MARK PLAN AND EXAMINER'S COMMENTARY

The marking plan set out below was that used to mark this examination. Markers were encouraged to use discretion and to award partial marks where a point was either not explained fully or made by implication. More marks were available than could be awarded for each requirement. This allowed credit to be given for a variety of valid points that were made by candidates.

Question 1 – Mostly Chilled Insurance

General comments

The scenario was a UK-based general insurer, which specialised in insurance of road haulage vehicles and cold chain distribution in particular. The candidate was placed in the role of the audit senior for the first year audit. The insurance company was a relatively minor part of a road haulage group owned by an entrepreneur (Hermione DeVera). The previous auditor had resigned following concerns from Hermione that they were unable to provide some advice on the design of new underwriting systems.

The owner of the group of companies had set up her own insurance company after feeling that she was paying too much for insurance of her haulage fleet relative to claims made. Implicit in this was the fact that, as a non-insurance specialist, she would be comparing claims notified to date with premiums paid to date, rather than all incurred losses. In other words, claims IBNR and IBNER may be matters of which she was unaware.

The company was partially funded by redeemable preference shares that had been issued to Hermione a few years before. There was no statement of a preference dividend % (ie interest rate) on these redeemable preference shares. Rather, the redemption value was set to be the issue proceeds, adjusted for 80% of the movement in the FTSE 350 index between issue and redemption. Hermione had provided a letter of representation to the previous auditors stating that she "had no intention" of seeking redemption of the redeemable preference shares. On the basis of this letter of representation and considering her considerable personal wealth, the previous auditors had allowed classification of the redeemable preference shares as equity within the statement of financial position.

Requirement 1.1

There is no clear indication of whether MCI will want to understate or overstate profit. On one hand, the company is privately owned and is likely to want to minimise reported profit, as to do so would defer payments of tax.

Against this, there appears to be evidence that management of the company, and Hermione in particular, do not fully understand the nature of potential long-tail liabilities. Hermione set up MCI in the first place because she believed that premiums paid to her previous insurers were very high relative to the value of claims settled. This might indicate that she is not aware of how there may still be latent claims in those older policies where her haulage company had been the policyholder.

It probably seems sensible to test primarily for understatement of liabilities, but also pay attention to the possibility that insurance liabilities might be intentionally overstated in order to minimise reported profit and taxable profit.

All insurance liabilities are subject to a high level of estimation uncertainty. Intentionally or otherwise, they are generally at risk of being materially under- or overestimated. Indeed, it is general industry practice to allow some measure of deliberate over-reserving in the first few years of an insurance policy, with these over-reserves progressively reduced as the probability of claims being made reduces.

The specific characteristics of the three perils given might best be summarised in a table, as below:

	Claims notified, including IBNER	Claims IBNR
Affecting all three perils	It is likely that claimants will overstate the costs of repairs, or include non-insured items. This will cause over-estimation of case reserves. This may be due to fraud, or an expectation that	The key matter here is how probable it is that a peril includes potential long-tail elements. A long-tail claim is one where a loss has occurred, but has either not been noticed by the policyholder (the largest

	a loss adjuster will automatically reduce the value of a claim, so initial claims made might be overstated to allow for some bargaining down to a fair figure. MCI may fail to deduct policy excesses when determining the value of claims, especially if there are different policy excesses for different types of peril. There is a possibility of recognising a liability where premiums have not been kept up to date, so cover did not exist. This would overstate case reserves for claims notified. There may be higher claims handling costs where an accident occurs outside the UK than when it occurs in the UK. Insurance liabilities must include a neutral best estimate of unavoidable claims handling costs. Where claims are to be settled in a foreign currency, there will be an ongoing translation risk. For example, if a claim of €500,000 had been booked when the exchange rate was €1.32 per £, but the year-end exchange rate is nearer €1.1 per £, the correct £ value of the claim will be materially higher at the year end than the £ value initially booked. Losses incurred outside the UK are very likely to be subject to the jurisdiction of the legal system where the accident happened. These may have different attitudes to determining damages, eg they could routinely award higher punitive damages than the UK.	component of IBNR) or the claimant is aware but has not yet notified the insurer of the claim (a comparatively smaller component of IBNR). The three perils appear mostly to be short-tail in nature and so claims IBNR is probably less of a risk for MCI than for businesses that write more personal lines business.
Accident losses	Estimate of repairs is subject to estimation uncertainty. Initial estimates of repair costs may be deliberately low to attract repair work, so be understated. IBNER: Some perils (eg negligence) are likely to not be immediately apparent, but would be likely to increase damages substantially. Eg if trucks not properly maintained or inspected. If there is an element of negligence, this could result in unexpectedly high punitive damages.	There is likely to be little risk of accident loss claims not being reported to MCI by the cut-off date for determining insurance liabilities. By their nature, accidents are immediately apparent. Although there may be some short delay in reporting an accident to an insurer (eg due to a driver being outside the UK), in the modern world with smartphones, it is very unlikely that any significant accident will remain unreported for very long. Although a claim may not be reported to the insurer by midnight on 31 December 2017, it is very likely to have been reported shortly after the year-end, thus being an adjusting event after the reporting date in accordance with IAS 10. MCI is a privately-owned insurer and so is unlikely to be under pressure to report its results quickly and is likely only to report results in accordance with regulatory deadlines. There will therefore probably

		be a period of a few months during which incurred claims can be reported. Even if a claim is not filed completely (eg if it requires a foreign police report, which may be slow to obtain), the initial notification is likely to have happened. The greater reserving risk is therefore probably case reserves for claims notified and IBNER rather than pure claims IBNR.
Goods-in-transit	Valuing damaged or stolen goods-in-transit ought to be a fairly simple exercise, since it is very likely that there will be some documentation of what goods were loaded to what truck (eg a bill of lading). Determining a replacement cost for damaged or stolen goods should therefore be fairly straightforward.	If a truck is on long journey, it may take time to notice goods are missing. It is unlikely that such losses would remain unreported to MCI by the date MCI uses to cut-off claims reserving, however. Failure of cold chain may result in food being spoiled without being apparent, eg if temperature rose but then fell again.
Third party accident	Long-tail losses such as whiplash injuries, trauma, PTSD. In general, casualty elements are likely to be longer-tail, so under-reported.	Accidents outside the UK likely to be notified somewhat slower by claimants than accidents in the UK, as foreign claimants may be less familiar with UK legal system.

