Australian Accounting Standards Board comments to
The HIH Royal Commission on its request for submissions
August 2002

BACKGROUND COMMENTS

Standard setting environment

Under section 227 of the *Australian Securities and Investments Act 2001* (ASIC Act 2001), the AASB has a specific function "to participate in and contribute to the development of a single set of accounting standards for world-wide use". Further, the ASIC Act 2001 provides in section 225 that a function of the Financial Reporting Council is:

> to monitor the development of international accounting standards and the accounting standards that apply in major international financial centres, and:
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> (i) to further the development of a single set of accounting standards for world-wide use with appropriate regard to international developments; and
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> (ii) to promote the adoption of international best practice accounting standards in the Australian accounting standard setting process if doing so would be in the best interests of both the private and public sectors in the Australian economy.

Consistent with this legislation, the AASB issued Policy Statement 4 "International Convergence and Harmonisation Policy" in April 2002. The following is an extract from Policy Statement 4.

> The primary objective of the Australian Accounting Standards Board (AASB) is to continually improve the quality of general purpose financial reports in Australia, so that users of those reports are better able to make and evaluate decisions about the allocation of scarce resources. This will assist in maintaining and improving the efficiency of Australian capital markets and in improving the accountability of private and public sector reporting entities. [paragraph 1]
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> There is considerable divergence between standards issued by national and international standard-setting bodies. The globalisation of economic activity has resulted in an increased demand for high quality, internationally comparable financial information. The AASB believes that it should facilitate the provision of this information by pursuing a policy of international convergence and international harmonisation of Australian accounting standards. In this context, "international convergence" means working with other standard-setting bodies to develop new or revised standards that will contribute to the development of a single set of accounting standards for world-wide use. "International harmonisation" of Australian accounting standards refers to a process which leads to these standards being made compatible with the standards of international standard-setting bodies to the extent that this would result in high quality standards. Both processes are intended to assist in the development of a single set of accounting standards for world-wide use. [paragraph 2]
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> There are several organisations which are working towards improving the international comparability of financial reporting. They include:
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> (a) the International Accounting Standards Board (IASB) established by the International Accounting Standards Committee, the objectives of which include the development of a single set of high quality, understandable and enforceable global accounting standards, International Financial Reporting Standards (IFRSs), and the convergence of national accounting standards and IFRSs;
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> (b) the International Federation of Accountants Public Sector Committee (PSC), which was established primarily to develop international standards and guidance for public sector entities; and
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> (c) the standard-setting bodies of Australia, Canada, France, Germany, Japan, New Zealand, United Kingdom, and United States of America which have liaison relationships with the

IASB, through members of the IASB who have formal liaison responsibilities with these national standard-setting bodies. [paragraph 3]

This Policy Statement outlines the AASB's international convergence and international harmonisation objectives and the strategies it will employ in achieving them. The strategies will allow the AASB to pursue international convergence and international harmonisation of Australian accounting standards. [paragraph 4]

Objectives

The AASB's international convergence objective is to pursue, through participation in the activities of the IASB and the PSC, the development of an internationally accepted single set of accounting standards which can be adopted in Australia and elsewhere for both domestic and world-wide use in order to achieve the benefits set forth in paragraph 7 of this Policy Statement. [paragraph 5]

A single set of internationally accepted accounting standards is not likely to be achievable in the short term. Accordingly, the AASB's international harmonisation objective is to work towards the development of accounting standards in Australia that harmonise with IFRSs and International Public Sector Accounting Standards (IPSASs) issued by the PSC, where the AASB concludes that such standards are likely to be in the best interests of both the private and public sectors in the Australian economy. Where IFRSs and/or IPSASs are considered by the AASB to not represent best international practice, the interim objective is to work towards adopting standards that are considered by the AASB to be best international practice and to endeavour to influence the deliberations of the IASB and the PSC to adopt what the AASB considers to be best international practice. [paragraph 6]

Benefits of Convergence and Harmonisation

The main benefits of international convergence and international harmonisation include:

(a) increasing the comparability of financial reports prepared in different countries and providing participants in international capital markets with better quality information on which to base investment and credit decisions. It will also reduce financial analysis costs through analysts not having to recast information on a common basis and requiring knowledge of only one set of financial reporting standards rather than several;

(b) removing barriers to international capital flows by reducing differences in financial reporting requirements for participants in international capital markets and by increasing the understanding by foreign investors of Australian financial reports;

(c) reducing financial reporting costs for Australian multinational companies and foreign companies operating in Australia and reporting elsewhere;

