

MARK PLAN AND EXAMINER'S COMMENTARY

The marking plan set out below was that used to mark this question. 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 which were made by candidates.

Question 1**Total Marks: 40****General comments**

The candidate is placed in the role of an ICAEW Chartered Accountant working in strategic planning at Bonelli Bank LLP. There are two main areas of focus:

1. One of Bonelli's trading desks, the fixed income, currency and commodity (FICC) trading desk, has performed poorly and the board is proposing a new strategy to use automated trading and to target more straightforward products.
2. There is a potential divestment of the structured products division. This has been suggested because of bank ring-fencing rules coming into force on 1 January 2019.

There are two audit issues arising from a skilled person report carried out by Gisela LLP because of the ring-fencing restructuring. Ethical issues arise because of a personal relationship between the audit committee chair and a partner at Gisela LLP.

1.1**FICC trading desk****Operational risks**

Additional staff are needed to maintain algorithms for automated trading. These members of staff must have sufficient IT and technical knowledge to perform the role and it may be difficult to find sufficient numbers of suitable candidates. However, there will be fewer traders needed to execute routine trades so there will be some offset from a risk perspective.

There is a risk that the algorithms will not capture changes in market dynamics. There is risk of cybercrime and external attacks influencing the behaviour of the algorithm.

If certain clients are permitted to initiate foreign exchange trades and Bonelli will support end to end processing, new risk management systems infrastructure will be required. Also, Bonelli will need to ensure clients meet the risk criteria before being allowed to initiate automated trading and that limits and monitoring are in place.

Risk management processes must be updated to reflect the specific risks of electronic and automated trading such as manual overrides and data collection for risk monitoring. Data protection law must be adhered to.

Back office operations must be capable of processing increased volumes of new business.

Market risks

In low volatility markets, the margins to be made from market making are small. If the market remains as it is, the margins will limit increases in performance unless volumes are dramatically increased.

If the yield curve steepens and interest rate rises are likely, profitability could improve further.

If the targeted 'flow' business results in Bonelli dealing in new products, Bonelli must have adequate resources to understand, measure and manage the risks arising therefrom.

Regulatory risks

Bonelli will need to comply with regulation relating to automated trading. Robust governance processes must be in place for the approval of automated trading along with adequate risk management processes.

Increasing flow business is likely to have a minimal impact on required regulatory capital because the financial products traded are straightforward in nature. Market risk will be taken into account using either standard coefficients or Bonelli's own internal models. Bonelli's Pillar 2A buffer may be increased by the PRA to allow for operational losses.

The use of electronic trading has been positive for local regulators because human error or intentional manipulation is removed from the equation. Markets are expected to function more effectively in this way.

Bonelli is targeting new clients and this increases the conduct risk of offering unsuitable products or not adequately communicating the risks involved. Weaknesses may lead to regulatory fines.

Strategic risks

The intended increase in flow business from corporate clients requires a large number of trades to make this low margin activity profitable. Bonelli must plan to become the preferred bank for a number of corporates. This strategy requires relationship building and associated resources such as sales staff. This is by no means a guaranteed income stream and sensitivity analysis should be performed to assess the likely returns on this strategy. It will be difficult for Bonelli to differentiate itself from its competitors using anything other than price, which leads to lower profitability.

Electronic trading generates smaller margins because prices are transparent to customers. This must be considered in generating reasonable profit forecasts. Electronic trading may, however, allow greater volumes of trades to be carried out.

The recognised intangible asset related to Bonelli's own trading platform may require impairment given the high costs of setting up electronic trading. There are indicators that its recoverable amount has fallen, because of the reducing revenue in FICC, and an impairment review may be necessary. The likely sales value of the system should also be taken into account in the impairment review.

Staff may be underused because of low levels of client activity. These members of staff may be redirected into other parts of the business or redundancies may be considered to improve profitability.

Bonelli must have sufficiently robust systems in place to prevent financial losses and/ or market crashes in times of instability such as the Global Financial Crisis of 2007/08.

Basel III pressure on capital requirements places pressure on Bonelli to generate sufficient returns for its investors.

Examiner's comment

A significant majority of candidates answered the first requirement comprehensively and scored accordingly high marks. Candidates used the Exhibit in the question thoroughly to generate ideas.

A significant minority of candidates incorrectly assumed that the new strategy would generate more market risk exposure for Bonelli. Banks hedge customer trades back-to-back and therefore little additional exposure is generated.

A large proportion of weaker candidates wasted time copying information from the question without adding their own analysis of it. Simply copying text from the question does not generate marks and wastes time that could be spent elsewhere.

Candidates also wasted time writing down definitions of the different types of risks from their open book texts. Simple definitions are not awarded marks as no application of the knowledge is demonstrated.

The vast majority of candidates used the headings provided in the requirement to structure their answers and generated more marks in this way because it ensured that their answers addressed diverse risks. Candidates need to be careful that if they use bulleted lists, which is an acceptable approach, they are still explaining their points well enough to generate the marks.

