

ACCOUNTING STANDARD

AASB 1023

July 2004

General Insurance Contracts



Australian Government

**Australian Accounting
Standards Board**

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PREFACE

Reason for Re-issuing AASB 1023

The Australian Accounting Standards Board (AASB) is implementing the Financial Reporting Council's policy of adopting the Standards of the International Accounting Standards Board (IASB) for application to reporting periods beginning on or after 1 January 2005. The AASB has decided it will continue to issue sector-neutral Standards, that is, Standards applicable to both for-profit and not-for-profit entities, including public sector entities. Except for Standards that are specific to the not-for-profit or public sectors or that are of a purely domestic nature, the AASB is using the IASB Standards as the "foundation" Standards to which it adds material detailing the scope and applicability of a Standard in the Australian environment. Additions are made, where necessary, to broaden the content to cover sectors not addressed by an IASB Standard and domestic, regulatory or other issues.

The IASB defines International Financial Reporting Standards (IFRSs) as comprising:

- (a) International Financial Reporting Standards;
- (b) International Accounting Standards; and
- (c) Interpretations originated by the International Financial Reporting Interpretations Committee (IFRIC) or the former Standing Interpretations Committee (SIC).

The Australian equivalents to IFRSs are:

- (a) Accounting Standards issued by the AASB that are equivalent to Standards issued by the IASB, being AASBs 1 – 99 corresponding to the IFRS series and AASBs 101 – 199 corresponding to the IAS series; and
- (b) UIG Interpretations issued by the AASB corresponding to the Interpretations adopted by the IASB, as listed in AASB 1048 *Interpretation and Application of Standards*.

Compliance with IFRSs

This Standard has been revised to incorporate the limited improvements to accounting for insurance contracts required by AASB 4 *Insurance Contracts* (the Australian equivalent to IFRS 4 *Insurance Contracts*). General insurers applying this Standard and Australian equivalents to other IFRSs will therefore be compliant with IFRSs.

The following requirements in this Standard have been introduced to ensure compliance with IFRSs:

- (a) definition of an insurance contract (section 18 and Appendix);
- (b) embedded derivatives (paragraph 2.3.1);
- (c) deposit components (paragraph 2.4.1);
- (d) liability adequacy test (section 9);
- (e) impairment of reinsurance assets (section 12);
- (f) presentation of acquired insurance contracts (paragraphs 13.3.1 to 13.3.4);
- (g) disclosure – explanation of recognised amounts (paragraph 17.6); and
- (h) disclosure – amount, timing and uncertainty of cash flows (paragraph 17.7).

In applying paragraphs and sections listed in (a) to (c) and (e) to (h) above, general insurers may refer to the *AASB 4 Implementation Guidance* which is the Australian equivalent to *IFRS 4 Implementation Guidance*.

Main Features of this Standard

Application Date

This Standard is applicable to annual reporting periods beginning on or after 1 January 2005. To promote comparability among the financial reports of Australian entities, early adoption of this Standard is not permitted.

First-time Application and Comparatives

Application of this Standard will begin in the first annual reporting period beginning on or after 1 January 2005 in the context of adopting all Australian equivalents to IFRSs. The requirements of AASB 1 *First-time Adoption of Australian Equivalents to International Financial Reporting Standards*, the Australian equivalent of IFRS 1 *First-time Adoption of International Financial Reporting Standards*, must be observed. AASB 1 requires prior period information, presented as comparative information to be restated as if the requirements of this Standard had always applied. This differs from previous Australian requirements where changes in accounting policies did not require the restatement of the income statement and balance sheet of the preceding period. However, AASB 1 provides an exemption from the requirement to restate comparative information for this Standard, AASB 139 *Financial Instruments: Recognition and Measurement*, AASB 4 and AASB 1038 *Life Insurance Contracts*.

This Standard states that, except for the disclosures about accounting policies, and recognised assets, liabilities, income, expense and cash flows, an insurer need not apply the disclosure requirements in this Standard to comparative information that relates to annual periods beginning before 1 January 2005. However, where an insurer does apply the disclosure requirements in this Standard to comparative information that relates to annual periods beginning before 1 January 2005, if it is impracticable to apply any requirements of this Standard to comparative information that relates to annual periods beginning before 1 January 2005, an entity shall disclose that fact. In applying paragraph 17.7.1(c)(iii), an entity need not disclose information about claims development that occurred earlier than five years before the end of the first annual reporting period in which it applies this Standard. Furthermore, if it is impracticable, when an entity first applies this Standard, to prepare information about claims development that occurred before the beginning of the earliest period for which an entity presents full comparative information that complies with this Standard, the entity shall disclose that fact.

Main Requirements

Definition of Insurance

This Standard includes a definition of an insurance contract. An insurance contract is defined as a contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.

Insurance risk is risk other than financial risk. Financial risk is defined as the risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.

Insurance risk is significant if, and only if, an insured event could cause an insurer to pay significant additional benefits in any scenario, excluding scenarios that lack commercial substance.

A contract that transfers financial risk alone, or only insignificant amounts of insurance risk, is treated under AASB 139, to the extent that it gives rise to a financial asset or financial liability.

This Standard deals with those contracts that meet the definition of a general insurance contract. Insurance contracts that are life insurance contracts shall be treated under AASB 1038.

Liability Adequacy Test

This Standard includes a liability adequacy test. An insurer considers the adequacy of its unearned premium liability by considering current estimates of the present value of the expected future cash flows relating to future claims arising from the rights and obligations under current general insurance contracts. If the unearned premium liability less any related deferred acquisition costs and intangible assets is insufficient to meet future cash flows expected relating to future claims under current insurance contracts, then the entire deficiency is recognised in the income statement. The related intangible assets and deferred acquisition costs are first written down and any additional liability required is then recognised as an unexpired risk liability. The liability adequacy test for the unearned premium liability is performed at the reporting entity level by class of business. A class of business is to be determined using the Prescribed Classes of Business used by the Australian Prudential Regulation Authority (“APRA”) for general insurers registered with APRA. Insurers not registered with APRA perform the test at the Prescribed Classes of Business level or at an equivalent class of business level. For example, a reporting entity that consists of a group of two entities, both of which write compulsory third party business, performs the liability adequacy test by looking at the combined results of the two compulsory third party portfolios.

Assets Backing General Insurance Liabilities

The principle used by the Board in developing this Standard is to require assets backing general insurance liabilities to be measured at fair value wherever possible without creating an inconsistency with IFRSs.

This Standard restricts insurers' measurement choices, under the applicable Australian Accounting Standards, when measuring assets backing general insurance liabilities. When assets are not backing general insurance liabilities, measurement choices available in other Australian Accounting Standards are not restricted.

Assets backing general insurance liabilities shall be measured on a basis that is consistent with the measurement of the general insurance liabilities. As this Standard requires general insurance liabilities to be measured using an expected present value calculation, this Standard requires insurers to measure assets backing general insurance liabilities at fair value with changes in fair value recognised in the income statement wherever this option is available in the applicable Australian Accounting Standards. For example, under AASB 139, financial assets backing general insurance liabilities are required to be designated, on first application of this Standard, or on initial recognition, as "at fair value through profit or loss".

This Standard does not define the expression "assets backing general insurance liabilities" and requires general insurers to disclose the process used to determine which assets back general insurance liabilities.

Outstanding Claims Liability

The outstanding claims liability includes a risk margin to reflect the inherent uncertainty in the central estimate of the present value of the expected future payments. This Standard does not prescribe a fixed risk margin, or probability of adequacy.

Under AASB 1023 *Financial Reporting of General Insurance Activities*, issued in 1996, the outstanding claims liability was measured at the present value of expected future payments. It could be argued that the explicit requirement in this Standard to include a risk margin in the outstanding claims liability is conceptually different from the measurement at the present value of expected future payments. The IASB's tentative conclusions for Phase II of the Insurance Project indicate that a fair value model may be appropriate for the recognition and measurement of insurance contracts. AASB 4 defines fair value as the amount for which an asset could be exchanged, or a liability settled between knowledgeable, willing parties in an arm's length transaction. The IASB has proposed that the measurement of fair value would include an adjustment for the premium (discount) that marketplace participants would demand for the risks in the expected cash flows – the market value margin. This Standard requires the use of a risk margin to reflect the risk inherent in the central estimate rather than a market value margin. Nevertheless, the use of a risk margin to reflect the risk inherent in the central estimate is consistent with the anticipated move towards a fair value model.

Discount Rates

Outstanding claims liabilities are discounted for the time value of money using risk-free rates that are current observable, objective rates that relate to the nature, structure and term of the outstanding claims liabilities.

Disclosure

This Standard introduces additional disclosure requirements. It requires disclosures for general insurance contracts that explain the recognised amounts in its balance sheet and income statement that arise from general insurance contracts, and that help users to understand the amount, timing and uncertainty of future cash flows from general insurance contracts. The insurer determines the appropriate level of aggregation that is required to satisfy the disclosure principles.

Embedded Derivatives

This Standard is applied to derivatives embedded in a general insurance contract where the embedded derivatives are themselves general insurance contracts. Embedded derivatives that are not general insurance contracts are treated under AASB 139, unless exempted under this Standard.

Premium Revenue

Premium revenue (being premiums from direct business and premiums from reinsurance business) are recognised in the income statement, from the attachment date, in accordance with the pattern of the incidence of risk expected under the contract. For general insurance contracts that have contract periods greater than one year, the pattern of the incidence of risk expected is reassessed at the end of each reporting period.

Acquisition Costs

Acquisition costs incurred in obtaining and recording general insurance contracts are deferred and recognised as assets where the amount to be recovered can be reliably measured and where it is probable that they will give rise to premium revenue that will be recognised in the income statement in subsequent reporting periods.

Possible Future Changes to this Standard

Financial Guarantee Contracts and Credit Insurance

Financial guarantee contracts and credit insurance contracts that meet the definition of an insurance contract, are treated under this Standard, except for

those that an entity incurs or retains when it transfers financial or non-financial assets or liabilities to another party. The IASB has issued *Exposure Draft of Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement and IFRS 4 Insurance Contracts – Financial Guarantee Contracts and Credit Insurance*. Under these proposals financial guarantee contracts and credit insurance contracts that meet the definition of an insurance contract are to be recognised initially at fair value under IAS 39 and are subsequently measured at the higher of: the amount determined under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and the amount initially recognised less cumulative amortisation recognised in accordance with IAS 18 *Revenue*.

The AASB will issue an Exposure Draft requesting comment on these proposals and will consider submissions received. It is proposed, by the IASB, that the Exposure Draft will apply to reporting periods beginning on or after 1 January 2006.

Fair Value Option

IAS 39 currently allows any financial asset or financial liability to be designated as “at fair value through profit or loss” on initial recognition or on first adoption of the standard. This Standard requires financial assets backing general insurance liabilities to be designated as “at fair value through profit or loss” under AASB 139. The IASB has issued *Exposure Draft of Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement – The Fair Value Option*. Under these proposals there will be restrictions on the financial assets and financial liabilities that can be designated as “at fair value through profit or loss”. The AASB has issued ED 132 *Request for Comment on IASB ED Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement – The Fair Value Option*.

It is proposed that to be designated as “at fair value through profit or loss”, the fair value of financial assets and financial liabilities must be verifiable, that is, there must be a low variability in the range of reasonable fair value estimates. The fair value of some unlisted securities may not be considered to be verifiable.

In addition, it is proposed that to be designated as “at fair value through profit or loss” a financial asset or financial liability must meet one of five conditions. Under the IASB proposals, some financial assets and financial liabilities that this Standard requires to be designated as “at fair value through profit or loss” may no longer be able to be designated in this way. For example, a financial asset that meets the definition of a loan or receivable may not meet one of the five conditions. It is common for insurers to hold non-quoted fixed interest assets to back their insurance liabilities.

It is proposed, by the IASB, that the Standard resulting from the Exposure Draft apply to reporting periods beginning on or after 1 January 2005. ED 132 proposes that any changes to the fair value option be applicable for periods beginning on or after 1 January 2006, with early adoption permitted.

Phase II of IASB's Insurance Project

This Standard incorporates Phase I of the IASB's Insurance Project, represented, in Australia, by AASB 4. The IASB is currently progressing Phase II of the Insurance Project, which will consider the recognition and measurement of insurance contracts. This project is not expected to be completed before 2007. It is expected that the outcome of Phase II will be a revised insurance contracts standard that will replace this Standard, AASB 1038 and AASB 4.

COMPARISON WITH INTERNATIONAL PRONOUNCEMENTS

AASB 1023 and IFRS 4

AASB 1023 *General Insurance Contracts* incorporates the limited improvements to accounting for insurance contracts required by IFRS 4 *Insurance Contracts*.

General insurers applying this Standard and Australian equivalents to IFRSs will be compliant with IFRSs¹.

IFRS 4 is being implemented in Australia using three accounting standards:

- (a) AASB 4 *Insurance Contracts* (the Australian equivalent to IFRS 4) which applies to fixed-fee service contracts that meet the definition of an insurance contract;
- (b) AASB 1023 which applies to general insurance contracts; and
- (c) AASB 1038 *Life Insurance Contracts* which applies to life insurance contracts.

IFRS 4 applies to all insurance contracts and financial instruments with discretionary participation features whereas AASB 1023 only applies to general insurance contracts as well as certain aspects of accounting for assets that back general insurance liabilities. Whereas IFRS 4 only includes limited improvements to accounting for insurance contracts and disclosure requirements, AASB 1023 addresses all aspects of the recognition, measurement and disclosure of general insurance contracts.

IFRS 4 allows insurers to make changes to accounting policies if the changes make the financial report more relevant to the economic decision-making needs of users and no less reliable, or more reliable and no less relevant to those needs. Under the revised AASB 1023, general insurers shall change their accounting policies to reflect the revised requirements of the Standard but will not be able to make any additional changes to accounting policies.

¹ General insurers that are not-for-profit entities and that use treatments in other Australian Accounting Standards relating to not-for-profit entities that are not consistent with IFRS treatments will not be in compliance with IFRSs.

IFRS 4 allows insurers to use a practice described as “shadow accounting”.
The revised AASB 1023 does not allow shadow accounting.

AASB 1023 and IPSASs

The International Public Sector Accounting Standards (IPSASs) are issued by the Public Sector Committee of the International Federation of Accountants.

There is no specific IPSAS dealing with accounting for insurance contracts at present.

