

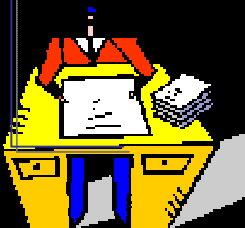
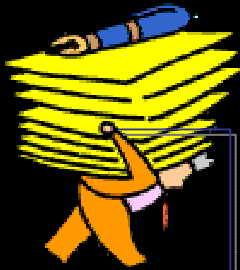
Southeastern Actuaries Conference

Actuarial Auditing After Enron

Jeff Klanderman

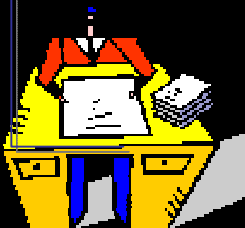
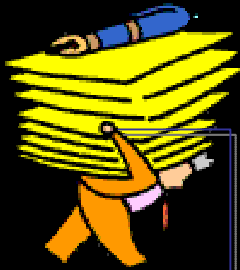
KPMG LLP

June 2002



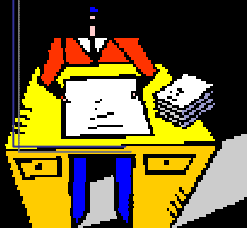
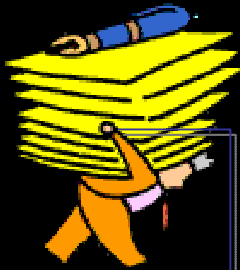
Arthur Andersen – What Happened?

- Up to the 1970s, audit firms were exactly that due to independence concerns.
- AA is historically a firm that would stand up to clients.
- In the late 1960s, audit firms realized that extra money could be made by offering consulting and tax services to existing clients.
 - There were some concerns within these firms due to independence.
 - The services offered were within SEC rules, so okay.
 - In 1978, consulting provided 21% of AA's revenue.



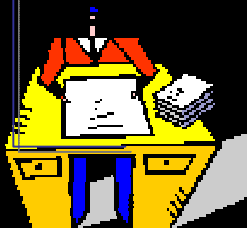
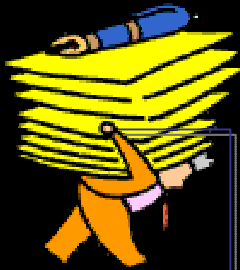
Arthur Andersen – What Happened?

- Through the 1980s and 1990s, increasing amounts of money were made on these “extra” services.
- Specifically, these services represented increasing percentages of the revenue at Arthur Andersen, from 20% in the 1970s to over 50% in the late 1990s.



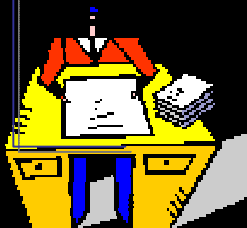
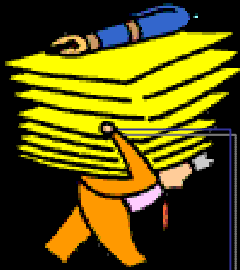
Arthur Andersen – What Happened?

- In 1988, Andersen Consulting split off from Arthur Andersen LLP.
 - Now 2 units under one organization.
 - AA LLP to bid on smaller clients only.
 - Significant lost revenue to AA LLP.
 - This also created disparity between consultants and auditors.



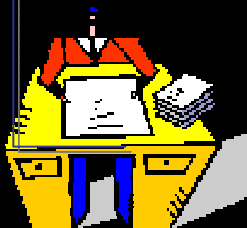
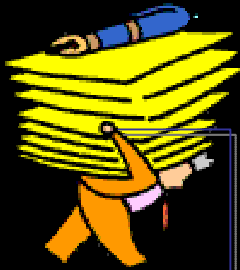
Arthur Andersen – What Happened?

- In 1997, Andersen Consulting filed to split from AA LLP.
 - Approved by courts in August 2000.
 - AA LLP receives \$100 mm separation settlement, after turning down original \$1 B offer.
 - AA LLP Revenue goes from \$16.3 B to \$7.3 B.
 - This places a tremendous pressure on audit fees and remaining consulting services.
 - The increased pressure results in firmwide pressure to bend rules to retain key clients.



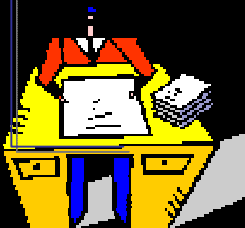
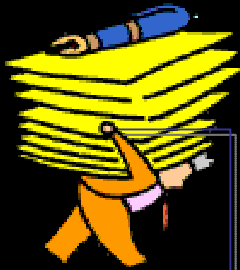
Arthur Andersen – What Happened?

- 2001: Enron.
 - Total breakdown of AA internal peer review processes.
 - AA did not appropriately address problems with Enron's accounting.
 - Not limited to Enron. AA has had problems with other clients as well.