Total possible marks	15
Maximum full marks	12

1.2

The Bonelli board has taken the decision to either sell or close its structured products division (division). The decision has been taken to reduce the capital requirements facing Bonelli in the non-ring-fenced bank (NRFB). The action may meet this goal, but Bonelli must ensure that other factors are also considered, notably lost revenue and other strategic factors.

Impact on profitability

The division is a complex trading division staffed by experienced and technical traders. To lose these members of staff would involve a loss of expertise that would be difficult to replace. The cost income ratio for the division is very high at 82.9%, which is likely to reflect these staff costs. If the staff were redistributed within the business these costs would not be saved. Alternatively, redundancies could be made with the relevant one-off costs.

In terms of total assets, the division represents 11.2% ($25,730/229,250 \times 100\%$) of the bank but it represents 14.8% ($20,580/138,760 \times 100\%$) of its risk weighted assets (RWA). Therefore, the division is disproportionately risky which is a reason why the board has identified it for divestment or closure.

However, it contributes substantially to revenue (15% in the year ended 30 June 2018) which is the same figure as the FICC business above. This contributes £185 million ($((100\%-82.9\%) \times 1,080)$) to operating profit.

A sale would require significant management time to execute and a price is not guaranteed. The cash received could be invested in a different, less risky, part of the business to improve returns.

The risk committee and Bonelli's treasury department must ensure that the risk profile of the bank is managed closely during the transition. There may be macro hedge arrangements that must be unwound. Some of the positions may require unwinding which may not be possible.

Impact on regulatory capital

Bonelli's CET1 ratio of 11.6% is very close to its minimum requirement (including buffers) of 11.2%. This is a significant concern to the board and should be immediately addressed with a plan to improve the capital position. Such a small excess over the minimum is a very worrying position for Bonelli to be in, as market changes to risk weight assets (RWA) and/ or profitability could easily mean the minimum is breached. The impact of the divestment of the division on capital adequacy must be examined.

The division has a disproportionately high percentage of RWA relative to its total assets. Total assets for the division are 11.2% of Bonelli's total assets and its RWA are 14.8% of the total.

The new CET1 ratio can be calculated as follows:

	Division	Bonelli	Bonelli excluding division
RWA (£m)	20,580	138,760	118,180
Revenue (£m)	1,080	7,200	6,120
Cost/ income percentage (%)	82.9	65.3	
Profit $((1 - \text{cost income percentage}) \times \text{revenue})$ (£m)	185	2,498	2,313

Bonelli's CET1 capital is £16,096 million ($11.6\% \times 138,760\text{m}$). After the divestment, Bonelli's capital will no longer deduct the division's intangible assets of £120 million and will therefore become £16,216 million. The new CET1 ratio would be approximately 13.7% ($16,216\text{m} / 118,180\text{m}$). This gives more headroom to Bonelli above its capital requirement of 11.2%.

Both a sale or a closure of the division will take time so Bonelli must have plans in place to meet its capital requirements within the NRFB until this occurs.

In closing the division, Bonelli must be conscious of its regulatory and legal responsibilities to its clients.

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Examiner's comment

There was a great deal of divergence in how fully candidates answered this requirement. The trend was that a strong answer to this requirement generated a good pass mark on the paper as a whole. Candidates who struggled to answer this requirement, also found other requirements difficult.

A large proportion of candidates used the figures provided in Exhibit 2 to perform quantitative analysis of the impact of the divestment. This insightful approach was rewarded. Sometimes marks were limited by a lack of workings where it was not possible to determine the source of figures. Candidates are urged to present workings to enable follow through marks for be awarded.

Other candidates used the figures in a limited way and discussed qualitative points. These discussion points were awarded marks when relevant. Weaker scripts included very simple observations such as the fact that revenue would fall if the division was sold or closed.

Total possible marks	13
Maximum full marks	12

1.3**Relationship with external auditors**

The audit committee is responsible for Bonelli's relationship with its external auditors. The following points are particularly relevant to the first audit after the implementation of structural reform changes:

- The new legal structure of the ring-fenced bank (RFB) and NRFB must be clearly communicated to the external auditors.
- There is a very short timescale to deal with any problems before the statutory deadline of 1 January 2019 which increases the risk facing Bonelli.
- All information must be available to the auditors and they may wish to perform testing during the transition.
- The terms of engagement with the auditors may need to be amended to reflect the new structure.
- If new board members are appointed, ensure that ethical independence and objectivity remains upheld.
- Make relevant internal audit reports available to the external auditors.

Scope for fraud

Bonelli's audit committee must communicate with other parts of the bank to ensure that:

- Customers are made aware of the changes in legal structure and account details.
- An awareness campaign is undertaken to ensure customers are aware of how the bank contacts them and how to avoid cybercrime techniques.
- An assessment is made of the likely financial impact of any successful cybercrime.
- Contingency planning is up to date and tested in case of malicious or accidental loss of service during the changeover.

Examiner's comment

Many candidates used the context of the question and their own technical knowledge of the learning materials to generate sensible points to answer this requirement. This requirement needed the application of skills that candidates should possess at this stage of their qualification.

Time was wasted by weaker candidates by explaining what a skilled person report is, which does not answer the requirement.