Examiner's comments

Most candidates produced marginal pass standard answers to this requirement. There were very few very good answers. Given the nature of the insurance industry and the nature of the paper, future candidates would do well to study the model answer to this question, as these are some issues that are likely to be future visitors to the BP:I examination. Identifying how a company may not have determined adequate case reserves for claims notified (ie claims IBNER) or may be wholly unaware of non-notified claims (ie claims IBNR) are central to understanding the key characteristics of the insurance industry.

A number of candidates elected to combine the two elements of this requirement, combining assessment of claims IBNER and claims IBNR. This almost always resulted in disappointing marks. Although related concepts, IBNER and IBNR are significantly different to each other and are best considered separately.

Some scripts earned strong marks with very concise answers. Indeed, it ought to have been possible to score near full marks with a fairly short 3x2 table (one row for each peril and two columns for IBNER and IBNR).

Only very limited marks were available for stating the definitions of IBNER and IBNR. Candidates are allowed to take any learning materials they wish into the BP:I examination and so the examiner is unlikely to award many marks for copying out from a study manual. The marks are invariably concentrated in the application of concepts to the facts of the scenario.

The best answers gave only very brief definitions of IBNER and IBNR (if any at all) and then broke this requirement into six elements, considering each in turn. As noted above, very few marks are available for copying definitions from the study materials. Sensible application of the concepts to the scenario provides the examiner with sufficient evidence that a candidate understands without having to copy out long text definitions.

The better scripts were able to give brief examples of the kinds of factors of the business that may cause final claims to be bigger than initially expected including such matters as:

- Transport of toxic chemicals, with potential long-tail pollution claims arising
- Spill of toxic chemicals possibly causing long-tail personal injury claims
- Latent claims arising from injury to drivers, eg whiplash
- Lack of familiarity with foreign jurisdictions, possibly resulting in higher than expected claims settlements or higher than expected claims handling costs
- Claims denominated in foreign currencies being subject to foreign currency movement risk
- The possibility of punitive damages if there is any suggestion of an accident being caused by negligence.

Many scripts seemed to be rather confused about the difference between claims IBNER, IBNR and normal cut-off. Although some credit was given for stating that a driver may not notify of a claim because they were outside the UK at the time of MCI's year-end, in practice, this is very unlikely to be a significant cause of claims IBNR. It is unlikely that a privately-owned company like MCI would report its results very shortly after the year-end. With any insurer, there is always a period after the year-end for identification of adjusting events after the reporting period.

There seemed to be some belief that if an insurer were not notified of a claim by precisely midnight at its year-end date, this would give rise to claims IBNR. In reality, the risk for claims IBNR arises because at the date when the financial statements are authorised for issue, loss events have not been notified to the insurer.

Most scripts that scored well on requirement 1.1 went on to produce very strong results over all other questions.

Maximum marks 1.1	12

Requirement 1.2

Matters include:

- Gilchrist only appears to audit MCI because of its involvement with other companies in Hermione's business empire.
- Their use of external actuaries is normal, but if this is very extensive, it may be that Gilchrist placed excessive reliance on third party experts.
- Clear error in misclassification of the loan from Hermione; both in classification and valuation. This brings Gilchrist's competence into question.
- Excessive, unjustifiable reliance on management representations in respect of the loan. Treating management representations as sufficient, appropriate evidence when this is clearly insufficient evidence.
- The lack of an in-house actuarial function suggests that Gilchrist may not have sufficient scale to have the skills necessary to audit an insurance company.
- Lack of insurance experience, evidenced by the inability to provide Hermione with the advisory work that she was seeking.
- Potential independence issues: they audit the rest of her companies, so could be subject to self-interest threat.
- Hermione's removal of Gilchrist as the auditor of MCI may suggest that she is a forceful character who provides an intimidation threat.
- Will need to be satisfied as to completeness and valuation of insurance liabilities brought forward, since this will directly affect current year profit. As it appears that GM has been rather "pushed out" by Hermione, they may be reluctant to provide us with access to their working papers. There is no ethical duty on them to provide us with access to their work.

Examiner's comments

The quality of answers to this question were also somewhat variable. The most common weakness was to interpret the question as asking for generic steps that will always be undertaken on the opening balances in a first-year engagement. These generic steps (sometimes copied out at considerable length) earned very few marks, since they unfortunately failed to answer the question set. Although not wrong, these answers were irrelevant.

A number of weaker scripts suggested that it was unprofessional to question the competence of a previous auditor, since they are also chartered accountants, or stated that it would always be appropriate to rely on the work of another chartered accountant.

Only a very few scripts picked up that the previous auditor had accepted a letter of representation as sufficient, appropriate evidence on which to conclude on the appropriate presentation of the redeemable preference shares that were then discussed further in requirement 3.

Although there is no formal prohibition on an audit firm taking on the audit of an insurance company if that audit firm does not have an in-house actuarial function, this would be unusual and likely to cause some concern to UK regulators including the PRA and the Financial Reporting Council. This was included in the pilot paper for BP:I and is in the Question Bank, so it was a little surprising how very few scripts picked up on the significance of this point, which was intentionally clear in the facts of the scenario.

In general, those candidates who recognised that the question was essentially ethics-based, requiring the incoming auditor to determine the competence and objectivity of the outgoing auditor performed well, sometimes with very brief answers.