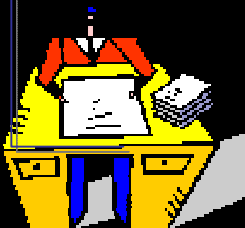
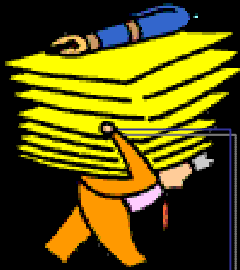
Actuarial Audit Assist

- Beginning in the 1980s, the actuarial profession gave a great deal of power with regard to insurance companies away to the accounting profession.
- Traditional audit in the 1990s - the actuary is working at the direction of the accounting partner to address areas where the accounting partner feels he does not have sufficient expertise.



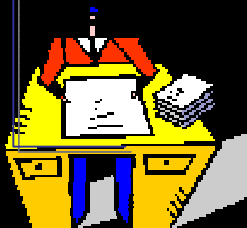
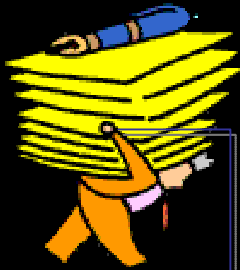
Actuarial Audit Assist

- The actuary reviews the detailed actuarial workpapers with regard to assembly of reserve, claim liabilities and DAC items in the financial statements. Recalculations on a sample basis are performed.
- Audit beginning in 2000:
 - Continued pressure on audit fees.
 - Continued increase in actuarial billing rates.



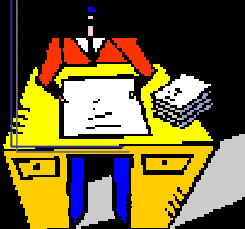
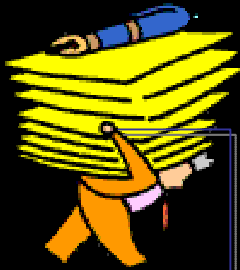
Actuarial Audit Assist

- Audit beginning in 2000:
 - Increased amounts of the company's actuarial work is done by computer systems and electronic interfaces instead of manual processing. The scope of the audit moves away from detailed testwork, with increased focus on procedures and controls in place at companies.



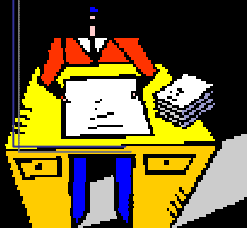
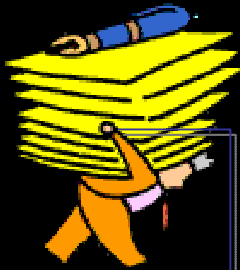
Actuarial Audit Assist

- Audit beginning in 2000:
 - The audit is more of a risk management exercise than a search for errors.
 - Unfortunately, much of actuarial science is focused on details. The tools actuaries use (or should use) to monitor their own work is detailed. Problems and errors are found through detailed examination of information.



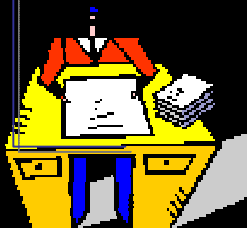
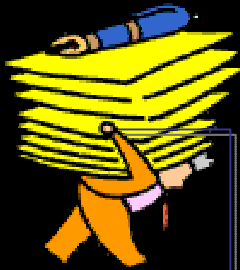
What is the Impact of Enron?

- Increased disclosure – Rules are changing such that details of business relationships and transactions must be very clear.
- Stricter independence rules – Rules are changing to restrict the kinds of activities a company can perform and still be considered independent for auditing.



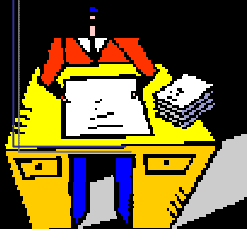
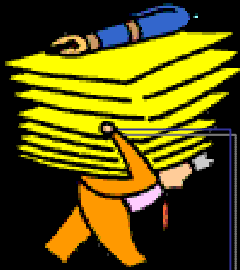
What is the Impact of Enron?

- Stricter independence rules – There will be a reduction in the type of consulting work an actuary can perform for a company if he/she is auditing the company, or if he/she is associated with the auditing firm.
- Use of a specialist – It is anticipated that stricter rules will define when a specialist (actuary) must be involved in an audit.



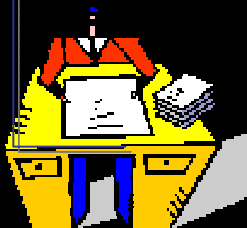
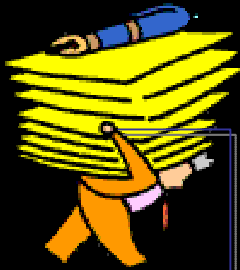
What is the Impact of Enron?

- Use of a specialist – The involvement of an actuary in certain situations will be mandatory. Areas that the actuary is used will no longer be at the judgment of the audit partner.
- Increased focus on role of the audit committee – Report issued by the Big Five accounting firms and the AICPA providing a “call to action.”