The fraud issue was answered more fully by the majority of candidates, although some scripts contained a list of controls to prevent cybercrime. The question asks instead how the audit committee should address the issue, so a more high-level response was needed.

Many candidates generated good points about the relationship between the audit committee and external auditors. These included keeping the auditors informed about the new structure and ensuring that auditor's independence and objectivity is upheld.

Total possible marks	10
Maximum full marks	8

1.4

Ethical issues

The primary ethical issue here is the relationship between Yatong Li, the audit committee chair, and Herman Gisela, the partner of Gisela Ltd, who prepared the skilled person report. It appears that the relationship is of a personal as well as professional nature. This does not necessarily mean that Gisela has prepared the skilled person report in a biased manner, but there could be a perceived lack of independence and objectivity.

Yatong is likely to be a qualified accountant and is therefore bound by the IESBA Code of Ethics. Its fundamental principles include integrity and objectivity. Yatong should be open and honest in her role and should not allow conflicts of interest to influence her decision making. A familiarity threat may exist here because of a personal friendship.

Yatong is also in a senior management function (SMF) under the PRA's senior managers regime (SMR). She will have been approved by the PRA prior to taking on her role as a 'fit and proper' individual for the role.

Actions that you should take

You are also bound by the ICAEW Code of Ethics and must show integrity by dealing with this information. The first step is for to inform senior management of your concerns. This should be done in a professional manner and you are protected by whistleblowing procedures. It could be the case that the personal relationship, if there is one, has developed after working together for a number of months. Yatong and Herman may not have known each other prior to this professional appointment. You must not accuse Yatong of wrong-doing, you must give the information to senior management to deal with appropriately.

Whistleblowing is dealt with very seriously by banks and banking regulators and Bonelli should have internal whistleblowing procedures to allow you to notify your concerns to senior management. This should be possible without fear of negative consequences for yourself.

Senior management should undertake an internal investigation and consider what appropriate actions it should take. Senior management should consider Yatong's responsibilities as audit committee chair and whether other decisions may have been taken without due care.

Appropriate safeguards

Safeguards that should be in place to prevent this situation include:

- Clear ethical guidelines in Bonelli's staff manual
- Continued professional development (CPD) to make sure employees are aware of their ethical responsibilities.
- Corporate governance regulations for the audit committee's composition and procedures
- Disciplinary procedures to deal with known instances on unethical behaviour.

There is insufficient information currently to conclude on Yatong's behaviour, but any behaviour outside the spirit of ethical behaviour must be disciplined accordingly to show that Bonelli does not tolerate such behaviour.

Examiner's comment

Candidates performed fairly well in the ethics requirement, as expected from previous BPB exams. The ethical issues were identified correctly in the vast majority of scripts.

However, some scripts did not explain why the relationship between Yatong and Herman could be a threat to objectivity. This led to very brief answers and limited marks.

Actions were usually included, although actions should include more than simply telephoning the ICAEW ethics hotline, for which very limited marks are available. Actions should be specific to the question provided.

A significant minority of candidates did not address the final part of the requirement which asked for safeguards that could prevent similar issues arising in the future. This may have been overlooked or candidates may not have been able to produce any ideas. Ethical safeguards are included in the BPB syllabus and in the ethics chapter of the study manual.

Total possible marks	10
Maximum full marks	8

Question 2**Total Marks: 30****General comments**

The candidate is placed in the role of internal auditor at Flatfive Bank. The candidate is performing a loan review to ascertain if the credit quality of the loan book remains acceptable to Flatfive.

Details of a loan to Papsak Ltd are provided including its latest financial statements for qualitative and quantitative analysis.

Forbearance has been provided to another borrower, Lekker Ltd, and figures are given to calculate an impairment in Flatfive's financial statements.

Flatfive's lending criteria and credit assessment procedures are provided.

2.1**Financial stability**

Although gross profit margin has held up at 20.7% ($753/3,629 \times 100\%$) for 2018 versus 21.1% ($912/4,324 \times 100\%$) for 2017, Papsak's main problem appears to be the 16.1% ($((4,324-3,629)/4,324) \times 100\%$) decline in its revenue which would be consistent with changing European retail environment.

The fall in revenue has resulted in a decline in asset turnover from 2 ($4,324/((2,289 + 2,001)/2)$) to 1.5 ($3,629/((2,512 + 2,289)/2)$) and operating margin falling from 8.2% ($355/4,324 \times 100\%$) to 3.0% ($110/3,629 \times 100\%$). The worsening asset turnover and operating margin combine in a large decrease in return on assets from 16.6% ($355/((2,289+2,001)/2) \times 100\%$) to 4.6% ($110/((2,512+2,289)/2) \times 100\%$).

This decrease in return on assets also reflects a failure to control other expenses. This may result from an inability to rapidly reduce costs associated with operating retail outlets, regardless of declining sales.

In order to return to profitability, the company will need to either expand its sales, or find a way to reduce its operating expenses. Rapidly reducing the number of retail outlets to achieve the latter may prove difficult if Papsak is committed to long term leases on retail premises. In addition, it is likely to lead to significant write offs of retail fixtures and fittings in non-current assets.

