division. In Fiscal Year 2004, the Division processed $182 million in premium taxes, of which about $4.2 million was received directly by the Division. The remaining tax payments were received by the Division through a lock box system.

In general, we found that the Division has adequate controls in place with respect to the assessment and collection of premium taxes, except for those areas discussed in the report. In this chapter we discuss several areas where the Division can make improvements to increase the effectiveness of the premium tax process, including penalties, home or regional home office designations, non-licensed companies, cash and professional cash bail bond agents, and cash management.

Penalties

Statute allows the Division to assess and collect penalties for late premium tax payments and payments not paid in full. Section 10-3-209(1)(e), C.R.S., provides that premium taxes are due on March 1st of each tax year, but allows a 30-day grace period for payments to be submitted. Payments received after the 30 days are subject to a penalty of up to $100 per day. When payments are not paid in full, the insurance company must pay interest of 1 percent a month from the date the payment was due until it is paid in full, as well as a penalty of up to 25 percent of the outstanding amount. In addition, as discussed previously, insurance companies are required to submit estimated quarterly tax payments if their previous year's tax liability was more than $5,000. Section 10-3-209(3)(b), C.R.S., requires a penalty of

up to $100 per day for quarterly tax payments received more than 30 days past their due date.

Division staff determines whether penalties should be assessed and the amount of the penalty during their review of annual premium tax returns. Once a penalty has been assessed, staff sends the insurance company a letter documenting the amount of the penalty and its due date. The Division tracks penalty payments in a spreadsheet which documents the insurance company, tax year, the reason for the penalty, and amount paid. We reviewed the Division's procedures for assessing and collecting penalties and interest on late tax payments and payments not paid in full and identified the following three issues:

Penalties are not consistently assessed. We reviewed 2002 and 2003 tax payment information and identified 73 instances where tax payments were received after the due date. The Division imposed penalties totaling about $8,200 for only three of the 73 instances (4 percent) where tax payments were received late. Of the remaining 70 late payments identified, we reviewed 22 to determine why penalties were not assessed. According to the Division, penalties are not assessed if a company self-reports late payments or if quarterly tax payments are late during the first year they are due. The 22 late payments reviewed met one of these exemption criteria. At the time of review, the Division had not documented the exemption criteria in the Premium Tax Procedures Manual.

In addition, the Division does not review quarterly tax payments until year-end to determine if all payments have been made. We identified two insurance companies that failed to make their required quarterly tax payments. One company missed payments due on March 31, 2004 and June 30, 2004, while the other company missed payments due on September 30, 2004. At the time of the audit, the Division had not yet conducted a compliance review of these payments which were more than 265 days past due. Since the Division reviews quarterly tax payments only once a year, penalties cannot be assessed until that annual review is performed. By failing to consistently and timely assess and collect penalties, the Division reduces the effectiveness of penalties as an enforcement mechanism to prevent late tax payments.

Penalty payments are not timely. We reviewed the timeliness of all penalty payments made during 2002, 2003, and 2004 and found that seven of the 16 penalties assessed for late tax payments and tax underpayments during this time period were paid late. These penalties totaled about $37,600. On average, the penalties were paid anywhere from seven days late in 2003 to 30 days late in 2002. Currently there are no repercussions to the insurance companies when penalty payments are late. This reduces the effectiveness of penalties as an enforcement mechanism for ensuring timely tax payments.

Penalties are not assessed at amounts allowable by statute. Statute allows penalties to be assessed in an amount up to $100 per day. Of the 16 penalties assessed in 2002, 2003, and 2004, none were assessed the maximum amount allowed by statute. Increasing penalty amounts to the maximum amount allowed by statute when penalty payments are late could help improve the effectiveness of this enforcement mechanism.

The Division does not have documented procedures in place to ensure penalties are consistently assessed and paid timely. Therefore, the Division should develop and document standard criteria to use when determining whether penalties should be assessed or waived to ensure the consistency of decisions.

The Division should also require that decisions to assess or waive penalties undergo supervisory review. Currently one individual is responsible for determining when penalties should be assessed or waived and there is no supervisory review of these decisions to ensure they are consistent with Division policy. The level of review required could be determined by using a graduated scale based on the dollar amount of the penalty. Staff should document the criteria used to reach waiver decisions. The Division should also ensure the timely review of quarterly tax payments, by using the Premium Tax Database to monitor payments on a quarterly basis, rather than annually. Further, the Division should use the penalty tracking spreadsheet to track penalty amounts and due dates to help ensure timely payments are made, and follow up with insurance companies when penalty payments are late. Finally, the Division should establish procedures to increase penalty amounts up to the maximum amount allowed by statute when penalty payments are late.

Recommendation 1:

The Division of Insurance should improve the penalty assessment and collection process by:

a. Establishing and documenting standard criteria to use when determining if penalties should be assessed or waived. The criteria established should be periodically reviewed to ensure appropriateness.

b. Establishing procedures for management review and authorization of penalties and waivers. The Division should consider the use of a graduated scale based on the dollar amount of the penalty to determine when supervisory approval is needed before the penalty is assessed. The same controls should be considered for penalty waivers. In addition, all penalty waivers should document the criteria used to reach the waiver decision.

c. Using data in the Premium Tax Database to identify companies on a quarterly basis that have not timely submitted their quarterly tax payments in compliance with statute.

d. Including penalty due dates and the amount due in the penalty tracking spreadsheet and reviewing the spreadsheet to ensure penalty payments have been received in a timely manner.

e. Establish procedures to increase penalty amounts when penalty payments are late, up to the maximum amount allowed by statute.

Division of Insurance Response:

a. **Agree. Implemented.** The Division reviewed and updated its existing policies and procedures in the fall of 2005 to update standard criteria to use to determine penalties and interest. The Division will, at least annually, review the policies and procedures to ensure their appropriateness.

b. **Agree. Specific policies and procedures for management review will be established and incorporated into existing policy and procedures by March 1, 2006.** During the course of the audit, the Division made some organizational changes to ensure greater oversight over this process. The staff member who handles premium tax collection now reports directly to the Manager of Corporate Affairs. Both the Manager and the Deputy Commissioner will review all penalties and interest charges and cases where the decision to waive is invoked.

c. **Agree. Implementation of formal polices and procedures will be completed with the new electronic system by March 1, 2006.** Companies will be identified on a quarterly basis that have not submitted their quarterly payments in compliance with Colorado insurance law. This process has been initiated for the quarterly returns that were due on October 31, 2005. The Division is working with ITS personnel to implement an automated, electronic web-based premium tax program for the filing and payment of quarterly and annual premium tax payments. The new system should be operational by February 2006 and will assist in identifying entities that have not submitted quarterly payments as required. This is currently being done on a manual basis.

d. **Agree. Implementation of formal polices and procedures will be done with the new electronic system by March 1, 2006.** The information is being currently included in the tracking system.

e. **Agree. Implementation of formal polices and procedures will be done with the new electronic system by March 1, 2006.** Colorado insurance law, §10-3-209, C.R.S., is very specific about the penalties and interest the Division may or may not impose on different circumstances with regards to premium taxes. The Division reviewed and updated its existing policies and procedures in the fall of 2005 to update standard criteria to use to determine penalties and

interest. In addition, the Division will take a more aggressive oversight to ensure that penalty and interest payments are made in a timely manner. The Division had required a 15 day response time in previous assessments. Considering the time for mail to reach and be returned from an insurer, and the time it takes to process a payment, the Division believes this was too short of a timeframe and led to the findings in the audit of 7 to 22 days late in some cases. The Division will give insurers 30 days to make the payments. This is in accordance with timeframes within Regulation 1-1-8. Responses not received within that timeframe are subject to an additional minimal fine of $500.00 per occurrence.

