24 October 2007

The Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West Victoria 8007

Dear Sir

Discussion Paper – Preliminary Views on Insurance Contracts

The Australian automobile clubs are pleased to provide specific comments on the above named Discussion Paper and recommendations relating to the development of the phase 2 exposure draft.

The Australian automobile clubs believe contracts for car breakdown services should be excluded from the scope of AASB 4 *Insurance Contracts*, in the same way that certain product warranties are excluded, and that the costs of applying the proposed accounting model will significantly exceed the benefits to users of the financial statements. We also believe AASB 4 should be amended to clarify that the assessment of significance insurance risk is performed from the contract issuers perspective to eliminate divergent accounting practices.

Background

Phase I Standard

AASB 4 introduced a new definition of an insurance contract and stated that roadside assistance contracts may fall within the scope of the standard where the definition is met.

Paragraph B7 of AASB 4 also states:

> "Applying the Standard to the contracts described in paragraph B6 is likely to be no more burdensome than applying the Standard that would be applicable if such contracts were outside the scope of this Standard.
>
> (a) There are unlikely to be material liabilities for malfunctions and breakdowns that have already occurred.

(b) If AASB 118 *Revenue* applied, the service provider would recognise revenue by reference to the stage of completion (and subject to other specified criteria). That approach is also acceptable under this Standard, which permits the service provider (i) to continue it's existing accounting policies for these contracts unless they involve practices prohibited by paragraph 14 and (ii) to improve its accounting policies if so permitted by paragraphs 22-30.

(c) The service provider considers whether the cost of meeting its contractual obligation to provide services exceeds the revenue received in advance. To do this, it applies the liability adequacy test described in paragraphs 15-19 of this Standard. If this Standard did not apply to these contracts, the service provider would apply AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* to determine whether the contracts are onerous.

(d) For these contracts, the disclosure requirements in this Standard are unlikely to add significantly to disclosures required by other Australian Accounting Standards."

Paragraph BC75 of the Basis for Conclusions on IFRS 4 Insurance Contracts also states that "The Board may need to review this conclusion in phase II". As most of the points in paragraph B7 are now invalid under the phase II project, the conclusion reached by the Board should be reviewed as part of the exposure draft process.

Roadside Assistance Services (RAS)

Roadside assistance services (RAS) represents one component of a range of benefits and services offered by the Australian automobile clubs as part of their membership. The RAS benefit involves getting a member's vehicle going or having the vehicle towed to a place where repairs can be carried out at the member's expense. Whilst this benefit is not regulated as an insurance contract in Australia it can still fall within the scope of AASB 4 where there is a significant transfer of insurance risk.

The Australian automobile clubs, which operate as mutuals, have the ability to use their discretion in determining the level and extent of benefits provided to members. In addition to RAS, other benefits of membership include motoring and touring advice, advocacy, discounted products and services such as insurance, maps and accommodation. They operate predominantly on a fixed benefit and fixed cost model which largely stays the same as membership levels grow. Some costs are variable such as towing and petrol, however these are not significant as they are limited by restricting the areas covered or towing distances.

The provision of roadside assistance services by the Australian automobile clubs differ from typical insurance contracts as follows:

- Whilst service is provided as soon as possible, response times are not guaranteed as members share the available resources equally with all other members who have made a service call.
- No material outstanding claim or residual liability accrues once the service is provided.
- Membership subscriptions are not risk rated on the likelihood of a request for breakdown services and therefore members are not required to make disclosures on the condition of their vehicle or their driving history.

- The clubs have the ability to use their discretion in determining the level and extent of services and benefits provided to members.
- There is little or no uncertainty in respect of future cash flows during either the period of membership (i.e. pre-claims liability) or after a breakdown occurs (i.e. incurred claims liability).
- There is little or no need to assess probabilities or exercise professional judgement when measuring amounts within the financial statements in relation to these services.
- The services are not regulated as insurance contracts.

In accordance with AASB 4, the accounting policies currently applied to these services are based on AASB 118 *Revenues* (recognised by stage of completion) and AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* (a liability adequacy test is applied to ensure the cost of providing the service does not exceed revenues received in advance).