In addition, inventory days and receivables days have both increased. Although payables days has increased from 30.2 ($(282/3,412) \times 365$) to 41.2 ($(325/2,876) \times 365$), there has been a net increase in working capital of £138,000 ($(753 - 282) - (934 - 325)$) which appears to have been funded by an increase in the overdraft. Failure to control working capital has placed additional financial strain on the company in 2018 and resulted in additional overdraft interest. The increase in inventory may be the result of sales being below the level anticipated. Nonetheless, given the difficult operating conditions in which Papsak found itself in 2018 the failure to control working capital is a concern.

The worsening financial position for Papsak creates significant risk as to whether future payments will be met.

Affordability

Gearing is still relatively modest at 53.1% ($((171 + 1,000 - 32)/(1,006 + 171 + 1,000 - 32) \times 100\%$) up from 49.7% ($((7 + 1,000 - 27)/(993 + 7 + 1,000 - 27) \times 100\%$) in 2017, but interest cover has fallen from 4 ($355/89$) to 1.2 ($110/93$). This increases the risk that Papsak will be unable to meet future interest payments.

In order to rebuild profitability and affordability it is essential that Papsak finds a way to expand revenue, reduce its operating costs, or both. Given the stated strategy of Peter Vardy it would seem that the latter is the more likely strategic target.

If revenue were to at least stabilise, a relatively modest reduction in operating costs would rebuild interest cover.

Viability

The collapse of Papsak's profitability in 2018 calls into question the ability of the company to make the capital repayment of £1 million in 2021.

Even in the more successful 2017, profit for the year was less than a quarter ($234/1000 = 23.4\%$) of the required capital repayment in May 2021. Thus, with only two and a half years until the repayment of capital, even if Peter's new strategy could return the company to the profitability it enjoyed in 2017, it would be unlikely to generate sufficient cash to meet the capital payment when it falls due.

Since it seems unlikely that the business will turn around sufficiently rapidly to generate cash of £1 million, there is a significant risk as to the viability of repayment. It is probable that the loan repayment will need to be refinanced, or Flatfive will need to exercise its security to recover as much of the outstanding amount as possible.

Security

The security is stated as having a total value in 2016 of £1.09 million (0.71m + 0.38m), marginally exceeding the loan principal. Although inventory has grown to £512,000 apparently increasing the level of security, it is likely that this consists principally of wine for resale and may not be realisable at this amount if security is exercised.

The fixed charge over the distribution facilities may also not yield the amount expected due to the specialised nature of the premises. Together with the usual costs associated with realisation of security (legal and transaction costs) these factors suggest that Flatfive would be unlikely to realise sufficient from the exercise of security to cover the outstanding principal amount in full.

Management

The departure of the previous chief executive and his replacement by Peter Vardy creates an additional risk. As founder of Papsak, the previous chief executive had demonstrated a track record of financial success. Peter Vardy is an unknown quantity and his ability to implement an effective strategy to restore profitability is critical to Papsak's ability to meet the loan repayment.

Capital structure

In 2018 gearing was 53.1%, only a modest increase over 2017. Although the level of gearing is not particularly high it will nevertheless be problematic for the company to service this debt if the very low level of profitability in 2018 persists.

In addition, at 31 October 2018 the company had increased its overdraft to £171,000 from £7,000 the previous year. Given the financial situation that Papsak finds itself in, the provider of this overdraft may be reluctant to see it expand further. If no further debt finance is available, the company will need to survive on its internally generated cash flow. Again, this may prove difficult unless the company can rapidly restore profitability.

Conclusion

From the information above, it is evident that although Papsak may be able to continue to service interest on the loan there is a very significant risk that it will be unable to meet the repayment. Its financial results are consistent with a failure of Papsak's European roll out strategy to generate sufficient revenue from that investment. The fact that there is a new chief executive without a proven track record also increases risk.

Although some of this risk is mitigated by asset security there is considerable uncertainty as to the extent to which exercising such security would facilitate a repayment. In all likelihood there would be a significant shortfall.

In summary the credit risk is likely to no longer be acceptable to Flatfive.

Examiner's comment

This requirement generated a wide range of answers with some candidates providing comprehensive analysis and other candidates providing very brief responses. Candidates are reminded that analysis of a borrower is a key skill in the BPB syllabus. There are numerous practice questions in the learning materials that candidates can use.

Several candidates scored maximum marks on this requirement by using the information provided in the question and generating thoughtful and meaningful analysis. Well structured answers used the standard credit analysis headings, which meant that answers were coherent and fully addressed the requirement.

Greater marks can be awarded where candidates comment on a change that has occurred in the business (a movement in a ratio, or greatly increased overdraft in this question) and draw inferences about what this could mean for Papsak and for Flatfive as its lender.

Weaker candidates simply calculate a ratio, sometimes incorrectly, and do not comment upon it. Very limited marks, if any, can be awarded in this case.

Candidates are reminded that workings must be shown for credit to be given if the resulting figure is incorrect.

