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 – Welsh Life

General comments

This question is based on a UK-based life insurer about to voluntarily early adopt IFRS 17 for the preparation its upcoming financial statements. The insurer also owns and operates a price comparison website, the operations of which were described in an exhibit.

The other two exhibits provided a (flawed) attempt by another member of the insurer's finance team to calculate the liability on initial recognition related to a long-term insurance contract and the necessary information from the actuaries required to enable the calculation of this liability using the general measurement method of IFRS 17.

The scenario also described mortality bonds issued by the insurer and measured at FVTPL. The opening and closing liability is provided together with the information to enable the determination of how much of the reduction in the FV of the liability over the year is attributable to the change in the insurer's own credit risk.

The scenario also contains a (partially incorrect) statement by the finance director regarding the way in which underwriting profits and losses will be spread through the P/L over a long-term insurance contract's life under IFRS 17.

This question had the highest average mark on the paper. This was largely as a result of strong performance on the first three financial reporting based requirements which covered IFRS 17. It was gratifying to see candidates continuing to perform well on this new area to the syllabus for 2018.

By contrast, the final requirement, which covered ethical and regulatory aspects, was typically answered poorly and had the second lowest average mark achieved. Answers were frequently too brief to do justice to the question. This may have been the result of candidates spending too long on the first two requirements of this question.

Requirement 1.1

Errors in Francis' calculation are as follows:

- The net present value of cash inflows and cash outflows is incorrectly described as fulfilment cash flows. Deduction of the adjustment for non-financial risk is required to arrive at fulfilment cash flows
- The figure calculated by Francis for the adjustment for non-financial risk is incorrect because it is derived from the net present value of cash flows, rather than the present value of cash outflows as stated.
- The adjustment for non-financial risk has also been added to the net present value of cash flows, whereas it should be deducted.
- The value of the insurance contract should not be included in profit or loss for the year. Francis should have recognised a contractual service margin equal and opposite to the fulfilment cash flows to arrive at nil value for the contract on initial recognition.

The corrected calculation for the initial recognition of contract 196-588:

	£m
PV of cash inflows	20.69
PV of cash outflows	(17.52)
Adj. for non-financial risk	(0.70)
Fulfilment cash flows	2.47
Contractual service margin	(2.47)
Value on initial recognition	0

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Examiner's comments

This requirement focused on the measurement of an insurance contract on initial recognition. This topic has featured in a previous exam in 2018, but in this case the requirement provided an incorrect calculation where candidates had to identify the errors and then prepare their own correct version.

Most candidates scored very well on this requirement, many achieving full marks. This was reflected in the fact that the average for this requirement was the highest on the paper.

There were four errors made in the calculation given, it was a little surprising how few candidates managed to spot them all. The addition, rather than deduction, of the adjustment for non-financial risk was the most commonly missed.

The only real negative on this question was the surprisingly high number of candidates who provided a narrative description of the workings of the General Measurement Method (GMM) of IFRS 17 or discussed, sometimes at length, the issue of whether the GMM should be used for this contract and the criteria for so doing. Such information was often fairly extensive, but unfortunately not required and garnered no marks as a consequence. Unfortunately this may have cost many candidates valuable time that could have been better used elsewhere.

Of the candidates who failed to score a pass mark on this question, all but one went on to fail the examination as a whole. This was far from inevitable given the marks allocated. However, performance on this requirement seemed to be rather a litmus test of a candidate's overall level of preparation.

Maximum marks 1.1	7

Requirement 1.2

	PV of future cash flows £m	Adj for non-financial risk £m	Fulfilment cash flows £m	Contractual service margin £m	Liability for remaining coverage £m
Opening bal - 1 Dec 2017	0	0	0	0	0
Changes related to future service	3.17	(0.70)	2.47	(2.47)	0
Cash inflows	(2.40)	-	(2.40)	-	(2.40)
Insurance finance income/(expense)	0.04	-	0.04	(0.12)	(0.08)
workings	*(3.17–2.4) x 5%*			*(2.47) x 5%*	
Changes related to current service	0	0.10	0.10	0.37	0.47
workings		*0.7÷7*		*(2.47+0.12)÷ 7*	
Cash outflows	0.85	-	0.85	-	0.85
Closing bal - 30 Nov 2018	1.66	(0.60)	1.06	(2.22)	(1.16)

Statement of profit or loss for year ended 30 November 2018

	£m	£m	***workings***
Insurance revenue	1.32		*0.47 + 0.85*
Insurance expenses	(0.85)		*from table above*
Insurance service result		0.47	*from table above*
Insurance finance expense	(0.08)		*from table above*
Investment income	0.05		*2.4 x 2%*
Investment result		(0.03)	
Profit for year		0.44	

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Examiner's comments

This requirement went further than previous questions set on IFRS 17 by focusing on subsequent measurement of an insurance contract at the year end. Previous 2018 examination questions had required only initial valuation, reflecting the phased introduction of IFRS 17. Part (a) asked for a reconciliation of opening to closing liability for the year and part (b) the profit or loss impact.

This was also answered fairly well on average. However, there was a higher dispersion of marks than the previous requirement. An impressively high number of candidates scored full or near full marks and headroom marks were occasionally awarded. There were rather more weak answers than for requirement 1.1. Quite a few scripts showed evidence of a lot of time being spent in getting a largely incorrect answer.