Recommendations/comments on the Discussion Paper and the phase II Exposure Draft

Exclude RAS from the scope of AASB 4

We believe RAS should be specifically excluded from the scope of the standard in the same way that certain product warranties are currently excluded. Product warranties issued directly by a manufacturer, dealer or retailer are specifically excluded even though they have more in common with a typical insurance contract than RAS (i.e. the cash flows of these warranties are uncertain both during the coverage period and when a claim is made), and therefore we believe RAS should also be specifically excluded from the standard.

As noted in the *Framework of the Preparation and Presentation of Financial Statements* (*Framework*), the objective of financial reporting is to provide information that is useful in economic decision making. The attributes that make the information useful to users are understandability, relevance, reliability and comparability. One of the key reasons for the IASB insurance project was to eliminate the diverse accounting practices for insurance contracts and therefore enhance the comparability of financial reports.

The current accounting policies applied to RAS, which as noted above are based on AASB 4 and AASB 118, more than adequately meet the objectives of the *Framework*. As noted previously, unlike a typical insurance contract, the provision of these services involves very little or no uncertainly in respect of their future cash flows and there is little or no need for making assumptions to measure amounts in the financial statements. There is also no risk of diverging accounting practices when applying existing accounting standards to these types of services.

Applying the Proposed current exit value model

The costs of applying the proposed current exit value model to RAS will exceed the benefits to users as it will impose significant additional costs both on implementation (relating to establishing and validating the model and obtaining data) and on an ongoing basis (relating to an increase in financial statement disclosures, maintaining the model and updating the data). Although pre-claim liabilities and liabilities for incurred claims are insignificant, a measurement model will still be required.

Applying the proposed model will not make the financial statements of the Australian automobile clubs more relevant and reliable to the decision-making needs of users, but will add a level of complexity in accounting and disclosures which may also be considered misleading by users.

Assessing significant insurance risk

The current guidance within AASB 4 will generally result in typical insurance contracts being classified consistently whether the assessment of significant insurance risk is performed from either the contract issuer's or contract holder's perspective. However in situations where the majority of the costs associated with a contract relate to servicing the contract rather than the adverse event itself, such as RAS, differing classification can occur depending on which perspective the significance of insurance risk is assessed from.

Where the majority of the costs relate to servicing the contract, the occurrence of an adverse event will result in no or little additional costs by the contract issuer as the servicing costs are incurred regardless of whether the adverse future event occurs, i.e. the contract issuer is predominately exposed to financial risk rather than insurance risk. From the contract holder's perspective however, insurance risk will always be assessed as significant as the assessment would compare the benefit payable if there is no event (i.e. nil) and that payable on occurrence of the adverse event.

When the significance of insurance risk is assessed from the contract holder's perspective, service contracts such as RAS will in most instances fall within the scope of AASB 4. However whilst the service is contingent on an uncertain future event that adversely affects the contract holder, the contract exposes the contract issuer to significantly more financial risk than insurance risk.

We believe the intention of AASB 4 is to base this assessment from the perspective of the contract issuer, not the contract holder, as the objective of financial reporting is to provide relevant and reliable financial information in respect of a reporting entity, i.e. the contract issuer. To do otherwise would result in contracts which do not expose the contract issuer to significant insurance risk falling within the definition of an insurance contract.

Examples of references in the standard that indicate the assessment is performed from the contract issuer's perspective are:

- Paragraph B8: "A contract that exposes the issuer to financial risk without significant insurance risk is not an insurance contract."
- Paragraph B10: "Some contracts expose the issuer to financial risk, in addition to significant insurance risk."
- Paragraph B23:"Insurance risk is significant if, and only if, an insured event could cause an insurer to pay significant additional benefits in any scenario."

To eliminate the risk of divergent accounting practices for contracts which expose the contract issuer to significantly more financial risk than insurance risk, we believe the standard should be amended to clarify that the assessment of significant insurance risk is performed from the contract issuer's perspective, and not from the contract holder's perspective.

We appreciate the opportunity to comment on the phase II exposure draft and the proposed accounting model for insurance contracts.

If you have any queries in relation to this submission or require further information, please do not hesitate to contact Julie Bakker on (03) 9790 2613 or email Julie_Bakker@racv.com.au .

Respectfully submitted:

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