(d) facilitating more meaningful comparisons of the financial performance and financial position of Australian and foreign public sector reporting entities; and

(e) improving the quality of financial reporting in Australia to best international practice. [paragraph 7]

Strategies

The AASB views its international convergence and international harmonisation objectives as integral to its standard-setting activities for both private and public sector reporting entities. [paragraph 8]

The AASB will adopt work program strategies and international liaison and monitoring strategies that enable it to:

(a) participate in and contribute to the development of a single set of accounting standards for world-wide use; and

(b) to increase the comparability of Australian accounting standards with IFRSs and IPSASs and the accounting standards of other IASB liaison member standard-setting bodies. [paragraph 9]

Work program strategies

In relation to its work program, the AASB will endeavour to:

(a) align its work program with that of the IASB and the PSC, but only after having due regard to issues that may not affect or may not have the same priority as the IASB and the PSC and subject to the programs of the IASB and the PSC being reflective of the issues identified as priorities by the IASB liaison member standard-setting bodies;

(b) allocate staff and other resources so that the AASB can, as agreed with the IASB, the PSC and other IASB liaison member standard-setting bodies, lead projects on certain issues on the agendas of the IASB and the PSC and provide support on others;

(c) fully consider the views of the IASB and the PSC and other IASB liaison member standard-setting bodies in its deliberations on issues;

(d) issue, where relevant, IASB and PSC discussion papers and exposure drafts, with minimum modifications dealing with domestic issues, for input from AASB constituents;

(e) work with the IASB and the PSC, through the AASB liaison IASB member and the Australian representative on the PSC, to remove incompatibilities between an existing or proposed international accounting standard and the corresponding Australian existing or proposed accounting standard, in situations where the AASB is of the view that the international accounting standard is inappropriate in the Australian context. In this regard the AASB will also work towards achieving harmonisation of general purpose financial reports and Government Finance Statistics;

(f) accept the views of the IASB, the PSC and the majority of other IASB liaison member standard-setting bodies on an issue in question where such acceptance will lead to international convergence on the issue, even though that view is not the preferred position of the Board, unless such acceptance is considered not to be in the best interests of both the private and public sectors in the Australian economy. [paragraph 10]

International liaison and monitoring strategies

The AASB will endeavour to:

(a) routinely and closely monitor international developments in financial reporting;

(b) maintain and enhance relationships with the IASB, the PSC and other IASB liaison member standard-setting bodies by:

 (i) participating in meetings of IASB liaison standard-setting bodies and other relevant meetings with the IASB, PSC and other IASB liaison member standard-setting bodies;

 (ii) ensuring there is an effective information exchange between the AASB, the IASB, the PSC and other IASB liaison member standard-setting bodies;

 (iii) participating in staff exchange programs with the IASB, the PSC and other IASB liaison member standard-setting bodies;

 (iv) making submissions, where resources permit, on proposed accounting standards issued by the IASB, the PSC and other IASB liaison member standard-setting bodies; and

 (v) making AASB staff available to the AASB liaison IASB member and the Australian representative on the PSC for briefings on technical matters; and

(c) maintain and enhance relationships between the Urgent Issues Group of the AASB and the International Financial Reporting Interpretations Committee of the IASB (IFRIC) and similar groups of other IASB liaison member standard-setting bodies by ensuring there is an effective information exchange between the various groups. [paragraph 11]

The AASB liaison IASB member, the Australian representative on the PSC and a New Zealand standard-setting representative have non-voting observer status at AASB meetings. [paragraph 12]

The Financial Reporting Council recently announced its support for entities subject to the *Corporations Act 2001* being required to comply with IASB standards by 1 January 2005.

Accounting for general insurance

Australia is one of only three jurisdictions[1] to have an accounting standard relating specifically to the general insurance industry – AASB 1023 "Financial Reporting of General Insurance Activities". AASB 1023 was first issued in 1990 and reissued in 1996 with minor modifications. The USA has Statement 60 "Accounting and Reporting by Insurance Enterprises" issued by the Financial Accounting Standards Board (FASB) in 1982 and Statement 113 "Accounting and Reporting of Short-Duration and Long-Duration Contracts" issued in 1992. New Zealand has FRS-35 "Financial Reporting of General Insurance Activities" issued in 1999, which is based on AASB 1023.

ROYAL COMMISSION'S REQUEST FOR SUBMISSIONS – Financial Reinsurance and Accounting for Insurance and Reinsurance Contracts

Finite Risk or Financial Reinsurance Contracts

Q1. Is there a legitimate role for the products variously known as alternative risk transfer products or finite risk reinsurance or financial reinsurance? If yes, what is that role?