Regional Home Office Determination

As discussed previously, the premium tax rate is 2 percent for insurance companies unless they are exempted from paying premium taxes or are charged a different rate by statute. For companies maintaining a home office or a regional home office in Colorado, statute (Section 10-3-209(1)(b)(I)(B), C.R.S.) reduces the tax rate to 1 percent. This means that companies receiving the home or regional home office designation receive a 50 percent tax break on premium taxes. According to statute, any office in Colorado can be designated a company's home or regional home office if the office substantially performs specific functions within the State. These functions include actuarial, legal, the approval or rejection of applications, issuance of policies, information and service, public relations, hiring, and training of sales and service forces. To receive the home or regional home office designation, a company must submit an application for qualification to the Division on an annual basis, along with proof that the company is performing the required functions in Colorado. As part of the approval process, the Division conducts on-site reviews prior to approving the initial designation to confirm information included in the applications. On-site reviews include an inspection of the premises of the Colorado office, verification of the information contained in the application, and interviews with the senior officers of the Colorado office. In addition, Division procedures require that companies applying for home or regional home office re-designation have an on-site review every five years unless the annual application review warrants an immediate visit.

We reviewed the home and regional home office designation process and found that some application files do not contain sufficient documentation, as required by Division policies, to support the designations. Maintaining sufficient documentation to support the home or regional home office designation is an important control to ensure that companies do not inappropriately receive the tax benefit that accompanies this designation. Specifically, we reviewed 11 home and regional home office applications that had been approved and found:

- Seven of the 11 applications contained no evidence that on-site reviews were conducted.

- Five of the 11 applications did not include corporate seals. Division policies state that a complete application shall include the application form, all required original signatures, seals, and attachments specified by the application form and instructions.

We also reviewed eight applications that had been denied and found the denial letters for three of the applications did not include instructions for the administrative appeals process. Division policies require that applicants be notified of the right to appeal if their application is denied.

As mentioned previously, when insurance companies receive the home or regional home office designation, they get a 50 percent tax break. If companies inappropriately receive this designation, this results in lost revenue to the State. Therefore, the Division needs to improve its home and regional home office designation process to ensure that only those companies that meet qualification standards receive the designation. This should include establishing management oversight procedures to ensure that on-site reviews are conducted in accordance with Division procedures. Additionally, the Division needs to establish procedures specifying what documentation should be included in application files and train staff on these procedures. Finally, the Division should develop a standard application denial letter that includes instructions for the administrative appeals process.

Recommendation 2:

The Division of Insurance should improve the home and regional home office designation process by:

a. Establishing management oversight procedures to ensure on-site reviews are conducted in accordance with Division procedures.

b. Establishing procedures specifying what documentation should be included in application files and providing training to staff on these procedures.

c. Developing a standard application denial letter that includes instructions for the administrative appeals process.

Division of Insurance Response:

a. **Agree. Implemented.** A schedule for on-site reviews was established in August 2005 to ensure all companies with a Regional Home Office status designation will receive reviews in accordance with procedures. Since August 2005, 13 companies (seven groups) have undergone on site reviews.

b. **Agree. Implemented.** The Division has reviewed its existing procedures regarding the documentation to be retained in the application files for Regional Home Office designation.

Management will ensure that procedures are followed and all pertinent records maintained. A checklist consisting of the required documents needed will be reviewed prior to filing and storage of the files.

c. **Agree. Implemented.** A standard application denial letter that includes instructions for the administrative appeals process has been developed.

Non-Licensed Companies

Statute (Section 10-3-903, C.R.S.) defines the specific acts and transactions that, if conducted by a company within the State, are considered transacting insurance business within Colorado. These include acts such as taking or receiving applications for insurance, entering into an insurance contract within the State, and collecting premiums or other consideration for any type of insurance. When a company is found to be transacting insurance business within the State, under Section 10-3-209, C.R.S., premium taxes are due on the premiums charged on any resulting policies. There are times when an insurance company that is licensed in another state (but is not licensed in Colorado) may transact insurance business within Colorado. Examples include surplus lines insurance, insurance that is purchased independently through negotiations occurring entirely outside of the State, and transactions involving group life insurance where the master policy was issued and delivered in another state. In these cases, the Division is responsible for identifying these companies and ensuring that the proper taxes are paid for the insurance business transacted in Colorado.

Overall, we found that some non-licensed insurance companies that reported collecting premiums in Colorado did not pay any premium taxes. We reviewed the National Association of Insurance Commissioners (NAIC) database, which contains information on premiums collected by each insurance company by state, to identify any non-licensed companies collecting premiums in Colorado in 2003. We then compared the NAIC information with the Division's database of insurance companies paying premium taxes in 2003 and identified 95 non-licensed companies that may have been required to pay premium taxes. These companies collected about $5.8 million in premiums from policies within Colorado during this time period, but did not pay premium taxes. Taxes due on these premiums could be as much as $116,000 when the 2 percent premium tax rate is applied. At the time of the audit, the Division had not reviewed these companies to determine if taxes were due on the collected premiums. The policies written by each individual company must be reviewed to verify if tax was due under the specific facts and circumstances of each case. By not reviewing the Colorado policies written by these companies, the Division could be missing potential tax revenue owed to the State.

The Division currently takes no action to identify non-licensed companies transacting business in Colorado to ensure all appropriate premium taxes are paid. According to the Division, in the 1990's it aggressively sought to identify and collect taxes from non-licensed companies conducting business

in Colorado. However, due to staffing reductions and cost-benefit concerns, the Division no longer takes steps to identify these companies. Further, a 1992 Office of the Attorney General memorandum, responding to legal jurisdiction issues raised by a non-licensed company, determined that Colorado could not collect premium taxes on life insurance renewal premiums received by a non-licensed insurance company from Colorado residents when they renewed their policies, which were originally purchased and issued outside of Colorado. However, the memorandum also stated that the Division may be able to assess and collect premium taxes from some non-licensed insurance companies in the future, depending on the specific facts of a case.

The Division has interpreted the Attorney General's memorandum as providing an exemption from premium tax requirements for all non-licensed companies doing business in Colorado. As a result, the Division no longer investigates these companies to determine if the facts and circumstances in these cases are different from those discussed in the memorandum. We believe the Division's interpretation is too narrow. For example, the conclusion reached in the Attorney General's memorandum was based on the fact that the premiums in question were for the renewal of a life insurance policy that had originally been issued in another state and the simple act of collecting the renewal premium did not meet the definition of transacting insurance business within Colorado. However, if this policy had been renegotiated in some manner, or if the amount of the insurance had been increased as the result of discussions between the insurance company and the person purchasing the insurance, these actions may have resulted in a determination that the company was transacting insurance business in Colorado and tax would have been due. Without actually reviewing the types of policies in question, and the facts and circumstances of each, the Division cannot determine if the memorandum is applicable and whether premium taxes should be paid by these non-licensed companies. Therefore, the Division should develop and implement procedures for identifying non-licensed companies collecting premiums in Colorado and determining if premium taxes are due. At a minimum, this process should include identifying companies through NAIC reports, developing standard inquiries that can be used to determine the facts and circumstances for the specific policies written, and reviewing the facts to determine if taxes are due. This review process should include the companies discussed above that were identified during the audit. To help with the review process, the Division should consult with the Office of the Attorney General, as needed, to establish criteria to use when determining if a non-licensed company should pay premium taxes in Colorado.