ACCOUNTING STANDARD AASB 1023

The Australian Accounting Standards Board makes Accounting Standard AASB 1023 *General Insurance Contracts* under section 334 of the *Corporations Act 2001*.

Dated 15 July 2004

D.G. Boymal
Chair – AASB

ACCOUNTING STANDARD AASB 1023

GENERAL INSURANCE CONTRACTS

1 Application

1.1 This Standard applies to:

- (a) **each entity that is required to prepare financial reports in accordance with Part 2M.3 of the Corporations Act and that is a reporting entity;**
- (b) **general purpose financial reports of each other reporting entity; and**
- (c) **financial reports that are, or are held out to be, general purpose financial reports.**

1.2 This Standard applies to annual reporting periods beginning on or after 1 January 2005.

1.3 This Standard shall not be applied to annual reporting periods beginning before 1 January 2005.

1.4 The requirements specified in this Standard apply to the financial report where information resulting from their application is material in accordance with AASB 1031 *Materiality*.

1.4.1 The requirements specified in this Standard apply to the financial report where information resulting from their application is material, in accordance with AASB 1031. An example of the application of materiality is that disclosures about general insurance contracts in the context of a group that includes a general insurer are required

where the general insurance business is material in the context of the group.

- 1.4.2 For the purposes of AASB 134 *Interim Financial Reporting*, the determination of the outstanding claims liability does not necessarily require a full actuarial valuation. In accordance with AASB 134, the outstanding claims liability would need to be determined on a reliable basis, would be based on reasonable estimates, would include a full review of all assumptions, and would not be materially different from the outstanding claims liability determined by a full actuarial valuation.

1.5 When applicable, this Standard supersedes:

- (a) **Accounting Standard AASB 1023 *Financial Reporting of General Insurance Activities* as approved by notice published in the *Commonwealth of Australia Gazette* No S 415, 6 November 1996; and**
- (b) **AAS 26 *Financial Reporting of General Insurance Activities* issued in November 1996.**

- 1.6 Both AASB 1023 (issued in November 1996) and AAS 26 remain applicable until superseded by this Standard.

- 1.7 Notice of this Standard was published in the *Commonwealth of Australia Gazette* No S 294, 22 July 2004.

2 Scope

General Insurance Contracts

2.1 This Standard applies to:

- (a) **general insurance contracts (including *general reinsurance contracts*) that a general insurer issues and to general reinsurance contracts that it holds;**
- (b) **certain assets backing *general insurance liabilities*;**
- (c) ***financial liabilities* and *financial assets* that arise under *non-insurance contracts*; and**
- (d) **certain assets backing financial liabilities that arise under non-insurance contracts.**

- 2.1.1 There are various types of *insurance contract*. This Standard deals with general insurance contracts (including general reinsurance contracts). General insurance contracts are defined as insurance contracts that are not *life insurance contracts*.
- 2.1.2 This Standard applies to general insurance contracts issued by Registered Health Benefits Organisations (RHBOs) registered under the *National Health Act 1953*. RHBOs apply this Standard to contracts that meet the definition of a general insurance contract and to certain assets backing general insurance liabilities.
- 2.1.3 For ease of reference, this Standard describes any entity that issues an insurance contract as an insurer, whether or not the issuer is regarded as an insurer for legal, regulatory or supervisory purposes.
- 2.1.4 A reinsurance contract is a type of insurance contract. Accordingly, all references in this Standard to insurance contracts also apply to reinsurance contracts.
- 2.1.5 Weather derivatives that meet the definition of a general insurance contract under this Standard are treated under this Standard. A contract that requires payment based on climatic, geological or other physical variables only where there is an adverse effect on the contract holder is a weather derivative that is an insurance contract. To meet the definition of a general insurance contract, the physical variable specified in the contract will be specific to a party to the contract.

Transactions Outside the Scope of this Standard

2.2 This Standard does not apply to:

- (a) *life insurance contracts* (see AASB 1038 *Life Insurance Contracts*);
- (b) **product warranties issued directly by a manufacturer, dealer or retailer** (see AASB 118 *Revenue* and AASB 137 *Provisions, Contingent Liabilities and Contingent Assets*);
- (c) **employers' assets and liabilities under employee benefit plans** (see AASB 119 *Employee Benefits* and AASB 2 *Share-based Payment*) and **retirement benefit obligations reported by defined benefit retirement plans** (see AAS 25 *Financial Reporting by Superannuation Plans*);

- (d) **contingent consideration payable or receivable in a business combination (see AASB 3 *Business Combinations*);**
- (e) **contractual rights or contractual obligations that are contingent on the future use of, or right to use, a non-financial item (for example, some license fees, royalties, contingent lease payments and similar items), as well as a lessee's residual value guarantee embedded in a finance lease (see AASB 117 *Leases*, AASB 118 and AASB 138 *Intangible Assets*);**
- (f) **financial guarantees that an entity incurs or retains when it transfers financial or non-financial assets or liabilities to another party, regardless of whether they are described as financial guarantees, letters of credit or insurance contracts (see AASB 139 *Financial Instruments: Recognition and Measurement*);**
- (g) ***direct insurance contracts* that the entity holds (that is *direct insurance contracts* in which the entity is a *policyholder*). However, a *cedant* shall apply this Standard to reinsurance contracts that it holds; and**
- (h) **fixed-fee service contracts, that meet the definition of an insurance contract, if the level of service depends on an uncertain event, for example maintenance contracts or roadside assistance contracts (see AASB 4 *Insurance Contracts*).**

Embedded Derivatives

- 2.3.1 AASB 139 requires an entity to separate some embedded derivatives from their host contract, measure them at *fair value* and include changes in their fair value in the income statement. AASB 139 applies to derivatives embedded in a general insurance contract unless the embedded derivative is itself a general insurance contract.
- 2.3.2 As an exception to the requirement in AASB 139, an insurer need not separate, and measure at fair value, a policyholder's option to surrender an insurance contract for a fixed amount (or for an amount based on a fixed amount and an interest rate) even if the exercise price differs from the carrying amount of the host *insurance liability*. However, the requirement in AASB 139 applies to a put option or cash surrender option embedded in an insurance contract if the surrender value varies in response to the change in a financial variable (such as an equity or commodity price or index), or a

non-financial variable that is not specific to a party to the contract. Furthermore, that requirement also applies if the holder's ability to exercise a put option or cash surrender option is triggered by a change in such a variable (for example, a put option that can be exercised if a stock market index reaches a specified level).

Deposit Components

- 2.4.1 Some general insurance contracts contain both an insurance component and a *deposit component*. In some cases, an insurer is required or permitted to *unbundle* those components.
- (a) Unbundling is required if both the following conditions are met:
 - (i) the insurer can measure the deposit component (including any embedded surrender options) separately (that is, without considering the insurance component); and
 - (ii) the insurer's accounting policies do not otherwise require it to recognise all obligations and rights arising from the deposit component.
 - (b) Unbundling is permitted, but not required, if the insurer can measure the deposit component separately as in paragraph 2.4.1(a)(i) but its accounting policies require it to recognise all obligations and rights arising from the deposit component, regardless of the basis used to measure those rights and obligations.
 - (c) Unbundling is prohibited if an insurer cannot measure the deposit component separately as in paragraph 2.4.1(a)(i).
- 2.4.2 The following is an example of a case when an insurer's accounting policies do not require it to recognise all obligations arising from a deposit component. A cedant receives compensation for losses from a *reinsurer*, but the contract obliges the cedant to repay the compensation in future years. That obligation arises from a deposit component. If the cedant's accounting policies would otherwise permit it to recognise the compensation as income without recognising the resulting obligation, unbundling is required.
- 2.4.3 A general insurer, in considering the need to unbundle the deposit component of the general insurance contract, would consider all expected cash flows over the period of the contract and would consider the substance of the contract. For example, while some

financial reinsurance contracts may require annual renewal, in substance they may be expected to be renewed for a number of years.

- 2.4.4 To *unbundle* a general insurance contract, an insurer shall:
- (a) apply this Standard to the insurance component; and
 - (b) apply AASB 139 to the deposit component. When applying AASB 139, an insurer shall designate the deposit component as “at fair value through profit or loss”, on first application of this Standard or on initial recognition of the deposit component.

3 Purpose of Standard

3.1 The purpose of this Standard is to:

- (a) specify the manner of accounting for general insurance contracts consistent with AASB 4;**
- (b) specify certain aspects of accounting for assets backing general insurance liabilities;**
- (c) specify certain aspects of accounting for non-insurance contracts; and**
- (d) require disclosure of information relating to general insurance contracts.**

4 Premium Revenue

Classification

4.1.1 *Premium* revenue comprises:

- (a) premiums from direct business, that is, premiums paid by a policyholder (that is neither an insurer nor reinsurer) to a general insurer; and
- (b) premiums from reinsurance business, that is, premiums received by a reinsurer from an insurer or from another reinsurer.

- 4.1.2 Premiums from direct business arise from contracts when a policyholder transfers significant insurance risk to an insurer.
- 4.1.3 Premiums from reinsurance business arise from contracts when an insurer or reinsurer transfers significant insurance risk to another reinsurer.

Recognition

- 4.2 **Premium revenue shall be recognised from the *attachment date* as soon as there is a basis on which it can be reliably estimated.**
 - 4.2.1 The amount of premium is determined by a general insurer or reinsurer so as to cover anticipated claims, reinsurance premiums, administrative, acquisition and other costs, and a profit component (having regard to expected income from the investment of premiums). The amounts collected in respect of these components are income of an insurer on the basis that they are collected in consideration for the insurer rendering services by indemnifying those insured against specified losses.
 - 4.2.2 For certain classes of general insurance business, government authorities may require the payment of levies and charges. For example, workers' compensation insurance levies, annual licence fees and fire brigade charges may apply. Such levies and charges are expenses of the insurer, rather than government charges directly upon those insured. The insurer is not acting simply as a collector of these levies and charges. Although not compelled to collect these amounts from those insured, the insurer is entitled to include in premiums an amount to cover the estimated amount of the levies and charges. The insurer is usually responsible for paying the levies and charges at a later date. The amount paid by the insurer does not depend on the amounts collected from those insured in relation to the levies and charges. Therefore, the amounts collected to meet levies and charges are income of the insurer. The insurer accrues for all levies and charges expected under the general insurance contracts written in the period.
 - 4.2.3 In most States, stamp duty is charged on individual general insurance contracts and is separately identified by insurers on policy documents. The insurer is normally required to collect and pass on to the government an equivalent amount. Because such stamp duty is a tax collected on behalf of a third party and there is no choice on the part of the insurer but to collect the duty from the insured, it is not income of the insurer. Similarly, Goods and Services Tax (GST) is not income of the insurer.

- 4.2.4 Premium revenue needs to be recognised from the date of the attachment of risk in relation to each general insurance contract because insurers earn premium revenue by assuming insurance risks from that date on behalf of those insured. However, for reasons of practicality, many general insurers use bases of recognition that attempt to approximate this date. Such bases are acceptable provided that they do not result in the recognition of a materially different amount of premium revenue in a particular reporting period than would be the case if recognition occurred from the date of attachment of risk for each general insurance contract.
- 4.2.5 In recognising premium from the attachment date, an insurer may recognise premiums relating to general insurance contracts when the contract period commences after the reporting date, commonly referred to as premiums in advance. The attachment date is the date from which an insurer accepts risk. An insurer may accept risk prior to the date a contract commences: for example, it is not unusual for insurers to issue renewals, and for renewals to be paid for by policyholders, prior to the commencement date of an insurance contract. For commercial lines insurance, where the policyholder may be using the services of an insurance broker, the renewal terms could be agreed by both the insurer and policyholder prior to the commencement date and before the policyholder has paid the premium. In this situation, there may also have been a transfer of risk. As premiums in advance relate entirely to insurance cover to be provided in a future period, premiums in advance are recognised as part of the unearned premium liability. Premiums in advance are considered as part of the liability adequacy test required by section 9.

Reinsurance Premiums

- 4.2.6 From the perspective of the reinsurer, reinsurance premiums accepted are akin to premiums accepted by a direct insurer. The reinsurer recognises inwards reinsurance premiums ceded to it as revenue in the same way as a direct insurer treats the acceptance of direct premiums as revenue.
- 4.2.7 Premiums accepted by the reinsurer are recognised from the attachment date, that is, the date from which the reinsurer bears its proportion of the relevant risks underwritten by the cedant. Reinsurers usually use bases of recognition that approximate the dates of bearing the risks. For example, the reinsurer may assume that its acceptance of risks occurs from the middle of the period for which the aggregate ceded premiums are advised by the cedant. This approach is acceptable provided that the premiums received or receivable in respect of the reporting period are recognised in that

period, whether or not the periodic advice from the cedant has been received.

Measurement

- 4.3 Premium revenue shall be recognised in the income statement from the attachment date:**
- (a) over the period of the general insurance contract for direct business; or**
 - (b) over the period of indemnity for reinsurance business;**
- in accordance with the pattern of the incidence of risk expected under the general insurance contract.**
- 4.4 In the case of business where the premium is subject to later adjustment, the adjusted premium shall be used, where possible, as the basis for recognising premium revenue. Where this is not possible, the *deposit premium*, adjusted for any other relevant information, shall be recognised as the premium revenue, provided that it is expected that this amount will not be materially different from the actual amount of premium.**
- 4.4.1 Premium revenue is recognised in the income statement when it has been earned. An insurance contract involves the transfer of significant insurance risk. The insurer estimates the pattern of the incidence of risk over the period of the contract for direct business, or over the period of indemnity for reinsurance business, and the premium revenue is recognised in accordance with this pattern. This results in the allocation of the premium revenue and the claims incurred expense and hence the gross underwriting result over the period of the contract for direct business, or over the period of indemnity for reinsurance business, in accordance with the pattern of the incidence of risk.
- 4.4.2 Measuring premium revenue involves the following steps:
- (a) estimating the total amount of premium revenue expected under the contract;
 - (b) estimating the total amount of claims expenses expected under the contract and estimating when the claims are expected to arise;
 - (c) estimating the pattern of the incidence of risk from the result of (b); and

- (d) recognising the premium revenue under the contract identified in (a) when it will be earned, that is, in accordance with the pattern of the incidence of risk determined in (c).