Maximum marks 1.2	5

Requirement 1.3

It is appropriate to recognise a transaction as debt if there is an obligating event, an expected outflow of resources and if a reliable (meaningful) estimate can be made.

The existence of Hermione's right to require repayment means that an obligation exists. If Hermione requests repayment, the company probably has no choice other than to repay.

This would cause an outflow of funds.

The redeemable preference shares are thus a liability, rather than equity. Hermione's assertion that she does not intend to seek repayment does not remove the obligation. An intention does not override a legal obligation, though it might be sufficient to possibly override a constructive obligation. If Hermione, or her businesses, were to encounter future financial difficulties, it is likely that her intention not to seek repayment of the redeemable preference shares would change. To classify the amounts potentially repayable to her as anything other than debt would be to provide poor predictive value of the financial statements.

Having been identified as a liability, the next matter that arises is whether these should be shown as held-to-maturity, loans and receivables, or at fair value through profit or loss (FVTPL).

The treatment of held-to-maturity and loans and receivables is to value at amortised cost. Amortised cost requires a known date and value for both issue and redemption, in order to be able to assess the effective rate. As Hermione's loans are adjusted for 80% of the movement in the FTSE 350 since the money was advanced, this creates an unknowable redemption value in the future. Using the amortised cost approach is therefore impossible.

The loans will need to be revalued each period to show the cumulative return to date.

In effect, one might argue that this is an interest-free loan, with an embedded derivative of a FTSE 350 index future. This embedded derivative will need to be separated and shown at fair value through profit or loss. Derivatives, other than those held under a qualifying hedge, are always shown at FVTPL.

As the insurance company's assets are likely to be carried at fair value through profit or loss, recognition of either the entire loan at FVTPL, or the loan as interest free at amortised cost with an embedded derivative at FVTPL will remove an accounting mismatch. If the FTSE 350 index were to rise, the value of investments would rise and so would the value of Hermione's loan. To recognise the assets at FVTPL but the loan on some other basis would create an accounting mismatch.

The most appropriate presentation is therefore to recognise this as a current liability, since it is possible that the amount could be required to be repaid in less than one year, at FVTPL.

IFRS 9

If MCI were to report under IFRS 9 (this is unlikely, as few insurance companies have elected to adopt IFRS 9 early and the use of IAS 39 or IFRS 9 is unstated in the question), the transaction would still be classified as a loan, for the reasons noted above.

IFRS 9 does not require separating out of embedded derivatives from host contracts, but rather would require the entire financial instrument to be shown at fair value. By default, this would be at fair value through profit or loss.

The use of the amortised cost method would be impossible, for the reasons noted with IAS 39.

Examiner's comments

There were some strong answers to this question, though most fell into a pattern of writing all there is to be said generally about the categories of financial instrument, without careful application to the scenario.

The key issue in the classification was whether an obligation existed. If so, the redeemable preference shares must be classified as a loan. A large number of candidates attempted to argue that the redeemable preference shares were a convertible, which was an understandable avenue to explore, but unsupported by the facts in the question.

It was very disappointing to see how few candidates adequately addressed the issue of Hermione's stated intention not to seek repayment of a loan. Not intending to seek repayment is a statement of intent that is far from certain to extinguish a legal liability. Had her other businesses run into trouble, it is likely that she would seek repayment of the money advanced to MCI. No candidates addressed the issue of what the core purpose of reporting is: to give relevant and reliable information to users of financial statements. It would have been misleading to provide information to the PRA that classified a transaction that is likely to represent a liability as equity.

Candidates were awarded marks for the thoroughness of their analysis, rather than the conclusion reached. It was possible for candidates to reach a different conclusion to the one intended, yet still score well, so long as the conclusions reached followed from the stated logic and so long as that stated logic was appropriately linked to the accounting standard.

Many candidates stated that the classification of a liability depends on whether interest payments are compulsory. This was a curious argument, since interest-free loans are clearly loans. Similarly, in UK law, any preference share only has an obligation to pay preference dividends if an ordinary dividend has been declared. Although candidates who pursued this line of argument generally scored some marks because their argument peripherally brought in other issues such as the existence of an obligation to repay the loan principal, it was not possible to give it many marks, since it is technically incorrect. Perhaps that this may have arisen from incorrectly adopting the accounting bifurcation of convertible bonds into liability and equity elements.

The redemption value of the interest-free loan was stated to be linked to the movement in the FTSE 350 index. Accordingly, the amortised cost treatment of the whole transaction would be impossible. Under IAS 39, the most appropriate treatment would be to show the underlying loan at amortised cost, with the FTSE 350 adjustment shown as an embedded derivative at fair value through profit or loss. However, if the entire loan were to be shown at fair value (ie recalculated redemption value) the financial statements would be the same as if it had been bifurcated into amortised cost (loans and receivables) element and derivative element. No candidate considered this practical matter.

There was an argument for treating the loan at fair value through profit or loss because an increase in any equity investments held for trading would be partially matched by an increase in the redemption value of the redeemable preference shares. Classification at fair value through profit or loss could therefore partially avoid an accounting mismatch. Few candidates appeared to appreciate this point and those who did tended to give the impression that they stated the phrase "asset-liability matching" frequently in the hope that it might be relevant. Accordingly, few candidates were given many marks for this point.

The potential to answer under IFRS 9 was answered well in some cases, though there was much irrelevant explanation of the treatment of fair value changes arising from own credit risk changes in other comprehensive income. This was irrelevant to the question. Inclusion of large amounts of irrelevant information tends to suggest that such candidates do not really understand, and are instead widely scoping their answers in the hope of finding relevance.