The AASB is responsible for promulgating accounting standards for reporting on the effects of transactions and other events. It is not the AASB's role to opine on whether the transactions or other events themselves have merit.

Q2. To what extent do the advantages of such products depend upon their being accounted for as insurance contracts rather than as some other form of funding mechanism? Is such a distinction in accounting treatment justified? If not how should it be addressed?

The AASB is not in a position to determine the motives of those who undertake such transactions. However, motive is sometimes used by standard setters in helping to determine an appropriate accounting treatment (for example, with hedging transactions).

The financial reporting of transactions and other events should be determined based on the application of principles having regard to substance over form. Please also see our responses to questions 7 to 15.

Q3. Is there a potential for such products to be abused? If so, what safeguards would be desirable and effective to prevent abuse?

There is always a risk that entities will use an accounting treatment that does not result in the nature and substance of a transaction or other event being faithfully represented. In the AASB's experience, the best way of avoiding such abuse is to write principle-based standards. Please also see our responses to questions 7 to 15.

1 The UK has a Statement of Recommended Practice prepared by the Association of British Insurers and "franked" by the UK's Accounting Standards Board, which does not have the status of a standard. Canada has a standard for life insurers, but not for general insurers.

Accounting Standards

General

Q4. What amendments, if any, are required to the accounting standards from 1 July 2002 following the introduction of the new APRA Prudential Standards? What processes are in train to address any such changes?

It is desirable that the AASB and APRA reporting requirements be harmonised to the extent feasible to help minimise costs of reporting by the industry. However, the AASB sets accounting standards for general purpose financial reporting and its role is not to automatically change in response to changes in regulatory reporting required by APRA.

There has been a significant amount of liaison between the AASB and the APRA (and its predecessors) since the late 1980s and both organisations have attempted to harmonise their reporting requirements to the extent feasible. The AASB has been monitoring the development and issue of the recent changes to the APRA reporting requirements. At the same time, the IASB has been progressing its insurance project and the AASB made the decision, consistent with its legislative functions, to contribute to the International Accounting Standards Board's (IASB's) project, rather than diverting resources to revising AASB 1023 to the extent that harmony with the APRA rules is consistent with financial reporting principles. The AASB considered that it would be inappropriate to fundamentally change the requirements of AASB 1023 in the short run only to possibly change them fundamentally once again in harmonising with the IASB. It was considered that this would be likely to create confusion among users and preparers of financial reports.

To the extent possible, the AASB will endeavour to harmonise with both the IASB and the APRA rules. To facilitate the harmonisation process, the AASB will continue to liaise with the APRA on the IASB's insurance project. In addition, it is our understanding that the APRA participates in the work of the International Association of Insurance Supervisors (IAIS) and that the IAIS is represented on the Insurance Contracts Advisory Committee of the IASB.

Q5. What progress has been made in the formulation of any international standard for accounting for insurance contracts? What is the likely timeframe for the formulation of such a standard? What is it envisaged will such a standard provide?

The IASB is in the process of developing an accounting standard on insurance, which has progressed to the stage where the IASB is discussing principles relating to insurance contracts. AASB staff have been involved in the development of the project and the AASB, consistent with its policy of international harmonisation, expects to revise Australia's existing insurance standards[2] to converge with the IASB standard. The IASB's project covers all types of insurance contracts.

The definition of insurance contract proposed by the IASB's Insurance Steering Committee (the forerunner to the Insurance Contracts Advisory Committee) is as follows.

> a contract under which one party (the insurer) accepts an insurance risk by agreeing with another party (the policyholder) to make payment if a specified uncertain future

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2 AASB 1023 and AASB 1038 "Life Insurance Business" would both be affected.

> event occurs (other than an event that is only a change in a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index, or similar variable). [IASC, Insurance Issues Paper, November 1999, page iv]

All insurance contracts are financial instruments, but only some financial instruments are insurance contracts. The IASB Insurance Contracts Steering Committee's definition distinguishes insurance contracts from other financial instruments.

The IASB's web site notes that an Exposure Draft is expected in late 2002 and a standard in 2003, however, our liaison member has informed us that the project is likely to take longer than originally planned and that there are now two projects – (1) an interim solution and (2) a long term standard.

