All you ever wanted to know about auditing but were afraid to ask

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Agenda

1. Trust and Public Perception
2. Audit Insights
3. Some Important Audit Concepts
4. The Actuarial Side to Audit
Trust and public perception
Public Perception – Trusted People?


https://twitter.com/MallowNews/status/1019523917529190400
Public Perception – Trusted Brands?

https://www.opinium.co.uk/most-trusted-companies-in-uk/
https://www.campaignlive.co.uk/article/guardian-trusted-sun-least-trusted-online-news-brand-pamco-reveals/1492881
Public Perception – A Case Study (non-Actuarial)

- Volkswagen emission scandal in September 2015
- Severe loss of public trust and large share price crash
- Gained 40% since low point, but still down from peak
# Users of financial statements

<table>
<thead>
<tr>
<th>Users</th>
<th>Purpose</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity investors (report addressee)</td>
<td>Assess company's performance</td>
</tr>
<tr>
<td>Debt investors</td>
<td>Assessment of lending</td>
</tr>
<tr>
<td>Equity analysts</td>
<td>Base point for future prospects</td>
</tr>
<tr>
<td>Rating agencies</td>
<td>Informative for rating decisions</td>
</tr>
<tr>
<td>PRA and FCA</td>
<td>Informative for understanding financial performance (albeit not Solvency II capital)</td>
</tr>
<tr>
<td>HMRC</td>
<td>Starting point for corporation tax</td>
</tr>
<tr>
<td>Pension fund trustees</td>
<td>Assess strength of pension covenant</td>
</tr>
<tr>
<td>Employees</td>
<td>Share price performance</td>
</tr>
<tr>
<td>Trade unions</td>
<td>Employee prospects</td>
</tr>
<tr>
<td>Consumer organisations</td>
<td>Assess company stability to recommend to consumers</td>
</tr>
<tr>
<td>Financial press</td>
<td>Reporting news, scandals, investigations</td>
</tr>
</tbody>
</table>
Operating environment for audit firms

- Audits typically performed with unlimited liability.
- Tolerance for business failures post the Global Financial Crisis is low.
- Perception of huge rewards for directors in business and limited penalties for failure.
- Carillion and BHS two particularly high profile business failures subject to extensive scrutiny.
- Increased dialogue with both PRA and FCA – they expect a frank exchange of views from the auditors and regular meetings on bipartite and tripartite basis.
- Routine inspection of work internally and by the Financial Reporting Council.
Auditor responsibilities for statutory audit

Auditor’s responsibilities

• Obtain reasonable assurance about whether the financial statements as a whole are
  – free from material misstatement, whether due to fraud, other irregularities (see below), or error, and;
  – to issue our opinion in an auditor’s report.

• Reasonable assurance is a high level of assurance, but does not guarantee that an audit will always
detect a material misstatement when it exists.

• Misstatements can arise from fraud, other irregularities or error.

• Consideration is given to the materiality (defined later).
Specialists in the audit

• Auditors need support across the audit, they can’t do everything!
• It is a multi-disciplinary team
• Specialists may include
  – Actuarial
  – Tax
  – IRM
  – Valuations
  – Forensics
## Enforcement cases against actuaries

<table>
<thead>
<tr>
<th>Case 1</th>
<th>Case 2</th>
<th>Case 3</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Date</strong></td>
<td>22 February 2017</td>
<td>22 February 2017</td>
</tr>
<tr>
<td><strong>Role</strong></td>
<td>Former Chief Actuary</td>
<td>A former Actuary</td>
</tr>
<tr>
<td><strong>Fine</strong></td>
<td>£101,500</td>
<td>£45,500</td>
</tr>
<tr>
<td><strong>Costs to be paid</strong></td>
<td>£11,000</td>
<td>£3,500</td>
</tr>
<tr>
<td><strong>Regulatory impact</strong></td>
<td>Ineligible for 3 years for a</td>
<td>A Reprimand</td>
</tr>
<tr>
<td></td>
<td>practising certificate</td>
<td></td>
</tr>
</tbody>
</table>
Some Important Audit Concepts
Key Terms and Definitions

• Materiality
  – Materiality, Performance Materiality, Audit Misstatement Posting Threshold ("AMPT")

• Estimate

• Error

• Professional scepticism

• Disconfirming evidence

• Benchmarks
Materiality - concept

• The determination of materiality is a matter of professional judgement, and is affected by our perception of the financial information needs of users of the financial statements.