Maximum marks 1.3	9

Requirement 1.4

Audit procedures may include:

- Review premium records and agree to sample of underlying contracts.
- Document reinsurance arrangements and confirm premium ceded against related reinsurance contracts.
- Sample test cancelled contracts and confirm related adjustments to premium income.

- Verify sample of premium adjustments recorded in the system against submissions by policyholders.
- Perform analytical procedures on premium income total considering number of policies written, types of business covered, average premium rates in the industry (benchmark against competitors).
- Inspect a sample of policy renewals for any significant changes in declared risks. These are likely to have existed before the year-end date and so should have been subject to a positive premium adjustment.
- Recalculate a sample of premium adjustments to ensure that they have been correctly calculated, in accordance with the terms of the policy.
- Inspect underlying source documentation (eg vehicle mileage records from government safety inspection records) to verify data used in the adjustment premium sample recalculations.

Examiner's comments

This was generally answered well, with many candidates earning good marks. Where a script earned a disappointing mark for this requirement, this was almost always caused by one of the following factors:

- Writing long answers (which often appeared to have been copied from learning materials, as rather generic in nature) that mostly related to the claims cycle rather then premium cycle. Audit procedures that did not relate to premiums earned no marks.
- Providing vague answers, such as "consider the adequacy of the premiums handling system". This is so high level and obvious that it could not be given more than nominal marks.
- Confusing audit procedures with assertions or audit objectives. For example: "we will need to ensure appropriate year-end cut-off" is not an audit procedure and accordingly cannot earn marks.
- Use of vague terminology, such as "check", "consider", "determine". These are intrinsically vague and seldom provide the examiner with sufficient, appropriate evidence that a candidate really would know what to do in order to obtain evidence on the appropriateness of the premiums figure in the financial statements. Where candidates used the verbs given in ISA 500 as means of obtaining evidence (eg "recalculate"), these answers were briefer, clearer and so scored higher marks.
- A repeated step of "discuss with management". Discussion with management is weak evidence and is mostly used at the planning stage of an audit to determine how a system works and where the errors are most likely to occur. A candidate who presents a list of questions to ask management would not generate sufficient, appropriate evidence on which to base an audit conclusion, so this cannot obtain a pass mark without a range of other more reliable audit procedures as well.

There remains a surprisingly high level of confusion about the difference between a walk-through test and a test of controls.

Maximum marks 1.4	9

Requirement 1.5

Questions asked will need to provide underwriting data that will allow underwriters to make an informed estimate about the risks typically taken over the coming year of the policy. As this is a business-to-business contract, the terms of the Insurance Act 2015 will apply, rather than CIDRA 2012, which only applies to consumer contracts.

Questions might include:

- Frequency of transport outside UK - longer journeys; may result in additional rescue/recovery/repair costs in the event of vehicle failure.
- Nature of goods being transported – safety around hazardous materials might be higher, but so to would be the financial effect of an insured event, e.g. clean up costs associated with spilled toxic substances.
- Experience of/changes to driving team – more experience may indicate lower risk.
- Any significant change of business intention – e.g. new products to be carried; new geographical locations for delivery.
- Covered events that occurred in the period but for which no claim was made (if any) – frequent minor events not claimed may indicate higher risk.

Examiner's comments

This was very well answered, with the majority of candidates obtaining full marks. The most common

cause of failing to earn full marks was asking questions that would be specific to a particular journey rather than recurring elements of underwriting risk that would cover a full year (eg maintenance arrangements, restrictions on who could drive). Although some credit was given for asking if there would be any private use of vehicles, this suggested question did not earn full marks, as it was not clear how this would significantly change underwriting risk. There are also probably rather few situations where an articulated lorry is used to make a personal trip, so was perhaps a little naïve and maybe owed more to personal familiarity of what questions insurers ask when proposing motor insurance rather than being specifically related to the scenario. Candidates were provided with a headroom marks for acknowledging that the questions asked must fit within legislative requirements. As the contracts were likely to be business-to-business contracts, the most appropriate legislation to consider would have been the Insurance Act 2015, but candidates were given a half headroom mark for meaningful mention of CIDRA 2012.	
Maximum marks 1.5	5
Maximum marks – question 1	40

Question 2 – Tremendous Insurance

General comments

The candidate is placed in the role of an in-house accountant working for a UK-based general insurer.

The company is considering a change in investment policy to invest in higher risk and return investments, away from the existing portfolio of exclusively bank and term deposits.

It is also considering entering a new line of business – underwriting cyber risks. This is a very different area of risk compared with its current base of motor insurance. There is also very limited data available in the market for cyber risks.

The company follows IAS 39 but is considering early adoption of IFRS 9.

Two types of investment are to be purchased: short-dated gilts to meet immediate liquidity needs at maturity and UK corporate bonds; the latter under two separate investment guidelines: one portfolio for intermediate term holding with the possibility of sale and the second for trading/ arbitrage purposes.

Three short exhibits were provided, giving outline details of:

- The proposed change to investment guidelines and new investments
- The proposed move into cyber-insurance, and
- Consideration of changes to IFRS 9, with a hint that this would be decided by which would optimise solvency ratios.

Requirement 2.1a

Underwriting risk – high due to:

- Cyber-crime is a relatively new phenomenon, therefore there is a lack of historic, or even current, loss data on which to estimate risk.
- TI does not have experience of this area of risk and is likely to lack underwriters with expertise in this area.
- The threat from cybercrime is subject to rapid change as new technologies develop and criminals employ new tactics.
- The risk from cyber-crime is likely to grow in the future although this is highly difficult to predict with any accuracy.

Reserving risk – accurate estimation of liability difficult due to:

- Again the absence of historic data means that it will be difficult to establish appropriate case reserves in response to claims.
- TI may lack the expertise and systems to effectively reserve for claims received.
- Cyber-insurance losses may not be immediately apparent and the extent of harm may not be immediately apparent. Therefore losses may be long tail with a long emergence period (IBNR) and significant potential for claim development (IBNER).