Recommendation 3:

The Division of Insurance should ensure that all non-licensed insurance companies that have reported collecting insurance premiums in Colorado pay the appropriate premium taxes by:

a. Developing and implementing procedures for identifying non-licensed insurance companies collecting premiums in Colorado and determining if premium taxes are due. These procedures should include at a minimum, a process for identifying companies through National Association of Insurance Commissioner reports, developing standard inquiries that can be used to determine the facts and circumstances for the specific policies written, and reviewing the facts to determine if taxes are due. The Division should also review the companies identified during the audit to determine if taxes should have been collected.

b. Consulting with the Colorado Office of the Attorney General, as needed, to establish criteria to use when determining if a non-licensed company should pay premium taxes in Colorado.

Division of Insurance Response:

a. **Agree. Implementation date: March 1, 2006.** The Division will develop and implement cost effective polices and procedures for the identification of insurance companies not licensed or approved in Colorado but reporting or collecting premiums in Colorado and determine if premium taxes are due to the State. The Division believes it can absorb this additional function with existing staff. The Division would like to point out that the $116,000 amount cited in the report would be a possible, but highly unlikely, maximum that might be collected. Also, the Division realizes that the insurance companies that may appear on the reports are reputable entities licensed in other states and doubts that they would deliberately jeopardize their license by not paying or avoiding the payment of such a small amount of premium taxes where due. The Division believes that the costs associated with this investigation could outweigh the benefits possibly received.

b. **Agree. Implementation date: March 1, 2006.** The Division will continue to consult with the Office of the Attorney General on an as needed basis when the review of policies shows something out of the ordinary or a new scenario not previously reviewed and decided upon as a course of action.

Cash Bail Bonds

A bail bond is a financial guarantee, or a form of insurance policy for the court, that a criminal defendant will show up for court appearances and trial. The amount of the bond is dependent on the amount of bail set by the court. If a defendant does not show up for court appearances or trial, the amount of the bond is paid to the court. Bail bonds can be issued by a bonding company (surety) or by a bail-bonding agent using his or her own resources. Bonding companies and bail-bonding agents sell these bonds, or insurance policies, and charge a premium. The premium is a percentage of the total bond amount, usually about 10 percent.

Bail-bonding agents are required to pay a tax of 1 percent for every premium charged for a bond issued in Colorado. According to statute (Section 12-7-102, C.R.S.), there are three types of bail-bonding agents (1) surety bail agents, (2) professional cash bail agents, and (3) cash bail agents. Surety bail agents represent surety companies and are required to meet certain educational requirements. After a minimum of four years, surety bail agents can apply for licensure as a professional cash bail agent. Professional cash bail agents can transact bail bond business and post cash bonds without having to work with an authorized insurance company. Cash bail agents are licensed by the Division and are similar to professional cash bail agents. Cash bail agents, however, were grandfathered into the current regulatory structure and do not have to meet the additional educational requirements imposed on professional cash bail agents. Currently the Division licenses 522 surety bail agents, 32 professional cash bail agents, and 7 cash bail agents. Surety bail agents are overseen by the Division's Premium Tax Section because they work for surety companies that actually post the bonds. We reviewed surety companies during our review of other licensed insurance companies and did not identify any issues specific to these companies. The cash and professional cash bail agents are overseen by the Division's Investigations Section because they work independently and do not represent insurance companies. This issue focuses on the professional cash and cash bail agents. In Fiscal Year 2004 the 39 cash and professional cash bail agents licensed in Colorado paid about $65,000 in premium taxes.

We reviewed the Division's oversight of cash and professional cash bail agents and found the Division does not adequately monitor these agents to ensure all appropriate premium taxes are paid. Specifically, we found the Division does not follow up with agents to ensure they correctly report bail premiums. We reviewed the 2003 and 2004 premium tax records for 10 different cash and professional cash bail agents and identified several inconsistencies that indicate the premiums reported may not have been accurate. The Division did not perform further review on any of these records. Specifically, we identified:

- Thirty-eight bonds totaling $817,700 in which a bail agent did not charge a premium fee and two bonds totaling $6,500 in which the bail agent charged a premium fee of $.01. Premium income received from writing bail bonds is the primary source of income in the bail-bonding industry. Therefore, the fact that the bail agents did not charge a premium fee in these cases raises the question of whether premium fees were charged, but not reported. If a 10 percent premium was charged on the $817,700 in bonds, the agent would have owed about $817 in premium taxes.

- Twenty-one voided bond amounts in the semi-annual reports submitted by one bail agent. The reports contained no related information such as the person's name, the amount of the bail, or reasons for voiding the bonds so that the Division could validate that a premium was not actually collected on these bonds. The bail agent paid no premium taxes on these bonds.

- One bail agent who self-reported that he or she did not write any bonds during 2004. However, this agent reported about $2.1 million in bonds written the previous year. This agent's license does not expire until 2007, which raises the question of whether the agent is still in the bail-bonding business, but not reporting any bonds written. This bail agent paid no premium taxes in 2004.

We also found the Division does not take any steps to ensure that all cash and professional cash bail agents are accurately reporting their licensure status when posting bonds. When bonds are posted, the individual posting the bond must submit a form to the court. This form requires the individual to indicate if they are a licensed bail agent or if they are a private citizen posting bond on the defendant's behalf. In some cases the defendant, or friends and family of the defendant, have the resources and can post the bond themselves without using a licensed bail agent. Although the form requires bail agents to indicate if they are licensed, there is no mechanism for ensuring they report this accurately. Therefore, a licensed bail agent could actually indicate on the form that they are unlicensed. Unlicensed individuals do not have to pay taxes on bonds written. If a licensed agent issues the bond as an unlicensed individual there is no record of a cash bail bond having been posted by the licensed agent and no way for the Division to determine if taxes are due on the bond premium.

The General Assembly recognized the importance of oversight of cash bail bonds with the passage of House Bill 04-1240. This Bill resulted from a 2003 Department of Regulatory Agencies review of the Division's bail-bonding agent regulatory program. One of the key issues identified in the review was the Division's lack of oversight of the premium amounts charged by cash and professional cash bail agents. In addition, the Division was not able to verify the accuracy of premium tax reporting or payments because there was no way to validate the information self-reported by the bail agents. House Bill 04-1240, which was effective July 1, 2004, addressed several of the deficiencies noted in the Department's review by standardizing record retention policies for cash and professional cash bail agents by requiring all indemnity agreements, promissory notes, premium and collateral receipts, and bond revocation agreements to be in writing and signed by the bail-bonding agent and defendant. The Bill also requires agents to maintain a current and up-to-date bond register that identifies every executed bond or undertaking. Further, the Bill grants the Division the authority to examine cash and professional cash bail agents' records at any time.

The Division has not reviewed any cash and professional cash bail agents' records since House Bill 04-1240 went into effect. In addition, the Division does not review the complete premium tax records submitted by agents that list bonds written, nor does it reconcile the premium amounts itemized in the premium tax records to the total dollar amount of fees charged. As a result, the Division does not know if cash and professional cash bail agents are actually complying with record retention policies established by House Bill

04-1240. Further, the Division does not know if cash and professional cash bail agents are accurately reporting premiums written and paying the appropriate premium tax.

The Division needs to improve its oversight of cash and professional cash bail agents. This should include using the authority granted by House Bill 04-1240 to examine the records of a sample of agents' records annually. The Division could select the sample based on its initial review of premium tax records submitted by the agents and any inconsistencies identified, like those described above. With such a small closely connected community, even a single detailed examination could have a substantial impact on voluntary compliance with the law. Additionally, the Division should establish procedures to reconcile premium fee amounts itemized in the affidavits submitted by agents to the total dollar amount of fees charged. Finally, the Division should work with the State Court Administrator's Office to explore the use of a system for verifying the premium information reported by cash and professional cash bail agents.