Common errors in part (a) were to include the present values of all cash inflows/outflows over the contract's life as the cash inflows/outflows for the year, getting the correct value for insurance finance, but recording income as expense or vice versa. From this it would appear that subsequent measurement of insurance liabilities and the necessary reconciliation is not universally well understood.

There was a tendency for candidates to not provide workings for figures in the reconciliation in part (a). This was unfortunate as there is a limit to how much the marker can audit the answer provided in order to work out how values have been derived. Where workings were provided partial credit was given for correct elements of the candidate's methodology even if the value provided was incorrect.

Maximum marks 1.2	12

Requirement 1.3

Kaylee's statement that underwriting profits and losses would be spread over the contracts to which they relate is only partly correct.

Kaylee is correct that General Measurement Method of IFRS 17 recognises profit related to an insurance contract over the contract's life. This is accomplished by recognising a contractual service margin equal to the contract's fulfilment cash flows, which is amortised to profit or loss over the period of coverage. The release of the contractual service margin, in fact, occurs in line with the amount of coverage provided, in most cases, but not all, this is likely to be the same as apportionment over time.

However, her assertion is incorrect in relation to underwriting losses. If the fulfilment cash flows on a contract's initial recognition are negative, indicating that the contract is expected to be loss making over its life, no contractual service margin is created. Loss-making contracts are referred to as onerous by IFRS 17 and losses on onerous contracts are recognised in full in the statement of profit or loss in the year of inception. All future losses are also recognised in the profit of loss for the year if a non-onerous contract becomes onerous in that period.

Examiner's comments

This requirement was answered well by nearly all candidates, by correctly identifying that Kaylee's statement regarding the spreading of underwriting profits and losses under the GMM was only partly correct.

Unfortunately , some candidates got rather distracted by ethical issues surrounding the question of Kaylee's competence, given her incomplete understanding of IFRS 17.

A few candidates interpreted Kaylee's comments as principally relating to capitalising and spreading catastrophe losses experienced over a number of periods. This is probably an echo of questions set in previous sessions. It was not an accurate answer to this requirement.

Maximum marks 1.3	4

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Requirement 1.4a

Relevant points include:

- Value of term life liabilities will depend on mortality rates
- This is because mortality rate assumptions are use to determine likelihood and timing of payment of death benefits
- If mortality experience differs from assumptions previously used in calculating insurance liabilities this gives rise to gains or losses in profit or loss
- Amounts payable by Welsh Life under the mortality bond it has issued decrease in response to increased mortality experience, thus decreasing the mortality bond liability
- This reduction in the bond liability will (partly) offset the effect of changes in the value of insurance liabilities related to mortality experience from contracts in force
- Under IFRS 9 (and IAS39) bond liabilities would normally be classified as other liabilities and measured at amortised cost. As a result changes in fair value would not be reported in profit or loss
- Welsh Life have used the fair value option to designate the mortality bonds as FVTPL (rather than at amortised cost)
- FVTPL classification of the mortality bond liability by Welsh Life avoids the accounting mismatch that would otherwise arise
- Use of the fair value option ensures that the effects of mortality experience on the bond liability and the insurance liability are both recorded in profit or loss
- Volatility of reported profit will be reduced as a consequence

Requirement 1.4b

- Changes in the fair value of a financial liability can be caused by changes in the issuing entity's credit risk
- Prior to IFRS 9 such changes were recognised in the issuer's profit or loss, leading to the counter-intuitive result that a deterioration in an entity's credit risk could increase its profit
- Under the 'own credit' provisions of IFRS 9 such changes in the fair value of financial liabilities related to the issuing entity's own credit risk are recognised in other comprehensive income, not profit or loss [On derecognition of bond liability, the cumulative amount recognised in OCI can be transferred within equity, but not transferred through P/L].
- Therefore gains arising from the fall in the fair value of mortality bonds related to deterioration in the credit worthiness of Welsh Life is taken to OCI
- Fall in value relating to the reduction in credit rating (10% x 56.7 = £5.7m) to OCI
- Fall resulting from other factors (such as a change in mortality experience) (56.7 – 50.2 – 5.7 = £0.8m) to P/L.

Journals to record the change in value under IFRS 9

	£m	£m
Dr Financial liability at FVTPL (SOFP)	6.5	
Cr Gain from change in FV of liabilities at FVTPL attributable to own credit (OCI)		5.7
Cr Gain from change in FV of liabilities at FVTPL (P/L)		0.8

Examiner's comments

This requirement covered the liability related to mortality bonds that the insurer had issued. Part (a) focused on the way in which the liability was measured under IFRS 9 (FVTPL) and the benefits of this for the insurer. Part (b) required an explanation of the correct treatment under IFRS 9 for the fall in the bond's value which was, in part, due to deterioration in the insurer's own credit rating. Journals to record this were also required.

In part (a) a disturbingly high number of candidates discussed the bond as if it were an asset held by the insurer. This was identified by the examining team as a potential pitfall and as a consequence the fact that the bond was **issued** by the insurer and represented a **liability** was reiterated in the requirement as well as being clear from the scenario itself. This illustrates that some candidates still have a tendency to react to key words (like 'bond') and produce standard responses, rather than reading the question and requirements sufficiently carefully.