The interim solution is to require the continued use of National standards or generally accepted accounting practice for insurance contracts and also existing IASB standards, where relevant. In Australia, this would mean that the existing AASB 1023 would apply to general insurers in respect of assets, liabilities and revenues and expenses resulting directly from insurance contracts and that the IASB's standards would apply to all other assets, liabilities, revenues and expenses. A potential impact of this would be that investment assets integral to a general insurer's operations would be recognised and measured in accordance with IAS 39 "Financial Instruments: Recognition and Measurement"[3] and IAS 40 "Investment Property"[4], rather than all being measured at net market value with changes in net market value recognised in profit, as required under AASB 1023. If this approach were adopted in Australia, it would mean that the accounting treatment of investments would become less harmonised with the APRA requirements than they are at present.

The long-term solution is a new IASB standard based on the work of the IASB's Insurance Contracts Advisory Committee and further work of the IASB itself.

Q6. Should the "insurance risk capital charge", the "investment risk capital charge", the "concentration of risk capital charge", the "prudential margins" and any other, and if so, what, requirements of the new Prudential Standards be recognised as liabilities in a general insurer's accounts? If so how? If not, how if at all should they be reflected in a general insurer's accounts?

From the AASB's viewpoint, this question raises two issues: (1) whether the financial reporting liability should include a margin for uncertainty; and (2) the display of other margins required for prudential purposes.

Margin for uncertainty

AASB 1023 requires the recognition of a liability for outstanding claims measured as "the present value of the expected future payments" [paragraph 5.1]. There has been some debate about whether this liability is a best estimate or whether it includes some margin for uncertainty. The debate goes to the heart of the IASB's deliberations and the AASB

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3 IAS 39 identifies three categories of financial instruments (1) trading [measured at fair value, with changes in fair value recognised in profit]; (2) available for sale [measured at fair value, with changes in fair value recognised in equity]; and (3) held to maturity [measured at cost, with amortisation of that cost recognised in profit].

4 IAS 40 requires investment property to be measured at fair value, with changes in fair value recognised in profit. In "exceptional cases" it permits measurement at cost.

considers that any input it has on this issue should be channelled through the IASB rather than attempting to arrive at a solution ahead of, and in isolation from, the IASB.

The IASB's Insurance Contracts Advisory Committee has come to the view that insurance liabilities should be measured at fair value with reference to an actual or notional price for which a willing buyer would relieve the insurer of the liability. The Committee considers that such a price would include a margin for uncertainty. The IASB has yet to fully debate the issue, but this would be the starting point for the debate.

Other prudential margins

The APRA and its counterparts in developed jurisdictions typically require prudential margins to take into account a range of possible adversities, which would be over and above the margin for uncertainty. The AASB view, and the view of the IASB's Insurance Contracts Advisory Committee, is that such margins should not be included in financial reporting insurance liabilities. Such additional margins are an allocation of profit and are in the nature of reserves and should be presented in the equity section of the statement of financial position.

Accounting for Reinsurance Contracts

Q7. In ISC Circular No.G3 of 1994 the ISC said:

> ***"There are, of course, also significant accounting issues raised in the reporting of financial reinsurance assets and liabilities for our purposes and for reporting generally. Whilst these issues raise significant questions for the accounting and audit professions, the ISC's focus specifically is on <u>prudential supervision.</u> (Accounting standards and practice should be developed to match the approach set out in this paper). …" (emphasis in original).***

The term "reinsurance" seems to have two different meanings: (1) "genuine" reinsurance, which is an insurance contract that involves the transfer of risk, and is the meaning of the term as it is used in AASB 1023; and (2) contracts that may have the form of an insurance contract but do not have the substance of insurance contracts – they are financial instruments (such as investments or deposits) and are not insurance contracts. This second group includes contracts sometimes called "financial reinsurance" and "finite reinsurance", however, this is not to suggest that all contracts that have these names are not genuine reinsurance. The substance of contracts is the key, not the names they are given.

Q8. What consideration was given to the development of standards or guidance for the accounting of contracts of financial or finite reinsurance and what was the outcome of any such consideration?

AASB 1023 does not specifically mention contracts of financial or finite reinsurance. All of the discussion of inwards and outwards reinsurance in AASB 1023 presumes that the transactions concerned are effective in transferring risks between insurers.

Q9. Clause 1.3 of AASB 1023 provides that the standard applies to general insurance activities. Although it contains a description of insurance it does not deal specifically with the principles which determine whether products variously known as alternative risk transfer products, finite risk reinsurance or financial reinsurance should or should not be accounted for under AASB 1023.