Recommendation 4:

The Division of Insurance should improve its oversight of premium tax reporting and payments by cash and professional cash bail agents by:

a. Using the authority granted by House Bill 04-1240 to examine the records of a sample of cash and professional cash bail agents annually.

b. Establishing procedures to reconcile premium fee amounts itemized in the premium tax records submitted by cash and professional cash bail agents to the total dollar amount of fees charged.

c. Explore the use of third-party maintained records to help in tracking bail bond transactions, such as working with the State Court Administrator's Office to verify the premium information reported by cash and professional cash bail agents to the Division with bond records maintained by the courts.

Division of Insurance Response:

a. **Partially Agree. Implementation date: March 1, 2006.** The Division agrees that there needs to be some verification of the amount of premium being reported by cash bail agents and the professional cash bail agents. The Division is in the process of moving the oversight of Premium Tax collections as it pertains to the cash bonding agents and the professional cash bail agents from the Investigative Section to the Premium Tax Collection Section. The Division has considered and reviewed various options to improve its oversight of premium tax reporting and payments by cash and professional cash bail agents.

The Division has performed a Cost-Benefit Analysis of various options. Auditing all the records on an annual basis was one consideration. It is the Division's position that sampling is not the most cost effective method either and has an adverse side affect on the operations of the agents. The following are points to be considered: (1) The Division does not have existing personnel to perform this function. (2) A sample would not guarantee the accuracy of the entire population. (3) As permitted by Colorado insurance law, the Division could use independent auditors to examine all records, but this could be expensive to the agents and be disruptive of their business affairs.

Therefore, the Division is proposing an amendment to Regulation 1-2-13 that would require that the information contained in the bail bond reports submitted with the tax payment be verified by an independent certified public accountant. The report or statement from the independent certified public accountant, attesting to the accuracy of the information supplied with the tax payment, would be filed with the Division by the cash bonding agents and the professional cash bail agents along with the tax filing. This appears to be the least costly, most direct way of ensuring the accuracy of the reports and payment requirements of the cash and professional cash bail agents. If not, the Division would require an additional FTE to perform this function. This does not appear to be a cost effective way considering that the total premium tax for a year cited in the report only amounted to $65,000.00.

b. **Agree.** See response to above.

c. **Agree. Implementation date: March 1, 2006.** The Division will explore the use of the records maintained by the State Court Administrator's Office to verify bonds written.

Cash Management

Insurance companies can submit premium tax payments either through the Division's lock box, which is managed by a contractor, or directly to the Division. For payments submitted to the Division, staff in the Cash Management Section is responsible for (1) logging in payments, (2) recording payments in COFRS, the State's accounting system, and (3) reconciling payment logs with the amounts recorded in COFRS. According to Division cash management procedures, there should be three separate individuals performing these activities, but in situations where only two individuals are available, the same individual should not perform two consecutive activities. Currently there are four individuals who rotate performing these activities. In Calendar Year 2004 the Division received almost $4.2 million in tax payments directly from taxpayers which were processed by the Division's Cash Management Section.

We reviewed the Division's cash management procedures and found that overall, the procedures are sound. However, we identified two areas where improvements can be made and controls strengthened. First, we found that

the same individual is responsible for receiving and logging in checks and their supporting documentation. Having one person perform both functions presents the opportunity for the individual to remove the checks and destroy any evidence that the check was ever received by the Division. The second issue we found is that the log used for recording checks is not maintained securely on Division computers. This enables the individual who is responsible for reviewing the check log against the actual checks for accuracy to have access, and thus the ability, to amend check receipt information after the information has been logged in by a separate individual in the Division. The reviewer could misappropriate checks received and go back and alter the corresponding log-in records to conceal the misappropriated payment. Although the missing payments in both of these scenarios would ultimately be discovered when the Division followed up with the insurance company for not paying its taxes, the time it takes to do so could enable the individual to further compromise the system and to continue to conceal the wrong doing.

The Division needs to take steps to strengthen its cash management procedures. It should start by having staff separate checks and supporting documentation at the front desk when mail is opened. Checks should then be forwarded to the Cash Management Section for processing and the supporting documentation should be sent to the appropriate tax administration section. In addition, the Division should implement security procedures to limit the ability to make changes to the payment receipt log to certain staff. In the future, however, the Division should investigate alternatives to manually processing cash payments. This could include requiring all taxpayers to submit tax payments directly to the Division's lock box, requiring Division staff to forward payments directly to the lock box for processing, or implementing a system for taxpayers to submit tax payments through a web-based payment system. This would help reduce the risk of errors and abuse.

Recommendation 5:

The Division of Insurance should improve its cash management procedures by:

a. Implementing procedures to have Division staff separate checks and supporting documentation at the front desk when mail is opened. Checks should be forwarded directly to the Cash Management Section and the supporting documentation should be forwarded to the appropriate tax administration section.

b. Establishing a security procedure to limit the ability to make changes to the payment receipt log to only authorized staff.

c. Investigating alternatives to manually processing cash payments, which could include requiring all taxpayers to submit tax payments directly to the Division's lock box, requiring Division staff to

forward payments directly to the lock box for processing, or implementing a system for taxpayers to submit tax payments through a web-based payment system.

Division of Insurance Response:

a. **Agree. Implementation date: January 1, 2006.** The Division will review and investigate procedures to additionally minimize the possibility of any misappropriation of checks that are received at the initial step in the Cash Management process. The Division will be working with the Controller of the Department to implement new procedures for receiving and logging in checks that are delivered to the Division.

b. **Agree. Implementation date: January 1, 2006.** A security procedure using a password protect system to protect the payment receipt log from access by others will be implemented. Only the individual that is logging in will have the password and the ability to enter data. The other members working on the process will not. Rotation of individuals will ensure that adequate safeguards are in place.

c. **Agree. Implementation date: March 1, 2006.** The Division is in the process of implementing an automated, electronic web-based premium tax system for the filing and payment of quarterly and annual premium tax payments. This system should be operational by February 2006. The Division will promote the use of this system to the extent permitted by law and will continue to promote the use of the lock box for those entities that continue to paper file. The Division will explore the possibility of legislative change, if necessary, to require premium tax returns be submitted electronically or payments sent directly to the lock box.

Chapter 2: Collection of Taxes on Surplus Lines Policies

Background

Surplus lines insurance protects against unusual risks or exposures that traditional licensed insurance companies will not insure, including risks associated with property, casualty, and liability insurance. Examples of some of the types of risks covered by surplus lines insurance include professional and general liability insurance for a surgery center and property insurance for a business in an area prone to flooding and storm damage. Surplus lines insurance cannot be purchased directly from an insurance company, but must be purchased through a surplus line broker (broker), who acts as a middle-man between the insurance company and the individual purchasing the insurance. This is because the insurance companies providing surplus lines insurance are not licensed in Colorado, and therefore, cannot actively seek business in Colorado. Brokers are licensed as resident or non-resident surplus line brokers by the Division of Insurance (Division) and must meet certain minimum requirements, such as holding an active Colorado Producer license with the Property and Casualty Authorities, passing a surplus lines examination, and submitting a license application and supporting documentation. Surplus lines insurance is unique in that the insurance companies that provide surplus lines insurance are not responsible for paying the premium taxes associated with these policies. Instead, statute (Section 10-5-111, C.R.S.) requires surplus line brokers to pay a tax of 3 percent to the Division by March 1st each year on the premiums charged to their customers during the preceding year. In Fiscal Year 2004, the Division collected $13.8 million in premium taxes from surplus line brokers.