Part (b) was better answered on the whole. Candidates in previous sittings have often provided a description of the 'own credit' provisions of IFRS 9 in questions where it was not relevant. This requirement provided the opportunity for candidates to demonstrate that they could apply this knowledge to a practical scenario where it was relevant. Generally this was quite well answered, where there was a weakness, it tended to be

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incorrect double entry in the journals. Quite a few candidates got the right numbers, but the double entry the wrong way around with the reduction in the financial liability shown as a credit and the amounts shown in OCI and P/L as debits.

Also those candidates who mistakenly assumed this was an asset often went on to focus on impairment.

Maximum marks 1.4a	4
Maximum marks 1.4b	5

Requirement 1.5

Main issues to explore include:

Independence and transparency of ownership – potentially misleading
Welsh life doesn't appear to make clear its ownership of Chooselife. Users may assume it is independent, which is not the case.

Acceptability of differential pricing – potentially misleading
Customers who purchase Welsh Life policies through other PCWs and other distribution channels may pay higher premiums. Although pricing is to a large extent a commercial matter, this could be construed as not treating customers fairly, although different pricing may be justified if a higher service level is provided, such as advice. Also by extension other providers may also not be quoting the cheapest prices at which their products available. PCWs such as Chooselife purport to assist customers in selecting best value policies. In reality there is no guarantee of this and the same policy could be available at a lower elsewhere. Thus, unless these limitations are made clear, there is a danger that consumer expectations of price comparison website services exceed the actual service provided.

Appropriateness of preferencing own product – unfair and is misleading
Welsh Life is presenting its own products more advantageously. Describing its own products as 'Editor's best value' is misleading when in fact, due to the algorithm, another provider's product may be available at a price up to 10% cheaper. This is also indicative that Chooselife does not operate independently. The fact that 36% of Welsh Life policies are sold through Chooselife suggests that this approach may be commercially successful and that customers attach considerable weight to the 'Editor's best value' designation.

Exclusion of overseas insurers – potentially anti-competitive
The assertion that all non-UK insurers should be excluded to protect consumers is difficult to justify, particularly for EU insurers, which must offer equivalent investor protection. This could be seen as an unethical attempt to reduce the competition to Welsh Life's policies through Chooselife. In any case this limitation should be disclosed.

Large, low cost UK insurer not contributing quotes – potential for sub-optimal consumer outcomes
The fact that a large low cost provider doesn't quote through Chooselife is not in itself unethical or a breach of regulation. However, care should be taken to ensure that Chooselife doesn't purport to offer an exhaustive selection of all policies available to UK consumers, which is not in fact the case. Unless explicitly informed otherwise, customers are likely to assume that a PCW selects best prices from the entire universe of those available. Phrases such as 'Editor's best value' are likely to support this assumption. In fact it is only selecting the cheapest from those offering quotes through Chooselife. This could lead consumers to make ill informed decisions.

Encouraging consumer focus on price alone – potential for sub-optimal consumer outcomes
Chooselife, in common with other price comparison websites focuses principally on price. There is a danger that this could encourage consumers to solely consider price and not take into account the features of the policy. This could result in customers purchasing products that are not those best suited to their needs.

Examiner's comments

Responses to this requirement were disappointing. Many answers were far too brief to be able to gain a pass mark.

This question focused on industry, rather than practice ethics and necessitated the identification and explanation of possible ethical and regulatory issues related to the operation of a price comparison website.

There were actually a large number of issues evident from the exhibit that candidates could have explored to earn credit. In fact, considerably more than those needed to score full marks. Yet typically candidates focused only on one or two issues from the exhibit and often added rather generic points such as GDPR

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and the regulatory implications of holding data, that did not closely relate to the information given. Many were clearly intent on getting the PRA into their answers and spent time either discussing why it wouldn't be concerned or constructing somewhat tenuous arguments about how the price comparison website would impair the insurer's solvency. Only limited credit was available for this as it also failed to relate to the information provided. Leaving aside the issues of possible time pressure, candidates typically seem to perform less well on the more open-ended ethical issues specific to the insurance industry, clearly preferring the more prescriptive, and perhaps more familiar, practice ethics related to audit.	
Maximum marks 1.5	8

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Question 2 – Sizewell Insurance

General comments

This scenario places the candidate in the position of a newly qualified ICAEW Chartered Accountant who has taken over as manager of the audit of a medium sized UK general insurer following the departure of the previous audit manager after the interim audit.

The question revolves around finalising planning for the final audit with reference to three key matters identified at the interim stage provided in an exhibit.

One of these matters, a fraud in the client's claims handling, has been identified by the internal auditor, further details of which are provided in a second exhibit together with more information about the operations and structure of internal audit.

This average mark on this question was a little lower that for question 1. The performance on requirement 2.2 was markedly lower than for the other two requirements.

Although the key issues identified at the interim audit provided in Exhibit 1 have not featured in previous sessions, this question covered familiar auditing themes relating to them such as the identification of their significance to the audit, the appropriate response and internal controls.