Total possible marks	18
Maximum full marks	15

2.2

a) Appropriateness of extending forbearance to Lekker on 1 December 2018

The purpose of forbearance should be to ensure that a loan does not become non-performing or to remove a loan from this status. The objective should be to achieve a better outcome than foreclosure. This requires adjusting the loan terms to a level at which payments can realistically be met by the borrower.

The purpose of forbearance should not be simply to avoid recognising loan impairment.

In this instance the fact that Flatfive has agreed to extend the repayment on two occasions raises a concern that repayment is simply being pushed into the future without creating a realistic prospect of repayment.

Additionally, the fact that on 1 November 2018 Lekker requested reduced interest payments may indicate that its financial position is deteriorating. Therefore, the repeated forbearance may be to avoid recognising loan impairment under IAS 39 rather than an attempt to improve the prospects for repayment. In such circumstance this would not be an appropriate use of forbearance.

The value of any security held against the loan to Lekker should be determined. If the security can be realised at an amount significantly below the outstanding loan value, forbearance is a more attractive option. Additional security could be sought as a condition of offering further forbearance.

b) Appropriate financial reporting treatment of the loan to Lekker in Flatfive's financial statements at 30 November 2018

Forbearance provides an indicator that the loan to Lekker is impaired. An impairment allowance is recognised only if there is objective evidence that a loss has been incurred.

The value of £600,000 for the loan after forbearance on 30 November 2018 has been calculated by discounting the post-forbearance cash flows at the revised interest rate of 4% pa. This is incorrect as it is in effect revaluing the loan at fair value by using a current interest rate.

The original EIR of 6% pa should have been applied to the loan's future cash flows which would have resulted in a value of £577,993 $((24,000/1.06) + (624,000/1.06^2))$.

The loan is impaired because the recoverable amount is lower than the carrying amount. The difference of £22,007 $(600,000 - 577,993)$ should be reflected as a charge to profit or loss and it should reduce the loan by either directly writing it off or including it as an allowance for impairment.

There is also a question of whether a larger impairment allowance is required given that Lekker has

informed Flatfive of its inability to meet repayments on two occasions. Some consideration should be given as to whether this information constitutes objective evidence of further impairment in accordance with IAS 39.

If it is unlikely that Lekker can meet the bullet repayment of £1 million in 2020, Flatfive will need to exercise its security to attempt to obtain repayment. An assessment of the likely level of recovery would be necessary to determine the necessary extent of any impairment allowance.

Examiner's comment

Candidates made a good attempt at part (a) which questioned the appropriateness of offering forbearance to Lekker. This required consideration of different issues and tested higher skills.

Part (b), asking for the appropriate financial reporting treatment of an impairment, was answered well. Most candidates calculated the impairment loss correctly. A majority of candidates identified that the incorrect interest rate had been used by Flatfive which meant that the loan was being measured at fair value rather than amortised cost.

Total possible marks	9
Maximum full marks	8

2.3

Initially carry out a walk-through test on a small sample of loans to confirm that the procedures were implemented as described.

For a larger sample of retail loan approvals:

- Reperform the credit scoring process using the information from the application forms and credit history
- Verify that the score obtained met the approval threshold in place at that time
- Confirm that proof of income was provided and verify that it supported the amount disclosed on the application form
- Confirm that loans meeting the credit score threshold were signed off by a lending manager prior to approval
Where a guarantor was supplied, verify that the guarantee was put in place and that the loan was authorised at the specified level
- Confirm that direct debit instructions were put in place

(It may be appropriate to weight the above sample towards non-performing loans as there may be a positive correlation between non-performance and weaknesses in procedures applied)

Analyse changes made in the credit score threshold to establish whether there was a valid justification for the change.

Further, given that impairment losses are high, Flatfive will need to conduct a review of their scorecard to make sure that the scoring scale is consistent with industry best practice. Also, Flatfive will need to ensure that the scoring scale is linked to the probability of default assessment so that adequate capital is being held against the loan and the cost of capital and risk is priced into the product.

Analyse the total unsecured retail loans balance to produce an exception report for any individual loans in excess of £20,000 or with an original term exceeding 7 years. For any such loans identify whether they were approved, and if so by whom.

Where the above procedures identify that the bank's policies have not been followed an attempt should be made to identify whether this departure was an isolated event or evidence of a systematic failure or a pattern, perhaps related to particular staff members.

Examiner's comment

A significant minority of candidates did not use the information in Exhibit 4 fully and therefore their

<p>answers were very brief and did not fully address the requirement.</p> <p>Strong candidates worked through Exhibit 4 systematically and identified an appropriate approach that internal audit could take. Candidates should make sure they use the information provided in the question.</p> <p>Bullet points are permissible, but points need to be fully explained to gain marks. A list of bullets with single words will not get many marks at all, if any.</p>	
Total possible marks	8
Maximum full marks	7

Question 3**Total Marks: 30****General comments**

The candidate is an ICAEW Chartered Accountant working as an auditor for Lavans. The candidate is focusing on the audit of liabilities. Mozza Bank has pressure on liquidity because deposits are reducing, and the Bank of England term funding scheme must be repaid. Mozza's provision for misconduct has reduced significantly which is a cause for concern.