• Users:
  – a. have a **reasonable knowledge of business and economic activities and accounting**
  – b. understand that financial statements are prepared, presented and **audited to levels of materiality**
  – c. recognize the **uncertainties inherent** in the measurement of amounts
  – d. **make reasonable economic decisions** on the basis of the information
Changes in estimates versus errors

Prior period errors are:

- **Omissions from, and misstatements** in, the entity’s financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:
  - (a) was available
  - (b) could reasonably be expected to have been obtained and taken into account

- Such errors include the effects of **mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud.**
Estimates vs Ranges

• There can be differences between two point estimates, two actuaries will probably take different views

• The actuarial audit team may calculate what they consider to be a reasonable range

• The audit considers whether the company’s estimate falls within a reasonable range

• But what is reasonable?
Professional scepticism

• Auditors are required to exercise “professional scepticism”
  – This does not mean mistrust
  – But requires challenge and evidence rather than taking things on face value

• Professional scepticism is an attitude that includes a questioning mind

• When considering key judgements, higher levels of professional scepticism are applied in assessing the reasonableness – including consideration of historical reliability
Disconfirming Evidence

• What is disconfirming evidence?

• How to handle two opposing conclusions for two different pieces of evidence?
  – What to choose or rely on? How to record this?

• Consider the impact

• Actuarial examples:
  – Anchoring bias
  – Loss ratios significantly better than industry peers
  – Inappropriate exclusion of outliers
Benchmarking

- Information from sources independent of the entity that may be used as audit evidence.
- Benchmarks are a guide only.
- Being in or out of the middle does not necessarily mean good or bad.
- Need to consider any potential anomalies that arise out of the benchmarking exercise.
The Actuarial Side to Audit
Overview

• Auditing is not part of the actuarial exams.
• Yet reserving and accounting failure attract more attention than pricing failures.
• Actuaries must be part of the solution!
Actuarial Audit Work

- Need to assist the auditors in forming a view on whether the accounts and judgements are reasonable.
- Reasonable doesn’t mean that everyone is the same:
  - For example, signing off on two insurers with Ogden assumptions of -0.75% and 0%.
- We have to build up the overall view taking perspective across the business.
- Use a range of tests include quantitative and qualitative.
Actuarial Audit Work (cont.)

- Governance, experience, competence
  - Consider review process for setting reserves, who signs off
- Data
  - Reconcile data to prior years etc, but critically liaise with audit team
- Process and methodology
  - Review methodology to calculate large loss IBNR and/or controls around the process
- Judgements and assumptions
  - Compare assumptions to results from data and market benchmarks, e.g. EL tail
- Alternative estimates
  - Conduct projections on material lines of business with greater uncertainty
- Further tests
  - Reserving diagnostics or RI ‘netting down’ to spot any unusual data features
Actuarial Audit Work (cont.)

• No test is considered in isolation
• But combined and in aggregate to develop a view
• Findings in one test may require further work in another
  – E.g. racy assumptions and poorly documented methodology may mean a greater number
    of independent projections to gain comfort (or not) over the reserves
• The following slides will cover a few typical tests in more detail and a few of
  the key areas we look out for…
Group Task

• … but first, a group task!
• Each group will have different information on parts of the accounts and/or actuarial work
• You should discuss in your groups whether the data indicates any risks or the level of prudence in the reserves
• Assign a rating of 1 – 5, and justify!
  – 1: Overly optimistic
  – 3: Best estimate
  – 5: Overly prudent
• In each case, consider what might the criteria be to not be acceptable? Of it not, what further evidence could be gathered?
### Exercise 1 – Team