According to statute (Section 10-1-103, C.R.S.), the Division of Insurance is responsible for executing all laws related to insurance and has supervising authority over all insurance business conducted in Colorado. Section 10-5-115(2) C.R.S., however, states that the Commissioner of Insurance is to rely on the advice and assistance of a broker association when carrying out responsibilities related to premium taxes due on surplus lines insurance. In accordance with this statutory requirement, in 1982, the Division began working with the Surplus Lines Association of Colorado, Inc. (Association) to provide assistance with the surplus lines premium tax process. In 1999, the Division entered into a Memorandum of Understanding (MOU) with the Association to formalize their working relationship. The MOU, which was revised in November 2003, lists the Division's duties that the Association agreed to assume. The MOU also sets forth certain financial management and record-keeping requirements for the Association. These include maintaining monthly premium reports submitted by brokers, preparing annual statements of premium tax submissions, reconciling premiums reported by brokers to the premiums reported by surplus lines insurance companies, conducting analysis of fees charged for services, and maintaining financial records in accordance with a prescribed format.

The assessment and collection of premium taxes on surplus lines insurance is a complex area that creates unique obstacles for any state organization charged with regulating this line of business. Usually, surplus lines insurance will cross state lines and each state can have different laws covering it. This means that for a transaction involving a consumer resident in Nevada, who is seeking to insure business property located in Colorado, Arizona, and Texas, the broker handling this transaction must consider the premium tax laws of four different states and allocate the premiums to the risk existing within each state. Likewise, the Division has to consider these factors when verifying the allocation made by the broker to determine the appropriate amount of tax owed in Colorado. As a result of these allocation issues, it is essential that the Division have strong controls in place to effectively administer the surplus lines premium tax collection process.

We reviewed the Division's practices with respect to the surplus lines premium tax process and found problems with the reconciliation conducted to ensure premiums are reported and taxes are paid, the courtesy filing process, examination fees, the identification of taxpayers, and monitoring. Overall, we found that the Division needs to reassess its relationship with the Association to determine if continuing to use the Association's services is the most effective way to administer the surplus lines premium tax process and is in the best interest of the State.

Reconciliation of Reported Surplus Lines Premiums

Surplus line brokers are required to report the amount of premiums charged on surplus lines policies to the Association on a monthly basis. According to the terms of the MOU between the Association and the Division, the Association is responsible for conducting an annual reconciliation of the premium amounts reported by insurance companies to the premiums reported by brokers. The purpose of this reconciliation is to ensure that brokers report all premiums and pay their corresponding taxes to the State. The MOU requires the Association to reconcile only significant discrepancies between the amount reported by the broker and the amount reported by the insurance company. According to the Association, a verbal agreement was reached with the Division that established a two-tiered test to determine if a discrepancy is "significant" and requires further review. The first tier threshold is triggered if the difference between the premium amount reported by the insurance company and the combined amount reported by all brokers who report doing business with that insurance company is more than $250,000. If the $250,000 difference were determined to be taxable, at the 3 percent surplus lines premium tax rate, for each insurance company where such a difference was identified an additional $7,500 in premium taxes could be due the State. The second tier is triggered once the $250,000 threshold has been met; the Association then reconciles the policies reported by that insurance company with premiums over $25,000 to determine if all such premiums have been reported and recorded accurately in the Association database and if additional taxes are due.

We reviewed the reconciliation process for Calendar Year 2003 and found that the reconciliation is not identifying brokers who may misreport premium

amounts for tax purposes. First, we found that the Association is neither reconciling reported premiums in accordance with the $250,000 threshold nor completing the reconciliation on a timely basis. We reviewed the 112 insurance companies authorized to issue surplus lines insurance in 2003 and identified 37 (33 percent) that had differences of more than $250,000 between the premiums they reported and premiums reported by the brokers. Of the 37 identified, only 11 (30 percent) were included in the reconciliation performed by the Association which was provided to us at the beginning of the audit. No explanation was provided by the Association as to why the 26 companies were not included in their reconciliation. The Association also included one company in its reconciliation that did not meet the $250,000 threshold. These 37 insurance companies reported total premiums of $337.5 million and the difference between the premium amounts reported by the insurance companies and the brokers was about $133 million. As of November 2005, the Association had not yet completed the reconciliation for Calendar Year 2004.

For the 37 companies that we identified as having differences of more than $250,000, we conducted our own reconciliation of the policies reported for each company. We received policy information for 31 of the 37 companies and identified 489 policies with premiums over $25,000 that were not reported by the brokers. Of the 489 identified, 141 (29 percent) were not included in the reconciliation provided by the Association. We followed up on 75 of the 141 policies (53 percent) and verified that no additional taxes were due to the State for these policies. However, the Division needs to follow up on the remaining 66 policies to determine if taxes are due. Total premiums reported for these 66 policies totaled about $8.4 million.

Second, we found that the $25,000 premium threshold used to identify the specific insurance policies for review may be too high. As a result, a substantial amount of premiums are never reconciled. The 31 insurance companies for which we received policy information wrote surplus lines policies totaling about $209 million in premiums. However, because the second tier of the reconciliation included only those premium amounts over $25,000, about $22.5 million in premiums written by the insurance companies fell under this threshold and were not reviewed. If premium taxes were due on these premiums, taxes could be as much as $675,000.

Third, we found that the current thresholds used during the reconciliation do not actually reconcile the differences between premiums reported by insurance companies and premiums reported by brokers. Rather, the thresholds identify certain policies over $25,000 for further review. Since brokers are responsible for paying any underreported premium taxes identified by the reconciliation, it is more important that the difference in the premiums reported by the insurance company and the broker be reviewed to determine why there is a discrepancy. The Division may find that by reviewing the policies making up the discrepancy, limited resources are used more efficiently.

Fourth, we found that no documentation is collected during the reconciliation process to support a determination that a premium is or is not taxable in Colorado. As part of the reconciliation process, the Association contacts brokers to determine why premiums meeting the threshold amounts were not reported as taxable in Colorado. The Association will accept the broker's explanation as to why the premiums were not reported without further review or obtaining supporting documentation. It is the Association's position that verifying the brokers' statements and obtaining supporting documentation is not part of its responsibility in performing the reconciliation. However, by not verifying the brokers' assertions, the Association cannot ensure that all surplus lines premiums have been fully reconciled and reported properly and that all appropriate taxes have been paid. We identified an instance where requiring the broker to provide supporting documentation for them not paying the full amount of tax resulted in about $552,600 in additional tax revenue being paid to the State. For this policy, the insurance company reported premiums totaling approximately $20 million, compared to the broker's reported premiums of about $152,800. The Division followed up with the broker, obtained documentation related to the policy, and determined that about $552,600 in additional taxes was due to the State. These taxes have been collected.

Finally, no follow up occurs when companies make adjustments to premium schedules. Insurance companies report premium amounts written in each individual state to the National Association of Insurance Commissioners (NAIC) through a document known as a Schedule T. The Association uses the Schedule T to compare the amount of premiums insurance companies are reporting to the amount reported by brokers. To test the accuracy of the reconciliation, we compared the premium amounts recorded for the 12 insurance companies in the Association's reconciliation to premium amounts reported in the Schedule T for each of the companies to determine if the amounts used by the Association for its reconciliation were accurate. We identified one instance where the premium amount recorded in the Association's reconciliation did not match the amount reported in the Schedule T. In this case, there was a $2 million difference between the amount recorded in the reconciliation and the amount reported in the company's Schedule T due to a data entry error made by the Association during the reconciliation. In addition, we found five other instances where the premium amounts reported by the insurance companies in the Schedule T did not match the premiums used in the reconciliation. We determined that, in each of these instances, the insurance companies amended their Schedule T's after the reconciliation was performed. Although the initial reconciliation included the correct information at the time the reconciliation was performed, the Association did not follow up on any changes made to the Schedule T's to determine if these changes impacted the amount of premium taxes due to the State.