Some answers to this question really suffered from the lack of a coherent structure. This was particularly an acute for the first requirement, where poor structure often led to information being missed out, given in the wrong part of the solution, as well as repetition and lack of clarity.

Requirement 2.1a, b and c

	Significance (2.1a)	Additional steps (2.1b)	Reporting option (2.1c)
Key matter			
Significant fraud	• Existence of fraud implies weaknesses in the control environment and operation of controls • This is especially true given that the fraud was not a one-off event • The value of claims paid is overstated, since the cost of an inflated claim comprises both a legitimate claim cost and a fraud expense • It is unlikely that the total amounts dishonestly obtained by Kevin will be material to the financial statements, so the greater concern is probably the symptom of weak controls • It is understandable that Sizewell's head of compliance might wish to minimise any potential damage from the revelation of the fraud, his attitude appears to be one of secrecy with everybody rather than with just the world at large. This is an	• Fully understand the circumstances and control defects that allowed Kevin to perpetrate the fraud • Document the claims cycle accurately and analyse if there are opportunities for similar fraud by other claims handlers • Discuss fraud potential within the entire audit team (as required by ISA 240) to collect ideas of how similar frauds could be perpetrated • Discuss with management and the internal auditor what changes have been identified as necessary and implemented since the discovery of the fraud • Update all systems documentation accordingly and perform walk-through tests to ensure that the documentation of the	• This is a serious matter that would be likely to be of concern to the PRA, since the PRA would expect an insurer to have controls to prevent such fraud from occurring • The FCA would be less likely to be concerned, unless evidence exists that the policyholder claims had been reduced in order to provide an inappropriate commission to VCL • The auditor should encourage management to make full disclosure of these matters to the PRA • If management does not do this, or if the auditor is concerned that the disclosure lacks sufficient transparency, then the auditor should disclose them to the

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	unacceptable view to hold from both an ethical and regulatory point of view – the PRA and FCA are entitled to expect full transparency from management • Thus, this matter creates a concern about the control environment, the details of the specific fraud and the attitude of management	systems is complete and accurate	PRA, possibly in a bilateral meeting if one is scheduled soon (fast, informal, common as a disclosure route) or in a formal report under section 342 FSMA 2000 (comparatively rare, rather formal, possibly disproportionate) • Full disclosure of the auditor's understanding of the facts, potential reasons and potential consequences should be made in writing as soon as practically possible to TCWG per ISA 260 • Since the fraud relates to criminal activity, it is covered by the money laundering provisions of POCA 2002. Sizewell should be encouraged by the auditor to report this to the National Crime Agency. If not the auditors may have to consider reporting the matter themselves
Reduction in perils	• Changes to data processing create an increased inherent risk and control risk. • Inaccurate data transfer could misstate insurance liabilities. • Misstatement could be related to size of claims or timing of claims (assuming discounting applied). • Reduced number of perils could lead to less accurate loss development projections. • Assuming split of standard policy type into different perils in standard proportions likely to result in inaccurate projections of individual claims (each policyholder is likely to be somewhat different to an average).	• Identify proportion of redundant peril codes that are defunct and are likely to have no effect. • Enquire from management what specialist input/advice was sought. • Assess competence and independence of any experts used. • Inspect a sample of claims in progress or older policies and trace through the policy details to the new peril codes (to ensure completeness) • Compare past claims development of old peril codes to new codes that have been deemed equivalent. Even if the mapping exercise is logically inaccurate (eg employer liability described as occupier's	• No disclosure required to the FCA or PRA (unless serious defects detected) • Report to TCWG under ISA 260 should include a description of the changes made to systems, weaknesses identified and the auditor's observation on how successfully the changes appear to have been made. • The auditor should also provide findings of this investigation to both in-house actuaries (in-house at both client and auditor) and, with the client's permission, any external actuaries. Actuaries are likely to rely on the accountants and

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	• Changes may smooth out when managed as a portfolio of similar policies.	liability), if the development pattern is very similar, this inaccuracy will not much matter.	auditors for accurate data and so must be informed of any weaknesses in any data provided to them.
Unmatched cash	• Possibility of not complying with CASS • But, CASS has limited application and generally doesn't include general insurance business, probably not a large risk • May imply general control weaknesses that have not been previously identified, so greater chance of material error in the financial statements • Management attitude unjustifiably relaxed – represents weakness in the control environment • Inability to match cash to a policy may suggest that a policy proposal was not accepted - accepting cash may therefore result in being on risk for declined risk • Assuming rejected policies were rejected because they would be loss making - could be a sizeable exposure and would imply that insurance liabilities are understated • Recognising income from previous years as current year written premiums fails to recognise the need for a prior year adjustment to previous year's figures – it should not be recorded as current year income, since this would be an error, rather than a change in estimates • There is no mention of insurance liabilities having been increased alongside recognition of additional income. This is the same as assuming that those premiums had a 0% loss ratio – clearly unrealistic • All of the above matters may suggest an	• Determine if CASS rules apply to this situation by reference to appropriate rules and policies • Consider and document the impact on the control environment, inherent and control risks • Inspect missed premium reports from similar dates to when the unmatched cash was received. If they are about the same size, it may be legitimately unmatched due to small processing errors. If there are no missed premiums, then it implies that the cash may have related to declined insurance proposals • Analyse the proportion of total unmatched cash that was received before the start of the current year. If received before the start of the current year, it is likely to require restatement as a prior period adjustment, as cash is generally received on or shortly after the date when a policy incepts • For a sample of unmatched cash items inwards, attempt to reconcile to policy proposals (eg using name of the payer to see if similar names exist on missed premium reports)	• The existence of weak controls and unmatched cash might well be a matter of concern for the PRA and/or FCA. The PRA may be concerned that the company's control environment is weak. The PRA would almost certainly be concerned by the apparent lack of awareness from management that accepting unknown cash could expose the company to unknown, and unquantifiable, risks • The FCA may be concerned that the company is holding onto cash from proposals without actually being on risk to provide cover, when the policyholder believed that they were covered • This is probably best discussed with management first, encouraging management to make full disclosure to the PRA and FCA • If management refuses to disclose this to the PRA, then the auditor may raise it with the regulator at a scheduled bilateral meeting • Reporting to PRA and/or FCA under s342 FSMA 2000 could be considered if serious enough and management refuse to disclose • Full details (particulars, possible reasons and potential effect) of the unmatched cash