Claim risk – claims may be unexpectedly high, dependent on nature of cover, high losses may threaten profitability and could even threaten solvency:

- Cyber-insurance losses could be very high and go beyond damage to the insured's IT systems or data. Cyber-criminals may be able to access the business's bank accounts or may demand a ransom to unlock systems and data.
- If covered in the policy substantial claims could result from business and/or reputational damage as a consequence of cyber-crime.
- Potential for third party cover for losses by customers and other parties could be very high.

Requirement 2.1b

- Limitations and mitigations
- Price premiums high, in order to recognise the element of uncertainty as well as risk.
- Employ experienced staff and underwriters, potentially from other more established companies that have some experience of cyber-insurance claims.
- Buy relevant data from a reliable source. However, this may be difficult to obtain and may be expensive.
- Agree to share claims data with rival companies that also are entering the cyber-insurance market.
- Ensure that policies include carefully worded scope of cover and exclusions. Ensure these are explained clearly to policyholders.
- Reduce the risk at the client, eg by providing advice on cyber-security methods. This should reduce the risk of claims and the potential size of any claims made.
- Reinsure the risks assumed, though this may be difficult to obtain as reinsurers are also subject to the same characteristics of business uncertainty. Could consider:
  - Excess of loss (XL) cover
  - Stop loss cover, though this may be prohibitively expensive and/or difficult to obtain.
- A form of facultative (rather than treaty) reinsurance may be the most appropriate response to the policies written.
- Co-insure the risks with other insurance companies. This would increase the capacity to write larger risks, as the risk would be shared with other companies.
- Simply delay entry to this market until the risks are better understood.

Examiner's comments

Both elements of requirement 2.1 were generally answered well. Where there were weaknesses in the answers to requirement 2.1a, these tended to be:

- Long, generic explanations of what cybercrime was, without much application to the scenario of what new underwriting risks these exposed the company to.
- Considerable discussion about the need for the insurer to comply with new data protection laws. This would be an obligation even with the existing policy lines, so this did not fully answer the question set.

Many candidates scored well on requirement 2.1b, sometimes taking an effective columnar presentation to the two linked requirements of 2.1. As is often the case, some of the briefest answers scored the highest marks, since they directly addressed the requirements.

The strongest scripts not only considered risk mitigation strategies such as reinsurance, but went on to consider the commercial benefits and limitations of stop loss cover, excess of loss cover, etc. Only the strongest scripts observed that the process of taking out reinsurance may provide a source of underwriting data to the company, since specialist reinsurers were likely to have experience of writing this line of business.

Surprisingly few candidates identified risk reduction techniques at the policyholder level as a way to minimise risk to the insurer. Insurers of specialist risks are often a source of advice and basic consulting to policyholders, with the joint aim of reducing overall levels of risk.

Maximum marks 2.1	14

Requirement 2.2

Previously the only financial assets held were cash and fixed term bank deposits. Fixed term bank deposits would be classified under IAS39 as loans and receivables from TI's perspective and as a consequence be carried at amortised cost.

In order to hold the additional categories of assets under the new investment policy at amortised cost they would need to be classified under IAS39 as held-to-maturity financial assets.

The criteria for HTM is a non-derivative, financial asset with fixed or determinable payments and fixed maturity which the entity has the positive intention and ability to hold to maturity.

Considering the appropriateness of this classification to each element of the new investment policy in turn.

Gilts – satisfy the criteria for classification as HTM since gilts are very liquid and TI intends to purchase short-dated gilts and use redemption proceeds at maturity to meet cash outflows. It is quite possible for an investment to be held-to-maturity where the maturity date is a date in the near future.

Corporate bonds – first investment guideline

This portfolio could also possibly satisfy the criteria for HTM. However, TI intends to use this portfolio as source of liquidity if it faces unexpected losses. This would involve selling bonds prior to maturity and could lead to the operation of the tainting rules of IAS39.

Tainting describes the impact of a disposal or reclassification of a held-to-maturity investment before maturity on the remainder of financial assets classified in this way.

If TI were to sell significant amounts of corporate bonds classified as held-to-maturity it would be required to reclassify the remaining HTM investments to available-for-sale and it would be prohibited from classifying any investments as held-to-maturity for two financial years following.

Although this penalty would not apply if the sale were the result of an event beyond the TI's control which could not reasonably have been anticipated. This may be difficult to assert if TI plans from the outset to use this portfolio as a source of liquidity. This exemption only appears to have been intended to apply briefly in special circumstances around the Global Financial Crisis of 2008.

Given the portfolio's specified usage as a possible source of liquidity it may be more appropriate to classify as available-for-sale thus avoiding the potential application of the tainting rules.

Corporate bonds - second investment guideline

This is a portfolio designed to take advantage of arbitrage opportunities. As such, it is highly likely that it will involve active buying and selling of bonds prior to maturity. As such, the financial investments it contains would not satisfy the definition of HTM and would instead be classified as held-for-trading and recognised at fair value through profit or loss.

This would lead to the total return on the portfolio, including changes in FV, being recognised in profit or loss which is consistent with the objectives of this mandate and the way the portfolio will be managed.

<u>IFRS 9</u>
In contrast to the rules-based approach of IAS 39, IFRS 9 has a principles-based approach to the classification of financial assets. IFRS 9 focuses on the business model within which the asset is held and the cash flow characteristics of the asset.

Assets can only be held at amortised cost if the objective of the business model within which the asset is held is to hold assets in order to collect their contractual cash flows and where the contractual terms of the financial asset give rise, on specified dates, to cash flows that are solely payments of principal and interest on the principal amount outstanding. These criteria would be applicable to the gilt holdings under the new investment policy.