3.1**Issue 1: Early adoption of IFRS 9 for own credit**

Mozza has early adopted IFRS 9 in relation to accounting for own credit which is permitted by IFRS 9.

IFRS 9 rules for own credit require issued debt to be restated to fair value at each reporting date and the fair value gain or loss should be taken to other comprehensive income (OCI) as long as it relates to the bank's own credit risk.

Other fair value gains and losses are taken to profit or loss.

On derecognition, any gains or losses recognised in other comprehensive income are not transferred to profit or loss. The cumulative gain or loss may be transferred within equity as a reserves transfer.

Under IFRS 9, fair value movements in own credit may be designated as fair value through profit or loss if the recognition through other comprehensive income is creating an accounting mismatch.

It is not clear whether this has been accounted for accurately and therefore whether a correction is needed.

The change in accounting policy must be included in the notes to the financial statements.

Tutorial note: The comparative figures in the year ended 31 October 2017 may be restated but it is not mandatory under IFRS 9 7.2.15.

Issue 2: Repurchase agreements

The repurchase agreements were recognised as an outright sale rather than recognising a liability to repurchase the gold.

This has an impact on classification of gains and losses in the statement of profit or loss and the completeness of liabilities in the statement of financial position.

Revenue from the sale of gold will be incorrectly recognised and fair value gains and losses from financial instruments and interest expense will be incorrectly recognised.

The following correcting journal entry is required, even though it is below audit materiality:

Dr	Revenue	X
Dr	Financial asset - gold	X
Cr	Liability on 31 October 2018	3.7m

Issue 3: Currency swap

The debt issued in euros is a monetary financial liability that will be retranslated at each reporting date using the closing exchange rate.

As the pound appreciated against the euro during the month of October 2018, the fair value of the debt in pounds decreased, resulting in a foreign exchange gain of £363,059 (£10,256,410 – £10,619,469).

The fair value of the currency swap has reduced from nil at inception to a liability of £367,048.		
Mozza has implemented an economic hedge by entering into the currency swap agreement and the swap should offset any future changes in the pound sterling/ euro foreign exchange rate. Mozza measures its issued debt using the closing exchange rate and the currency swap is a derivative measured at fair value through profit or loss (FVTPL) therefore hedge accounting is not required for the hedge to be reflected in the statement of profit or loss simultaneously.		
The journal entry required for the currency swap is:		
Dr	Profit or loss – fair value loss on derivative	367,048
Cr	Financial liabilities	367,048
Examiner's comment		
The IFRS 9 treatment of issued debt has been examined before, but answers were mixed. A very common mistake was to assume that the question focused on financial assets and a detailed explanation of impairment rules was provided by candidates. The question clearly states that this is debt issued by Mozza. Strong candidates outlined the straightforward rules in IFRS 9 to deal with fair value movements on own debt.		
The repurchase agreement issue was answered well, with candidates discussing whether risks and rewards had transferred and attempting the journal entries to reverse out revenue. Journal entries were rarely 100% correct but marks were awarded for attempts to make the appropriate correction. Candidates were not fazed that the journal entries could not be completed in full.		
Candidates tended to perform well on the third issue, regarding hedging, as this is a well-practised topic. Candidates should take care to note that hedge accounting is not always the answer, as in this question there was a natural hedge to look out for.		
Total possible marks		14
Maximum full marks		9

3.2				
The liquidity coverage ratio (LCR) requirement is expressed as the ratio of high quality liquid assets (HQLA) to net cash outflows over a 30-calendar day stress period.				
The minimum LCR should be maintained at 90% from 1 January 2018 and the LCR must exceed 100% from 1 January 2019 under Basel III rules.				
HQLA				
Category	Asset	£'000	HQLA	
Level 1 assets	Cash	7,900	7,900	
	Central bank reserves	12,430	12,430	
	UK gilts	19,590	19,590	
	Total level 1		39,920	
Level 2A assets	Covered bonds	9,500		
	Investment grade corporate debt securities	22,680		
Level 2B assets	N/A			
	Total level 2	32,180		
	Maximum level 2 assets = 40% of total HQLA		26,613	
	39,920 x 40/60			
Total HQLA			66,533	
Net cash outflows				
Total cash inflows are limited to 75% of total expected cash outflows.				
Total expected cash outflows in 30 days under stress conditions =249,100				
Total expected cash inflows in 30 days under stress conditions (limited to 75% x 249,100) = 186,825				

Net cash outflows over the next 30 days = 62,275	
LCR	
LCR = $66,533/62,275 = 106.8\%$	
The LCR is above the current minimum level of 90% from 1 January 2018.	
However, the minimum increases to 100% from 1 January 2019 and Mozza does not have a large excess over the regulatory requirements to give a safety margin.	
The excess is equivalent to £4.3 million (66,533,000-62,275,000). The PRA accepts that the LCR may dip below the minimum level in times of stress, but there should be a plan to reinstate the minimum level as soon as possible.	
Examiner's comment	
Candidates generally made a very good attempt at this requirement and scored accordingly well.	
Total possible marks	6
Maximum full marks	4