The relationship between an insurer and a reinsurer is presumed to be the same as the relationship between an (individual) insured and an insurer. As discussed in paragraph 1.3.1, "General insurance provides protection for a specified period against specified losses resulting from the occurrence of specified types of events that may occur. Such events include theft or storms resulting in property loss or damage, work-related and motor vehicle accidents resulting in injury, and fires or floods resulting in interruptions to business. For certain amounts of *premium*, the insurer undertakes to accept, either wholly or in part, from the insured the risks of sustaining specified losses arising from such events within a specified period." Accordingly, there is a presumption that insurance contracts and reinsurance contracts are contracts that involve the transfer of risk. This is clear from the commentary in section 7.

> **If the rules or principles of accounting for premium expense and reinsurance recoveries over long term reinsurance contracts give a true and fair view of the financial position of the reporting entity in respect of such transactions, is it necessary to quantify or describe the extent of insurance or other risk needed for a transaction to qualify as an insurance transaction for accounting purposes?**

Rules-based standard setting, whereby quantitative limits are established, has been widely discredited. Quantitative rules provide a basis for easy-to-identify limits that facilitate the activities of those who are intent on abuse. If there were a requirement specifying that 20% of the "value" of a contract must relate to risk transfer, there would be proliferation of contracts with forms that precisely meet or fail the 20% limit, depending on the outcome desired. Standards that focus on the substance of a transaction are more likely to achieve their intended outcome than quantitative rules.

Q10. Should there be a standard or guidance note which addresses the issue of whether alternative risk transfer products, finite risk reinsurance or financial reinsurance products should be accounted for under AASB 1023? If so what should it provide? Should it follow the US standard FASB113, or the income tax rulings, or some other standard?

Under the AASB's existing standards, a financial instrument of a general insurer that is not covered by AASB 1023 would be covered by AASB 1033 "Presentation and Disclosure of Financial Instruments". AASB 1033 sets out a number of principles for the classification of financial instruments and is substantially the same as the IASB's IAS 32 "Financial Instruments: Presentation and Disclosure".

The AASB has not yet issued a standard dealing with recognition and measurement of financial instruments and a due process is in progress using the IASB's IAS 39 "Financial Instruments: Recognition and Measurement" in accordance with the AASB's international convergence and harmonisation policy.

The IASB's Insurance Contracts Advisory Committee considers that a principles-based approach should be adopted and has suggested a definition of insurance contracts (see question 5). Reinsurance contracts are not afforded any special treatment because they are regarded as being insurance contracts between an insurer and a reinsurer. Financial instruments that fall outside the insurance contracts definition would be treated in accordance with IAS 32 and IAS 39.

FASB Statement 113 addresses a number of issues, in particular, conditions for identifying a "genuine" reinsurance contract. These conditions are similar to the conditions mentioned in AASB 1023, paragraph 1.3.1, in describing insurance activities and to the definition of insurance contract being developed by the IASB. The AASB takes the view that it is preferable to address insurance contracts broadly and not to focus specifically on reinsurance contracts, since, in principle, reinsurance contracts are insurance contracts between insurers.

Clauses 7.1 and 10.6 of AASB 1023

Q11. What guidance has the Australian Accounting Standards Board, or any other professional, industry or governmental body, provided as to the meaning or application of clause 7.1 which requires that reinsurance premium expense be recognised *"in accordance with the pattern of reinsurance service?"*.

The AASB has not issued any guidance on paragraph 7.1 other than the commentary in section 7 of AASB 1023. The AASB is not aware of any other guidance that has been issued on paragraph 7.1.

Q12. What was the reasoning behind the adoption of this expression?

Again, we emphasise that the use of the word "reinsurance" in AASB 1023 means "genuine" reinsurance. The adoption of the expression "in accordance with the pattern of reinsurance service" for outwards reinsurance premiums was used to reflect the same notion as that adopted in relation to direct inwards premiums (paragraph 4.2). However, the use of identical expressions is not appropriate because the focus is different. The focus of paragraph 4.2, which says to recognise premiums "in accordance with the pattern of the incidence of risk" is dealing with inwards direct premiums from policyholders. The focus of paragraph 7.1 is outwards reinsurance premiums (reinsurance expenses) and the relevant risks are those ceded rather than those incurred. The expression "reinsurance service" relates to the cover provided for risks ceded.