The corporate bonds held under investment guideline 1 could also be held at amortised cost since, under IFRS 9, disposals prior to maturity in order to meet unexpected liquidity needs would not conflict with the business model criteria. This is the case even if those disposals are significant, provided that they are infrequent, which is likely from the information provided. (If disposals were expected to be frequent then it would be more appropriate to classify as fair value through other comprehensive income). Thus, there is no issue of tainting. A final determination of the applicability of this treatment would depend on factors including the way in which the bonds are managed and the manner in which the managers of the portfolio are remunerated and their performance evaluated. To be eligible for classification as amortised cost these factors should be related to contractual cash flows rather than gains on disposal and/or fair value.

In respect of the second investment guideline, the business model is clearly not solely to collect contractual cash flows and given its objectives would encompass frequent buying and selling. This mandate is essentially a trading portfolio and the managers would likely be monitored and remunerated based on the change in the fair value of that portfolio. These factors suggest that under IFRS 9 the bonds held under this mandate would be classified as fair value through profit and loss.

IFRS 9 overall appears unlikely to have a major impact on the above investments held by TI.

Ethical issues raised
The treatment of financial assets should be in accordance with relevant International Financial Reporting Standard(s) and should fairly reflect the commercial substance of the purpose for which they are held. Bill's final sentence implies that his decision on how to classify financial assets will be, at least partly, based on the objective of maximising TI's reported solvency. This would be unethical and would also be likely to conflict with the directors' duty under the UK Corporate Governance Code to present a fair, balanced and understandable assessment of the company's position in the financial statements.

The information contained in the financial statements is also used as a source for establishing an insurer's solvency under the provisions of the Solvency II Directive. The objective of this is to protect policyholders and other stakeholders from the risk of an insurer's financial collapse.

If Bill were to determine the classifications for financial assets in order to flatter the company's profits and assets it would increase its apparent solvency. This would frustrate the objectives of Solvency II and could thus be considered unethical for this reason. It is entirely acceptable to choose a new accounting policy that happens to increase profit or solvency if this improvement happens as part of a bigger picture to choose accounting policies that provide the most true and fair view possible. If the motive in selecting a new accounting policy is solely to improve profit or reported solvency, this amounts to creative accounting and is both unethical and probably unlawful.

Jane is a member of ICAEW and therefore is required to meet the requirements of the ICAEW Code of Ethics. Were she to assist Bill in selecting the classification of financial investments to maximise reported solvency she would be complicit in this action. This would be likely to breach her ethical duties of integrity and objectivity contained in the Code.

Jane's actions should be proportionate to the situation. A sensible first option would be to raise the matter directly with Bill and clarify exactly what he meant by the last sentence in his email.

If, after this, Jane is still concerned she could escalate the matter internally. Given Bill's position it may be desirable to use TI's internal whistle-blowing procedures which would specify the person with whom to raise concerns and provide confidentiality and protection from reprisal for the whistleblower.

Should Jane still not be satisfied with TI's response and have serious concerns about the potential for the financial statements and reported solvency to be distorted she would have the option to whistleblow to relevant external parties. If she were to take this action she would be protected by the Public Interest Disclosure Act 1998. This act provides that a person making disclosure in good faith to a "prescribed person', (which includes both the PRA and the Financial Reporting Council), of a matter which is in the public interest is protected from any disciplinary or other negative action by their employer in relation to whom they have blown the whistle.

Jane may be wise to get advice, particularly before taking this last course of action. She could seek initial advice on this matter from the ICAEW ethics helpline.

Examiner's comments

Requirement 2.2 mostly tested an ability to apply knowledge to financial instruments and ethics. It was generally answered well, though few candidates managed to make their answers insurance-specific (eg explaining why amortised cost may create an accounting mismatch when assets are held to fund longer-term liabilities). Statements such as "this creates an asset-liability mismatch" cannot earn nearly as many marks as "this creates an asset-liability mismatch because…", as the latter demonstrates understanding and an ability to apply knowledge and identify causality. Candidates who mentioned asset-liability mismatching as an issue for each classification of investments, without explaining why, were not awarded many marks, since it could be inferred that this was an attempt to speculate with unexplained technical terms.

As with question 1, candidates were given credit for sensible arguments, rather than having to reach a single correct answer. Many candidates lost time copying out long descriptions of what amortised cost means, without then immediately applying these definitions (which could have been very short) to the facts of the scenario in order to determine an appropriate presentation.

A pleasingly high proportion of candidates were able to identify the risk of falling foul of the “tainting rules” of IAS 39 should a portfolio of assets be classified as held-to-maturity but then sold materially before the maturity date. A very few were also able to mention that the company would be unlikely to benefit from the exemptions from the tainting rules, which only really applied to forced sales during the Global Financial Crisis.

The IFRS 9 element was answered pleasingly well by most candidates, with many justifiably reaching the conclusion that IFRS 9 would be unlikely to make a great difference to most of the investments given, with the possible exception of the bonds held to collect or sell and the disappearance of the risk of the tainting rules affecting the company, since they do not exist in IFRS 9.

The most persistent weakness in the answers to the IFRS 9 elements were for candidates to write about the impact of own credit risk and the requirement of IFRS 9 that fair value changes arising from changes in own credit risk be reported in other comprehensive income. This was not wrong, but was irrelevant as there was no suggestion that own credit risk was an issue, nor that Tremendous was the issuer of any financial liability. Writing lots of irrelevant material loses time and contributes to an impression that a candidate is providing a reflex response to trigger words (eg “IFRS 9”) with limited understanding.

The ethics element of requirement 2.2 was generally well answered. The best answers tended to start with a statement of what the purpose of financial reporting was and then went on effectively to question if the proposed change in accounting policy would provide users with more relevant and/or reliable information.

Stronger scripts also tended to consider the proportionality of proposed responses, such as stating that although whistleblowing should not be ruled out, it should be treated as a last option only to be used when all internal solutions had been exhausted.

