

4 April 2005

David Boymal  
Chairman  
Australian Accounting Standards Board  
PO Box 204, Collins St West Vic 8007  
**AUSTRALIA**

Dear David

**RE: Invitation to Comment - Liability Adequacy Test in AASB 1023 *General Insurance Contracts***

The Insurance Working Group on behalf of the Financial Reporting Standards Board (FRSB) of the Institute of Chartered Accountants of New Zealand (ICANZ) is pleased to submit its comments on the Invitation to Comment - Liability Adequacy Test in AASB 1023 *General Insurance Contracts* (hereafter referred to as the Invitation to Comment). The Insurance Working Group (IWG) consists of finance directors, Chief Financial Officers, auditors and actuaries working in New Zealand's insurance industry and a representative from the Insurance Council of New Zealand.

**Background**

At present Australian and New Zealand insurance standards are substantially the same except for differences that reflect variances in legislative and regulatory requirements. Given the close relationship between the insurance industries in New Zealand and Australia, the IWG considers that it is important that the insurance standards remain as similar as possible.

**IWG Deliberations**

The IWG has reviewed the Invitation to Comment and agrees with the AASB preliminary conclusion that option 4 is preferable over the four options presented on page 6 and 7 in the Invitation to Comment as a resolution of the issues raised by the Australian insurance industry.

However, the IWG has serious reservations with the proposal that the Liability Adequacy Test (LAT) be performed at the entity level. The IWG main concerns are as follows:

1. General insurers manage their business (e.g. loss ratios) using a portfolio approach. To be consistent with this the LAT should be performed using a portfolio approach.
2. Amending the requirement in AASB 1023 that the LAT to be performed at an entity level is inconsistent with AASB 1038 *Life Insurance Contracts* which requires the LAT to be performed by groups of related products (a portfolio approach). The IWG does not believe that there is justification for life insurance

accounting practices to diverge from general insurance accounting practices in this area.

3. Performing the LAT at the entity level may mask deficiencies that would otherwise be shown if the LAT was performed using a portfolio approach. Performing the LAT using a portfolio approach rather than an entity approach is consistent with best practice and overseas industry practice.

The IWG notes that the FRSB exposure draft for the proposed equivalent standard to AASB 1023 (ED FRS-35A *Financial Reporting of Insurance Activities* (ED FRS-35A)) exposed a LAT similar to that in AASB 1023 which requires the LAT to be performed by class of business.<sup>1</sup> The majority of submissions received on ED FRS-35A were supportive of the proposed LAT in ED FRS-35A and no submissions have been received disagreeing with the requirement to perform the LAT by class of business. It should be noted that ED FRS-35A and the New Zealand equivalent pronouncement to AASB 1023 does not contain a definition of the term ‘class of business.’

The IWG notes the Australian general insurance concern that the LAT in the current AASB 1023 far exceeds the requirements necessary to comply with IFRS 4 *Insurance Contracts*. The concern that the IWG has with the proposed amendment to paragraph 9.1, as drafted in the Invitation to Comment, is that it will prevent insurers who wish to conduct the LAT using a portfolio approach (arguably the more superior approach) instead of at the entity level.

### **Recommendation**

Instead, the IWG believes that pragmatically the LAT should be performed either by portfolios or at the reporting entity level depending on how an entity currently manages its risks (using portfolios or at the entity level) until the completion of the IASB’s insurance project phase II. The IWG recommends that the last sentence of paragraph 9.1 in AASB 1023 be amended to read as follows:

“The liability adequacy test for the unearned premium liability shall be performed at the reporting entity level by portfolios of contracts that are subject to broadly similar risks and are managed together as a single portfolio.”<sup>2</sup>

By not defining ‘portfolios of contracts that are subject to broadly similar risks’, which is consistent with IFRS 4.BC100, insurers, along with their auditors, will be required to make a judgement as to the whether the LAT should be performed at the reporting entity level or by portfolios consistent with the entity’s current practices. The above amendment will allow insurers to use their current systems for managing their business to conduct the LAT and avoid the difficulties caused by performing the LAT by class of business.

Alternatively, if the proposal above and other proposals by constituents to allow flexibility so that the LAT can be performed by portfolios are unacceptable, the IWG

<sup>1</sup> ED FRS-35A was issued in October 2004 with a comment deadline of 31 January 2004.

<sup>2</sup> The term ‘portfolios of contracts that are subject to broadly similar risks and are managed together as a single portfolio’ is from IFRS 4.18

recommends that the option to measure the LAT by portfolios be allowed and that the last sentence of paragraph 9.1 in AASB 1023 be amended as follows:

“The liability adequacy test for the unearned premium liability shall be performed at the reporting entity level **or** by portfolios of contracts that are subject to broadly similar risks and are managed together as a single portfolio.”

Some may argue that introducing an option will impair comparability; however, the IWG believes that this concern will be addressed by requiring the proposed additional disclosure in the short term until the completion of the IASB’s insurance project phase II. The IWG proposes that an additional disclosure be added to AASB 1023 paragraph 17.8 to require disclosure of whether the LAT was performed at an entity level or whether the portfolio approach is used.

### **New Zealand Implications**

Staff will be recommending to the FRSB that a discussion paper be issued proposing the finalised amendments to AASB 1023 in the equivalent New Zealand pronouncement in May 2005. The FRSB will be considering this recommendation at its April meeting.

If you have any queries or require clarification of any matters in this submission, please contact Joanna Yeoh ([Joanna.yeoh@icanz.co.nz](mailto:Joanna.yeoh@icanz.co.nz)) in the first instance, or me.

Yours sincerely

**Joanna Perry**

Chair – Financial Reporting Standards Board