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	overstatement of profit • Accepting cash where there is no knowledge as to its source could expose Sizewell to money laundering issues		should be provided in writing to TCWG

Examiner's comments

The first requirement had three parts; identify significance, outline additional audit steps and assess appropriate reporting options. These had to be applied to each of three key matters identified at the interim audit described in Exhibit 1. Therefore, it was important for candidates to produce a structured answer which made clear which part of the question was being discussed at any point.

Some candidates did this very successfully, often using a table, which was probably the most effective form for the answer to take. Candidates who used a less structured approach or offered answers which attempted to combine different parts of the requirement or different matters, typically produced weaker answers, often lacking specificity. At worst these poorly structured answers made it very hard to determine whether the candidate was actually applying knowledge to answer the question or simply providing a gallimaufry of information in the apparent hope that some of it might be relevant to some part of the question. As noted in previous examiner's comments there is a limit to how much a marker can or should 'read in' before they are effectively arranging the candidate's solution into a more effective answer themselves. Examiners go to considerable efforts to decide how to break requirements down in order to make them as easy as possible to answer and then mark. Future candidates who choose to aggregate requirements should be aware that they are doing something that is likely to cost them in clarity and marks.

Another familiar issue, evident in weaker answers to this requirement, was a propensity to provide very broad steps such as 'do more testing on liabilities' or stating objectives, but not the steps to achieve them, such as 'ensure that liabilities are not materially misstated'. To achieve strong marks an answer must be specific to the information provided in the question. Where a question asks for audit steps, candidates score very few marks for stating audit objectives and vice versa.

For part (c), candidates were generally good at identifying the various ways that the issues could be reported: such as to management, to those charged with governance (such as audit committee) or to the regulator whether under s342 FSMA 2000 or at a routine bilateral meeting between auditor and PRA supervisor. Where answers often fell down was in identifying the most appropriate means for reporting. Too many answers just described the various options without drawing any conclusions as to which would be appropriate.

Maximum marks 2.1a	6
Maximum marks 2.1b	6
Maximum marks 2.1c	8

Requirement 2.2

The audit relates to a UK public interest company and so the audit must be conducted in accordance with ISA (UK).

ISA 610 (UK) prohibits direct assistance from the internal auditor. That does not appear to have been proposed here, although the 'internal freelance' status of internal audit may make it tempting to use their assistance as they are likely to be available. The internal auditor must not perform work that is under the direct direction and control of the external auditor.

Before placing reliance on the work of the internal auditor, the external auditor must assess a number of factors including:

- Their competence (eg qualifications, relevant experience)
- Their independence (eg do they report to a person whose work they are scrutinising)
- Whether they follow an organised work plan
- Their organisational standing

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The following matters are relevant to this decision:

- The internal auditor has discovered a significant fraud. This could suggest that the internal audit function is competent. It is likely that internal audit will have done a lot of work on this area, which the external auditor is likely to be able to place considerable reliance on. However, the fact that the fraud persisted for a number of years prior to detection raises a question over the effectiveness of internal audit.
- The lack of a formal work programme suggests that the "ad hoc" nature of internal audit's work may lack rigour. This would suggest that less reliance can be placed on internal audit. The external auditor would be likely to review the internal auditor's work to determine if it has been done and documented to a sufficient standard to justify reliance.
- The internal auditor's organisational standing appears to have been diminished by the structural changes. Instead of reporting to the non-executive chairman, the reporting point is now the head of regulatory compliance; which is clearly a more junior position. The head of regulatory compliance also shows an unwillingness to take action in relation to the fraud identified. These factors are also likely to result in demotivation of the internal audit team and lower quality work as a result.
- The independence of the internal audit function is likely to have been significantly diminished in certain respects by reporting to the head of regulatory compliance. Many internal audit investigations are likely to concern matters for which the head of compliance is directly or indirectly responsible. This may place internal auditors in a position where they do not feel able to criticise as frankly as if the reporting point had still been to the non-executive chairman.

