PROFESSIONAL LEVEL EXAMINATION

TUESDAY 4 DECEMBER 2018

(2½ HOURS)

BUSINESS PLANNING: INSURANCE

This exam consists of **three** questions (100 marks).

Marks breakdown

Question 1	40 marks
Question 2	33 marks
Question 3	27 marks

1. Please read the instructions on this page carefully before you begin your exam. If you have any questions, raise your hand and speak with the invigilator before you begin.

2. Please alert the invigilator immediately if you encounter any issues during the delivery of the exam. The invigilator cannot advise you on how to use the software. If you believe that your performance has been affected by any issues which occurred, you must request and complete a candidate incident report form at the end of the exam; this form must be submitted as part of any subsequent special consideration application.

3. Click on the **Start Exam** button to begin the exam. The exam timer will begin to count down. A warning is given five minutes before the exam ends. When the exam timer reaches zero, the exam will end. To end the exam early, press the **Finish** button.

4. You may use a pen and paper for draft workings. Any information you write on paper will not be read or marked.

5. The examiner will take account of the way in which answers are structured. Respond directly to the exam question requirements. Do not include any content or opinion of a personal nature. A student survey is provided post-exam for feedback purposes.

6. Ensure that all of your responses are visible on screen and are not hidden within cells. Your answers will be presented to the examiner exactly as they appear on screen.

All references to IFRS are to International Financial Reporting Standards and International Accounting Standards.

Question 1

You are an ICAEW Chartered Accountant who has recently taken up the position of chief accountant of Welsh Life plc (Welsh Life), reporting to the finance director, Kaylee Modi. The finance department at Welsh Life has been short of staff for most of 2018. Welsh Life's main product line is term life insurance.

Kaylee is keen to adopt the latest financial reporting standards and she intends that Welsh Life will voluntarily adopt IFRS 17 and IFRS 9 for the preparation of the financial statements for the year ended 30 November 2018, (assume that IFRS 17 has been endorsed by the EU). Kaylee has also mentioned that adopting IFRS 17 will have the benefit of allowing Welsh Life to spread underwriting profits and losses over the lives of the insurance contracts to which they relate.

As a provider of long-term insurance contracts, Welsh Life expects to use the general measurement method of IFRS 17 for all insurance contracts it writes. Some work has already been done on the initial recognition of contracts under IFRS 17, but Kaylee is not confident that all work performed by the finance department is correct.

Consequently, she has asked you to review the way in which a group life insurance policy written at the beginning of December 2017 has been initially recognised. She has provided you with information related to this contract provided by the actuarial department (**Exhibit 1**), and a calculation for its initial recognition performed by Francis Albert, a member of the finance department (**Exhibit 2**).

Francis's understanding of IFRS 17 proved insufficient to enable him to calculate the figures for inclusion in the financial statements for the year ended 30 November 2018 in respect of this contract. However, he has correctly ascertained that in the year ended 30 November 2018 cash outflows related to the contract were £0.85 million and cash inflows were £2.4 million. These amounts were in line with the actuarial assumptions on initial recognition. All claims incurred and all related costs were settled and paid at 30 November 2018 and the premium was received immediately after the contract was written.

In the previous financial year, Welsh Life issued mortality bonds, the terms of which specify that returns paid to bondholders fall if mortality experience increases (life expectancy decreases). This financial liability is presented at fair value through profit or loss. The fair value of the liability at 30 November 2017 was £56.7 million. At 30 November 2018, the fair value of these bonds had fallen to £50.2 million. During August 2018 Welsh Life was downgraded by all the major credit rating agencies and it has been estimated that this led to a 10% fall in the value of all debt securities it has in issue.

Welsh Life also owns and operates a price comparison website (PCW) under a completely separate brand, 'Chooselife', a description of which is provided as **Exhibit 3**. In response to a request from Kaylee you have been looking into how Chooselife operates.

Requirements

1.1 Identify the errors in Francis's initial recognition calculations (Exhibit 2). Provide a revised calculation that shows how the contract should have been recorded on initial recognition.

1.2 Assuming that there have been no changes to the assumptions in Exhibit 1:

(a) Reconcile the opening to closing asset or liability related to insurance contract policy number 198-566 for the year ended 30 November 2018.

(b) Show how this contract should be presented in the statement of profit or loss for the year ended 30 November 2018.

1.3 Critically assess the view expressed by Kaylee regarding how underwriting profits and losses are recognised under IFRS 17 through the statement of profit or loss over a policy's life.

1.4 With respect to the mortality bonds issued by Welsh Life:

(a) Explain why Welsh Life is able to present the mortality bond liability at fair value through profit or loss (FVTPL). Identify the likely benefit to the company of doing so.

(b) Explain how the change in the fair value of mortality bonds would be presented in the financial statements for the year ended 30 November 2018 assuming IFRS 9 is adopted. Prepare journal entries to correctly record this change.

1.5 Identify and explain the ethical and regulatory issues for Welsh Life arising from its operation of Chooselife price comparison website.

