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Alan Mason Executive Director

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AASB 13-14 April 2005
 Agenda paper 8.2

The Chairman
 Australian Accounting Standards Board
 P.O. Box 204
 Collins St West
 VIC 8007

Dear Chairman

Invitation to Comment – Liability Adequacy Test in AASB 1023 – General Insurance Contracts

The Insurance Council of Australia (ICA) is pleased to provide the following comments in accordance with your Invitation to Comment on the Liability Adequacy Test in AASB 1023 General Insurance Contracts released in March 2005. This response has been considered and approved by a meeting of ICA's Finance and Accounting Standing Committee. The meeting was also attended by senior audit partners representing PricewaterhouseCoopers, Ernst & Young and KPMG.

1. ICA welcomes the AASB's invitation to comment and be part of the ongoing consultative process. In this regard, refer to our letters of 2 February and 8 March 2005 setting out our views on issues relating to the Liability Adequacy Test (LAT) and providing options and recommendations for the Board's consideration.

Reference is also made to presentations made to your Board by senior representatives of the insurance industry at your meeting on 3 February 2005.

2. ICA supports the AASB's preliminary conclusions:
 - (a) requiring the LAT to be performed at an entity level rather than a class of business level, and
 - (b) allowing a different Probability of Adequacy (POA) to be adopted in the Outstanding Claims Liability (OCL) and LAT, subject to appropriate disclosures. However, we are concerned that the remaining commentary under the final paragraph Section (b) on page 7 in fact contradicts the first sentence and implies that an entity is expected to have the same or similar POA for its OCL and the Liability for Future Claims (LFC) component of the Unearned Premium Liability (UPL), where it has consistent quality of data. I refer to our comments on this matter later in this letter.

3. Notwithstanding ICA's general acceptance of the AASB's preliminary conclusions (refer point 2(b) above, ICA does not agree with the AASB's adoption of Option 4. ICA believes that there is considerable argument for the adoption of Option 3 for the reasons clearly outlined in our letters of 2 February and 8 March 2005.
4. ICA supports the AASB's suggestion that the standard be amended and therefore does not support the retention of Option 1.
5. ICA understands that should Option 4 proceed the AASB is positively asserting that it is acceptable to have differing POA's for the OSC and the LAT. The reference to consistency of data and the example quoted in point (b) of the final paragraph of page 7 appear to have the unintended impact of limiting the circumstances within which an insurer could make the choice of adopting different POA's as is explicitly allowed in section 9.1.2.

Indeed the example provided in point (b) of the final paragraph of page 7 relating to variations in data quality does not support the adoption of differing levels of POA, but should more properly be reflected in the underlying probability distribution of cash flows relating to future claims.

ICA encourages the AASB to remove the misleading example provided in point (b) of the final paragraph of page 7 and clarify what it sees to be circumstances where it would be reasonable to adopt different POA's in the determination of OSC and LAT. ICA's discussions with the Industry, the Accounting and Actuarial professions has led us to believe that the strongest reason for adopting differing POA's in the determining OSC and LAT would be to reflect the differing objectives of the OSC and the LAT within the current accounting framework.

Put simply, these differences can be illustrated as:

- It is appropriate to adopt a conservative basis in the evaluation of the OSC, so as to reduce the risk of under reserving to an insignificant likelihood;
- given that the mechanism for the recognition of Premium Income within AASB 1023 is "the emergence of risk", it is not logical that insurers apply as high a likelihood that the unexpired business will ultimately prove profitable, in determining when the underlying income recognition mechanism should be overridden.

In this regard reference is made to the submission from the Institute of Actuaries of Australia, which has ICA's support.

6. ICA recommends that the detailed disclosures under paragraph 17.8 should only be required if the LAT is failed. If the LAT is passed, then it should be sufficient to say so, together with disclosure of the POA used. If the POA's are different, then the rationale for that difference should also be disclosed. The broader disclosure currently tabled may be misleading if disclosed calculations reveal a surplus. A reader of the financial statements could misconstrue the result as a profit, whereas it is only a timing difference derived from the method of recognition adopted.

7. Other issues:
- (a) The disclosure requirements in the proposed amended wording in paragraph 17.8(d)(ii) infer that the 'present value of expected future cash flows for future claims' equates to the 'central estimate of the present value of expected future cash flows' plus 'the component of present value of expected future cash flows related to the risk margin'. The wording should be amended to clarify that the risk margin is not a component of the future cash flows but rather is an additional amount included, as per the requirement for outstanding claims in paragraph 5.1.
 - (b) The term 'future claims' is unclear. It is presumed that this is referring to claims incurred after the reporting date relating to policies written on or prior to reporting date, however the wording of the standard should be amended to clarify this.
 - (c) The LAT makes no references to the treatment of related expenses in the conduct of the test. It could be argued that claims settlement costs are included implicitly in paragraph 17.8 but not policy maintenance costs. Rather than leave the industry having to develop a view on the appropriate treatment, the standard should clearly set out the required treatment.
 - (d) We note typographical errors in paragraph 17.1(c) in that the references to 17(e)(i) and 17(e)(ii) should refer to 17(b)(i) and 17(b)(ii).

We would appreciate the opportunity to assist the Board in amending the standard to the satisfaction of all stakeholders. If you would like to discuss any of the matters raised, please contact Peter Anderson, Manager, Policy Development and Research on (02) 9253 5135 or e-mail panderson@ica.com.au.

Yours sincerely



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