There are mixed elements in the scenario. Some suggest that a greater degree of reliance on internal audit than normal is acceptable. Overall though, the apparent demotion of internal audit in the year and the inappropriate reporting point would suggest that reduced reliance should be placed on the internal auditor's work this year, with a possible exception of using work they have done on the fraud to reduce the amount of direct investigation that the external auditor needs to undertake.

Examiner's comments

This was a fairly straightforward requirement, requiring candidates to apply the criteria for using the work of internal auditors from ISA 610 to the information provided by the exhibits.

Answers generally fell into two camps, those that provided the criteria of ISA 610 and applied them to score well and those that adopted a less specific approach, on occasion similar to that used when deciding on whether to rely on the work of an actuary, (something which has been examined in more than one previous exam). The latter approach did cover some relevant issues, but tended to produce lower marks as it typically failed to consider all relevant issues.

A fairly flexible approach was taken to awarding marks for conclusions, provided there was good reasoning. For example, the fact that a fraud had persisted undetected for three years could be given as a reason to question internal audit's competence, on the other hand it could validly be argued that the fact it was detected by internal audit at all could be used as some evidence of competence.

On the subject of competence, many candidates appeared to suggest that in order to be competent, members of internal audit would need to be ICAEW Chartered Accountants. Whilst professional pride in the qualification is admirable, it is probably also important for candidates to appreciate that other types of competent professional accountant are available.

Maximum marks 2.2	8

Requirement 2.3

Appropriate controls include the following.

Prevention

- Segregation of duties – at least two independent people required to approve claims
- Authorisation – substantial increase of case reserve from original estimate reviewed and signed off by an independent person
- Authorisation – approval required if details of claimant are changed once claim in progress
- Sample inspection of claims in progress without notice to identify any unjustifiable changes to case reserves
- Use of independent loss adjusters to validate level of claim prior to payment

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More timely detection (and thus partial prevention)

- Data analysis of claims by manager with periodic review by independent person. It appears that the internal auditor investigated using data analytics – these could have been used routinely even without pre-existing suspicion
- Data analytics used to see patterns of elevated claims by common data (eg involvement of VCL, particular claims handlers, peril type etc)
- Cold review of settled cases by internal audit or compliance team to determine if a claim had been defended adequately
- Analysis of average cost per claim handler to assess their performance in minimising the cost of inflated or fraudulent claims
- Clear, confidential procedures for staff to report concerns about possible fraud
- Provide financial incentives to staff to report suspicions of fraud by colleagues
- Ensure that the company has strong whistleblower protections in place for staff reporting concerns about fraud by management

Examiner's comments

The final requirement of this question required candidates to provide five internal controls that would have detected or prevented the occurrence of the fraud described in Exhibit 1.

This was generally done fairly well. The main reasons for candidates failing to achieve full marks were: offering controls that were too similar to each other, generic controls not related to the fraud or ineffective controls. Some candidates also described control objectives, rather than controls themselves.

The vast majority of candidates were able to suggest at least 3 effective controls.

Maximum marks 2.3	5

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Question 3 – Melchester Life

General comments

The final question of the examination focused on investments, risk and asset-liability matching and placed the candidate in an insurer's risk management department. These are three linked topics that are core to the BPI syllabus.

The scenario describes a UK mutual life insurer that sells a typical range of long-term life, investment and pension products. Products are either structured with fixed benefits/cover or as 'with profits', where benefits/cover are linked to the underlying 'with profits' investment portfolio.

The mutual's investment portfolio comprises two separate parts, one related to 'with profits' products and the other to products with fixed cover/benefits. The asset breakdown of each of these parts of the portfolio is provided as an exhibit, together with narrative notes providing further information about the characteristics of each of the portfolio's constituents.

The scenario also describes a complaint raised at the most recent members' meeting by a group of with profits members objecting to the fact that with profits returns had been too low and citing the fact that they were lower than the return from the FTSE100 as evidence of this.

A second exhibit contains an email from the candidate's boss requesting advice on how to mitigate the extreme mortality risk that could arise from an event, such as an influenza pandemic.

Question 3 was the least well-answered question on the paper. Performance varied considerably across the three requirements with weak performance on 3.2 being largely responsible for the weaker performance overall.

Many candidates seemed unsure of how to approach 3.2 despite the fact that the scenario clearly described the different nature of the liabilities related to 'with profits' and 'other products', something reiterated in the exhibit. Faced with a less familiar requirement some candidates seem to have a tendency to fall back on first looking for help in the learning materials, rather than looking more carefully at the information provided in the question itself.