4.4.3 For some general insurance contracts, especially complex multi-year reinsurance contracts, these estimations involve the use of significant judgement. The estimates are reassessed at each reporting date. This prospective estimate of all of the income and expenses expected under the contract is also necessary for the purposes of the liability adequacy test. Refer to section 9.

Direct business

4.4.4 For most direct general insurance contracts the specified period of the contract is one year. For many direct insurance contracts the pattern of the incidence of risk will be linear, that is, the risk of events occurring that will give rise to claims is evenly spread throughout the contract period. For these contracts the premium revenue will be earned evenly over the period of the contract. However, for some direct insurance contracts the risk of events occurring that will give rise to claims is not evenly spread throughout the contract. For example, with motor insurance contracts, the risk of events occurring that will give rise to claims may be subject to seasonal factors.

4.4.5 Insurers estimate the pattern of the incidence of risk expected under the general insurance contracts from the attachment date. An insurer may be able to reliably estimate the pattern for a particular type of insurance business based upon past experience. However, when there have been changes in the nature of the cover provided, or, when there has been a change in loss experience, the insurer reflects this in the estimations.

Reinsurance business

4.4.6 Reinsurers recognise reinsurance premiums over the period of indemnity provided by the reinsurance contract in accordance with the pattern of the incidence of risk. For a typical twelve-month proportional treaty, such as a quota share treaty, written on a “risks attaching basis”, the period of indemnity will be twenty-four months, as the proportional treaty will indemnify the direct insurer (or, for retrocession, the reinsurer) for losses arising under direct policies written during the twelve-month contract period. Hence, an underlying annual direct contract written on the last day of the reinsurance contract has twelve months of insurance cover beyond the last day of the reinsurance contract. The reinsurer estimates the

pattern of the incidence of risk over the twenty-four-month indemnity period.

- 4.4.7 The reinsurer may be able to reliably estimate the pattern for a particular type of reinsurance business based upon past experience. The reinsurer is likely to seek information from the cedant to estimate the pattern of the incidence of loss expected. When there have been changes in the nature of the cover provided or when there has been a change in loss experience the insurer will need to reflect this in the estimations.
- 4.4.8 To determine the pattern of the incidence of risk, reinsurers first determine the total reinsurance premiums expected under the contract. The premiums receivable under reinsurance treaties often depend on the volume of business written by the cedant after the reporting date but before the treaty expiry date. This is always true of proportional (quota share and surplus) treaties that span the reporting date, and is often true of non-proportional treaties. For such treaties, to estimate the total premium revenue expected under the reinsurance contract, the reinsurer estimates the inwards reinsurance premium it will receive under the contract by estimating the gross premium revenue that the cedant is likely to receive. The reinsurer is likely to estimate this by communicating with the cedant, and by reviewing past experience.
- 4.4.9 For a typical non-proportional treaty, such as an excess of loss treaty, the period of indemnity is usually the same as the contract period. For example, an excess of loss treaty could indemnify a cedant for all claims incurred above the excess (either individual claims or in aggregate) during the contract period, or for all claims made during the contract period. For some of these contracts the pattern of the incidence of risk is likely to be linear and hence for these contracts the premium revenue expected under the contract is earned evenly over the contract period.
- 4.4.10 With a non-proportional treaty the reinsurer estimates the total liabilities that are likely to arise under the underlying insurance contracts to enable an estimation of the total inwards reinsurance premium revenue expected under the contract. Where relevant, the reinsurer estimates whether the cedant is likely to want to reinstate the contract, in which case the reinsurer considers the additional reinstatement premiums it is expected to receive and the extent that they may have been earned at the reporting date. A reinsurer liaises closely with the cedant, reviews any market information on significant losses or events that may have arisen, for example a hailstorm or earthquake, and reviews past experience.

- 4.4.11 Some reinsurance contracts might involve an experience account. Whilst such contracts may require annual renewal, in substance the contract period is likely to be greater than one year. In estimating the total inwards reinsurance premium expected under the contract and in estimating the total reinsurance claims, to determine the pattern of the incidence of risk, the reinsurer considers the probability-weighted expected cash flows over the expected period of the contract, and discounts these cash flows to reflect the time value of money. Section 6 discusses the determination of discount rates. In determining the expected cash flows, the reinsurer considers any cash flows such as profit commissions and commission rebates.

Adjusted premiums

- 4.4.12 For some classes of insurance it is usual for the premium to be adjusted as a result of events and information that only become known during or after the insurance contract period. For example, marine cargo insurance is a type of “adjustable” business for which a deposit premium is paid at the beginning of the contract period and subsequently adjusted on the basis of a cargo declaration.

Unclosed Business

4.5 Premium revenue relating to unclosed business shall be recognised in accordance with paragraphs 4.2, 4.3 and 4.4.

- 4.5.1 Frequently, there is insufficient information available at the end of a reporting period to enable a general insurer to accurately identify the business written close to the reporting date for which the date of attachment of risk is prior to the reporting date. This is often referred to as unclosed business. Consistent with the principle stated in paragraph 4.2, that premium revenue is to be recognised from the attachment date, all unclosed business is estimated and the premium relating to unclosed business included in premium revenue.
- 4.5.2 Estimates of the amount of unclosed business can be made using information from prior periods adjusted for the impact of recent trends and events. In addition, information about unclosed business may become available after the reporting date and before the financial report is authorised for issue and may enable more reliable estimates to be made.

5 Outstanding Claims Liability

Recognition and Measurement

5.1 An outstanding claims liability shall be recognised in respect of direct business and reinsurance business and shall be measured as the central estimate of the present value of the expected future payments for *claims incurred* with an additional risk margin to allow for the inherent uncertainty in the central estimate.

5.1.1 The recognition and measurement approach requires estimation of the probability-weighted expected cost (discounted to a present value) of settling claims incurred, and the addition of a risk margin to reflect inherent uncertainty in the central estimate.

5.1.2 The longer the expected period from the reporting date to settlement, the more likely it is that the ultimate cost of settlement will be affected by inflationary factors likely to occur during the period to settlement. These factors include changes in specific price levels, for example, trends in average periods of incapacity and in the amounts of court awards for successful claims. For claims expected to be settled within one year of the reporting date, the impact of inflationary factors might not be material.

5.1.3 For claims expected to be settled within one year of the reporting date, where the amount of the expected future payments does not differ materially from the present value of those payments, insurers would not need to discount the expected future payments.

Central Estimate

5.1.4 In estimating the outstanding claims liability, a central estimate is adopted. If all the possible values of the outstanding claims liability are expressed as a statistical distribution, the central estimate is the mean of that distribution.

5.1.5 In estimating the outstanding claims liability, an insurer may make use of case estimates of individual reported claims that remain unsettled at the reporting date. An insurer may base case estimates on the most likely claim costs. Where the range in potential outcomes is small, the likely cost may be close to the mean cost. However, where the potential range in outcomes is large and where the probability distribution may be highly skewed, the most likely cost, or the mode, could be below the mean and hence below the central estimate. In this situation, the insurer would need to increase

the case estimates accordingly to ensure that they represent the central estimate.

Risk Margin

- 5.1.6 The outstanding claims liability includes, in addition to the central estimate of the present value of the expected future payments, a risk margin that relates to the inherent uncertainty in the central estimate of the present value of the expected future payments.
- 5.1.7 Risk margins are determined on a basis that reflects the insurer's business. Regard is had to the robustness of the valuation models, the reliability and volume of available data, past experience of the insurer and the industry and the characteristics of the classes of business written.
- 5.1.8 The risk margin is applied to the net outstanding claims for the entity as a whole. The overall net uncertainty has regard to:
- (a) the uncertainty in the gross outstanding claims liability;
 - (b) the effect of reinsurance on (a); and
 - (c) the uncertainty in reinsurance and other recoveries due.
- 5.1.9 In practice, however, outstanding claims liabilities are often estimated on a class-by-class basis, including an assessment of the uncertainty in each class and the determination of a risk margin by class of business. When these estimates are combined for all classes, the central estimates are combined, however the risk margin for all classes when aggregated may be determined by some insurers to be less than the sum of the individual risk margins. The extent of the difference that some insurers may decide to recognise is likely to depend upon the degree of diversification between the different classes and the degree of correlation between the experiences of these classes.
- 5.1.10 For the purposes of the liability adequacy test, required by section 9, the risk margin for the entity as a whole is apportioned across classes of business.
- 5.1.11 Risk margins adopted for regulatory purposes may be appropriate risk margins for the purposes of this Standard, or they may be an appropriate starting point in determining such risk margins.

Expected Future Payments

5.2 The expected future payments shall include:

- (a) amounts in relation to unpaid reported claims;
- (b) claims incurred but not reported (IBNR);
- (c) claims incurred but not enough reported (IBNER); and
- (d) costs, including claims handling costs, which the insurer expects to incur in settling these incurred claims.

5.2.1 It is important to identify the components of the ultimate cost to an insurer of settling incurred claims, for the purposes of determining the *claims expense* for the reporting period and determining the outstanding claims liability as at the reporting date. These components comprise the policy benefit amounts required to be paid to or on behalf of those insured, and claims handling costs, that is, costs associated with achieving settlements with those insured. Claims handling costs include costs that can be associated directly with individual claims, such as legal and other professional fees, and costs that can only be indirectly associated with individual claims, such as claims administration costs.

5.2.2 Policy benefit amounts and direct claims handling costs are expenses of an insurer, representing the consumption or loss of economic benefits. The outstanding claims liability includes unpaid policy benefits and direct claims handling costs relating to claims arising during current and prior reporting periods, as they are outgoings that an insurer is presently obliged to meet as a result of past events.

5.2.3 Indirect claims handling costs incurred during the reporting period are also expenses of an insurer, and include a portion of the indirect claims handling costs to be paid in the future, being that portion which relates to handling claims incurred during the reporting period. The outstanding claims liability includes these unpaid indirect claims handling costs.

5.2.4 It is important to ensure that claims are recognised as expenses and liabilities for the correct reporting period. For contracts written on a claims incurred basis, claims arise from insured events that occur during the insurance contract period. Some events will occur and give rise to claims that are reported to the insurer and settled within the same reporting period. Other reported claims may be unsettled at the end of a particular reporting period. In addition, there may be

events that give rise to claims that, at the end of a reporting period, have yet to be reported to the insurer. The latter are termed claims incurred but not reported (IBNR claims). The insurer also considers the need to recognise a liability for claims that may be re-opened after the reporting date.

- 5.2.5 For contracts written on a claims made basis, claims arise in respect of claims reported during the insurance contract period. The insured event that gave rise to the claim could have occurred in a previous period. While claims made insurance contracts should theoretically only give rise to outstanding claims liabilities and IBNR claims (see paragraph 5.2.10), as claims cannot be incurred but not reported under such a contract, this may not be the case for reinsurers. A reinsurer may have reinsured a claims made contract on a claims incurred basis. In this case whilst a loss or other event would be reported to the direct insurer during the period of insurance to generate a valid claim, the reinsurer may not have received information about the claim but would have an IBNR liability. Similarly, a reinsurer may have issued a claims made reinsurance contract but may need to consider that not all notices of claims may have been reported by the direct insurer. Insurers and reinsurers should also consider court rulings that may impact on the way claims made contracts are interpreted.
- 5.2.6 Claims arising from events that occur during a reporting period and which are settled during that same period are expenses of that period. In addition, a liability and corresponding expense is recognised for reported claims arising from events of the reporting period that have yet to be settled. This involves a process of estimation that includes assessment of individual claims and past claims experience.
- 5.2.7 When, based on knowledge of the business, IBNR claims are expected to exist, an estimate is made of the amount of the claims that will arise therefrom. This involves recognition of a liability and corresponding expense for the reporting period. As in the case of reported but unsettled claims, an estimate of the amount of the current claims incurred but not reported is based on past experience and takes into account any changes in circumstances, such as recent catastrophic events that may have occurred during the reporting period and changes in the volume or mix of insurance contracts underwritten, that may affect the pattern of unreported claims.
- 5.2.8 Some insurers use estimations or formulae, related to the amount of outstanding claims and based on the past experience of the insurer and the industry, to arrive at an estimate of direct and indirect claims handling costs.

- 5.2.9 Claims expense and the outstanding claims liability are adjusted on the basis of information, including re-opened claims, that becomes available after the initial recognition of claims, to enable the insurer to make a more accurate estimate of the ultimate cost of settlement. This is often referred to as claims development. As is the case with other liabilities, the effect of the adjustments to the liability for outstanding claims and to claims expense is recognised in the income statement when the information becomes available.
- 5.2.10 Where further information becomes available about reported claims and reveals that the ultimate cost of settling claims has been under-estimated, the upwards adjustment to claims expense and to the liability for outstanding claims is often referred to as claims incurred but not enough reported (IBNER claims). Where further information reveals that the ultimate cost of settling claims has been over-estimated, the adjustment is sometimes referred to as negative IBNER claims.
- 5.2.11 Appropriate allowance is made for future claim cost escalation when determining the central estimate of the present value of the expected future payments. Future claims payments may increase over current levels as a result of wage or price inflation, and as a result of superimposed inflation (cost increases) due to court awards, environmental factors or economic or other causes.
- 5.2.12 With inwards reinsurance claims the reinsurer will receive periodic advices from each cedant. These may include aggregate information relating to the claims liability. The reinsurer measures its outstanding claims liability on the basis of this information and its past experience of the claims payments made under reinsurance arrangements. The reinsurer also considers market knowledge of losses and other events such as hailstorms or earthquakes.

6 Discount Rates

- 6.1 The outstanding claims liability shall be discounted for the time value of money using risk-free discount rates that are based on current observable, objective rates that relate to the nature, structure and term of the future obligations.**
- 6.1.1 The discount rates adopted are not intended to reflect risks inherent in the liability cash flows, which might be allowed for by a reduction in the discount rate in a fair value measurement, nor are they intended to reflect the insurance and other non-financial risks and uncertainties reflected in the outstanding claims liability. The

discount rates are not intended to include allowance for the cost of any options or guarantees that are separately measured within the outstanding claims liability.

- 6.1.2 Typically, government bond rates may be appropriate discount rates for the purposes of this Standard, or they may be an appropriate starting point in determining such discount rates.
- 6.1.3 The portion of the increase in the liability for outstanding claims from the previous reporting date to the current reporting date which is due to discounted claims not yet settled being one period closer to settlement, ought, conceptually, to be recognised as interest expense of the current reporting period. However, it is considered that the costs of distinguishing this component of the increase in the outstanding claims liability exceed the benefits that may be gained from its disclosure. Thus, such increase is included in claims expense for the current reporting period.