<table>
<thead>
<tr>
<th>Team Member</th>
<th>Role</th>
<th>Experience</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>Chief Actuary</td>
<td>Has held the chief actuary role at the company for 15 years</td>
</tr>
<tr>
<td>B</td>
<td>Reserving Manager</td>
<td>5 years post qualification experience. New joiner, previously at a personal lines insurer</td>
</tr>
<tr>
<td>C</td>
<td>Reserving Manager</td>
<td>New qualified, joined 6 months ago but spent 4 years in a similar syndicate</td>
</tr>
<tr>
<td>D</td>
<td>Analyst</td>
<td>1 year experience</td>
</tr>
<tr>
<td>E</td>
<td>Analyst</td>
<td>New graduate</td>
</tr>
</tbody>
</table>

- **A Lloyd’s syndicate**
- **Stable and experienced senior management**
- **Managers with experience, but limited knowledge of the business**
- **Are there sufficient resources to carry out all the actuarial work to appropriate standards?**
- **Consider quantitative and qualitative**

![Team Size Benchmarking](attachment:image.png)

**26 October 2018**
Exercise 2 – Methodology

• Ogden assumption for reserving was 1%

• Implied rate on settlement is decreasing following the Lord Chancellors announcement

• But consistently above 0%

• Is a trend forming?

<table>
<thead>
<tr>
<th>Date of settlement</th>
<th>Amount</th>
<th>Implied Ogden Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>01/11/2016</td>
<td>£300,000</td>
<td>2.5%</td>
</tr>
<tr>
<td>14/12/2016</td>
<td>£150,000</td>
<td>2.1%</td>
</tr>
<tr>
<td>10/03/2017</td>
<td>£1,000,000</td>
<td>3.0%</td>
</tr>
<tr>
<td>21/07/2017</td>
<td>£1,300,000</td>
<td>1.7%</td>
</tr>
<tr>
<td>03/08/2017</td>
<td>£750,000</td>
<td>1.8%</td>
</tr>
<tr>
<td>19/10/2017</td>
<td>£100,000</td>
<td>1.5%</td>
</tr>
<tr>
<td>05/11/2017</td>
<td>£250,000</td>
<td>0.9%</td>
</tr>
</tbody>
</table>
Exercise 3 – Diagnostics

- Selected projection methodology only considers the incurred
- Something has caused the paid to speed up. Should we be worried?

Incurred Development as % of [Client] Ultimate

- Development Quarter
- % Developed
- 0% 20% 40% 60% 80% 100% 120%
- 0 2 4 6 8 10 12 14 16 18 20 22 24 26 28 30 32 34 36 38 40 42 44

Paid Development as % of [Client] Ultimate

- Development Quarter
- % Developed
- 0% 20% 40% 60% 80% 100% 120%
- 0 2 4 6 8 10 12 14 16 18 20 22 24 26 28 30 32 34 36 38 40 42 44

26 October 2018
Exercise 4 – IELRs

• There is a consistent upward trend in IELRs over the initial development for each UWY

• Recent IELRs may be optimistic both the trend and IELR<ULR, resulting in under-reserving when using the BF method

Table 1a - IELR Pick Development as at 31/12/2018 - Employers Liability

<table>
<thead>
<tr>
<th>UWY</th>
<th>YE13</th>
<th>YE14</th>
<th>YE15</th>
<th>YE16</th>
<th>YE17</th>
<th>YE18</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>50.0%</td>
<td>52.5%</td>
<td>54.1%</td>
<td>54.6%</td>
<td>54.6%</td>
<td>54.6%</td>
</tr>
<tr>
<td>2014</td>
<td>50.3%</td>
<td>52.8%</td>
<td>54.4%</td>
<td>54.9%</td>
<td>54.9%</td>
<td>54.9%</td>
</tr>
<tr>
<td>2015</td>
<td>47.2%</td>
<td>49.6%</td>
<td>51.1%</td>
<td>51.6%</td>
<td>51.6%</td>
<td>51.6%</td>
</tr>
<tr>
<td>2016</td>
<td>50.3%</td>
<td>52.8%</td>
<td>54.4%</td>
<td>54.4%</td>
<td>54.4%</td>
<td>54.4%</td>
</tr>
<tr>
<td>2017</td>
<td>49.1%</td>
<td>51.6%</td>
<td>54.4%</td>
<td>54.4%</td>
<td>54.4%</td>
<td>54.4%</td>
</tr>
<tr>
<td>2018</td>
<td>42.0%</td>
<td>47.9%</td>
<td>51.6%</td>
<td>51.6%</td>
<td>51.6%</td>
<td>51.6%</td>
</tr>
</tbody>
</table>