Total: 40 marks

Exhibit 1 - Information provided by the actuarial department relating to a group life insurance policy written in December 2017

Policy number	PV of cash inflows £m	PV of cash outflows £m
198-566	20.69	17.52

- Present values (PV) are calculated using an annual discount rate of 5%.
- Adjustment for non-financial risk is 4% of the PV of cash outflows.
- The expected contract life is 7 years.
- In the year ended 30 November 2018 Welsh Life earned 2% on premiums invested

Exhibit 2 – Calculation for initial recognition of contract 198-566 prepared by Francis Albert

	£m
PV of inflows	20.69
PV of outflows	(17.52)
Fulfilment cash flows	3.17
Adjustment for non-financial risk	0.13
Value of insurance contract 198-566	3.30

Therefore profit of £3.30m should be recognised in profit or loss.

Exhibit 3 – Description of the operations of Chooselife PCW

Chooselife is marketed as an independent, online life insurance product comparison platform. Consumers submit basic information such as the amount of cover required, age, gender and whether they smoke. Based on this information, Chooselife imports premium quotations, using electronic data interchange, from a selection of insurance providers with whom it has agreed a relationship. Chooselife provides quotes only from UK regulated insurers on the grounds that this provides better protection for customers. One large, low-cost UK life insurance provider does not participate in providing quotes via PCWs.

Chooselife ranks premiums quoted in order of increasing price to enable consumers to select the best value product available. A brief summary of each policy's terms is displayed to the consumer at this stage.

If the consumer clicks through from Chooselife to a provider's website and takes out a policy, Chooselife receives a sales commission. The level of sales commission is separately agreed with each provider.

Chooselife's premium search algorithm is designed so that if the premium quoted by Welsh Life is in the cheapest 10% of premiums quoted, its product is always shown first in the list of available quotes and highlighted as the 'editor's best value'.

Welsh Life offers substantially lower premium quotes for life policies through Chooselife compared with its quotes on alternative PCWs and other distribution channels. This is because when sales take place through Chooselife, Welsh Life does not need to pay an external commission to a broker or another PCW.

In the year ended 30 November 2018, Welsh Life sold 36% of its individual life insurance policies through Chooselife.

Question 2

You are an ICAEW Chartered Accountant working for Griffin Montgomery (GM), a firm of ICAEW Chartered Accountants. You are the newly appointed manager on the audit of Sizewell Insurance (Sizewell), a UK-based medium-sized general insurer. You are finalising audit planning for the year ending 31 December 2018. The interim audit was carried out by Beverley Leong, who recently left GM.

Sizewell has attempted to reduce claims handling costs by having as much as possible of its claims management processes online. Claimants must complete claims forms online, including providing scans of all supporting documentation.

Each claim is allocated to a claims manager, who has sole responsibility for ensuring that all claims are validated and paid on time. Approximately 90% of claims are paid with little or no manual scrutiny, as internally developed software assesses the details provided by the claimant, reads scanned documents to validate them and recommends immediate settlement for the claimed amount.

You have been provided with a summary of matters arising from the interim audit (**Exhibit 1**) and an outline description of a fraud in claims handling that Sizewell's internal auditor discovered during the year (**Exhibit 2**).

Requirements

2.1 In relation to the summary of key matters arising from the interim audit (Exhibit 1):

(a) Describe the significance of each of these key matters for the planning of the upcoming final audit visit.

(b) Briefly outline what additional steps should be undertaken between now and the completion of the final audit in response to these key matters.

(c) Assess the most appropriate option available to GM for reporting each of these key matters. Justify your conclusion and identify an appropriate addressee for your report.

2.2 Describe how the reorganisation of the internal audit function (Exhibit 2) may impact on how much reliance GM should place on procedures carried out by the internal auditors.

2.3 Describe **five** internal controls that might reasonably have been expected to detect, on a more timely basis, or prevent the fraud experienced in claims handling (Exhibit 2).

Total: 33 marks

Exhibit 1: Summary of key matters arising from the interim audit – produced by Beverley Leong

The interim audit visit was completed in October 2018. Each of the items below is expected to have a material impact on Sizewell's financial statements.

- An internal audit investigation during the year found what appears to be a significant fraud by a senior claims handler. This is explained further in Exhibit 2.

- From July 2018, the categories of perils were reduced from 200 to 80. This was to facilitate faster claims handling and easier data entry by claimants. All previous 200 perils were "mapped" onto the new 80 perils with some limited input from Sizewell's underwriters. Each policy type has a standard split of risk across a number of expected perils. This data is then used for reserving purposes.

- For many years, there has been a balance of approximately £140,000 on unmatched cash inwards. This is cash received by Sizewell that could not be matched to a policy proposal. All cash inwards is initially held in a bank account in a designated client money account. Once it is matched to a policy proposal that Sizewell has accepted, it is then moved automatically to Sizewell's general bank account. In September 2018, Sizewell's finance director instructed that the entire balance of £140,000 should be moved to the general company bank account and be classified as gross written premiums in 2018. His email giving this instruction stated: "if we've received the money, it must be from policyholders, possibly from policies that expired many years ago. If nobody has claimed it yet, it must be our money, and so our premium income. If we're wrong, we can make individual refunds easily enough."