7 Unearned Premium Liability

7.1 Premium that has not been recognised in the income statement is premium that is unearned and shall be recognised in the balance sheet as an unearned premium liability.

- 7.1.1 The unearned premium liability is to meet the costs, including the claims handling costs, of *future claims* that will arise under current general insurance contracts and the deferred acquisition costs that will be recognised as an expense in the income statement in future reporting periods.

8 Acquisition Costs

8.1 Acquisition costs incurred in obtaining and recording general insurance contracts shall be deferred and recognised as assets where they can be reliably measured and where it is probable that they will give rise to premium revenue that will be recognised in the income statement in subsequent reporting periods. Deferred acquisition costs shall be amortised systematically in accordance with the expected pattern of the incidence of risk under the related general insurance contracts.

- 8.1.1 Acquisition costs are incurred in obtaining and recording general insurance contracts. They include commission or brokerage paid to agents or brokers for obtaining business for the insurer, selling and

underwriting costs such as advertising and risk assessment, the administrative costs of recording policy information and premium collection costs.

- 8.1.2 Because such costs are usually incurred at acquisition whilst the pattern of earnings occurs throughout the contract periods, which may extend beyond the reporting date, those acquisition costs which lead to obtaining future benefits for the insurer are recognised as assets.
- 8.1.3 For an asset to be recognised, it will be probable that the future economic benefits will eventuate, and that it possesses a cost or other value that can be measured reliably. Direct acquisition costs such as commission or brokerage are readily measurable. However, it may be difficult to reliably measure indirect costs that give rise to premium revenue, such as administration costs, because it is difficult to associate them with particular insurance contracts.

9 Liability Adequacy Test

- 9.1 The adequacy of the unearned premium liability shall be assessed by considering current estimates of the present value of the expected future cash flows relating to future claims arising from the rights and obligations under current general insurance contracts. If the present value of the expected future cash flows relating to future claims arising from the rights and obligations under current general insurance contracts, plus an additional risk margin to reflect the inherent uncertainty in the central estimate, exceed the unearned premium liability less related intangible assets and related deferred acquisition costs, then the unearned premium liability is deficient. The entire deficiency shall be recognised in the income statement. In recognising the deficiency in the income statement the insurer shall first write-down any related intangible assets and then the related deferred acquisition costs. If an additional liability is required this shall be recognised in the balance sheet as an unexpired risk liability. The liability adequacy test for the unearned premium liability shall be performed at the reporting entity level by class of business.**
- 9.1.1 For general insurers registered with the Australian Prudential Regulation Authority (“APRA”), a class of business is determined using the Prescribed Classes of Business used by APRA. For general insurers not registered with APRA, the test is performed using the APRA Prescribed Classes of Business or at an equivalent

level of aggregation. For example, a reporting entity that consists of a group of two insurers, both of which write compulsory third party business, would add together each insurer's unearned premium liability related to the compulsory third party business and review the adequacy of the two compulsory third party portfolios by considering all expected cash flows under existing insurance contracts in both insurers.

- 9.1.2 In determining the present value of the expected future cash flows relating to future claims arising from the rights and obligations under current general insurance contracts, the insurer applies sections 5 and 6 and includes an appropriate risk margin to reflect inherent uncertainty in the central estimate, as set out in paragraphs 5.1.6 to 5.1.11.
- 9.1.3 The unearned premium liability may include premiums in advance as described in paragraph 4.2.5. Insurers also consider whether there are any additional general insurance contracts, where the premium revenue is not recognised in the unearned premium liability, under which the insurer has a constructive obligation to settle future claims that may arise. That is, there may be general insurance contracts where there has not been a transfer of risk, as described in paragraph 4.2.5, but where a constructive obligation has arisen. The cash flows expected under these contracts are considered as part of the liability adequacy test.
- 9.1.4 In reviewing expected future cash flows, the insurer takes into account both future cash flows under insurance contracts it has issued and the related reinsurance.
- 9.1.5 The related intangible assets referred to in paragraph 9.1 are those that arise under paragraph 13.3.1(b). As the liability adequacy test for the unearned premium liability is performed for the reporting entity as a whole at a class of business level, the intangible asset is allocated on a reasonable basis across these classes.
- 9.1.6 As the liability adequacy test applies to deferred acquisition costs and to intangible assets, these assets are excluded from the scope of AASB 136 *Impairment of Assets*.

10 Outwards Reinsurance Expense

- 10.1 Premium ceded to reinsurers shall be recognised by the cedant as outwards reinsurance expense in the income statement from the attachment date over the period of indemnity of the**

reinsurance contract in accordance with the expected pattern of the incidence of risk.

- 10.1.1 It is common for general insurers or reinsurers to reinsure a portion of the risks that they accept. To secure reinsurance cover, the cedant passes on a portion of the premiums received to a reinsurer. This is known as outwards reinsurance expense.
- 10.1.2 The cedant accounts for direct insurance and reinsurance transactions on a gross basis, so that the extent and effectiveness of the reinsurance arrangements are apparent to the users of the financial report, and an indication of the insurer's risk management performance is provided to users. The gross amount of premiums earned by the cedant during the reporting period is recognised as income because it undertakes to indemnify the full amount of the specified losses of those it has insured, regardless of the reinsurance arrangements. Correspondingly, the cedant recognises the gross amount of claims expense in the reporting period because it is obliged to meet the full cost of successful claims by those it has insured.
- 10.1.3 Accordingly, premium ceded to reinsurers is recognised in the income statement as an expense of the cedant on the basis that it is an outgoing incurred in undertaking the business of direct insurance underwriting, and is not to be netted off against premium revenue.
- 10.1.4 Outwards reinsurance expense is recognised in the income statement consistently with the recognition of reinsurance recoveries under the reinsurance contract. For proportional reinsurance the estimate of outwards reinsurance expense is based upon the gross premium of the underlying direct insurance contract. For non-proportional reinsurance the cedant estimates the total claims that are likely to be made under the contract and hence whether it needs to recognise additional outwards reinsurance expense under a minimum and deposit arrangement or whether it needs to recognise reinstatement premiums expense.
- 10.1.5 Some reinsurance contracts purchased by a cedant might involve an experience account. Whilst these contracts may require annual renewal, in substance, the contract period is likely to be greater than one year. In estimating the outwards reinsurance expense and reinsurance recoveries to be recognised in the reporting period the cedant considers the probability-weighted expected cash flows over the expected period of indemnity and discounts the cash flows to reflect the time value of money. In determining the discount rates to be adopted, an insurer applies the same principles that are used to determine the discount rates for outstanding claims liabilities

outlined in section 6. In considering all expected cash flows the reinsurer considers any profit commissions and commission rebates.

11 Reinsurance Recoveries and Non-reinsurance Recoveries

11.1 Reinsurance recoveries received or receivable in relation to the outstanding claims liability and non-reinsurance recoveries received or receivable shall be recognised as income of the cedant and shall not be netted off against the claims expense or outwards reinsurance expense in the income statement, or the outstanding claims liability or unearned premium liability in the balance sheet.

11.1.1 The reinsurance recoveries receivable in the balance sheet may not be received for some time. The reinsurance recoveries receivable are discounted on a basis consistent with the discounting of the outstanding claims liabilities outlined in section 6.

11.1.2 An insurer may also be entitled to non-reinsurance recoveries under the insurance contract such as salvage, subrogation and sharing arrangements with other insurers. Non-reinsurance recoveries are not offset against gross claims, but are recognised as income or assets, in the same way as, but separately from, reinsurance recoveries. The non-reinsurance recoveries receivable in the balance sheet may not be received for some time. The non-reinsurance recoveries receivable are discounted on a basis consistent with the discounting of the outstanding claims liabilities outlined in section 6.

11.1.3 Amounts that reduce the liability to the policyholder, such as excesses or allowances for contributory negligence, are not non-reinsurance recoveries and are offset against the gross claims.

12 Impairment of Reinsurance Assets

12.1.1 If a cedant's reinsurance asset is impaired, the cedant shall reduce its carrying amount accordingly and recognise that impairment in the income statement. A reinsurance asset is impaired if, and only if:

- (a) there is objective evidence, as a result of an event that occurred after initial recognition of the reinsurance asset, that the cedant may not receive amounts due to it under the terms of the contract; and

- (b) that event has a reliably measurable impact on the amounts that the cedant will receive from the reinsurer.

13 Portfolio Transfers and Business Combinations

13.1 Where the responsibility in relation to claims on transferred insurance business remains with the transferring insurer, the transfer shall be treated by the transferring insurer and the accepting insurer as reinsurance business.

13.1.1 Portfolio transfer is a term used to describe the process by which premiums and claims are transferred from one insurer to another. Transfers may be completed in a number of ways in relation to claims arising from events that occurred before the transfer. The receiving insurer may take responsibility in relation to all claims under the agreement or treaty that have not yet been paid, or it may take responsibility only in relation to those claims arising from events that occur after the date of transfer.

13.1.2 In relation to the transfer of insurance business, while the acquiring insurer agrees to meet the claims of those insured from a particular time, the contractual responsibility of the original insurer to meet those claims normally remains.

13.1.3 In relation to the withdrawal of a reinsurer from a reinsurance treaty arrangement, the contractual responsibility of the reinsurer to the direct insurer in relation to outstanding claims may be passed back to the direct insurer with a return of any premium relating to unexpired risk, or may be retained by the withdrawing reinsurer. In the former case, the direct insurer may choose to reinsure the outstanding claims with another reinsurer. This assuming reinsurer would be ceded premium for bearing liability in relation to existing outstanding claims.

13.1.4 Where the responsibility in relation to claims on transferred insurance business remains with the transferring insurer:

- (a) the transferring insurer recognises the transferred premium revenue and the relevant outstanding claims in the same way as other outwards reinsurance business; and
- (b) the accepting insurer recognises the premium revenue ceded to it and the relevant outstanding claims in the same way as other inwards reinsurance business.

- 13.2 Where the responsibility in relation to claims on transferred insurance business passes from the transferring insurer to the accepting insurer, the transfer shall be accounted for as a portfolio withdrawal by the transferring insurer and as a portfolio assumption by the accepting insurer.**
- 13.3 A portfolio withdrawal shall be accounted for by the transferring insurer by eliminating the liabilities and assets connected with the risks transferred. A portfolio assumption shall be accounted for by the accepting insurer by recognising the relevant amount of unexpired premium revenue and the outstanding claims for which the transferring insurer is no longer responsible.**
- 13.3.1 To comply with AASB 3, an insurer shall, at the acquisition date, measure at fair value the insurance liabilities assumed and *insurance assets* acquired in a business combination. However, an insurer is permitted, but not required, to use an expanded presentation that splits the fair value of acquired insurance contracts into two components:
- (a) a liability measured in accordance with the insurer's accounting policies for general insurance contracts that it issues; and
 - (b) an intangible asset, representing the difference between
 - (i) the fair value of the contractual insurance rights acquired and insurance obligations assumed; and
 - (ii) the amount described in paragraph 13.3.1(a).
- The subsequent measurement of this asset shall be consistent with the measurement of the related insurance liability.
- 13.3.2 An insurer acquiring a portfolio of general insurance contracts may use an expanded presentation described in paragraph 13.3.1.
- 13.3.3 The intangible assets described in paragraphs 13.3.1 and 13.3.2 are excluded from the scope of AASB 136 and from the scope of AASB 138 in respect of recognition and measurement. AASB 136 and AASB 138 apply to customer lists and customer relationships reflecting the expectation of future contracts that are not part of the contractual insurance rights and contractual insurance obligations that existed at the date of a business combination or portfolio transfer.

- 13.3.4 AASB 138 includes specific disclosure requirements in relation to this intangible asset.

14 Underwriting Pools and Coinsurance

14.1 Insurance business allocated through underwriting pools and coinsurance arrangements, by an entity acting as agent, shall be accounted for by the accepting insurer as direct insurance business.

- 14.1.1 Direct insurers or reinsurers may form underwriting pools or enter coinsurance arrangements as vehicles for jointly insuring particular risks or types of risks. Premiums, claims and other expenses are usually shared in agreed ratios by insurers involved in these arrangements.
- 14.1.2 Many underwriting pools and coinsurance arrangements involve the acceptance of risks by an entity acting as an agent for pool members or coinsurers. The entity receives premiums and pays claims and expenses, and allocates shares of the business to each pool member or coinsurer in agreed ratios. As the entity acting as agent is not an insurer, the business allocated to pool members and coinsurers is not reinsurance business. Pool members and coinsurers treat such business allocated to them as direct insurance business.
- 14.2 Business directly underwritten by a member of an underwriting pool or coinsurance arrangement shall be treated as direct insurance business and the portion of the risk reinsured by other pool members or coinsurers, determined by reference to the extent of the shares in the pool or arrangement of other pool members or coinsurers, shall be treated as outwards reinsurance. The pool member's or coinsurer's share of insurance business that other insurers place in the pool or arrangement shall be treated as inwards reinsurance.**

15 Assets Backing General Insurance Liabilities

Fair Value Approach

- 15.1.1 Paragraphs 15.2 to 15.5 address the measurement of certain assets backing general insurance liabilities or financial liabilities that arise under non-insurance contracts. The fair value approach to the measurement of assets backing general insurance liabilities or financial liabilities that arise under non-insurance contracts is

consistent with the present value measurement approach for general insurance liabilities, and the fair value measurement for financial liabilities that arise under non-insurance contracts, required by this Standard. Where assets are not backing general insurance liabilities or financial liabilities that arise under non-insurance contracts, general insurers apply the applicable accounting standards making use of any measurement choices available.