Furthermore, the expression "pattern of the incidence of risk" used for direct business may not suit some reinsurance contracts. Under some forms of reinsurance (proportional reinsurance), the pattern of reinsurance service would normally be consistent with the pattern of risk of the underlying direct insurance policies. Paragraph 7.1.5 explains that proportional reinsurance encompasses contracts under which the reinsurer's share of the ceding insurer's losses are in the same proportion as its share of the premiums. However, paragraph 7.1.5 further explains that, for non-proportional reinsurance, the expense would be recognised over the period of the reinsurance arrangement. Non-proportional reinsurance encompasses contracts under which the reinsurer's share of the ceding insurer's losses are not in the same proportion as its share of premiums, such as with excess of loss reinsurance that indemnifies the ceding insurer against a loss in excess of a specific amount (the "excess" or "deductible").

Q13. Should the standard expressly address accounting for long term reinsurance contracts where there are timing differences between the obligation to pay premiums and the right to receive reinsurance recoveries?

This question raises the issue of whether contracts should be unbundled. A contract may have an insurance risk element and other elements that do not relate to insurance risk. There is a presumption in AASB 1023 that a contract is either an insurance contract or it is not an insurance contract and that any delays between premium payment and receipt of reinsurance recoveries are only the normal delays experienced through normal administration of a contract. If other elements are present in a contract, there could be a basis for unbundling the contract into its insurance and non-insurance elements and treating the non-insurance element in accordance with the general requirements for financial instruments. The IASC's Insurance

Steering Committee (the forerunner to the IASB's Insurance Contracts Advisory Committee) was divided about whether insurance contracts should be unbundled, but feedback on the 1999 discussion paper indicated that unbundling may involve more costs than would be warranted by the potential benefits.

> **Should it expressly address matching a present or expected liability to pay future premiums and a present entitlement to receive or expectation of receiving future reinsurance recoveries? If so, how? Should an insurance company be required to record as a liability the present value of future premiums expense and record as an asset the present value of likely reinsurance recoveries? (See T4946, T4949).**

AASB 1023 currently uses a deferral and matching notion. It matches premiums received with claims for the period and defers any unearned premium. It does not take a prospective approach which would involve taking into account future revenues and expenses.

In terms of the IASB's work, the fair value approach being considered would require entities to determine the amount that would be required to settle the obligation relating to insurance contracts with a third party. The thinking at the IASB's Insurance Contracts Advisory Committee is that the method of determining this fair value (given the likelihood that there would not be an active market price for such liabilities) may involve taking into account future premiums and claims relating to existing policyholders. The future premiums and claims that would be taken into account would be those where policyholders have valuable renewal options. In other words, the policyholders have an economic incentive to keep paying premiums in order to obtain long-run benefits not available to "new" policyholders. This tends to occur in long term life insurance contracts, but may occur with general insurance.

Q14. Should clause 10.6, or the commentary to it, expressly provide that reinsurance recoveries can only be booked as assets if they are payable by the reinsurer from its own funds and not from money held on deposit or in an experience account? Should there be an express provision that reinsurance recoveries cannot be booked as assets if, and to the extent to which, the reinsured is entitled to receive a return of premium paid?

The asset definition and asset recognition criteria are explained in SAC 4 and implemented in AASB 1023. There is no reference to the source of funds as a factor in asset definition or recognition. We assume that the question is directed at contracts that are in substance deposits which are returned in part or in full to the depositor. We think it would be more productive to have rules that emphasise substance over form, rather than trying to change the rules regarding asset definition and recognition as a means of ensuring that information is representationally faithful.

Also refer to our response to question 10.

Q15. Do reinsurance arrangements which operate wholly or partly retrospectively require separate treatment? If so. What treatment?

We assume that "reinsurance arrangements which operate wholly or partly retrospectively" are contracts that operate on a claims-made basis. That is, they cover claims made during the contract period, as opposed to necessarily covering claims that arise from events occurring during the contract period (claims-incurred basis). Such contracts may have conditions, such as requiring continuity since the event occurred. The ceding insurer would have to take into account the contract conditions in determining its entitlement to recoveries under such policies. AASB 1023 does not include specific requirements in relation to claims made contracts and the work of the IASB's Insurance Contracts Advisory Committee has not yet specifically addressed claims made contracts.

Side Letters, Side Agreements and Parallel Contracts

Q16. Is clause 4.1 of AASB 1001 and the commentary thereto adequate for dealing with issues thrown up by side letters, side agreements and parallel contracts?

This can be viewed as a "unit of account" question – a transaction or other event that needs to be accounted for may constitute a number of contracts or a single contract. Paragraph 4.1 of AASB 1001 "Accounting Policies" may help in identifying the unit of account. Paragraph 4.1.8 comments that "For financial information to satisfy both the relevance and reliability concepts, it is necessary that the substance rather than the form of a transaction or other event be reported where substance and form differ." If in substance a transaction consists of several contracts and side agreements, under AASB 1001, the accounting policy adopted to report on the effects of those contracts and side letters should reflect that substance.