Exhibit 2: Summary of fraud in claims handling – produced by Sizewell's internal audit department

In March 2018, Sizewell reorganised some of its departments. Internal audit had previously reported directly to Sizewell's non-executive chairman, but it now reports to Sizewell's head of regulatory compliance.

The head of regulatory compliance has allowed internal audit to follow whatever investigations it considers appropriate on an ad hoc basis. This has led to the discovery of a fraud committed by a senior claims handler.

For the last three years, claims with an initial case reserve of at least £20,000 were always passed to Sizewell's senior claims manager, Kevin McCann. Internal audit had become concerned that the amounts paid to settle these large claims were escalating and typically appeared to be £10,000 more than the initial case reserve.

Investigations showed that almost all of these claims had been initially filed by the policyholder online, but the policyholder subsequently handed management of their claim to a claims management company called Victory Claims Ltd (VCL). Upon questioning, Kevin admitted that he had received a personal commission of £5,000 for each claimant whose details he passed to VCL. Kevin then authorised the final payment to the policyholder at an inflated value.

Kevin was immediately placed on unpaid leave, pending investigation by Sizewell's internal auditors. To date, no action has been taken other than to reallocate cases that Kevin had been working on to other claims handlers.

The head of internal audit reported this apparent fraud to Sizewell's head of regulatory compliance, who replied by email "This is an unpleasant matter that we should deal with quickly, but as quietly as possible – it's just one employee amongst many and we don't want this to damage the company's reputation. We must keep a sense of proportion. Please don't talk about this with anybody else without clearing it with me first."

Question 3

You are an ICAEW Chartered Accountant working in a risk management department of Melchester Life (Melchester).

Melchester is a UK-based mutual life insurer owned by its members (defined as its policyholders). It writes a variety of long-term protection policies, mainly term life and whole life insurance. It also provides pensions and other long-term investment products. To date, its products have been marketed only in the UK. All products are structured in one of two ways, either:

- providing for a fixed cover amount or benefit; or
- as 'with profits', where the cover amount or benefit is based on the performance of the underlying 'with profits' component of Melchester's investment portfolio.

At Melchester's most recent members' meeting in October 2018, a group representing a significant percentage of 'with profits' members argued that the current investment strategy does not provide an adequate return for 'with profits' policyholders. They cited the fact that the performance of Melchester's 'with profits' funds has been consistently below the total return of the FTSE100 index over the last three years.

Melchester's stated investment approach is to select a level of risk and then, subject to this risk level, maximise the level of return. It seeks to maximise this return by selecting the proportions of the total portfolio held in each asset class. The investment committee sets investment strategy and recommends the policy, limits and restrictions to the board.

You are part of a team led by Richard Phillotson. This team has been tasked by Melchester's board with reviewing current investment policies. You have been provided with the composition of the current investment portfolio held by Melchester as **Exhibit 1**.

Richard sent you an email (**Exhibit 2**) asking for some assistance.

Requirements

3.1 Describe the major risks arising from each type of investment held within Melchester's investment portfolio (Exhibit 1).

3.2 Critically evaluate the appropriateness of the structure of each of the two parts of Melchester's investment portfolio
(ie, 'with profits' and 'other products').

3.3 Respond to the email from Richard Phillotson (Exhibit 2) outlining two different methods of mitigating the exposure to an extreme mortality event, such as an influenza pandemic.

Total: 27 marks

Exhibit 1 – Investment assets of Melchester Life at 30 November 2018 extracted from management accounts

Members' funds are managed in two separate investment portfolios - assets related to 'with profits' products and assets related to 'other products' which have fixed benefits or cover.

Investment	With profits		Other products		Total
	£m	%	£m	%	£m
Equities					
- UK listed	393.7	31	1028.3	25	1422.0
- UK unlisted	63.5	5	287.9	7	351.4
- Non-UK listed	254.0	20	740.3	18	994.3
Bonds					
- Gilts	266.7	21	699.2	17	965.9
- Corporate	101.6	8	822.6	20	924.2
Property	152.4	12	411.3	10	563.7
Cash	38.1	3	123.4	3	161.5
Total	**1,270.0**	**100**	**4,113.0**	**100**	**5,383.0**

Notes:

UK listed equities consist of a diversified portfolio of equities in the FTSE 350 index and are managed by an external fund manager.

UK unlisted equities consist of venture capital investments in a number of young, fast growing companies. This part of the portfolio is managed in-house and the majority of current investments are in 'fintech' companies, (ie, those using technology in innovative ways to address the needs of the financial sector).

Non-UK equities are listed on recognised stock exchanges and issued by companies with large market capitalisations.

Gilt holdings include a range of maturities and coupons.

Corporate bonds are sterling denominated and have high investment grade credit ratings.

Property consists of retail and other commercial property in London.

Exhibit 2 – email to you from Richard Phillotson

Hi,

I recently attended a seminar on the risks for insurers arising from potential influenza pandemics in the UK. I am concerned that given our extensive life business, we could be exposed to an extreme mortality risk arising from a pandemic.

Our constitution does not permit us to issue debt securities directly linked to this risk, but can you think of any alternative ways in which we could mitigate this risk?

Regards

Richard