Measurement

- 15.2 Financial assets that are within the scope of AASB 139 and that back general insurance liabilities, shall be designated as “at fair value through profit or loss”, under AASB 139 on first application of this Standard or on initial recognition of the assets.**
- 15.2.1 An insurer applies AASB 139 to its financial assets. AASB 139 defines financial assets as “at fair value through profit or loss” as either a financial asset that is classified as held for trading or as a financial asset that is designated as “at fair value through profit or loss” upon initial recognition. AASB 1 *First-time Adoption of Australian Equivalents to International Financial Reporting Standards* allows entities to designate financial assets as “at fair value through profit or loss” on first application of the standard.
- 15.2.2 Those financial assets that are within the scope of AASB 139 and that the insurer considers back general insurance liabilities are to be designated as “at fair value through profit or loss” under AASB 139, on first application of this Standard or on initial recognition of the assets.
- 15.3 Investment property within the scope of AASB 140 *Investment Property* and that backs general insurance liabilities shall be measured using the fair value model under AASB 140.**
- 15.4 Property, plant and equipment that is within the scope of AASB 116 *Property, Plant and Equipment* and that backs general insurance liabilities, shall be measured using the revaluation model under AASB 116.**
- 15.4.1 An insurer applies AASB 116 to its property, plant and equipment. Under AASB 116 property includes owner-occupied property and property being constructed or developed for future use as investment property. Under AASB 116, the cost model, for measurement subsequent to initial recognition, is to carry property, plant and equipment at cost. However, AASB 116 also has a revaluation model: an entity, subsequent to initial recognition, may carry its

property, plant and equipment assets at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses.

15.4.2 Those property, plant and equipment assets that are within the scope of AASB 116 and that the insurer considers back general insurance liabilities are measured using the revaluation model under AASB 116.

15.5 When preparing *separate financial statements*, those investments in subsidiaries, jointly controlled entities and associates:

- (a) **that are within the scope of AASB 127 *Consolidated and Separate Financial Statements*;**
- (b) **that back general insurance liabilities; and**
- (c) **that are not classified as held for sale (or included in a disposal group that is classified as held for sale) under AASB 5 *Non-current Assets Held for Sale and Discontinued Operations*;**

shall be designated as “at fair value through profit or loss” under AASB 139, on first application of this Standard or on initial recognition of the assets.

15.5.1 An insurer applies AASB 127 to its investments in subsidiaries, jointly controlled entities and associates when preparing separate financial statements. Under AASB 127, in the parent’s own financial statements, the investments in subsidiaries, jointly controlled entities and associates can either be accounted for at cost or in accordance with AASB 139.

15.5.2 In the parent’s separate financial statements, investments in subsidiaries, jointly controlled entities and associates, that are within the scope of AASB 127, that are not classified as held for sale, under AASB 5, and that the insurer considers back general insurance liabilities are to be designated as “at fair value through profit or loss” under AASB 139, on first application of this Standard or on initial recognition of the assets.

15.5.3 When preparing consolidated financial statements subsidiaries are consolidated and investments in jointly controlled entities and associates are accounted for using the equity method in accordance with AASB 127.

16 Non-insurance Contracts Regulated under the *Insurance Act 1973*

- 16.1 Non-insurance contracts regulated under the *Insurance Act 1973* shall be treated under AASB 139 to the extent that they give rise to financial assets and financial liabilities. However, the financial assets and the financial liabilities that arise under these contracts shall be designated as “at fair value through profit or loss” on first application of this Standard or on initial recognition of the financial assets or financial liabilities.**
- 16.1.1 AASB 139 defines financial assets and financial liabilities as “at fair value through profit or loss” as either a financial asset or financial liability that is classified as held for trading or as a financial asset or financial liability that is designated as “at fair value through profit or loss” upon initial recognition. AASB 1 allows entities to designate financial assets and financial liabilities as “at fair value through profit or loss” on first application of the standard.
- 16.2 Paragraphs 15.2, 15.3, 15.4 and 15.5 shall also be applied to the measurement of assets that back financial liabilities that arise under non-insurance contracts.**

17 Disclosures

Income Statement

- 17.1 In relation to the income statement, the financial report shall disclose:**
- (a) the total deficiency recognised in the income statement under paragraph 9.1;**
 - (b) any write-down of deferred acquisition costs under the liability adequacy test in section 9;**
 - (c) any write-down of an intangible asset under the liability adequacy test in section 9;**
 - (d) the underwriting result for the reporting period, determined as the amount obtained by deducting the sum of claims expense, outwards reinsurance premium expense and underwriting expenses from the sum of**

direct and inwards reinsurance premium revenues and recoveries revenue;

- (e) ***net claims incurred* shall be disclosed, showing separately:**
 - (i) **the amount relating to risks borne in the current reporting period; and**
 - (ii) **the amount relating to a reassessment of risks borne in all previous reporting periods.**

An explanation shall be provided where net claims incurred relating to a reassessment of risks borne in previous reporting periods are material; and

- (f) **in respect of paragraphs 17.1(e)(i) and 17.1(e)(ii), the following components shall be separately disclosed:**
 - (i) **gross claims incurred – undiscounted;**
 - (ii) **reinsurance and other recoveries – undiscounted; and**
 - (iii) **discount movements shown separately for (i) and (ii).**

17.1.1 This Standard requires the underwriting result for the reporting period to be disclosed. This disclosure gives an indication of an insurer's underwriting performance, including the extent to which underwriting activities rely on investment income for the payment of claims.

17.1.2 Based on the total movement in net claims incurred, it may appear that there has not been a material reassessment of risks borne in previous periods, however, there may be material movements at a business segment level, that mitigate each other. For example, the insurer may have seen a material deterioration in its motor portfolio, which has been mitigated by material savings in the professional indemnity portfolio, such that when both portfolios are aggregated there appears to have been little change in the reporting period. In such circumstances, the insurer provides an explanation of the reassessments that took place in the net claims incurred for previous periods during the reporting period at the business segment level.

Balance Sheet

17.2 The financial report shall disclose:

- (a) in relation to the outstanding claims liability:**
 - (i) the central estimate of the expected present value of future payments for claims incurred; and**
 - (ii) the component related to the risk margin;**
- (b) the percentage risk margin adopted in determining the outstanding claims liability;**
- (c) the probability of adequacy intended to be achieved through adoption of the risk margin; and**
- (d) the process used to determine the risk margin, including the way in which diversification of risks has been allowed for.**

17.3 An insurer shall disclose the process used to determine which assets back general insurance liabilities and which assets back financial liabilities arising under non-insurance contracts.

Non-insurance Contracts

17.4 Where a general insurer has issued a non-insurance contract or holds a non-insurance contract as a cedant, and that non-insurance contract has a material financial impact on the income statement, balance sheet or cash flows, the general insurer shall disclose:

- (a) the nature of the non-insurance contract;**
- (b) the recognised assets, liabilities, income, expense and cash flows arising from the non-insurance contract; and**
- (c) information that helps users to understand the amount, timing and uncertainty of future cash flows from the non-insurance contract.**

17.4.1 In applying paragraph 17.4 a non-insurance contract shall be considered together with any related contracts or side letters, when

determining the need for disclosure, and in making the disclosures required.

Segment Information

17.5 Segment information shall be disclosed in the financial report in accordance with AASB 114 *Segment Reporting*. Geographical segments shall be determined on the basis of the location of risks insured.

17.5.1 General insurers are required by AASB 114 to provide particular information on business and geographical segments. The geographical segments are determined on the basis of the location of the risks insured, rather than the location where the business is written. This approach would enable better assessment of the insurer's exposure to risk.

Insurance Contracts – Explanation of Recognised Amounts

17.6 An insurer shall disclose information that identifies and explains the amounts in its financial report arising from insurance contracts.

17.6.1 To comply with paragraph 17.6, an insurer shall disclose:

- (a) its accounting policies for insurance contracts and related assets, liabilities, income and expense;
- (b) the recognised assets, liabilities, income, expense and cash flows arising from insurance contracts. Furthermore, if the insurer is a cedant, it shall disclose:
 - (i) gains and losses recognised in the income statement on buying reinsurance; and
 - (ii) if the cedant defers and amortises gains and losses arising on buying reinsurance, the amortisation for the period and the amounts remaining unamortised at the beginning and end of the period;
- (c) the process used to determine the assumptions that have the greatest effect on the measurement of the recognised amounts described in (b). When practicable, an insurer shall also give quantified disclosure of those assumptions;

- (d) the effect of changes in assumptions used to measure insurance assets and insurance liabilities, showing separately the effect of each change that has a material effect on the financial report; and
- (e) reconciliations of changes in insurance liabilities, reinsurance assets and, if any, related deferred acquisition costs.

17.6.2 In applying paragraph 17.6.1(b), the recognised assets and liabilities arising from insurance contracts would normally include:

- (a) gross outstanding claims liability;
- (b) reinsurance recoveries receivable arising from the outstanding claims liability;
- (c) gross unearned premium liability;
- (d) reinsurance recoveries receivable arising from the unearned premium liability;
- (e) unexpired risk liability;
- (f) other reinsurance recoveries receivable;
- (g) other recoveries receivable;
- (h) outwards reinsurance expense asset or liability;
- (i) direct premium revenue receivable;
- (j) inwards reinsurance premium revenue receivable;
- (k) deferred acquisition cost asset; and
- (l) intangible assets relating to acquired insurance contracts.

17.6.3 In applying paragraph 17.6.1(b), the recognised income and expenses arising from insurance contracts would normally include:

- (a) direct premium revenue;
- (b) inwards reinsurance premium revenue (including retrocessions);
- (c) reinsurance and other recoveries revenue;

- (d) direct claims expense;
- (e) reinsurance claims expense;
- (f) outwards reinsurance premium expense (including retrocessions);
- (g) acquisition costs expense; and
- (h) other underwriting expenses, including claims handling expenses.

17.6.4 When an insurer is presenting the disclosures required by paragraphs 17.6.1(c) and 17.6.1(d) the insurer determines the level and extent of disclosure that is appropriate having regard to its circumstances and the qualitative characteristics of financial reports under the *Framework for the Preparation and Presentation of Financial Statements* of understandability, relevance, reliability and comparability.

17.6.5 For an insurer that is involved in a large number of insurance classes, across different jurisdictions, disclosure by class of business is likely to be voluminous and may not be understandable to the user of the financial report. Furthermore, for such an insurer, disclosure for the entity as a whole is also likely to be at too high a level of aggregation to be relevant or comparable. It is expected that for most insurers disclosure at the major business segment level would normally be most appropriate. The insurer may believe that disclosure of a range of values would be relevant to the users of the financial reports.

17.6.6 Some of the assumptions that would normally have the greatest effect on the measurement of the recognised amounts described in paragraph 17.6.1(b), are discount rates, inflation rates, average weighted term to settlement from the claims reporting date, average claim frequency, average claim size and expense rates. The insurer determines whether these assumptions shall be disclosed given the requirements of paragraphs 17.6 and 17.6.1.

Insurance Contracts – Amount, Timing and Uncertainty of Cash Flows

17.7 An insurer shall disclose information that helps users to understand the amount, timing and uncertainty of future cash flows from insurance contracts.

17.7.1 To comply with paragraph 17.7, an insurer shall disclose:

- (a) its objectives in managing risks arising from insurance contracts and its policies for mitigating risk;
- (b) those terms and conditions of insurance contracts that have a material effect on the amount, timing and uncertainty of the insurer's future cash flows;
- (c) information about *insurance risk* (both before and after risk mitigation by reinsurance), including information about:
 - (i) the sensitivity of profit or loss and equity to changes in variables that have a material effect on them;
 - (ii) concentrations of insurance risk; and
 - (iii) actual claims compared with previous estimates (i.e. claims development). The disclosure about claims development shall go back to the period when the earliest material claim arose for which there is still uncertainty about the amount and timing of the claims payments, but need not go back more than ten years. An insurer need not disclose this information for claims for which uncertainty about the amount and timing of claims payments is typically resolved within one year;
- (d) the information about interest rate risk and credit risk that AASB 132 *Financial Instruments: Disclosure and Presentation* would require if the insurance contracts were within the scope of AASB 132; and
- (e) information about exposures to interest rate risk or market risk under embedded derivatives contained in a host insurance contract if the insurer is not required to, and does not, measure the embedded derivatives at fair value.

17.7.2 For an insurer that is involved in a large number of insurance classes, across different jurisdictions, disclosure by class of business is likely to be voluminous and may not be understandable to the user of the financial report. Furthermore, for such an insurer disclosure for the entity as a whole would normally be at too high a level of aggregation to be relevant or comparable. It is expected that for most insurers disclosure at the major business segment level would normally be most appropriate.

- 17.7.3 The claims development disclosure required by paragraph 17.7.1(c)(iii) only applies to classes of business where claims are not typically resolved within one year. The insurer, in disclosing claims development, ensures it is clear to the reader of the financial report, which classes of business, or which segments of the business, are covered by the disclosures and which classes of business, or which segments of the business, are not covered by the disclosures.
- 17.7.4 IG Example 5 in the *AASB 4 Implementation Guidance*, provides one possible format to meet the claims development disclosure requirements of this Standard. Such a format may be particularly appropriate for longer tail classes of business where the long tail nature of the claims is a significant aspect in the development of the claims, as this format illustrates the development of claims over a number of years. If this format is adopted, disclosure by accident year, gross and net of reinsurance, of undiscounted claims would normally be most relevant to the users of financial reports. The insurer explains the information presented. This includes whether the claims are discounted or undiscounted, gross or net of reinsurance and by accident year or underwriting year.

Other Disclosures

- 17.8.1 This Standard addresses disclosure requirements in relation to general insurance contracts. Other Australian Accounting Standards may be relevant to a general insurer's financial report. In particular, the disclosure requirements in AASB 132 would normally be relevant to general insurers.

18 Transitional Provisions

- 18.1 An entity need not apply the disclosure requirements in this Standard to comparative information that relates to annual periods beginning before 1 January 2005, except for the disclosures required by paragraphs 17.6.1(a) and 17.6.1(b) about accounting policies, and recognised assets, liabilities, income and expense and cash flows.**
- 18.2 Where an entity applies the disclosure requirements in this Standard to comparative information that relates to annual periods beginning before 1 January 2005, if it is impracticable to apply a particular requirement of this Standard to comparative information that relates to annual periods beginning before 1 January 2005, an entity shall disclose that fact. AASB 108**

Accounting Policies, Changes in Accounting Estimates and Errors explains the term “impracticable”.

- 18.3** In applying paragraph 17.7.1(c)(iii), an entity need not disclose information about claims development that occurred earlier than five years before the end of the first annual reporting period in which it applies this Standard. Furthermore, if it is impracticable, when an entity first applies this Standard, to prepare information about claims development that occurred before the beginning of the earliest period for which an entity presents full comparative information that complies with this Standard, the entity shall disclose that fact.
- 18.3.1 There are also references to transitional measurement requirements in paragraphs 15.2.1, 15.2.2, 15.5, 15.5.2, 16.1 and 16.1.1.