Q17. Are the auditing standards adequate to ensure that, if followed, auditors will be sufficiently informed of the existence and implications of such arrangements?

The AASB is not in a position to comment on auditing standards. The Auditing and Assurance Standards Board of the Australian Accounting Research Foundation is responsible for setting auditing standards in Australia [Level 10, 600 Bourke Street, Melbourne].

Claims Provisions

Q18. The insurance industry (which doubtless is not alone in this respect) has to account for assets and liabilities whose recovery or incurrence may be certain or highly uncertain. For example, what is an appropriate provision for long tail claims is very much a matter of opinion. It may be a counsel of perfection to expect management to make judgments on matters of opinion which affect reported current performance, with impartial objectivity and not to put pressure on employees, actuaries and auditors on how they go about forming their opinions. Statement of Accounting Concepts No.4 appears to adopt a pure probability test for the recognition of an asset or liability. Should the Statement of Accounting Concepts, or should the Standards, prescribe a principle of prudence or conservatism in the recognition of assets and liabilities?

SAC 4 "Definition and Recognition of the Elements of Financial Statements" deals with defining and recognising assets, liabilities, revenues and expenses, and uses a probability criterion, where probably means more likely than not. However, this approach may not necessarily lead to liabilities that do not include some margin for uncertainty.

The IASB's conceptual framework relating to recognition is highly similar to SAC 4. Consistent with the IASB framework, the IASB's Insurance Advisory Committee uses the recognition criterion of probability. When it considers measurement, a fair value notion is used and fair value is said to include a margin for uncertainty, because in a marketplace a buyer of an insurance liability that it did not underwrite would require a margin to compensate it for the uncertainties surrounding the liability. This margin is not based on prudence or conservatism, but is a result of applying a fair value measurement approach.

Q19. Are the new APRA Prudential Standards for liability valuations adequate and appropriate? Should the claims liabilities (or the central estimate thereof) be stated in the accounts using the same principles for their determination, as described in the new Prudential Standard – GPS 210?

The APRA requirements are designed for the purposes of prudential regulation. Accounting standards aim to provide relevant and reliable information to a range of users, which would include investors, creditors, employees and regulators. The same information may or may not satisfy the needs of all stakeholders. As noted earlier, the AASB aims to harmonise to the extent possible with the APRA requirements, because costs of preparation will be lower the more closely the requirements are harmonised. However, if the regulatory principles and the financial reporting principles differ, harmonisation may not be possible.

Q20. What work has been done to follow up the recommendations of the Working Group of the Institute of Actuaries on the Consistency and Reliability of Outstanding Claims contained in its Discussion Paper of 30 November 1998? (CORE.048.703). Is any further work proposed?

The AASB has had any substantial work on insurance on hold since 1998 because it is participating in the IASB's insurance project. This is consistent with the AASB's policy of international harmonisation. The AASB is conscious that any substantial change to the requirements would involve insurers and the users of their financial information in incurring substantial costs and that it is undesirable to change a treatment in the knowledge that the treatment may change again (to harmonise with the IASB).

Q21. Should liabilities be assessed at "fair value" or "market value" and if so, how should that be determined? What work done on this topic would be of benefit in Australia? For example what assistance does the White Paper of the CAS Task Force on Fair Valuing Property/Casualty Liabilities provide? (see http://casact.org/research/tffvl/index.htm)

This question will be resolved as part of the IASB's project in which the AASB is a participant. As a result of the IASB's project, a substantial amount of work has been undertaken by various bodies, many of them actuarial organisations. The CAS Task Force paper is one of those contributions which will be considered by the IASB's Insurance Contracts Advisory Committee.

Q22. What information should be made publicly available about how general insurers have determined their claims provisions? What disclosures are required in other comparable jurisdictions?

This question is being considered by the IASB's Insurance Advisory Committee. The disclosures required in those jurisdictions with standards on insurance are similar.

AASB 1023 presently requires disclosure of a number of key amounts and assumptions applied in determining the liability for outstanding claims.[5] In addition, AASB 1001 requires

5 In relation to the liability for outstanding claims, the financial report must disclose:
(a) the undiscounted amount of claims, reconciled to the liability for outstanding claims; and
(b) average inflation and discount rates applied for the following periods in measuring the liability for outstanding claims:

disclosure of "a description of each specific accounting policy that is necessary for an understanding of the financial report" [paragraph 8.1(d)].