Another factor that contributed to the weaker performance was the brevity of some answers. As mentioned above, time pressure may, for some candidates, have been the result of spending too much time on the first two requirements of question 1

Requirement 3.1

The following risks can be identified for each type of investment:

Investment types	**Risks**
Equities	Market/equity risk – variability of value/returns related to a wide range of factors that affect company and share performance No right to predictable fixed future cash flows Liquidity risk, the ability to realise investments at, or close to, fair value varies considerably for different types of equity
UK listed	Market/equity risk as above, diversification reduces overall level of risk Limited liquidity risk, although possible if large disposals required quickly Operational risk related to use of external fund manager
UK unlisted	Market risk is higher – as typically smaller, earlier stage companies Fintech companies particularly high risk as likely to be early stage and pre-profitability. The focus here creates a concentration risk Liquidity risk high, as no ready market for unlisted company shares
Overseas listed	Market/equity risk related to variables principally outside the UK

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	Currency risk is introduced into the portfolio since shares quoted and returns paid in foreign currency
Bonds	Credit risk related to the probability of an issuer failing to make specified payments of interest or capital Unless index-linked the real value of bonds is exposed to inflation risk If fixed interest, the value of a bond is inversely related to interest rates. This creates interest rate risk if the bond is not held to maturity. Interest rate risk can be measured using duration
Gilts	Gilts are effectively free of credit risk Interest rate risk is present if not held to maturity Inflation risk if gilts not index-linked as inflation affects the real value of returns
Corporate	Interest risk and inflation risk as for gilts In addition credit risk, as corporate issuers may not meet payments due. However this risk is relatively low as bonds are investment grade.
Property	Market/property risk based on performance of property market, not exactly correlated to equity markets Liquidity risk is high due to time and costs typically required to liquidate property Concentration risk created due to the focus of Melchester's property holdings on a specific geography and sector.

Examiner's comments

The first requirement was relatively straightforward on a core syllabus area where any well-prepared candidate should have done well. Many candidates offered good answers to this requirement and scored well as a result. In many answers it was pleasing to see better understanding, a greater level of granularity and a more nuanced approach to the identification of the risks related to types of investment held than has sometimes been displayed in previous sittings.

Where answers were weaker, it appeared to be the result of not having a sufficiently strong grasp of the nature and features of the types of investments held by the insurer or a failure to focus on the risks faced by the insurer itself. For example, on occasion credit risk was discussed in relation to equities. This assertion was usually derived from the fact that an equity issuer could become insolvent and lead to total loss of the shareholder's investment. However, since an equity holder does not have the right to any specific cash flows from the investee company, it is incorrect to identify this as credit risk.

Some risks apparent from the information given were rarely identified by candidates, such as the concentration risk arising from investing in fintech companies or through holding investment properties based in a single UK city.

Some candidates placed an excessive focus on valuation risk in their answers and an extensive discussion of block discounts on equities was quite common. Whilst of some limited relevance here, this was more an echo of answers to questions from previous sessions than an answer tailored to the question in hand. However, some limited credit was given.

There was also a surprising tendency in some answers to extensively describe risks not present. Very few marks were given for this information. Sometimes this was the result of an advantages/disadvantages approach taken to providing an answer, which was insufficiently tailored to reflect the requirement set.

Another approach taken by some candidates to this question, which was also less effective, was to organise answers by describing each risk in turn, rather than by investment type as the requirement stated.

Most candidates correctly identified currency risk in relation to non-UK listed equities. Quite a lot of these went on to describe how a change in the value of sterling could adversely affect returns. Curiously in most cases candidates incorrectly stated that returns from non-UK equities would be impaired by a fall in the value of sterling. Marks were not lost for this error, but it may indicate that understanding of currency effects on investment returns is weak.

Maximum marks 3.1	12

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Requirement 3.2

The nature of the product liabilities related to each part of the portfolio are as follows:

With profits

- Products offer a return based on the performance of underlying assets
- Policyholders benefit from higher investment returns through higher bonuses
- No fixed benefit liabilities (or possibly low guaranteed benefits)
- Products typically long-term nature so objective of long-term real return
- Given products (pensions/life/long-term investment) overall risk level would be expected to be low to moderate

Other products

- Also long-term products, but only entitled to a fixed insured amount
- Objective to ensure high probability that payments can be met
- Focus on nominal, rather than real return to meet nominal liabilities
- Higher returns beyond that required to meet fixed benefits do not directly benefit policyholders
- Risk tolerance likely to be low with a focus on asset-liability matching to reduce risk that liabilities can't be met.

Considering the above the following points can be made about appropriateness of the investments making up each fund

With profits

- Higher expected real return from equity (than gilts) justifies substantial investment in equity
- Diversification of equity portfolio reduces overall equity risk
- So overall equity proportion of 51% not necessarily excessive
- However 5% in higher risk, unlisted fintech company shares creates concentration risk which is harder to justify
- Similarly currency risk created by 20% holding in overseas equity seems unnecessary given underlying sterling based products
- Higher risk elements of portfolio must be justified by expected higher returns, but the level of risk may still not be appropriate for policyholders' risk tolerance
- Use of bonds creates diversification across asset classes
- Gilts have no credit risk, but return is low
- Gilts are low risk and reduce overall portfolio risk at the cost of reducing expected return
- Investment grade corporate bonds can increase return relative to gilts (with acceptable risk)
- Low yielding bonds will reduce expected return of this part of the portfolio below that of equities alone
- Mix of bonds and equity is appropriate given the lower risk profile of underlying product types
- Complaint of with profits customers that return is below FTSE100 is not proof of a defect in investment policy as it fails to consider risk and only considers the shorterm
- Property offers a higher return than gilts including an illiquidity premium
- Exposure to property further diversifies portfolio risk
- Real returns from property provide some protection against inflation risk
- Liquidity risk not likely to be a concern given limited amount invested
- Concentration risk might be better avoided with wider geographical/sectoral spread
- 3% cash for immediate liquidity needs reflects relatively low liquidity requirements
- Cash holding is low, but may be sufficient to meet anticipated claims and benefits
- Gilt holdings at 21% of portfolio offers further liquidity if necessary