19 Definitions

19.1 In this Standard:

attachment date means, for a direct insurer, the date as from which the insurer accepts risk from the insured under an insurance contract or endorsement or, for a reinsurer, the date from which the reinsurer accepts risk from the direct insurer or another reinsurer under a reinsurance arrangement

cedant means the *policyholder* under a *reinsurance contract*

claim means a demand by any party external to the entity for payment by the insurer on account of an alleged loss resulting from an *insured event* or events, that have occurred, alleged to be covered by an *insurance contract*

claims expense means the charge to the income statement for the reporting period and represents the sum of claims settled and claims management expenses relating to *claims incurred* in the period and the movement in the gross *outstanding claims liability* in the period

claims incurred means *claims* that have occurred prior to the reporting date, the claims could be reported or unreported at the reporting date

deposit component means a contractual component that is not accounted for as a derivative under AASB 139 *Financial Instruments: Recognition and Measurement* and would be within the scope of AASB 139 if it were a separate instrument

deposit premium means the *premium* charged by the insurer at the inception of a contract under which the final premium depends on conditions prevailing over the contract period and so is not determined until the expiry of that period

direct insurance contract means an insurance contract that is not a reinsurance contract

fair value means the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction

financial asset means any asset that is:

- (a) cash;
- (b) an equity instrument of another entity;
- (c) a contractual right:
 - (i) to receive cash or another *financial asset* from another entity; or
 - (ii) to exchange *financial assets* or *financial liabilities* with another entity under conditions that are potentially favourable to the entity; or
- (d) a contract that will or may be settled in the entity's own equity instruments and is:
 - (i) a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or
 - (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or other financial assets for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves

contracts for the future receipt or delivery of the entity's own equity instruments

***financial instrument* means any contract that gives rise to a *financial asset* of one entity and a *financial liability* or equity instrument of another entity**

***financial liability* is any liability that is:**

- (a) a contractual obligation:**
 - (i) to deliver cash or another *financial asset* to another entity; or**
 - (ii) to exchange *financial assets* or *financial liabilities* with another entity under conditions that are potentially unfavourable to the entity; or**
- (b) a contract that will or may be settled in the entity's own equity instruments and is:**
 - (i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or**
 - (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another *financial asset* for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments**

***financial risk* means the risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract**

***future claims* means *claims* in respect of *insured events* that are expected to occur in future reporting periods under policies where the attachment date is prior to the reporting date**

general insurance contract means an *insurance contract* that is not a *life insurance contract*

general insurer means an *insurer* that writes *general insurance contracts*

general reinsurance contract means a *reinsurance contract* that is not a *life reinsurance contract*

insurance asset means an *insurer's* net contractual rights under an *insurance contract*

insurance contract means a contract under which one party (the *insurer*) accepts significant *insurance risk* from another party (the *policyholder*) by agreeing to compensate the *policyholder* if a specified uncertain future event (the *insured event*) adversely affects the *policyholder*

(Refer to Appendix for additional guidance in applying this definition.)

insurance liability means an *insurer's* net contractual obligations under an *insurance contract*

insurance risk means risk, other than *financial risk*, transferred from the holder of a contract to the issuer

insured event means an uncertain future event covered by an *insurance contract* and creates *insurance risk*

insurer means the party that has an obligation under an *insurance contract* to compensate a *policyholder* if an *insured event* occurs

inwards reinsurance means *reinsurance contracts* written by *reinsurers*

liability adequacy test means an assessment of whether the carrying amount of an *insurance liability* needs to be increased (or the carrying amount of the related deferred acquisition costs or related intangible assets decreased) based on a review of future cash flows

life insurance contract means an *insurance contract*, or a financial instrument with a discretionary participation feature, regulated under the *Life Insurance Act 1995*, and similar contracts issued by entities operating outside Australia

life reinsurance contract means a *life insurance contract* issued by one *insurer* (the *reinsurer*) to compensate another insurer (the *cedant*) for losses on one or more contracts issued by the *cedant*

net claims incurred means direct claims costs net of reinsurance and other recoveries, and indirect claims handling costs, determined on a discounted basis

non-insurance contract means a contract regulated under the *Insurance Act 1973*, and similar contracts issued by entities operating outside Australia, which fails to meet the definition of an *insurance contract* under this Standard

(An example of a non-insurance contract might be a type of complex financial reinsurance contract.)

outstanding claims liability means all unpaid claims and related claims handling expenses relating to claims incurred prior to the reporting date

policyholder means a party that has a right to compensation under an *insurance contract* if an *insured event* occurs

premium means the amount charged in relation to accepting risk from the insured, but does not include amounts collected on behalf of third parties

reinsurance assets means a *cedant's* net contractual rights under a *reinsurance contract*

reinsurance contract means an *insurance contract* issued by one *insurer* (the *reinsurer*) to compensate another insurer (the *cedant*) for losses on one or more contracts issued by the *cedant*

reinsurer means the party that has an obligation under a *reinsurance contract* to compensate a *cedant* if an *insured event* occurs

separate financial statements are those presented by a parent in which its investments are accounted for on the basis of the direct equity interest rather than on the basis of the reported results and net assets of the investees

unbundle means to treat the components of a contract as if they were separate contracts

***weather derivative* means a contract that requires payment based on climatic, geological or other physical variables**

APPENDIX

DEFINITION OF AN INSURANCE CONTRACT

This Appendix is an integral part of AASB 1023.

- 1 This Appendix gives guidance on the definition of an insurance contract in section 18 of the Standard. It addresses the following issues:
- (a) the term ‘uncertain future event’ (paragraphs 2-4);
 - (b) payments in kind (paragraphs 5-6);
 - (c) insurance risk and other risks (paragraphs 7-16);
 - (d) examples of insurance contracts (paragraphs 17-20);
 - (e) significant insurance risk (paragraphs 21-26); and
 - (f) changes in the level of insurance risk (paragraphs 27 and 28).

Uncertain future event

- 2 Uncertainty (or risk) is the essence of an insurance contract. Accordingly, at least one of the following is uncertain at the inception of an insurance contract:
- (a) whether an *insured event* will occur;
 - (b) when it will occur; or
 - (c) how much the insurer will need to pay if it occurs.
- 3 In some insurance contracts, the insured event is the discovery of a loss during the term of the contract, even if the loss arises from an event that occurred before the inception of the contract. In other insurance contracts, the insured event is an event that occurs during the term of the contract, even if the resulting loss is discovered after the end of the contract term.
- 4 Some insurance contracts cover events that have already occurred, but whose financial effect is still uncertain. An example is a reinsurance contract that covers the direct insurer against adverse development of claims already reported by policyholders. In such

contracts, the insured event is the discovery of the ultimate cost of those claims.

Payments in kind

- 5 Some insurance contracts require or permit payments to be made in kind. An example is when the insurer replaces a stolen article directly, instead of reimbursing the policyholder. Another example is when an insurer uses its own hospitals and medical staff to provide medical services covered by the contracts.
- 6 Some fixed-fee service contracts in which the level of service depends on an uncertain event meet the definition of an insurance contract in this Standard but are not regulated as insurance contracts in some countries. One example is a maintenance contract in which the service provider agrees to repair specified equipment after a malfunction. The fixed service fee is based on the expected number of malfunctions, but it is uncertain whether a particular machine will break down. The malfunction of the equipment adversely affects its owner and the contract compensates the owner (in kind, rather than cash). Another example is a contract for car breakdown services in which the provider agrees, for a fixed annual fee, to provide roadside assistance or tow the car to a nearby garage. The latter contract could meet the definition of an insurance contract even if the provider does not agree to carry out repairs or replace parts.

Distinction between insurance risk and other risks

- 7 The definition of an insurance contract refers to insurance risk, which this Standard defines as risk, other than financial risk, transferred from the holder of a contract to the issuer. A contract that exposes the issuer to financial risk without significant insurance risk is not an insurance contract.
- 8 The definition of financial risk in section 18 of the Standard includes a list of financial and non-financial variables. That list includes non-financial variables that are not specific to a party to the contract, such as an index of earthquake losses in a particular region or an index of temperatures in a particular city. It excludes non-financial variables that are specific to a party to the contract, such as the occurrence or non-occurrence of a fire that damages or destroys an asset of that party. Furthermore, the risk of changes in the fair value of a non-financial asset is not a financial risk if the fair value reflects not only changes in market prices for such assets (a financial variable) but also the condition of a specific non-financial asset held by a party to a contract (a non-financial variable). For

example, if a guarantee of the residual value of a specific car exposes the guarantor to the risk of changes in the car's physical condition, that risk is insurance risk, not financial risk.

- 9 Some contracts expose the issuer to financial risk, in addition to significant insurance risk. For example, many life insurance contracts both guarantee a minimum rate of return to policyholders (creating financial risk) and promise death benefits that at some times significantly exceed the policyholder's account balance (creating insurance risk in the form of mortality risk). Such contracts are insurance contracts.
- 10 Under some contracts, an insured event triggers the payment of an amount linked to a price index. Such contracts are insurance contracts, provided the payment that is contingent on the insured event can be significant. The link to the price index is an embedded derivative, but it also transfers insurance risk. If the resulting transfer of insurance risk is significant, the embedded derivative meets the definition of an insurance contract, in which case it need not be separated and measured at fair value (see paragraph 2.3.1 of this Standard).
- 11 The definition of insurance risk refers to risk that the insurer accepts from the policyholder. In other words, insurance risk is a pre-existing risk transferred from the policyholder to the insurer. Thus, a new risk created by the contract is not insurance risk.
- 12 The definition of an insurance contract refers to an adverse effect on the policyholder. The definition does not limit the payment by the insurer to an amount equal to the financial impact of the adverse event. For example, the definition does not exclude 'new-for-old' coverage that pays the policyholder sufficient to permit replacement of a damaged old asset by a new asset.
- 13 Some contracts require a payment if a specified uncertain event occurs, but do not require an adverse effect on the policyholder as a precondition for payment. Such a contract is not an insurance contract even if the holder uses the contract to mitigate an underlying risk exposure. For example, if the holder uses a derivative to hedge an underlying non financial variable that is correlated with cash flows from an asset of the entity, the derivative is not an insurance contract because payment is not conditional on whether the holder is adversely affected by a reduction in the cash flows from the asset. Conversely, the definition of an insurance contract refers to an uncertain event for which an adverse effect on the policyholder is a contractual precondition for payment. This contractual precondition does not require the insurer to investigate

whether the event actually caused an adverse effect, but permits the insurer to deny payment if it is not satisfied that the event caused an adverse effect.

- 14 Lapse or persistency risk (i.e. the risk that the counterparty will cancel the contract earlier or later than the issuer had expected in pricing the contract) is not insurance risk because the payment to the counterparty is not contingent on an uncertain future event that adversely affects the counterparty. Similarly, expense risk (i.e. the risk of unexpected increases in the administrative costs associated with the servicing of a contract, rather than in costs associated with insured events) is not insurance risk because an unexpected increase in expenses does not adversely affect the counterparty.
- 15 Therefore, a contract that exposes the issuer to lapse risk, persistency risk or expense risk is not an insurance contract unless it also exposes the issuer to insurance risk. However, if the issuer of that contract mitigates that risk by using a second contract to transfer part of that risk to another party, the second contract exposes that other party to insurance risk.
- 16 An insurer can accept significant insurance risk from the policyholder only if the insurer is an entity separate from the policyholder. In the case of a mutual insurer, the mutual accepts risk from each policyholder and pools that risk. Although policyholders bear that pooled risk collectively in their capacity as owners, the mutual has still accepted the risk that is the essence of an insurance contract.

Examples of general insurance contracts

- 17 The following are examples of contracts that are general insurance contracts, if the transfer of insurance risk is significant:
- (a) insurance against theft or damage to property;
 - (b) insurance against product liability, professional liability, civil liability or legal expenses;
 - (c) medical cover;
 - (d) surety bonds, fidelity bonds, performance bonds and bid bonds (i.e. contracts that provide compensation if another party fails to perform a contractual obligation, for example an obligation to construct a building);

- (e) credit insurance that provides for specified payments to be made to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due under the original or modified terms of a debt instrument. These contracts could have various legal forms, such as that of a financial guarantee, letter of credit, credit derivative default product or insurance contract. However, these contracts are outside the scope of this Standard if the entity entered into them, or retained them, on transferring to another party financial assets or financial liabilities within the scope of *AASB 139 Financial Instruments: Recognition and Measurement* (see paragraph 4(d));
- (f) product warranties. Product warranties issued by another party for goods sold by a manufacturer, dealer or retailer are within the scope of this Standard. However, product warranties issued directly by a manufacturer, dealer or retailer are outside its scope, because they are within the scope of *AASB 118 Revenue* and *AASB 137 Provisions, Contingent Liabilities and Contingent Assets*;
- (g) title insurance (i.e. insurance against the discovery of defects in title to land that were not apparent when the insurance contract was written). In this case, the insured event is the discovery of a defect in the title, not the defect itself;
- (h) travel assistance (i.e. compensation in cash or in kind to policyholders for losses suffered while they are travelling). Paragraphs 5 and 6 of this Appendix discuss some contracts of this kind;
- (i) catastrophe bonds that provide for reduced payments of principal, interest or both if a specified event adversely affects the issuer of the bond (unless the specified event does not create significant insurance risk, for example if the event is a change in an interest rate or foreign exchange rate);
- (j) insurance swaps and other contracts that require a payment based on changes in climatic, geological or other physical variables that are specific to a party to the contract; and
- (k) reinsurance contracts.

- 18 The following are examples of items that are not general insurance contracts:
- (a) contracts that have the legal form of insurance, but pass all significant insurance risk back to the policyholder through non-cancellable and enforceable mechanisms that adjust future payments by the policyholder as a direct result of insured losses, for example some financial reinsurance contracts or some group contracts (such contracts are normally non-insurance financial instruments or service contracts, see paragraphs 19 and 20 of this Appendix);
 - (b) self-insurance, in other words retaining a risk that could have been covered by insurance (there is no insurance contract because there is no agreement with another party);
 - (c) contracts (such as gambling contracts) that require a payment if a specified uncertain future event occurs, but do not require, as a contractual precondition for payment, that the event adversely affects the policyholder. However, this does not preclude the specification of a predetermined payout to quantify the loss caused by a specified event such as an accident;
 - (d) derivatives that expose one party to financial risk but not insurance risk, because they require that party to make payment based solely on changes in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (see AASB 139);
 - (e) a financial guarantee contract (or letter of credit, credit derivative default product or credit insurance contract) that requires payments even if the holder has not incurred a loss on the failure of the debtor to make payments when due (see AASB 139);
 - (f) contracts that require a payment based on a climatic, geological or other physical variable that is not specific to a party to the contract (commonly described as weather derivatives);
 - (g) catastrophe bonds that provide for reduced payments of principal, interest or both, based on a climatic, geological

or other physical variable that is not specific to a party to the contract; and

(h) life insurance contracts.