3.3

Audit risk	Audit procedure
<p>Reduction in funding Mozza's funding is reducing because retail and corporate deposits are falling and the Bank of England term funding scheme is being repaid. There is a risk to Mozza's liquidity and solvency if alternative funding sources are not found.</p>	<p>Test the input figures to Mozza's LCR calculation to ensure accuracy.</p> <p>Assess HQLA to ensure asset types are classified correctly by comparing to prior year calculations and classifications.</p> <p>Ensure that the reporting systems are accurately picking deposits from treasury systems.</p> <p>Test a sample of loans from origination (treasury system) to finance (reporting).</p> <p>Obtain statements from central banks and compare to financial statements for consistency.</p> <p>Obtain forecasts for improving liquidity position.</p> <p>Consider informing the PRA if it becomes likely that Mozza will fail to meet its minimum LCR level before audit sign off as part of its responsibilities to report to the regulator.</p> <p>Compare figures in the financial statements with liquidity narrative in the annual report for consistency.</p>
<p>Bank of England term funding Bank of England term funding may not be repaid in accordance with the agreed terms leading to fines or reputation risk.</p>	<p>Obtain correspondence with the Bank of England for the repayment of the term funding.</p> <p>Obtain forecasts for the repayment strategy from Mozza's treasury department and assess for reasonableness.</p> <p>Challenge assumptions made by management and assess contingency plans if cash inflows are not received on a timely basis.</p>

	<p>Review internal funding mismatch reports to understand the duration and basis risks.</p> <p>Check whether these risks are within the board risk appetite.</p>	
<p>Provision for misconduct Provision for misconduct related to PPI is understated given the deadline for claims is within 12 months.</p> <p>Unrecognised claims exist.</p>	<p>Test a sample of customers to determine that letters have been sent informing customers of their right to compensation.</p> <p>Examine claims received but not processed for volume and size of claims.</p> <p>Compare cash payments post 31 October 2018 to the year-end provision of £2.155 million to assess completeness and accuracy of claim amounts.</p> <p>Recalculate the year-end provision by performing analytical procedures on the outstanding claims listing and multiplying outstanding claims by the average amount of compensation.</p> <p>Assess uphold rates for claims where Mozza was at fault. Ensure that a reasonable uphold rate is applied to future claims so the provision is adequate.</p> <p>Perform sensitivity analysis to reflect the uncertainty around the number of claims and the amount of each claim to address uncertainties over the overall total cost.</p> <p>Discuss the amount of average compensation settled with the complaints handling team for reasonableness given historic settlements and knowledge from other banks in publicly available information.</p> <p>Request correspondence with a sample of "closed" claims to assess whether claims were disputed and a higher amount eventually settled. If so, there is a possibility that the year-end provision is understated.</p> <p>Review correspondence with the Financial Conduct Authority (FCA) to understand if Mozza is subject to any fines for not treating customers fairly. Ensure any fines are provided for or disclosed as contingent liabilities unless remote.</p> <p>Assess disclosures for adequacy and to ensure they show the movement on the provision in the current year including additional amounts provided for, amounts used, unused amounts reversed in the period and any unwinding of the discount if the time taken to settle the claims is deemed to make a material difference to the present value of the compensation.</p> <p>Assess disclosures to make sure they are sufficiently clear regarding significant uncertainties that exist in respect of provisions volumes and financial amount. Examine correspondence with legal counsel.</p> <p>Compare Mozza's provisions with those of its peers and</p>	

<p>Going concern assumption may be challenged by reputational damage.</p>	<p>seek an explanation for any material differences.</p> <p>Obtain correspondence with Mozza's legal counsel.</p> <p>Receive management representation that all provisions are provide for.</p> <p>Review cash flow forecasts to assess potential impact of future misconduct payments on liquidity and solvency.</p>	
<p>Early adoption of IFRS 9 re own credit IFRS 9 and IFRS 7 disclosures are insufficient.</p>	<p>Compare early adoption requirements in IFRS 9 and IFRS 7 disclosures to the notes to the financial statements. Ensure the accounting policy note is sufficiently explanatory.</p>	
<p>Repurchase agreements Repurchase agreements are incorrectly recognised as outright sales.</p> <p>Revenue is overstated because of the gold repurchase agreement was incorrectly treated as an outright sale. Although the year end liability of £3.7 million is below materiality, the classification error may well be material.</p>	<p>Perform sample testing on the repurchase agreements using gold as collateral to assess whether IAS 39 derecognition criteria has been correctly applied.</p> <p>Assess and test the design and operating effectiveness of the controls over the derecognition of liabilities.</p> <p>Assess the design and operating effectiveness of controls over new transaction types and the accounting thereof.</p>	
<p>Debt securities Manual journal entries are not sufficiently controlled.</p> <p>Euro denominated debt is translated into pounds sterling using the incorrect rate.</p> <p>Fair value of currency swap is inaccurate.</p>	<p>Compare manual journal entries with those posted for the prior year end of 31 October 2017 for completeness.</p> <p>Use your knowledge of Mozza's business to understand which manual journals are required.</p> <p>Perform sample testing on journal entries to ensure validity and accuracy.</p> <p>Obtain the euro/ pound sterling foreign exchange rate from a third party source such as oanda.com.</p> <p>Reperform the calculation to ensure accuracy.</p> <p>Ensure the foreign exchange gain or loss is correctly classified in the statement of profit or loss.</p> <p>Assess and test the design and operating effectiveness of the controls over the identification, measurement and management of valuation risk.</p> <p>Ensure management understand the basis of the quoted prices used to ensure that price reflects market conditions at the measurement date.</p> <p>Assess whether the pricing source is independent of Mozza.</p> <p>Attest a sample of financial liabilities to appropriate supporting third party valuation documentation (eg Bloomberg, FT database) and confirm these are based on quoted prices.</p>	