The weaker scripts tended to:

- Include unnecessary definitions of the different types of threat to independence.
- Assume that the question was based around the scenario of being an external auditor, when it stated that the candidate was an in-house accountant. Consideration of such matters as ISA 260 could not therefore be given marks.
- An over-eagerness to suggest calling the ICAEW helpline. This is only ever worth nominal marks and tends to give an impression of weakness when it is listed as the first response to any ethical dilemma.

Maximum marks 2.2	16
Maximum marks – question 2	30

Question 3 – Everidge Life Assurance & Pensions plc (ELAP)

General comments

The final question was based around a UK-based life insurer. The company reported under both IFRS and provided voluntary financial information under market consistent embedded values (MCEV).

The company sold a mix of individual and group plans, with a current opportunity to bid for a large group policy that the information suggested was tendered by the sponsoring employer ("LQG") once every five years.

Following an aborted attempt to diversify into Slovakia, the company had also sold its one non-UK investment property in the period for materially lower than its latest fair value in the financial statements. Although generating a profit on disposal, the sales proceeds had been 14% lower than the most recently determined fair value.

Requirement 3.1

Investment properties held at fair value are given a fair value in accordance with IFRS 13. IFRS 13's hierarchy of fair values must be used, meaning that where a Level 1 fair value exists (market value for an identical asset), it must be used. If it is not possible to determine a Level 1 fair value, then a Level 2 fair value must be used (fair value of a similar asset, adjusted for differences in the asset's characteristic). Only if no Level 1 or Level 2 fair value exists can a Level 3 fair value can be used; being a subjective valuation such as discounted cash flow.

Reasons why the auditor may have agreed a fair value 14% higher than eventual sales proceeds might include:

- The auditor may simply have been negligent in their work, failing to obtain sufficient, appropriate evidence on which to base an opinion as to the fair value of the property.
- Any non-remote possible error in fair valuation of the property may have been significantly below the auditor's materiality and/or performance materiality figure, meaning that the auditor may legitimately not have performed much work on the fair value of the property.
- Sales proceeds are fair value less costs to sell, not just fair value. Costs of selling will be significant, though they are unlikely to be as high as 14% of selling price.
- Translation into pounds from euro may account for part of the difference. There may have been exchange rate instability with the sales proceeds not hedged between the date of the valuation and the date of the translation of the transaction into pound.
- Unique properties, so likely to be IFRS 13 level 2 or level 3, rather than level 1 fair values. This creates a high level of estimation uncertainty, so the difference may be within tolerable range of expected error.
- The property used to determine the fair value may have been more different than originally expected to the asset disposed of, meaning that a Level 2 fair value adjustment from Level 1 would have been done inaccurately.
- The property market for commercial properties may be volatile, as sensitive to under- or over-supply. Even small time differences may be significant. The latest fair valuation is nearly a year out of date.
- The external auditors are likely to have engaged the services of a local expert. Although they will have been satisfied about the expert's credentials, it's likely not to have been their own judgement what the valuation was.
- It is very probable that the difference of 14% will have been caused by a number of the above factors acting together, rather than any one in isolation.

<u>Alternative methods</u>
As noted above, if a suitable proxy asset is not available upon which to base a Level 2 fair value, then Level 3 methodologies must be used. These are likely to use fundamental valuation techniques (discounted cash flows) or some market based approach (eg rental yields). A combination of methods may be used to determine a single point estimate of fair value within a viable range of likely values.

As fair value is defined as the price for which an asset will be sold, market-based methods are likely to give a fairer estimate of "exit value" for any asset, even if the company has no immediate intention to sell that asset. For example, if similar commercial properties in Slovakia were yielding a return of 7% (net rental income/ fair value x 100), then this could be used to work back to fair value if rentals were known, as:

Rental x 100/7 = Fair value.

Discounted cash flows could be used to determine fair values. If so, these must consider the best alternative use of the asset (though a shopping centre is likely to have only one use), discounted at a suitable discount rate that uses the same assumptions as the estimated cash flows. For example, if the estimates of future cash flows do not include expected inflation (are “real” cash flows), then these must be discounted using a cost of capital/ discount rate that also excludes inflation (a “real” discount rate).

It is possible to show investment properties using the depreciated historical cost method, thus treating them similarly to property, plant and equipment. This would be unlikely to show a true and fair view of the assets available to the company, as evidenced by the fact that the property was sold for a value significantly higher than its historical cost. Depreciated historical cost is seldom used by insurance companies.

Examiner’s comments

Answers to requirement 3.1 were somewhat variable, with some excellent answers but others that seemed not to have sufficient technical knowledge to see what the reasons might be, thus struggling to provide possible reasons. The strongest answers tended to start with a very brief definition of what comprises fair value, then considered how each of the different elements might not have been followed (eg non-orderly rushed transaction, non-knowledgeable market participants). As always, the greatest marks were to be found in the application of knowledge but those who started with a summary definition were able to use this definition as a structure for their subsequent analysis.

Pleasingly, almost all candidates were able to identify that fair value does not mean fair value less costs to sell, thus meaning that the difference may simply be a difference between fair value and net realisable value. The strongest scripts invariably followed this observation with a comment that 14% of sales price appears to be rather high to be sales commissions and so this would probably only be one element of the difference.

Perhaps surprisingly, no candidate mentioned that one possible reason might simply be that the auditor’s work on this area had not been adequate, nor that the difference between net sales proceeds and fair value may have been within the auditor’s level of materiality or performance materiality.

The best answers to the second element of requirement 3.1 were able to identify the possibility of using depreciated historical cost for investment properties, whilst also noting that this would be unusual for insurance companies and would probably fail to provide fully useful information, including information that would be useful to regulators.

Maximum marks 3.1	12

Requirement 3.2

Pricing

Pricing is likely to be easier for group policies provided detail about the group are available. With large numbers, the group of insured persons should behave more predictably than individual insured risks.