Projection Method: Incurred CL, Incurred BF, Paid

ULR % Development to Ultimate

<table>
<thead>
<tr>
<th>YE18</th>
<th>Paid</th>
<th>Incurred</th>
</tr>
</thead>
<tbody>
<tr>
<td>54.6%</td>
<td>50.2%</td>
<td>73.0%</td>
</tr>
<tr>
<td>54.9%</td>
<td>45.3%</td>
<td>65.9%</td>
</tr>
<tr>
<td>51.6%</td>
<td>40.0%</td>
<td>56.6%</td>
</tr>
<tr>
<td>60.2%</td>
<td>34.7%</td>
<td>50.5%</td>
</tr>
<tr>
<td>55.0%</td>
<td>17.1%</td>
<td>44.9%</td>
</tr>
<tr>
<td>47.9%</td>
<td>10.5%</td>
<td>23.1%</td>
</tr>
</tbody>
</table>

26 October 2018
Exercise 5 – Alternative Estimates

- Materiality £3m, total reserves £142m
- Overall, there is negligible difference
- But this is split looking CY vs PY
  - CY has a £9m deficit
  - PY has a £9m surplus
- This might be a case of optimistic business plans or IELRs
- What would be the impact on pricing or reserving for future years?
- What about the Solvency II impact?

<table>
<thead>
<tr>
<th>UWY</th>
<th>Client Ultimate</th>
<th>Auditor’s Ultimate</th>
<th>Surplus / (Deficit)*</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>73</td>
<td>73</td>
<td>1</td>
</tr>
<tr>
<td>2014</td>
<td>74</td>
<td>72</td>
<td>2</td>
</tr>
<tr>
<td>2015</td>
<td>78</td>
<td>75</td>
<td>2</td>
</tr>
<tr>
<td>2016</td>
<td>79</td>
<td>79</td>
<td>0</td>
</tr>
<tr>
<td>2017</td>
<td>80</td>
<td>77</td>
<td>3</td>
</tr>
<tr>
<td>2018</td>
<td>89</td>
<td>98</td>
<td>(9)</td>
</tr>
<tr>
<td>2017 &amp; Prior</td>
<td>773</td>
<td>724</td>
<td>9</td>
</tr>
<tr>
<td>Total</td>
<td>822</td>
<td>822</td>
<td>(0)</td>
</tr>
</tbody>
</table>

*small differences due to rounding
Exercise 6 – More Diagnostics

• Personal motor severity for small bodily injury
• Marked change in the severity development from notification post April 2013
• Why? LASPO?
• Need to investigate if this has been allowed for in the projections
Making the most of auditors

- Now you should have an insight into what the auditors do and are looking for
- How are they to be engaged?
  - Two way communication
  - Understand purpose of the work
- How can you help them?
  - Provide evidence to back up assumptions and processes
  - Propose changes in advance to get feedback on any remedial action required
- How can you get the greatest insight? How can they help you?
  - Benchmarking against peers
  - Supporting where there is pressure to reduce or increase selections
  - Extra level of challenge to check areas you should be thinking about
  - Help improve standards, c.f. upcoming IFoA peer review
  - Testing robustness before presenting to audit committee
Audit as an actuarial discipline

• Technical skills different to internal reserving
• TAS 200
• Learn different skills key to audit, those being: challenge, evidence based review, documentation
• Market understanding
• Board exposure
• A skill set applicable beyond audit
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