<p>Fair value of issued debt is misstated.</p>	<p>Ensure changes in fair value of issued debt are derived from changes in Mozza's credit spread measured by observable market data, such as spreads on Mozza's issued bonds or credit default swaps.</p> <p>Compare a list of debt securities in issue at 31 October 17 with the list provided for 31 October 2018. Obtain evidence of repayments or maturing balances.</p> <p>Obtain details of new issues during the year, ensuring any issue costs are dealt with correctly.</p>	
<p>Mozza's statement of financial position Financial liabilities are understated.</p> <p>Financial liabilities are incomplete</p> <p>Customer and bank deposits are misstated</p> <p>Derivative financial liabilities measured at fair value are misstated where inputs other than quoted prices are used (level 2) or significant judgement is required to measure financial liabilities without observable data (level 3).</p>	<p>Assess and test the design and operating effectiveness of the controls over the identification and recognition of transactions and liabilities.</p> <p>Discuss with staff whether they have been asked to override controls at any point.</p> <p>The expertise and experience of the client staff involved in this area should be determined.</p> <p>Circulate confirmations to central counterparties to ensure completeness and existence.</p> <p>Examine derivative transactions documentation with zero initial cost to ascertain whether fair value movements should be recognised.</p> <p>Test controls over origination and servicing of customer deposits including calculation of interest and fees.</p> <p>Review and test controls over Vostro reconciliations to ensure reconciling items are dealt with appropriately and reconciliations are reviewed by a senior member of the team.</p> <p>Circulate balance confirmations to a sample of other banks.</p> <p>Compare last year's list of banks with this year's balances and obtain reasons for any differences.</p> <p>Where observable data in active markets is unavailable; examine internal pricing processes through discussion with management.</p> <p>Consider whether an auditor's expert should be used to provide assurance over level 2 or 3 valuations.</p> <p>Ensure all processes have been followed including determining whether level 1 inputs are actually available.</p> <p>Assess significant management assumptions used for level 3 assets. For example, future cash flows, discount rates and comparability of the liability to observable inputs used in the models.</p>	

	<p>Assess the controls over the pricing processes to ensure judgemental valuations are compared with other information indicative of an appropriate price.</p> <p>Examine how prices or inputs from external sources used as inputs for level 3 liability valuations were calculated in order to assess their reliability. For example, in an active market a broker quote on an untraded instrument is likely to reflect actual transactions on a similar financial instrument. In an inactive market the broker quote may rely on more proprietary valuation techniques to determine prices.</p> <p>Examine gains and losses on disposals and other events which provide evidence about the appropriateness of valuations on the reporting date.</p> <p>Review recent transactions, including transactions after the reporting date in the same instrument. Adjustments may be required to reflect market conditions at the measurement date.</p> <p>Review current or recent transactions in similar instruments known as "proxy pricing". Adjustments will be required to reflect differences in the two instruments e.g. differences in liquidity or credit risk.</p> <p>Review indices for similar instruments. Adjustments will be required to reflect the difference between the instrument being priced and the instrument(s) from which the index is derived.</p> <p>For issued debt instruments assess the reasonableness of the discount rates used by comparing them to rates used by Beta for similar instruments.</p>	
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Examiner's comment

This requirement is a typical requirement for the BPB exam, but candidates often spend too long answering it. As the final requirement, answers scored well but were not too detailed.

In common with previous sittings, a significant minority of candidates copied irrelevant material from their open book materials which wasted time and generated no marks. For example, impairments were sometimes mentioned at length despite the question focusing on liabilities.

Good scripts used the information provided in the question about the liquidity issues facing Mozza, the repayment of the term funding scheme and the uncertainty over the provision for misconduct. These scripts scored very well by applying their knowledge of the technical issues and generating audit risks specific to Mozza and designing audit procedures to address each risk.

Candidates are reminded that audit procedures must be sufficiently detailed to explain what the auditor is going to do to gain assurance that the financial statements are free from material misstatement.

It is recommended that audit risks are followed immediately by the relevant audit procedure. Marks are awarded regardless of presentation. However, answers are of better quality when audit procedures are directly linked to the audit risk and this is done more effectively when considered at the same time.

Total possible marks	20
Maximum full marks	17