This can somewhat reduce underwriting risk and so result in lower premium rates per person insured.

The group has significant market power and is willing to shop around periodically, as evidenced by how ELAP last bid for the group contract five years ago. This will tend to reduce premiums per insured person, by simple supply and demand factors.

The costs of acquiring business are likely to be lower per insured person with a group policy than for individuals, since commissions will not be paid to intermediaries, there will be no advertising costs, etc. This would allow a saving per insured person that ELAP could pass on, making premiums per insured person lower than for individual policies.

Persistency

- As evidenced by the five-year tender, although a large amount of business may be acquired quickly, it could also be lost equally quickly. ELAP may not have time to reduce its own cost base in an orderly fashion if this were to happen, resulting in losses.
- Individuals tend to be less informed about financial products available to them than managers of group policies are. They also have limited time to shop around for the best deal. This means that individual policyholders are generally seen to have high persistency (low persistency risk).
- Persistency should be assumed to be lower for a group policy than for an individual policy therefore (ie persistency risk if likely to be higher for a group policy).

Claims handling costs

- Claims handling costs likely to be more predictable for a group – should be an expectation of a certain minimum number of claims in the period. For individual policies this may be more difficult to predict.
- Claims handling services may also be specified in the group policy agreement in some instances, with some initial claims handling possibly being done by the employer, so reducing claims handling costs for ELAP.
- There may be some economies of scale that might reduce claims handling costs per insured person.
- Ultimately, although the group of policies might be sold together and so premiums treated as a portfolio, within that group, each individual policyholder is unique and so each claim will be unique. Each claim will require individual investigation. The scope to reduce claims handling costs as part of a group policy may therefore not be very high.

Examiner's comments

Requirement 3.2 was generally answered well. Although in practice, it is virtually certain that group policies would be priced lower per insured person than an individual policy, candidates were given good marks for valid reasons why the opposite might be true (eg having access to underwriting data about individuals and so not taking a sort of portfolio risk).

As the scenario hinted that the group policy in question had last been available for ELAP to bid five years ago, candidates who argued that persistency risk was higher for individual policies than for group policies struggled to obtain full marks for that statement.

Candidates were given full credit for considering what factors might affect claims handling costs, and full marks for a conclusion so long as that conclusion flowed from their sensible arguments. The strongest scripts observed that although a group policy is likely to be negotiated with a bulk discount on premiums, each claim is still a claim relating to an individual, so claims handling costs are likely to be similar to the claims handling costs of an individual policy.

Maximum marks 3.2	8

Requirement 3.3 (a)

Contribution from policies written in the year

- A shift of business to group plans means that proportion of new business from new group policies may be expected to increase.
- Group policies may be priced more aggressively than individual policies and so although the total may be likely to increase, the profit embedded value of the policy per insured person would be likely to decrease.
- The effect on MCEV profit will therefore depend on the absolute size of new group policies written, as profit per insured person may be somewhat lower, but a very large group policy can still generate a substantial profit in absolute terms, despite low "unit" profitability.

Contribution from policies in-force at 1 January

- Policies in force at 1 January will not be affected by the change, as their expected lifetime cash flows would be unlikely to be affected by the new group policies written.

Operating experience variances and effect of assumption changes

- If group plans are more predictable, volatility in experience should reduce, thereby reducing experience adjustments.
- Group policies are likely to be subject to higher persistency risk. This may increase the volatility of profit in future years.
- Claims handling costs per policy may reduce, as noted above.
- The appropriate discount rate might also change (eg more group policies might be seen to reduce overall company risk and so reduce discount rates).
- The effect will be difficult to predict, but changing the mix between group and individual policies is likely to result in more assumption changes (forward looking) than experience variances (backward looking).

Requirement 3.3 (b)

The MCEV performance could be expected to be better than the reported performance under IFRS.

When a new long-term policy with a life element is underwritten, the insurer is exposed to the mortality risk for the duration of that policy, such as a risk that the policyholder will die within the next 20 years. Even at present values, this liability exceeds the amount of premiums received. This means that IFRS policies initially report a loss.

As time progresses, the probability of a person dying reduces, but the cumulative premiums (or funds under management, if also including a deposit element) increase. This means that the profitability under IFRS is recognised towards the expiry date of a long-term policy rather than towards the inception of the policy.

MCEV profit would be expected to be higher than profit based on IFRS 4.

This is not driven so much by the shift in balance between group and individual plans, but rather a reflection of what can be expected to happen when any life insurer is expanding.

Requirement 3.3 (c)

This depends on the effect of the items in 3.3 (a) above and the relative significance of each element.

Profit (and MCEV) per policyholder/ insured person can probably be reasonably assumed to be lower than for an individual, simply due to the ability for a group policy to negotiate a better deal for policyholders in a collective policy.

So, a shift towards more group plans is likely to result in a lower overall profit. Given the potentially higher persistency risks of group plans, this may also increase commercial risk. Group policies may therefore primarily be attractive because of their large size and ability to acquire a lot of new business quickly, with lower business acquisition costs.

Examiner's comments

Despite being the last part of the exam answered by most candidates, and so subject to risks arising from time misallocation, this was answered well. The technical content of this area is challenging, but good knowledge of the basics enabled candidates to score well. Most candidates were able to provide convincing evidence that they understood how IFRS 4 measures tend to under-report the profit on a new long-term policy in its early years.

Many candidates were able to give very justifiable answers that taking on a new group policy would not affect the value of in-force business brought forward, nor necessarily result in any experience adjustments. It takes a certain courage and depth of understanding to feel sufficiently confident to say: "this would not be affected because…" and those who did this generally were able to score very strong marks on this question.

Maximum marks 3.3	10
Maximum marks – question 3	30
Maximum marks – entire examination paper	100