Other products

- 25% held in equities seems high given the fixed nature liabilities and uncertainty of equity values/returns
- The likelihood of excessive risk is exacerbated by concentration and currency risk
- No rationale why amounts held in unlisted equities and overseas listed both exceed the proportions held in the with profits fund which would be expected to have a higher risk tolerance than other products
- Large holdings of equities, rather than bonds, creates a mismatch between the fixed liabilities and the assets that support them
- Equity risk Increases chance of being unable to meet liabilities and excess return beyond fixed amount of liabilities would not benefit policyholders
- Corporate bonds and gilts have the appropriate risk characteristics to match liabilities – given this, the proportion of bonds could be considered to be too low.
- A greater proportion of bonds in the portfolio would reduce the risk of being unable to meet fixed liabilities when they fall due

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- The lower proportion in gilts relative to with profits may reflects higher return available from investment grade corporate bonds
- Investing solely in gilts would reduce returns to a very low level and could may make Melchester's products uncompetitive
- Given low gilt yields, investment grade corporate bonds may allow higher returns at an acceptable risk
- Some limited property holdings may be appropriate given the long-term and largely illiquid liabilities related to other products
- Higher long-term returns from property may also permit Melchester's products to be more competitive – but as above concerns exist as to concentration risk.
- No reason to suggest 5% cash is inadequate
- The higher level of cash than with profits may represent greater near term liabilities

Examiner's comments

Despite the fact that many candidates struggled with this requirement, it was in essence an asset-liability matching question: a core part of the syllabus that has been previously examined on several occasions. Additional complexity was created compared to previous sessions by the fact that the investment portfolio was split into two parts, related to the two different types of product. As clearly stated, the 'other products' gave rise to fixed liabilities, which meant that the investment risk lay entirely with the insurer and holders of such products would have no interest beyond ensuring a high probability that fixed liabilities could be met. Whereas the benefits accruing to 'with profits' policies were dependent on the performance of the underlying part of the investment portfolio, meaning that higher returns would benefit both Melchester and these policyholders.

Given the differing nature of the liabilities covered by each of the two parts of the investment portfolio there were a number of asset allocations that appeared anomalous and could be questioned. Relatively few candidates successfully identified many of these or made a significant attempt to compare the risks and rewards of the assets held in each part of the portfolio to the characteristics of the relevant liabilities.

Many answers were too brief to achieve a pass mark on this requirement and it was not uncommon for candidates to reproduce descriptive material on areas such as the financial reporting treatment for with profits products, which did not serve to answer the requirement.

A good approach to this requirement would have been to consider each part of the portfolio in turn, perhaps first briefly reiterating the features of the objectives and liabilities of the products related to each part of the portfolio, before proceeding to consider the extent to which each investment class and the proportions held were a suitable match.

It should, however, be noted that some candidates did use this approach or similar and produced very good answers to this requirement as a result, but these were disappointingly uncommon.

Maximum marks 3.2	12

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Requirement 3.3

An influenza pandemic would lead to a large increase in mortality.
Increased deaths accompanying a pandemic would lead to large increase in life insurance claims beyond those expected.
Actuarial mortality assumptions implicit in insurance liabilities may not take into account the possibility of such extreme mortality events.

To mitigate the effect of dramatically higher mortality experience the following could be considered:

Arrange reinsurance

- Transfer a portion of the risk related to unexpectedly large increase in mortality to the reinsurer
- Excess of loss insurance most appropriate as it would effectively cap Melchester's exposure to pandemic related mortality increases
- Losses sustained in excess of specified amount, would be borne by the reinsurer in return for the payment of a reinsurance premium
- This would limit Melchester's exposure, but it would have to bear the cost of reinsurance affecting profitability

Develop business exposed to longevity

- Life insurance is exposed to increases in mortality/decreases in life expectancy
- By contrast annuities are exposed to longevity/increased life expectancy
- This is because if more annuitants die than expected, it reduces future annuity payments and thus reduces annuity related liabilities
- Therefore the effect of pandemic related mortality increases on annuities could, at least partly, offset the increased life insurance claims arising from such circumstances.
- This creates a natural hedge of mortality risk between annuities and life insurance
-

Examiner's comments

This shorter requirement was relatively straightforward, requiring candidates to provide two methods by which the insurer's exposure to extreme mortality risk could be mitigated.

All candidates offering an answer to this requirement identified at least one method with many identifying two appropriate approaches. Many candidates scored full marks here and achieving a headroom mark was not uncommon.

Exhibit 2 precluded the issue of securities linked to mortality by the insurer, despite this, a few candidates did proffer mortality bonds as an option. This was not awarded marks.

A few candidates suggested that Melchester should issue contingent convertibles. These would not directly address the mortality exposure, but rather could reduce the risk to solvency that could arise a result of it. Credit was given for this suggestion if sufficiently well explained.

Maximum marks 3.3	3

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