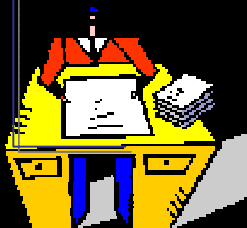
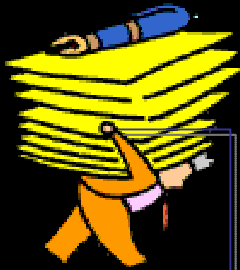
What is the Impact of Enron?

- Increased focus on role of the audit committee – Report included a list of ways to improve financial reporting. The desired goal is high quality, transparent financial reporting.
 - Evaluate management’s “tone from the top.”
 - Challenge management about uncorrected audit differences.



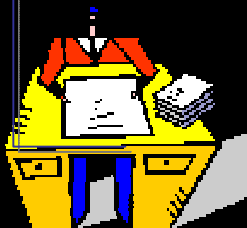
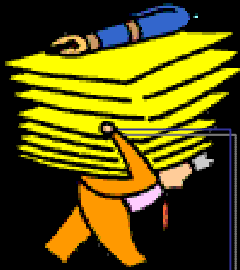
What is the Impact of Enron?

- Increased focus on role of the audit committee –
 - Understand related party transactions and disclosures.
 - Determine that users can understand financial statements and MD&A disclosures.
 - Ask auditors about pressure from management.



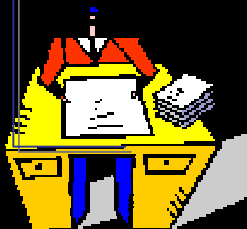
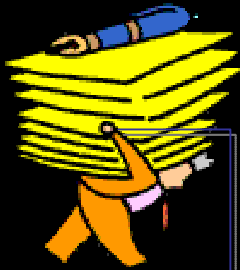
What is the Impact of Enron?

- Increased focus on role of the audit committee –
 - Challenge management and the auditors about:
 - Risks and risk of material misstatement.
 - Estimates and judgments.
 - Impact of changes in the business environment.



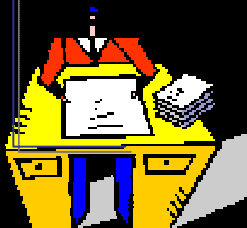
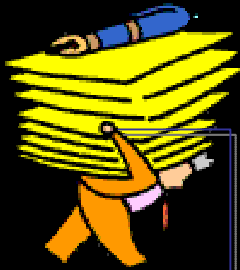
What is the Impact of Enron?

- Increased focus on role of the audit committee –
 - Challenge management and the auditors about:
 - Critical accounting principles.
 - Quality of financial reporting and disclosures.
 - “Gray” areas of accounting.



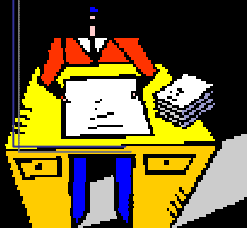
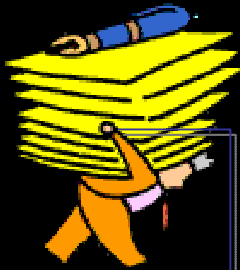
What is the Impact of Enron?

- New rules regarding audit committee membership:
 - Require at least 3 independent “financially literate” members.
 - One member must have financial expertise.
 - In response, many audit committees have initiated some form of self-evaluation, especially with regard to independence.



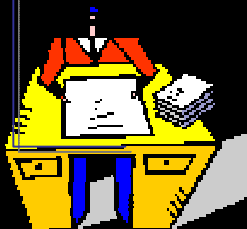
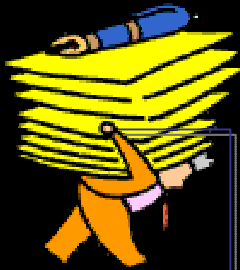
What is the Impact of Enron?

- Call to action report available on:
 - http://ftp.aicpa.org/public/download/news/risk_factor.doc
 - Or ...
 - <http://www.us.kpmg.com/microsite/auditcommittee/home.html>



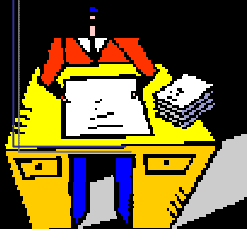
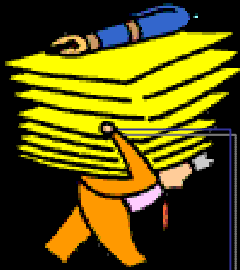
What is being done to be sure we are not an Enron?

- Common responses:
 - “We don’t back off the issues.”
 - Communication to management and the audit committee.
 - Confidence in the audit program currently in place.



What is being done to be sure we are not an Enron?

- My response to the actuaries:
 - What are you getting out of your audit?
 - *What do you want from your audit?*
 - Just looking for the signature? Or ...
 - Quality peer review:
 - Supplement internal analyticals and testwork.
 - Discussion of industry trends with someone who sees many companies.
 - With time pressures on actuaries daily, who doesn't need a second opinion?



What is being done to be sure we are not an Enron?

- My response to the actuaries:
 - We are the auditors, we are here to help.

