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# Audit and Actuarial

Giro 2016

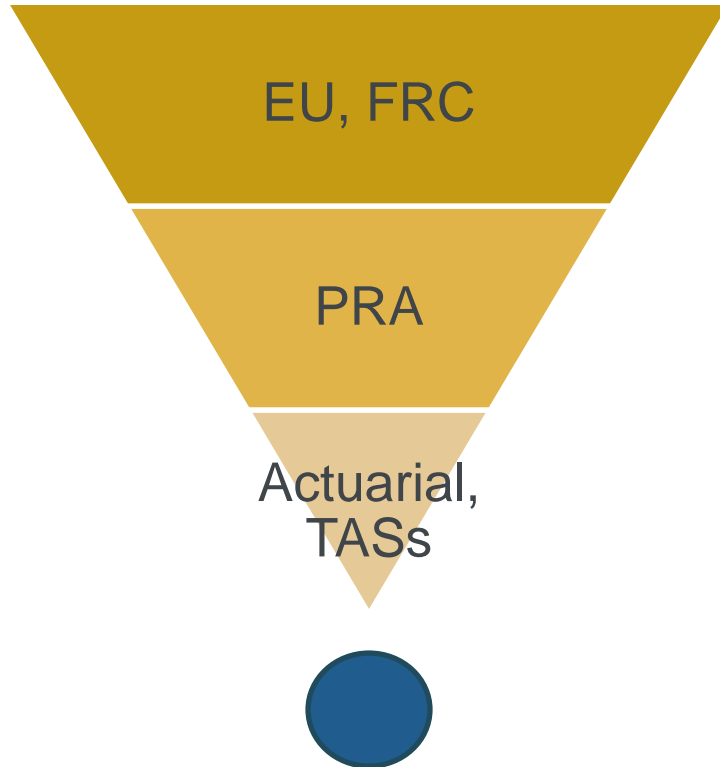
Natasha Regan and Karen Seidel



# Agenda



**Audit Drivers: Benefits and Challenges**



} **Update on Developments**

**Case Studies**



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## Drivers of Audit: Benefits ...

Common perception:

- Audits promote confidence in financial reporting
- Address agency risks, help better allocation of capital

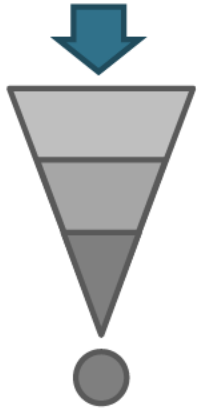
**Legal requirement:**

Statutory audit provides

- An independent opinion
- To shareholders
- On the truth and fairness of the financial statements



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## ... With Limitations

### Expectation gap

1. Opinion relies on objectivity, **professional scepticism** and judgement  
**Not** detective skills
2. Audit addresses information asymmetry between s/holders and management  
**Not** potential investors, creditors, government or the public at large
3. Reasonable assurance that the financial statements are not materially misstated  
**Not** on effectiveness of internal controls, detection of fraud or future viability of the business.





## ... and Challenges

Auditing firm Arthur Andersen collapsed over

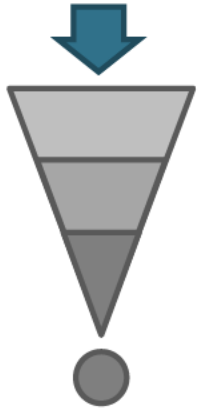
### Fudged audit of Enron (2001)

- Houston-based commodities, energy and service corporation
- CEO Jeff Skilling and former CEO Ken Lay kept huge debts off balance sheets.
- Turned in by internal whistleblower Sherron Watkins
- Filed for bankruptcy in 2001: Shareholders lost \$74 billion, thousands of employees and investors lost their retirement accounts, and many employees lost their jobs.
- Penalties: Lay died before serving time; Skilling got 24 years in prison.

### And was also auditor of Worldcom (2002)

- Telecommunications company; now MCI, Inc.
- Inflated assets by as much as \$11 billion, leading to 30,000 lost jobs and \$180 billion in losses for investors.