Without a strong reconciliation process in place, the Division does not know if surplus line brokers are accurately reporting premium amounts and thus, paying the appropriate premium taxes. Considering the number of problems identified with the current reconciliation process, the Division should evaluate whether the Association should continue to perform this function on the Division's behalf. If the Association continues to perform this function, the Division needs to improve its monitoring of the Association, specifically with respect to the reconciliation process, to ensure the Association is carrying out its duties in accordance with the State's best interests.

Regardless of who performs the reconciliation, the Division needs to strengthen the process to ensure the accuracy of reported premiums and taxes paid. First, the Division should evaluate whether the $250,000 and $25,000 thresholds are still effective for determining which premium amounts should be reviewed further. In conjunction with the thresholds, additional data analysis should be conducted on the reported premiums to identify higher risk areas that should be evaluated further. For example, trend analyses of premiums reported by brokers from year-to-year could be conducted to identify any significant decreases. This analysis could help identify surplus line brokers who may be underreporting premiums, or not reporting them at all. Second, the Division needs to develop and implement the procedures that should be used during the reconciliation process. At the time of the audit, the $250,000 and $25,000 thresholds used to trigger the reconciliation process had not been documented anywhere. In addition, there are currently no requirements related to the follow-up that should occur when discrepancies are noted between the amount of premiums reported by insurance companies and the amount reported by brokers. At a minimum, documentation should be obtained to support brokers' assertions that premiums identified in the reconciliation are not taxable. Finally, the Division should follow up on the remaining 66 policies that were not included in the 2003 reconciliation to determine if additional taxes are due to the State on these policies.

Recommendation 6:

The Division of Insurance should ensure a robust reconciliation process by:

a. Evaluating whether the Surplus Lines Association (Association) should continue to perform the reconciliation function on behalf of the Division. If the Association continues to perform this function, the Division should improve its monitoring of the Association and the reconciliation process.

b. Reassessing whether the $250,000 and $25,000 thresholds are still effective to ensure adequate review of the policies making up the discrepancies in reported premiums. As part of this process, additional analysis should be conducted on the reported premiums to identify higher risk areas that should be evaluated further.

c. Developing and implementing procedures to be used during the reconciliation process. These procedures should address the threshold amounts, as well as what steps should be taken to follow up on discrepancies noted between the amount of premiums reported by insurance companies and the amount reported by brokers. At a minimum, documentation should be obtained to support brokers' assertions that premiums identified in the reconciliation are not taxable. As part of this process, the Division should follow up on the remaining 66 policies that were not included in the 2003 reconciliation to determine if additional taxes are due to the State on these policies.

Division of Insurance Response:

a. **Agree. Implementation date: July 1, 2006.** The Division has evaluated whether the Surplus Lines Association should continue to perform the reconciliation function. The Division finds that it is in the best interest of the State to bring the collection and reconciliation of premium tax for surplus lines in-house. In order to successfully collect premium tax payments and reconcile the annual reports of insurance companies regarding reported Colorado premium for surplus lines transactions, the Division will require 2 additional FTEs beginning in Fiscal Year 06-07. Bringing these processes in-house will be contingent upon budget approval for the appropriation necessary to compensate these 2 FTEs. The Department of Regulatory Agencies will request the new FTEs in the budget process. The Division will work with the Surplus Lines Association in making the transition. The Division will enter into an agreement with the Association to establish its duties to assist the Division during the transition period and thereafter.

b. **Agree. Implementation date: July 1, 2006.** The Division has reassessed the appropriateness of the thresholds. The Division does not believe that any thresholds are appropriate. By moving the reconciliation process in-house, the Division personnel can address the entire population of policies listed with the insurance companies and surplus lines brokers. If the new FTEs are not obtained in the budget process, the Division will implement new threshold amounts with the Association.

c. **Agree. Implementation date: July 1, 2006.** The Division will develop policies and procedures regarding reconciliation of reports submitted by the insurance companies.

Courtesy Filings

As noted earlier, statute (Section 10-5-111, C.R.S.), requires all surplus line brokers to pay a 3 percent tax on the premiums written for surplus lines insurance during the preceding calendar year. Brokers who are licensed in Colorado pay the required tax directly to the Division. Brokers who are not resident in Colorado, should pay the 3 percent tax if the insurance is to cover

a risk in Colorado. Division rules allow any licensed surplus line broker to file premium taxes on behalf of a non-resident broker. The MOU between the Division and the Association also authorizes the Association to receive the taxes due from non-resident brokers and then forward the full amount to the Division. This process is known as a courtesy filing. According to the MOU, the Association is authorized to collect a $50 filing fee for each courtesy filing transaction. The Association reports that in Fiscal Year 2004 it collected about $659,000 in premium taxes through courtesy filings and about $41,200 in courtesy filing fees. In Fiscal Year 2003 the Association collected almost $785,000 in premium taxes and almost $43,000 in filing fees.

We reviewed the courtesy filing process and identified two issues that may result in the State not receiving the full amount due on surplus lines premium tax payments:

The Division does not verify that all premium taxes collected by the Association through courtesy filings are paid to the State. Courtesy filings processed by the Association are submitted to the Division by the Association's executive director under his own broker license number. Before submitting these payments, the Association is responsible for verifying that the transaction complies with all surplus lines statutory requirements. If the Association determines that the transaction is appropriate, policy information will be entered into the Association database and the tax payment will be deposited into the Association's bank account. There is currently no process in place to verify that the Association forwards all courtesy filing tax payments it receives to the Division. The Division does not reconcile courtesy filing tax information maintained in the Association database to bank account records. In addition, the Division has not reviewed the Association's cash management procedures and controls to ensure they are appropriate.

Our initial review of the Association's cash management procedures found that basic cash handling controls, such as separation of duties, have not been established to ensure cash is deposited accurately and timely and that access to these accounts is properly restricted. Currently the Association's executive director has the sole responsibility for receiving, depositing, and forwarding tax payments received through the courtesy filing process. In addition, compensating controls have not been established for those situations where a separation of duties is not possible. Assigning a separate Division employee to review and reconcile cash deposits and balances and creating a strong cash management process at the Association would ensure an independent review and enhance oversight over the Association. Without this, the risk of fraud and abuse is increased and the Division cannot ensure all premium taxes collected by the Association are actually paid to the State.

The State does not receive the interest earned by the Association on premium taxes paid through courtesy filings. Brokers can pay premium

taxes through courtesy filings at any time during the year. As discussed above, the Association retains the payments in its own bank account until it makes one payment to the Division on March 1st each year. During the period from when payments are received until they are forwarded to the Division, the Association earns interest on these funds. For Calendar Years 2002 and 2003, the Association reported earning about $23,100 and $41,900 respectively, in interest on account balances that include courtesy filing tax payments. The Association did not provide the amount of interest earned in Calendar Year 2004. The Association currently keeps all interest earned on these funds and does not forward it to the State. The MOU between the Division and the Association is silent on this issue and does not specify who should keep the interest. To date, the Division has not questioned whether it is appropriate for the Association to keep the interest it earns on tax payments.