19 If the contracts described in paragraph 18 of this Appendix create financial assets or financial liabilities, they are within the scope of AASB 139. Among other things, this means that the parties to the contract use what is sometimes called deposit accounting, which involves the following:

(a) one party recognises the consideration received as a financial liability, rather than as revenue; and

(b) the other party recognises the consideration paid as a financial asset, rather than as an expense.

20 If the contracts described in paragraph 18 of this Appendix do not create financial assets or financial liabilities, AASB 118 applies. Under AASB 118, revenue associated with a transaction involving the rendering of services is recognised by reference to the stage of completion of the transaction if the outcome of the transaction can be estimated reliably.

Significant insurance risk

21 A contract is an insurance contract only if it transfers significant insurance risk. Paragraphs 7 to 20 of this Appendix discuss insurance risk. The following paragraphs discuss the assessment of whether insurance risk is significant.

22 Insurance risk is significant if, and only if, an insured event could cause an insurer to pay significant additional benefits in any scenario, excluding scenarios that lack commercial substance (i.e. have no discernible effect on the economics of the transaction). If significant additional benefits would be payable in scenarios that have commercial substance, the condition in the previous sentence may be met even if the insured event is extremely unlikely or even if the expected (i.e. probability-weighted) present value of contingent cash flows is a small proportion of the expected present value of all the remaining contractual cash flows.

23 The additional benefits described in paragraph 22 of this Appendix refer to amounts that exceed those that would be payable if no insured event occurred (excluding scenarios that lack commercial substance). Those additional amounts include claims handling and claims assessment costs, but exclude:

- (a) the loss of the ability to charge the policyholder for future services;
- (b) a payment conditional on an event that does not cause a significant loss to the holder of the contract. For example, consider a contract that requires the issuer to pay one million currency units if an asset suffers physical damage causing an insignificant economic loss of one currency unit to the holder. In this contract, the holder transfers to the insurer the insignificant risk of losing one currency unit. At the same time, the contract creates non-insurance risk that the issuer will need to pay 999,999 currency units if the specified event occurs. Because the issuer does not accept significant insurance risk from the holder, this contract is not an insurance contract; and
- (c) possible reinsurance recoveries. The insurer accounts for these separately.

- 24 An insurer shall assess the significance of insurance risk contract by contract, rather than by reference to materiality to the financial report². Thus, insurance risk may be significant even if there is a minimal probability of material losses for a whole book of contracts. This contract-by-contract assessment makes it easier to classify a contract as an insurance contract. However, if a relatively homogeneous book of small contracts is known to consist of contracts that all transfer insurance risk, an insurer need not examine each contract within that book to identify a few non-derivative contracts that transfer insignificant insurance risk.
- 25 Paragraph 22 of this Appendix refers to additional benefits. These additional benefits could include a requirement to pay benefits earlier if the insured event occurs earlier and the payment is not adjusted for the time value of money.
- 26 If an insurance contract is unbundled into a deposit component and an insurance component, the significance of insurance risk transfer is assessed by reference to the insurance component. The significance of insurance risk transferred by an embedded derivative is assessed by reference to the embedded derivative.

² For this purpose, contracts entered into simultaneously with a single counterparty (or contracts that are otherwise interdependent) form a single contract.

Changes in the level of insurance risk

- 27 Some contracts do not transfer any insurance risk to the issuer at inception, although they do transfer insurance risk at a later time.
- 28 A contract that qualifies as an insurance contract remains an insurance contract until all rights and obligations are extinguished or expire.

DIFFERENCES BETWEEN UPDATED AASB 1023 AND PREVIOUS AASB 1023

This analysis of differences accompanies, but is not part of, AASB 1023.

This section identifies differences between this Standard, AASB 1023 *General Insurance Contracts* (“updated AASB 1023”), and AASB 1023 *Financial Reporting of General Insurance Activities* (“previous AASB 1023”) under the following headings:

- A: Incompatibilities between updated AASB 1023 and previous AASB 1023
- B: Previous AASB 1023 is more detailed or restrictive
- C: Updated AASB 1023 is more detailed or restrictive
- D: Previous AASB 1023 disclosures are more extensive
- E: Updated AASB 1023 disclosures are more extensive

The analysis of differences should not be taken as providing an exhaustive list of differences.

Introduction

Updated AASB 1023 includes a definition of an insurance contract. An insurance contract is defined as a contract under which an insurer accepts significant insurance risk from a policyholder by agreeing to compensate the policyholder if a specified uncertain future event adversely affects the policyholder. Updated AASB 1023 applies to those contracts that meet the definition of a general insurance contract. A general insurance contract is an insurance contract that is not a life insurance contract. Previous AASB 1023 applies to general insurance activities. Previous AASB 1023 does not define general insurance activities except by way of example.

As updated AASB 1023 applies principally to general insurance contracts, the requirements in relation to investments integral to general insurance activities in previous AASB 1023 have been removed. However, whilst investments are not treated principally under updated AASB 1023, updated AASB 1023 does restrict the measurement choices available under the other standards applicable. Under previous AASB 1023 all investments integral to the entity’s general insurance activities are measured at net market value. Under updated AASB 1023 all assets backing general insurance liabilities are

measured at fair value with changes in fair value recognised in the income statement, where this measurement basis is allowable under the applicable standards.

As updated AASB 1023 applies principally to general insurance contracts, certain embedded derivatives and certain deposit components are treated under AASB 139 *Financial Instruments: Recognition and Measurement*. Previous AASB 1023 does not address embedded derivatives or deposit components.

The fundamentals of the deferral and matching model, contained in previous AASB 1023, have been retained. However, updated AASB 1023 includes additional requirements in relation to:

(a) Liability Adequacy Testing

Under previous AASB 1023 insurers assess the recoverable amount of the deferred acquisition cost asset and write down this asset when the sum of the deferred acquisition costs and the present value of both future expected claims and settlement costs, in relation to business written to the reporting date, exceed related unearned premiums. Under updated AASB 1023 the insurer not only writes down the deferred acquisition cost asset but also recognises any additional liability warranted;

(b) Risk Margins

Under previous AASB 1023 insurers recognise a liability for outstanding claims measured as the present value of the expected future payments. Under updated AASB 1023 insurers recognise an outstanding claims liability measured as the central estimate of the present value of the expected future payments for claims incurred plus an additional (explicit) risk margin; and

(c) Disclosure

Updated AASB 1023 introduces disclosure principles. It requires disclosures that explain the recognised amounts in the balance sheet and income statement that arise from insurance contracts, and that help users to understand the amount, timing and uncertainty of future cash flows from insurance contracts. The insurer determines the appropriate level of aggregation that is required to satisfy the disclosure principles.

Previous AASB 1023 requires outstanding claims liabilities to be discounted. Updated AASB 1023 also requires discounting but requires the use of different discount rates. Updated AASB 1023 requires outstanding claims liabilities to be discounted for the time value of money using risk-free

discount rates based on current, observable, objective rates that directly relate to the nature, structure and term of the future obligations.

Previous AASB 1023 requires discount rates to be the rates of return that the insurer anticipates it could earn if sufficient funds were available to meet claims liabilities as they fall due. The discount rates are determined by reference to market-determined risk-adjusted rates of return appropriate to the insurer.

Updated AASB 1023 clarifies the measurement of premium revenue and outwards reinsurance expense, providing additional guidance. Direct premium revenue, reinsurance premium revenue and outwards reinsurance expense must be recognised from the attachment date in accordance with the pattern of the incidence of risk. Updated AASB 1023 provides additional guidance on how the pattern of the incidence of risk is determined. Previous AASB 1023 requires direct premium revenue and reinsurance premium revenue to be recognised from the attachment date in accordance with the pattern of the incidence of risk, but it requires reinsurance premium expense to be recognised in accordance with the pattern of reinsurance service.

Differences

A. Incompatibilities between previous AASB 1023 and updated AASB 1023

A.1 Scope

Updated AASB 1023 applies to those contracts that meet the definition of a general insurance contract. Previous AASB 1023 applies to general insurance activities. Previous AASB 1023 does not define general insurance activities except by way of example in paragraph 1.3.1.

Section 19 of updated AASB 1023 includes a definition of an insurance contract. An insurance contract is defined as a contract under which an insurer accepts significant insurance risk from a policyholder by agreeing to compensate the policyholder if a specified uncertain future event adversely affects the policyholder. A general insurance contract is an insurance contract that is not a life insurance contract. Updated AASB 1023 applies to contracts issued by Registered Health Benefits Organisations and medical indemnity funds that meet the definition of an insurance contract in updated AASB 1023. Previous AASB 1023 does not apply to medical benefits insurance.

Under paragraph 2.2(h), updated AASB 1023 does not apply to fixed-fee service contracts that meet the definition of an insurance contract, if the level of service depends on an uncertain event, for example a maintenance contract

or roadside assistance contract. These contracts are treated under AASB 4 *Insurance Contracts*. Fixed-fee service contracts are not treated under the previous AASB 1023 as they are not considered general insurance contracts under that Standard.

A.2 Risk margins

Under paragraph 5.1.6 of updated AASB 1023 the outstanding claims liability includes an explicit risk margin to reflect the inherent uncertainty in the central estimate of the present value of the expected future payments. Updated AASB 1023 does not prescribe a fixed risk margin or level of adequacy.

Under paragraph 5.1 of previous AASB 1023 the outstanding claims liability is measured at the present value of expected future payments. In practice, under previous AASB 1023, some insurers include a risk margin and some insurers reserve at the central estimate.

A.3 Discount rates

Under paragraph 6.1 of updated AASB 1023 the outstanding claims liability is discounted for the time value of money using risk-free discount rates that are current observable, objective rates that relate to the nature, structure and term of the outstanding claims liabilities, to reflect the principle that the measurement of general insurance liabilities is independent of the assets supporting those liabilities.

Under paragraph 5.3 of previous AASB 1023 the discount rates used are rates of return that the insurer anticipates it could earn if sufficient funds are available to meet claims liabilities as they fall due. The discount rates are determined by reference to market-determined risk-adjusted rates of return appropriate to the insurer.

A.4 Liability adequacy test

Under paragraph 9.1 of updated AASB 1023 the adequacy of the unearned premium liability is assessed by considering current estimates of the present value of the expected future cash flows relating to future claims arising from the rights and obligations under current general insurance contracts. In reviewing expected future cash flows, the insurer takes into account both future cash flows under insurance contracts it has issued and the related reinsurance (paragraph 9.1.4 of updated AASB 1023). Where the unearned premium liability less deferred acquisition costs (and less any related intangible asset) is not sufficient to meet the costs of future claims (including a risk margin) then the entire deficiency must be recognised in the income statement.

Any deficiency must be recognised:

- firstly, by writing down any related intangible asset;
- secondly, by writing down the deferred acquisition cost asset; and
- finally, by recognising an unexpired risk liability.

Under previous AASB 1023 the liability adequacy test is more limited. Insurers assess the recoverability of the deferred acquisition cost asset rather than assess the adequacy of the unearned premium liability. Under paragraph 10.5 where the recoverable amount of the deferred acquisition costs is below cost, that is, where the sum of the deferred acquisition costs and the present value of expected future claims costs exceeds the related unearned premiums then deferred acquisition costs are written down to their recoverable amount. There is no requirement to reflect an unexpired risk liability.

Under updated AASB 1023 the liability adequacy test is performed at the reporting entity level by class of business. Under paragraph 9.1.1 the class of business is determined using the APRA Prescribed Classes of Business, for insurers regulated by APRA. For insurers not regulated by APRA, insurers apply the APRA Prescribed Classes of Business or an equivalent level of aggregation.

Under paragraph 10.5.1 of previous AASB 1023 the assessment of the recoverability of the deferred acquisition cost asset is based on an assessment of the aggregate portfolio of insurance business written by the insurer.

A.5 Insurers' assets

Under paragraph 15.1 of updated AASB 1023 insurers' assets are treated under the applicable accounting standards, for example an insurer's investments in equities are treated under AASB 139. However, under updated AASB 1023 all assets backing general insurance liabilities are measured at fair value, with changes in fair value recognised in the income statement, where this is allowable under the applicable accounting standards.

Under paragraph 10.1 of previous AASB 1023 investments integral to the entity's general insurance activities are measured at net market values as at the reporting date. Any changes in net market value are recognised in the income statement in the year in which the changes occur.

Financial Assets

Within the limits of the requirements of AASB 139, updated AASB 1023, paragraph 15.2, requires financial assets backing general insurance liabilities

to be measured as “at fair value through profit or loss”. AASB 139 allows entities to designate any financial asset as “at fair value through profit or loss” on initial recognition. Updated AASB 1023 allows an insurer to designate any financial asset as “at fair value through profit or loss” on first application of updated AASB 1023. However, to impose discipline on the designation as “at fair value through profit or loss”, AASB 139 does not allow the transfer of assets into or out of this category after initial recognition or after first application of updated AASB 1023. For example, an insurer with reported insurance liabilities of \$95m has determined that the assets backing general insurance liabilities are \$100m. If the claims development were such that liabilities increased to \$110m, under AASB 139, an insurer would not be able to redesignate additional existing assets as “at fair value through profit or loss”. In determining which assets back general insurance liabilities, therefore, an insurer makes appropriate allowance for the potential for future deterioration in the insurance liabilities.

Investment Property

Under paragraph 15.3 of updated AASB 1023 an insurer applies AASB 140 *Investment Property* to its investment property. Under AASB 140, with the exceptions noted in (a) and (b) below, an entity may choose as its accounting policy either a fair value model or a cost model, and applies that policy to all of its investment property. The exceptions are that an entity may:

- (a) choose either the fair value model or the cost model for all investment property backing liabilities that pay a return linked directly to the fair value of, or returns from, specified assets including that investment property; and
- (b) choose either the fair value model or the cost model for all other investment property, regardless of the choice made in (a).