## ... leaving the Big Four dominant

- Deloitte
- Ernst & Young
- KPMG
- PWC

Concentration of FTSE Audits*	
	Big Four (%)
FTSE 100	98.0
FTSE 250	96.8
Other UK main market	71.1
All main market	83.3

\* As at 31/12/2015. Source: FRC report





## ... in 10 out of 15 cases under investigation by FRC

Company	Auditor	Investigation Announced	Case Status
Cattles plc	PWC	23-Jul-09	31/08/2016 £2.3m fine for PWC
Connaught plc	PWC	29-Nov-10	FD misconduct: non-disclosure to auditors
Aero Inventory plc	Deloitte	03-Mar-11	FD misconduct, complaint against Deloitte Tribunal hearing held in May/June 2016
Equity Syndicate Management Ltd	KPMG	06-Mar-12	See separate slide
RSM Tenon	PWC	13-Aug-12	Investigation ongoing
Autonomy Corporation plc	Deloitte	11-Feb-13	Investigation ongoing
The Co-Operative Bank plc	KPMG	20-Jan-14	Investigation ongoing
Computer 2000 Distribution Ltd	EY	12-May-14	Investigation ongoing
Tesco plc	PWC	22-Dec-14	Three former Tesco execs charged with fraud Investigation into PWC ongoing
Quindell plc	KPMG	05-Aug-15	Investigation ongoing

Source: FRC



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## Equity Red Star (ERS) - Lloyd's Syndicate 218

In June 2010, an actuarial review concluded that ERS reserves needed strengthening by £210m i.r.o. prior years.

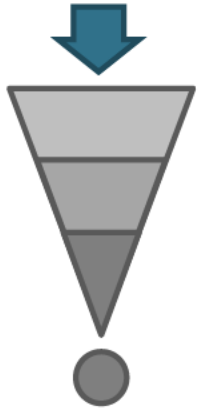
Year of account	Net earned premiums £000	Claims ratio %	Operating ratio %
2012	464,114	70.2	108.1
2011	543,841	69.7	108.1
2010	508,962	163.2	199.1
2009	568,203	68.5	99.7
2008	546,629	70.7	103.1

(Source: ERS Annual report and accounts 2012)



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## Equity Red Star (ERS) – the fall out

Section 166 review by FSA

Actions by Lloyd's

- ERS chief exec banned from Lloyd's for two years

FRC disciplinary tribunals

- Director of ERS: failure to act with professional competence and due care in relation to reserving
- Audit partners at KPMG: concern about the audit work carried out in respect of reserving, the sufficiency of evidence obtained and the unqualified opinions given.
- Deloitte: formal complaint under the Actuarial Scheme for provision of actuarial services to ERS management board



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## Key legislative changes ...

Audit regulation for 'Public Interest Entities' (PIEs): listed companies, banks, building societies, and insurers

- June 2014: EU's Audit Regulations and Directive (ARD) published
- June 2016: UK secondary legislation brings ARD into effect

Audit regulation specific to insurers

- July 2016: PRA consults on external audit of public disclosure under Solvency II. Applies to SFCRs from November 2016
- TASs





## ... aim to open up the market to wider competition

- Rotation and tendering for audits
  - Tendering at least every 10 years
  - Mandatory audit firm rotation at least every 20 years
- Non-Audit Services fees limits
  - Group NAS fees may not exceed 70% of the average of group statutory audit fees over the previous three years. As application does not use retrospective data, this does not apply until three years of audit fee data post 17 June 2016 are available
- Non-Audit Services prohibitions
  - Includes tax, internal audit, corporate finance





## ... improve Audit tender proposals

- Greater emphasis on quality
- Reference to AQR reports
- Quality of the partner and specialist or local knowledge of the team
- Better use of IT and Technology
- No cross-selling
- Independence