The interest earned on deposits of premium tax dollars made through courtesy filings is derived from state funds (tax payments) and therefore should belong to the State. Although the MOU is silent on who should keep the interest, it clearly states that the examination and filing fees are the only source of compensation to the Association for its services performed on behalf of the Division. If the Division decides to continue to use the Association for premium tax collection, the Division will need to improve controls over courtesy tax filings. If the Association retains tax payments made through courtesy filings and makes one payment each year, the MOU should clearly state that all interest earned on these funds should be forwarded to the State. Alternatively, the Division could require the Association to remit all tax payments made through the courtesy filing process to the State within 15 days of receipt by the Association. This would eliminate the interest issue and greatly reduce the risk of loss or abuse of these funds. Failure of the Association to remit the funds timely should carry an interest charge to the Association.

Recommendation 7:

If the Division of Insurance continues to use the Surplus Lines Association's (Association's) services, it should ensure that all tax payments made through courtesy filings with the Association are forwarded to the State by:

a. Establishing procedures for Division staff to review Association records and bank accounts to ensure all taxes collected through courtesy filings are remitted to the State. Procedures should include a reconciliation of courtesy filing information maintained in the Association database to bank records. In addition, the total amount recorded as taxes collected for courtesy filings should be reconciled to the taxes remitted under the Association's executive director's surplus line broker's license.

b. Ensuring the Association implements proper cash management controls to reduce the risk of fraud or abuse of funds held by the Association on behalf of the State.

c. Requiring the Association to remit all tax payments received through the courtesy filing process to the State within 15 days of receipt by the Association. Failure to remit the funds timely should result in an interest charge to the Association. Alternatively, the Division should require the Association to forward any interest on courtesy filings to the State.

Division of Insurance Response:

a. **Agree. Implementation date: July 1, 2006.** All non-resident producers who file with the Surplus Lines Association for premium taxes will be instructed to file directly with the Division, beginning July 1, 2006. The Division would like to point out that Section 10-5-107, C.R.S. permits any licensed surplus lines broker to accept courtesy filings. The Executive Director of the Association is so licensed. Some legislative change may be needed to require producers to file directly with the Division and not the Association.

b. **Agree. Implementation date for cash management controls: January 1, 2006. Implementation date for filings directly to the Division: July 1, 2006.** Having the filings sent directly to the Division should eliminate, for the most part, the collection of taxes by the Surplus Lines Association and minimize the cash handled by the Association. The Division will require the Association to implement cash management controls to reduce the risk of fraud or abuse for any filings that may be sent to the Association in the future and during the transition period. These controls would include keeping a log of incoming cash receipts or utilization of a lock box. On a monthly or quarterly basis, the Division will reconcile the log to the Association's database and bank records and investigate any discrepancies.

c. **Partially Agree. Implementation date for monthly remittances: January 1, 2006. Implementation date for filings directly to the Division: July 1, 2006.** During the transition period, the Division will work with the Association to implement a monthly remittance program. The Division believes that a 15 day period may not be sufficient time for the Association or its Accountant to adequately process and reconcile all the documents that would be necessary to submit to the Division and is recommending a monthly remittance due within 30 days after the end of each month. Policies and procedures as well as the agreement with the Association will address specific requirements of the Association.

Examination Fees

Statute (Section 10-5-115(8)(a), C.R.S.) authorizes the Commissioner of Insurance to approve an examination fee that the Association can charge to surplus line brokers to reimburse the Association for the cost of the Association's activities that are conducted on behalf of the Division. These

activities include but are not limited to, collecting and monitoring monthly premium transaction reports for every surplus line broker, providing each broker an annual statement documenting premium tax liability, and communicating with brokers on behalf of the Division regarding any changes in the law or Division regulations. According to statute, the examination fee cannot be more than 1 percent of the total amount of surplus lines premiums written during the tax year. Currently the examination fee is set at 0.1 percent and in Calendar Year 2004 the Association collected almost $651,000 in examination fees. According to the MOU, any additional activities performed by the Association are to be funded through sources other than the examination fee. The MOU requires the Association's financial statements to separate out revenue sources and expenditures to distinguish between activities performed on behalf of the Division and additional activities.

The MOU allows the examination fee to be set at an amount to cover the Association's operating expenses and to allow the Association to maintain a reasonable surplus of funds. The MOU defines a reasonable surplus to be an amount not to exceed two years of operating expenses which is about $600,000, according to the Association's previous three years of operating expenses as reported in its financial statements. We reviewed the Association's 2003 financial statements and found the Association's surplus exceeded its operating expenses by about $1.4 million. At the time of the audit, the Association was carrying an accumulated cash surplus of approximately $2.0 million. The excess surplus indicates that the examination fee may be set too high, and thus the Association is collecting more revenue than necessary to cover its expenses. The MOU does not identify any remedies for noncompliance with the surplus limitations.

One reason that the examination fee and consequently, the Association's surplus, may be too high is because the fee has not been evaluated as required by the MOU. According to the MOU, beginning January 1, 2000 the Association is required to evaluate the examination fee every two years and based on this evaluation, make recommendations to the Division for fee adjustments. The MOU also allows the Association to recommend fee adjustments sooner than every two years, if warranted. The purpose of this evaluation is to allow the Association to raise the fee if it is not sufficient to cover operating expenses or to lower the fee if it is resulting in an excess surplus. Since January 2000, the Association has evaluated and lowered the fee once, in January 2004 effective for the 2004 tax year. At that time, the fee was lowered from 0.2 percent to the current rate of 0.1 percent. The amount of examination fees collected by the Association increased from about $405,100 in 2001 to about $828,400 in 2003. In 2004 the amount of examination fees collected by the Association dropped to about $651,000 due to the lower rate. However, at the end of 2004 the Association still reported an excess surplus of $331,600 for the year.

A 1999 Division review of the Association also found that the Association was carrying an excess surplus and at that time, the Division's review

recommended that the fee be evaluated and discontinued until the surplus was used up. However, the examination fee has never been discontinued and as mentioned above, it was not reduced until January 2004.

If the Division decides to continue using the Association's services to assist with the surplus lines premium tax collection process (as discussed in Recommendation 10), it needs to evaluate the examination fee, as well as the excess surplus, and reduce the fee to ensure that an excess surplus does not accrue in the future. Additionally, the Division should consider suspending the examination fee temporarily to reduce the surplus more quickly. Furthermore, the Division needs to establish monitoring procedures for the Association, specifically with respect to the examination fee and the Association's financial statements which contain information on the Association's operating expenses and any surplus amounts. These procedures should include provisions for the Division to evaluate the fee on a regular basis and make adjustments to the fee when necessary. If the Division determines that the Association's services are no longer necessary, it should eliminate the examination fee and evaluate the Association's accumulated surplus to determine whether the funds belong to the Association or whether they should be returned to the State, pursuing statutory change as necessary.

Recommendation 8:

If the Division of Insurance continues to use the Surplus Lines Association's (Association's) services, it should ensure examination fees are appropriate by:

a. Evaluating the examination fee charged to brokers and the excess surplus currently carried by the Association on a regular basis and making adjustments to the fee when necessary. This evaluation should include recommendations for the examination fee that prevent the accumulation of excess surplus funds and consider suspending the examination fee until the surplus is reduced.

b. Establishing monitoring procedures for reviewing the Association's financial activities to ensure compliance with the terms of the Memorandum of Understanding between the Division and the Association. This should include reviewing the Association's annual financial statements and any other relevant documentation.

If the Division determines that the Association's services are no longer necessary, it should eliminate the examination fees and evaluate the Association's accumulated surplus to determine if these funds belong to the Association or whether they should be returned to the State, pursuing statutory change as necessary.