Any investment property within the scope of AASB 140, that the insurer considers backs general insurance liabilities, is measured using the fair value model in AASB 140, that is, is measured at fair value with changes in fair value recognised in the income statement.

General insurance liabilities are unlikely to pay a return linked directly to the fair value of, or returns from, specified assets including investment property. Where a general insurer holds investment property that backs general insurance liabilities, and where the general insurance liabilities do not pay a return linked directly to the fair value of, or returns from, specified assets including that investment property, then, in using the fair value model for the investment property that backs general insurance liabilities, the insurer will be required to measure any other investment property using the fair value model, even where it is not backing general insurance liabilities.

Owner-occupied land and buildings

Under paragraph 15.4 of updated AASB 1023 owner-occupied land and buildings are treated under AASB 116 *Property, Plant and Equipment*. AASB 116 allows measurement at cost or fair value via a revaluation reserve. Under updated AASB 1023 where owner-occupied land and buildings back general insurance liabilities the insurer applies the fair value measurement allowed under AASB 116. Where owner-occupied land and buildings do not back general insurance liabilities the insurer chooses either the fair value measurement or cost measurement allowed under AASB 116.

Under paragraph 10.2 of previous AASB 1023 land and buildings must be accounted for as investments and hence those integral to general insurance activities are measured at net market value.

A.6 Non-insurance contracts

Under paragraph 16.1 of updated AASB 1023 contracts regulated under the *Insurance Act 1973* that do not meet the definition of an insurance contract under updated AASB 1023 are treated under AASB 139, to the extent that they give rise to financial assets and financial liabilities. Such contracts are defined as non-insurance contracts under updated AASB 1023. The financial assets and financial liabilities that arise under non-insurance contracts are designated as “at fair value through profit or loss” under AASB 139.

Under previous AASB 1023 the financial reporting treatment of contracts that do not meet the description of general insurance activities in paragraph 1.3.1 are not specifically regulated.

A.7 Embedded derivatives

Under paragraph 2.3.1 of updated AASB 1023, a derivative that is embedded in a host insurance contract and that is not itself an insurance contract, is treated under AASB 139 *Financial Instruments: Recognition and Measurement* and measured at fair value, with changes in fair value recognised in the income statement. Under previous AASB 1023 an embedded derivative is treated under that Standard.

Under paragraph 2.3.2 of updated AASB 1023, however, an insurer need not separate a policyholder’s option to surrender an insurance contract for a fixed amount (or for an amount based on a fixed amount and an interest rate) even if the exercise price differs from the carrying amount of the host insurance liability. The requirement in AASB 139 applies to a put option or cash surrender option embedded in an insurance contract if the surrender value varies in response to the change in a financial variable (such as an equity or commodity price or index), or a non-financial variable that is not specific to a party to the contract. Furthermore, that requirement applies if the holder’s

ability to exercise a put option or cash surrender option is triggered by a change in such a variable (for example, a put option that can be exercised if a stock market index reaches a specified level).

Under updated AASB 1023, a derivative that is embedded in a host insurance contract and that is itself an insurance contract, is treated under updated AASB 1023. This is consistent with previous AASB 1023.

A.8 Deposit components

A general insurance contract may consist of an insurance component and a deposit component. Under paragraphs 2.4.1 to 2.4.4 of updated AASB 1023, in some cases, an insurer is required or permitted to unbundle the insurance and deposit components. The deposit component is treated under AASB 139 and the insurance component under updated AASB 1023:

- (a) Unbundling is required if the insurer can measure the deposit component separately and the insurer's accounting policies do not otherwise require it to recognise all obligations and rights arising from the deposit component;
- (b) Unbundling is permitted, but not required, if the insurer can measure the deposit component separately but its accounting policies require it to recognise all obligations and rights arising from the deposit component, regardless of the basis used to measure those rights and obligations; and
- (c) Unbundling is prohibited if an insurer cannot measure the deposit component separately.

It is not common for general insurance contracts to include a deposit component. However, deposit components could, for example, arise under certain reinsurance contracts. It is expected that, in most cases, given the requirements of updated AASB 1023 in relation to the measurement of premium revenue and outwards reinsurance expense, the insurer's accounting policies are likely to require it to recognise all obligations and rights arising from the deposit component, and hence that unbundling would not be required in many cases, but may be permitted.

Previous AASB 1023 does not include any requirements in relation to deposit components and both the deposit component and insurance component of a general insurance contract are treated as an insurance contract.

A.9 Amortisation of deferred acquisition costs

Under paragraph 8.1 of updated AASB 1023 deferred acquisition costs are amortised in accordance with the expected pattern of the incidence of risk

under the related general insurance contracts. This treatment is consistent with the recognition of premium revenue.

Under paragraph 10.5 of previous AASB 1023 deferred acquisition costs are amortised over the financial years expected to benefit from the acquisition costs incurred.

B. Previous AASB 1023 is more detailed or restrictive

None noted.

C. Updated AASB 1023 is more detailed or restrictive

C.1 Measurement of premium revenue and outwards reinsurance expense

Under paragraph 4.3 of updated AASB 1023 premium revenue (both direct and reinsurance premium revenue) is recognised in the income statement from the attachment date over the period of the general insurance contract for direct business, or over the period of indemnity for reinsurance business, in accordance with the pattern of the incidence of risk expected under the general insurance contract. Outwards reinsurance expense is also recognised from the attachment date over the period of indemnity in accordance with the pattern of the incidence of risk.

Paragraph 4.4.2 of updated AASB 1023 states that measuring premium revenue involves the following steps:

- (a) estimating the total amount of premium revenue expected under the contract;
- (b) estimating the total amount of claims expenses expected under the contract and estimating when the claims are expected to arise;
- (c) estimating the pattern of the incidence of risk from the result of (b); and
- (d) recognising the premium revenue under the contract identified in (a) when it will be earned, that is, in accordance with the pattern of the incidence of risk determined in (c).

Under paragraphs 4.1 and 4.2 of previous AASB 1023 direct premium revenue and reinsurance premium revenue is recognised from the attachment date in accordance with the pattern of the incidence of risk, but the manner in which the pattern of the incidence of risk is determined is not explained.

Under paragraph 7.1 of previous AASB 1023 outwards reinsurance expense is recognised in accordance with the pattern of reinsurance service. Paragraph 7.1.5 of previous AASB 1023 states that for proportional reinsurance the pattern of reinsurance service would normally be consistent with the pattern of risk of the underlying direct insurance policies and for non-proportional reinsurance the expense would normally be recognised over the period of the reinsurance arrangement. Previous AASB 1023 does not explain the manner in which the pattern of reinsurance service is determined.

C.2 Insurance assets and liabilities acquired in a business combination

Under paragraph 13.3.1 of updated AASB 1023 an insurer is permitted but not required to use an expanded presentation that splits the fair value of acquired insurance contracts into two components:

- (a) a liability measured in accordance with the insurer's accounting policies for general insurance contracts that it issues; and
- (b) an intangible asset, representing the difference between:
 - (i) the fair value of the contractual insurance rights acquired and insurance obligations assumed; and
 - (ii) the amount described in paragraph 13.3.1(a).

Under previous AASB 1023 there are no specific provisions relating to the presentation of acquired insurance contracts and insurers apply normal consolidation requirements.

C.3 Impairment of reinsurance assets

Under paragraph 12.1.1 of updated AASB 1023 a reinsurance asset is impaired if there is objective evidence, as a result of an event that occurred after initial recognition of the reinsurance asset, that the cedant may not receive amounts due to it under the terms of the reinsurance contract. Where a reinsurance asset is impaired the cedant reduces its carrying amount and recognises the impairment in the income statement. In addition, in paragraph 5.1.8 of updated AASB 1023, in determining the risk margin the insurer has regard to the inherent uncertainty in the central estimate in relation to reinsurance and other recoveries due.

Under paragraph 10.6 of previous AASB 1023 claims recoveries receivable from reinsurers are recognised as assets where the amount to be recovered can be reliably measured. The probability of receiving the recoveries is assessed in the light of prevailing circumstances, including the ability of the debtor to meet its obligations.

The ability to recognise impairment under updated AASB 1023 is therefore more specific than that allowed under previous AASB 1023.

D. Previous AASB 1023 disclosures are more extensive

D.1 Assets and liabilities

Under paragraph 11.1 of previous AASB 1023 insurers disclose the following assets and liabilities classified into current and non-current categories:

- (a) investments by class of business;
- (b) operating assets by class of business;
- (c) deferred acquisition costs;
- (d) reinsurance and other recoveries receivable;
- (e) liability for outstanding claims; and
- (f) unearned premiums.

Under paragraph 17.6.1(b) of updated AASB 1023 insurers disclose the recognised assets and liabilities arising from insurance contracts. Paragraph 17.6.2 lists the recognised assets and liabilities that would normally arise but does not require specific disclosures of the various categories of asset or liability.

D.2 Income and expenses arising from insurance contracts

Under paragraph 11.2 of previous AASB 1023 insurers disclose the following revenues or expenses included in the determination of the operating profit for the period:

- (a) direct premium revenue;
- (b) inwards reinsurance premium;
- (c) reinsurance and other recoveries revenue;
- (d) investment revenue or expense, and its individual components;
- (e) direct claims expense;
- (f) reinsurance claims expense;

- (h) outwards reinsurance premium expense; and
- (i) acquisition costs expense.

Paragraph 11.3 of previous AASB 1023 also requires outwards reinsurance premium expense to be disclosed separately as a deduction from total premium revenue, and reinsurance and other recoveries to be disclosed separately as a deduction from total claims expense.

Updated AASB 1023 does not require specific disclosures of categories of revenue or expenses. AASB 132 *Financial Instruments: Presentation and Disclosure* deals with the disclosure of investments and investment income relating to financial instruments. AASB 140 deals with investment property and AASB 116 deals with property, plant and equipment.

D.3 Assumptions

Under previous AASB 1023 insurers disclose average inflation and discount rates and the average weighted expected term to settlement from the reporting date of the claims included in the liability for outstanding claims.

Under updated AASB 1023 insurers, when practicable, give quantified disclosure of assumptions that have the greatest effect on the measurement of recognised amounts. In paragraph 17.6.6, updated AASB 1023 lists the assumptions that would normally have the greatest effect on the measurement of recognised amounts but does not require disclosure of specific assumptions.

E. Updated AASB 1023 disclosures are more extensive

E.1 Insurance contracts – explanation of recognised amounts

Under paragraph 17.6 of updated AASB 1023 insurers disclose information that identifies and explains the amounts in its financial report arising from insurance contracts. An insurer discloses:

- (a) its accounting policies for insurance contracts and related assets, liabilities, income and expense;
- (b) the recognised assets, liabilities, income, expense and cash flows arising from insurance contracts. Furthermore, if the insurer is a cedant, it discloses:
 - (i) gains and losses recognised in the income statement on buying reinsurance; and

- (ii) if the cedant defers and amortises gains and losses arising on buying reinsurance, the amortisation for the period and the amounts remaining unamortised at the beginning and end of the period;
- (c) the process used to determine the assumptions that have the greatest effect on the measurement of the recognised amounts described in (b). When practicable, an insurer also gives quantified disclosure of those assumptions;
- (d) the effect of changes in assumptions used to measure insurance assets and insurance liabilities, showing separately the effect of each change that has a material effect on the financial report; and
- (e) reconciliations of changes in insurance liabilities, reinsurance assets and, if any, related deferred acquisition costs.

Updated AASB 1023 requires insurers to apply these disclosure principles. As documented in section D of this document, previous AASB 1023 requires specific disclosures about various categories and components of assets, liabilities, revenues and expenses.

E.2 Insurance contracts – amount, timing and uncertainty of cash flows

Under paragraph 17.7 of updated AASB 1023 insurers disclose information that helps users to understand the amount, timing and uncertainty of future cash flows from insurance contracts. An insurer discloses:

- (a) its objectives in managing risks arising from insurance contracts and its policies for mitigating risk;
- (b) those terms and conditions of insurance contracts that have a material effect on the amount, timing and uncertainty of the insurer's future cash flows;
- (c) information about insurance risk (both before and after risk mitigation by reinsurance), including information about:
 - (i) the sensitivity of profit or loss and equity to changes in variables that have a material effect on them;
 - (ii) concentrations of insurance risk; and
 - (iii) actual claims compared with previous estimates (i.e. claims development). The disclosure about claims development starts from the period when the earliest material claim arose for which

there is still uncertainty about the amount and timing of the claims payments, but need not go back more than ten years. An insurer need not disclose this information for claims for which uncertainty about the amount and timing of claims payments is typically resolved within one year;

- (d) the information about interest rate risk and credit risk that AASB 132 *Financial Instruments: Disclosure and Presentation* would require if the insurance contracts were within the scope of AASB 132; and
- (e) information about exposures to interest rate risk or market risk under embedded derivatives contained in a host insurance contract if the insurer is not required to, and does not, measure the embedded derivatives at fair value.

Updated AASB 1023 requires insurers to apply these disclosure principles. As documented in section D of this document, previous AASB 1023 requires specific disclosures about assumptions used in determining the liability for outstanding claims.

E.3 Risk margins

Under paragraph 17.2 of updated AASB 1023 insurers disclose:

- (a) in relation to the outstanding claims liability:
 - (i) the central estimate of the expected present value of future payments for claims incurred; and
 - (ii) the component related to the risk margin;
- (b) the percentage risk margin adopted in determining the outstanding claims liability;
- (c) the probability of adequacy intended to be achieved through adoption of the risk margin; and
- (d) the process used to determine the risk margin, including the way in which diversification of risks has been allowed for.

Previous AASB 1023 does not include such disclosure requirements.

E.4 Assets backing insurance liabilities

Under paragraph 17.3 of updated AASB 1023 an insurer discloses the process used to determine which assets back general insurance liabilities and which assets back financial liabilities arising under non-insurance contracts.

Previous AASB 1023 does not include such a disclosure requirement.

E.5 Non-insurance contracts

Under paragraph 17.4 of updated AASB 1023 where an insurer has issued a non-insurance contract, or holds a non-insurance contract as a cedant, and that contract has a material financial impact, the insurer is required to make certain disclosures in relation to the contract. The insurer is required to disclose the nature of the contract, the recognised amounts in the income statement, balance sheet and cash flow arising from such contracts and information explaining the amount, timing and uncertainty of cash flows arising from such contracts.

Previous AASB 1023 does not include specific disclosure requirements for such contracts.