## ... raise quality and scrutiny of annual audits

- A move away from the use of generic language to more entity specific (and therefore more informative) descriptions;
- Effective disclosures around materiality including the benchmarks used and basis of the calculation;
- Disclosure of the magnitude of unadjusted differences being reported to the audit committee;
- Reporting of detailed audit findings with respect to identified risks – in year one this was limited to comparatively few ‘best in class’ reports. In year two the prevalence of this reporting increased. Many investors would like to see it become the norm;
- Experimentation with detailed explanation of the audit scoping process;
- A good alignment between the information included in the auditor’s extended report and in audit committee reports;
- Improved presentation of auditor’s reports through the use of diagrams and graphs;
- Addressing going concern disclosures in auditor’s reports; and
- Locating the auditor’s overall opinion at the beginning of the report rather than at the end.





## ... strengthen audit committees

How do audit committees choose an auditor?

- Surveys of management and finance staff
- Extent to which the auditor can demonstrate knowledge of the business
- Perceived calibre of the individuals in the audit team
- Continuity within the audit team
- The extent to which the auditor can add value

Source: FRC survey of audit committee members



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# PRA Consultation paper on external Audit

CP23/16:

Audit requirements for Solvency and Financial Condition Report (SFCR)

## Key Points

- Addressee of the audit report is the PRA
- Audit opinion will be on whether the relevant elements have been prepared in all material respects in accordance with the PRA rules and Solvency II regulations
- Except where specifically excluded, the information in the 'Valuation for solvency purposes' and 'Capital management' sections of the SFCR should be in scope



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## Internal Capital Models are exempt ...

- exclusion of any information that 'is, or derives from' the SCR calculated using a full or partial internal model at the solo and group level.
- noted that the standard formula elements of a partial internal model are excluded from scope







## ... or are they?

- Model validation
- Data audit
- IT audit
- Documentation audit
- ....



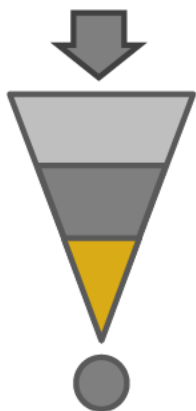


## Accelerating pace of assurance and review

In 2016, in separate assignments between us we have carried out or been subject to all these different types of review:

- Peer reviewed actuarial calculations
- Designed, performed and documented model testing
- Solvency II Model validation
- Actuarial support for an Internal Audit pricing review
- Audit Quality Review - reviewed actuarial audit work of the big 4
- Thematic Review of Actuarial reports
- Had documentation quality assured
- Public consultation of a draft document
- Audit of Data and IT used
- Management review of work, and performance review.





# Update to TASs (Audit and Assurance) - Scope

## Current Insurance TAS: Audit

This standard shall apply to actuarial work concerning **insurance business** performed by an auditor's expert to support the auditor's opinion on an **insurer's** or its parent undertakings' financial statements that are intended to give a true and fair view of their financial position and profit or loss (or income and expenditure) and their regulatory returns other than actuarial work that is within the scope of the **Specific TAS** on *Pensions*.

## Exposure Draft TAS 200: **Audit and assurance**

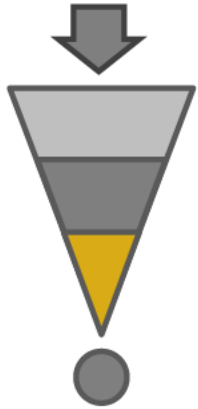
TAS 200 is applicable to:

**Technical actuarial work** to support the provision of an audit opinion on an **insurer's** financial statements

**Technical actuarial work** to support the provision of an auditor's assurance opinion for regulatory reporting



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# Update to TASs (Audit and Assurance) - Provisions

Exposure Draft TAS 200: ***Audit and assurance***

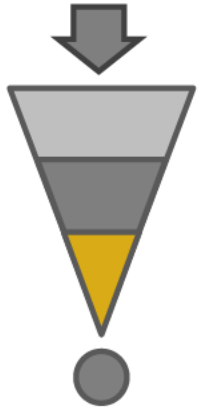
22. The initial scope of the **technical actuarial work** and the reasons for any variances from the initial scope shall be **documented**.