Division of Insurance Response:

a. **Agree. Implementation date: January 1, 2006.** The Division has already reevaluated the Association's surplus and operating needs. The Division has advised the Association that effective January 1, 2006 the examination fee will be eliminated for the calendar year 2006. The Division will review again prior to the end of calendar year 2006 and advise the Association accordingly. The Association may request a review earlier if circumstances warrant. Implemented.

b. **Agree. Implementation date: January 1, 2006.** The Division will ensure that the Association's annual financial statements are remitted to the Division through the revised agreement with the Association. The Division will also ensure that these will be reviewed and discussed with the association as it pertains to the need for any future examination fees.

Agree. Implementation date: July 1, 2006. As noted the Division has already reevaluated the Association's surplus and operating needs. The Division has advised the Association that effective January 1, 2006 the examination fee will be eliminated for the calendar year 2006 and to be reviewed again later that year. The Division will evaluate and research if the accumulated surplus belongs to the Association or if it could possibly be turned over to the State.

Identification of Taxpayers

The MOU between the Division and the Association requires the Association to collect monthly premium transaction data and prepare an annual statement of premiums written and taxes owed for each surplus line broker. The purpose of this requirement is to identify all surplus line brokers who have written premiums in the State and to track the amount of taxes due each year. To assist with this process, in 2003 the Association developed a database that maintains the following data: the population of licensed surplus line brokers, premium amounts written by brokers, taxes due from brokers, taxes paid by brokers, and any outstanding tax liabilities. This database is the State's system of record for identifying brokers responsible for paying premium taxes and the amount of tax owed. According to the Association, the population of licensed surplus line brokers in the database is updated at least monthly through an interface with the Division's licensing system which contains a listing of all licensed brokers in the State. Brokers are responsible for directly accessing the database through the internet to report monthly premium transactions for inclusion in the annual report prepared by the Association. Division staff are responsible for entering tax payment information into the database. In 2004, the Association database contained information on 525 licensed surplus line brokers who remitted approximately $13.8 million in premium taxes.

We reviewed the procedures used to verify that the surplus lines database contains complete information on surplus line brokers and taxes owed. We

found that the Division does not perform any data reliability procedures, such as record counts or other types of digit checks, to verify the accuracy of the information in the database. Therefore, the Division does not know if the entire population of surplus line brokers is captured in the database and verified for tax purposes. This database is the system of record for identifying brokers responsible for paying surplus lines premium taxes. Without procedures in place to verify the accuracy and completeness of the information contained in the database, the Division cannot ensure that all brokers conducting business in the State are paying the full amount of premium taxes owed. This could result in lost tax revenue for the State.

Recommendation 9:

The Division of Insurance should ensure the accuracy and completeness of data maintained in the surplus lines database by periodically performing data reliability procedures to verify the integrity of data.

Division of Insurance Response:

Agree. Implementation date: January 1, 2006. The Division will establish polices and procedures and assign personnel to periodically review the accuracy of the Association's database on brokers. The Division will work with the Association and amend the agreement with the Association on this issue.

Program Responsibility

As discussed previously, statute (Section 10-5-115(2), C.R.S.) requires the Commissioner of Insurance to rely on the advice and assistance of a broker association when carrying out his or her responsibilities related to premium taxes due on surplus lines insurance. Our review of the current surplus lines premium tax process found that this may not be the most effective way of collecting taxes. The Division's use of a private association to assist with the tax collection process is unique in the State. We did not identify any other state agencies that use a private association in the same way. In addition, there may be an inherent conflict in having an association that represents the industry, participating in the tax enforcement process over its members. Although the Association is not responsible for enforcing the collection of premium taxes, it is responsible for helping to identify brokers who have not paid their taxes and notifying the Division of these individuals so that the Division can take enforcement action.

We also found that functionally speaking, the Division has delegated all responsibility for surplus lines premium taxes to the Association, even though statute only requires the Commissioner to rely on the advice and assistance of a broker association. At the time of the audit, the only function retained by the Division was to record surplus lines premium tax payments in the surplus lines database. Further, by relying on the Association to carry out the surplus lines premium tax functions, the Division is essentially relying on the Association's executive director to complete these functions. The executive director is the primary individual responsible for conducting

all of the Association's functions and he has not documented with the Division the procedures he performs on behalf of the Division. This is a risk to the State because the Division may not be able to maintain effective operations over the surplus lines premium tax process in his absence. Additionally, we found that the Division has not used a binding contract with enforcement provisions to clarify the Association's responsibilities. Rather the Division has relied on an MOU that does not have the authority of a contract and does not allow the Division to impose remedies against the Association for not adequately fulfilling its responsibilities. Finally, as discussed throughout this chapter, we found that the Division has provided limited oversight over the functions performed by the Association on behalf of the Division.

Overall, we found numerous problems with the current surplus lines premium tax collection process that can affect the State's ability to collect the full amount of premium taxes due the State. Therefore, the Division should evaluate whether using the Association to assist with the process is the most effective means of collecting taxes and is in the best interest of the State. If the Division decides to discontinue using the Association's services, the Division should propose statutory changes, as necessary, to eliminate the requirement that the Division rely on the advice and assistance of a broker association and bring the duties currently performed by the Association back in-house. If the Division continues to use the Association's services it is essential that the Division establish comprehensive oversight procedures to adequately monitor Association performance. In addition, the Division must clearly define the Association's responsibilities in a binding contract between the Division and the Association, rather than through an MOU. The contract should include provisions consistent with statute (Section 10-5-115(4), C.R.S.) which allows the Commissioner to suspend or revoke the acceptance of the Association if the Association is not adequately performing its duties. If the Division finds that the Association is not adequately performing its duties, the Division should invoke this provision and discontinue using the Association's services.

Recommendation 10:

The Division of Insurance should evaluate whether continuing to use the Surplus Lines Association (Association) to assist with the surplus lines premium tax collection process is the most effective way to administer this process and in the best interest of the State. If the decision is made to discontinue using the Association's services, the Division should propose statutory changes, as necessary, to eliminate the requirement that the Division rely on the advice and assistance of an association and bring the duties currently performed by the Association back in-house.

Division of Insurance Response:

Agree. Implementation date: July 1, 2006. The Division has evaluated whether to continue to use the Association to assist with surplus lines premium tax collections. The Division has decided to move the surplus lines tax collection in-house if the Division is granted two FTEs. If necessary, the Division will pursue any statutory changes necessary. The Division is also pursuing appropriations for additional personnel to handle this function.

Recommendation 11:

If, based on the evaluation conducted in Recommendation 10, the Division of Insurance decides to continue using the Surplus Lines Association's (Association) services to assist with the surplus lines premium tax collection process, the Division should take immediate steps to improve the process by:

a. Clarifying and documenting the Association's responsibilities in a contract between the Division and the Association. The contract should also include remedies against the Association for failure to adequately perform its duties.

b. Establishing comprehensive oversight procedures for Division staff to adequately monitor Association performance. If the Division finds that the Association is not adequately performing its duties, the Division should discontinue using the Association's services and propose statutory changes, as necessary.

Division of Insurance Response:

a. **Agree. Implementation date: January 1, 2006.** A formal contract will be developed and implemented with the Association including responsibilities of both parties, deadlines, and remedies for failure to comply.

b. **Agree. Implementation date: January 1, 2006.** The Division will establish comprehensive policies and procedures for staff to follow in regards to the oversight of the Association. A formal contract will be developed and implemented with the Association. If the Association does not adequately perform its duties, the Division will seek remedies and statutory change, if necessary.

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