23. **Technical actuarial work** undertaken shall be planned and performed with **professional scepticism** recognising that circumstances may exist that cause the financial statements or regulatory information to be materially misstated.

24. **Communications** shall state the nature and extent of any reliance on information prepared by another party and the conclusions of the **technical actuarial work** including any concerns on material deficiencies or limitations.



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# Responses to the TAS 200 Consultation (Audit and Assurance)

## Scope

- The majority of respondents agreed that audit should be in scope
- The majority of respondents agreed that assurance should be in scope
- One respondent agreed although had concerns that audit costs would increase unless applied appropriately by practitioners

## Provisions

- The majority of respondents agreed or had no comments;
- Several respondents explicitly welcomed the inclusion of a provision relating to professional skepticism and one considered that it should be a core provision for all work in the scope of TAS 200.





## Case studies

Based in part based on issues raised during Roundtable discussions between actuaries and audit partners  
things those new to audit would like to be aware of, Won't be news for experienced practitioners – they might contribute to the discussion, recognising the variety of reasons for seeking assurance and roles that are played





## Case Study 1 - Reporting

In an audit of financial statements the actuary has performed a reprojection of reserves and come out with a lower answer. The audit partner will present findings to the Audit Committee.

“If you’re an internal actuary it’s really annoying if someone comes in with less knowledge of the business and rides roughshod over your numbers”

“As an actuary as part of the audit we sometimes need to remind the Audit Committee of our role.. which is not to set the numbers!”





## Case Study 1 - Questions

What is the role of the actuarial reprojection work in the audit?

How can the external actuary effectively communicate results and differences to the Audit Committee?

Does the internal actuary have any role to play in this process?

What steps can be taken to maintain audit independence over time?







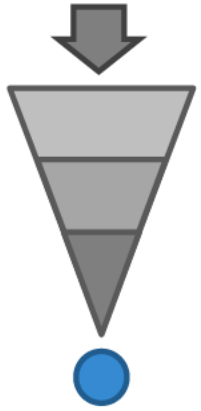
## Case Study 2 - Judgements

Your firm has been newly appointed, after a retendering process, to audit a medium sized liability insurer.

The previous audit had no major issues but you notice that recent years' claims data is starting to show signs of developing more quickly than previous years.

There is debate within the insurer about the true position of ultimate claims and management highlight that changes to personnel and to claims management processes render actuarial projections unreliable.





## Case Study 2 - Questions

What investigations could you carry out as part of the audit?

What are your options if there is still uncertainty?

How can the actuary demonstrate professional skepticism?

What support do you have?





## Case Study 3 - Materiality and Timescales

The Board would like to sign off the latest Solvency II SCR being sighted of both the capital number and all validation findings. Validation is being led by the Internal Audit department and this time incorporates a full data and documentation audit.

- Capital Modelling Actuary: “The validation questions always happen when I’m really busy and some of the issues aren’t that important”
- Internal Auditor: “The numbers keep changing right until the last minute! Once I was given results on Wednesday to deliver my validation report by Friday. And by the way I didn’t make the rules!”





## Case Study 3 - Questions

Timescales can be notoriously difficult for Internal Model submissions.

- What can the parties do to make it work?
- What should you do as an internal actuary if the auditor is focusing on immaterial matters?
- Should you volunteer information if there is something material the auditor does not know?



# Questions?



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# Audit Acronyms

- ARD: EU Statutory Audit Directive and Audit Regulation
- RSB: Recognised Supervisory Body
- RQB: Recognised Qualifying Body
- CMA
- PIEs: Public Interest Entities (listed companies, banks, building societies and insurers)
- AFGC: Audit Firm Governance Code
- INE: Independent Non-executive director
- IAASB: International Auditing and Assurance Standards Board
- AQR: Audit Quality Review