Similarly, FASB Statement 60 requires a number of a number of key policies and assumptions relevant to insurance liabilities.[6]

New Zealand's FRS-5 has the same disclosure requirements as AASB 1023.

Other disclosures may also be promulgated as a result of the IASB's project to improve 12 of its existing standards, which are outlined in the AASB's Invitation to Comment "Proposed Improvements to International Accounting Standards and their Impacts on Australian Standards". One proposal is to require disclosure of the judgements made by management in applying accounting policies that have the most significant effect on the amounts of items recognised in the financial statements.[7] Another proposal is to require disclosure of key assumptions about future events, and other sources of measurement uncertainty, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year.[8]

Q23. Should the Standards require (or permit) the discounting of the liability to make future payments for claims, and of future reinsurance recoveries? What countries other than Australia require or permit such discounting? What advantages would there be, if any, in consistent international accounting principles on this issue?

The measurement approach adopted in the future will presumably be the approach adopted by the IASB. This may or may not involve discounting. The present direction of the IASB's project is a fair value approach, and the methods used to determine a fair value may involve discounted cash flow techniques.

Of the three jurisdictions with existing insurance accounting standards, both the Australian and New Zealand standards require discounting. The standard in the USA does not require

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(i) the succeeding year; and
(ii) later than one year from the reporting date; and

(c) the average weighted expected term to settlement from the reporting date of the claims included in the liability for outstanding claims;

except that reinsurers may exclude proportional treaty reinsurance business from the disclosures required by paragraphs 11.4(b) and (c). [paragraph 11.4]

Subject to paragraph 11.7, *net claims incurred* must be disclosed, showing separately the amount relating to risks borne in the current financial year and the amount relating to a reassessment of risks borne in all previous financial years. For each of the current financial year and previous financial years net claims incurred, the following components must be separately disclosed:

(a) gross claims incurred – undiscounted; and
(b) reinsurance and other recoveries – undiscounted; and
(c) discount movements shown separately for parts (a) and (b). [paragraph 11.5]

Subject to paragraph 11.7, an explanation must be provided where net claims incurred relating to a reassessment of risks borne in previous financial years are material. [paragraph 11.6].

6 The basis for estimating the liabilities for unpaid claims and claim adjustment expenses. Disclosure of the methods and assumptions used in estimating the liability for future policy benefits with disclosure of the average rate of assumed investment yields in effect for the current year is encouraged.

7 IASB Exposure Draft of Proposed Improvements to International Accounting Standards, IAS 1 "Presentation of Financial Statements", paragraphs 108 & 109.

8 IASB Exposure Draft of Proposed Improvements to International Accounting Standards, IAS 1, paragraphs 110 & 115.

discounting, which probably reflects the greater emphasis in that jurisdiction on the historical cost measurement basis.

The advantages of a consistent international approach to measuring insurance liabilities would be the same advantages that would flow from harmonised standards in general. These advantages include greater comparability across entities in different jurisdictions.

Q24. The effect of discounting claims liabilities by the rates of return which the insurer anticipates it could earn if sufficient funds were available to meet the liabilities as they fall due (clause 5.3) is to anticipate income which has not yet been earned. (See the illustration in the opening submissions of Counsel Assisting at T87-88). Is that appropriate?

It is not clear whether the concept of present value is being questioned or whether the rate of discounting is being questioned. (The AASB has not been able to locate the illustration in the opening submissions of Counsel Assisting at T87-88, either via The Royal Commission's web site or thought telephoning The Royal Commission's staff.)

In relation to the notion of present value – it is a measurement technique that is widely used where cash is expected to flow in the longer term. The theory underlying the measurement of claims liabilities is that the insurer attempts to estimate all the events that will take place between reporting date and the time claims are settled. This includes claims settlement costs, claims development, claims inflation and the impact of not having to pay claims until some time after the reporting date. If an insurer were not to discount claims liabilities, then they should probably not attempt to estimate any of these other effects, which all tend to increase the present value of the liability.

In relation to discount rates, please refer to our response to question 25.

Q25. What guidance has the Australian Accounting Standards Board or any other professional, industry or governmental body, given as to the meaning of the expression "*market determined risk adjusted rates of return appropriate to the insurer*" in clause 5.3? If claims liabilities are to be discounted should guidance be given as to the meaning and application of that expression? If claims liabilities are discounted at a rate higher than a risk free rate, should the insurer be required to make other, and if so what, allowance for the risk to capital notionally allocated to meet the liabilities? If an insurer does not have fixed interest securities of an amount and term matching its expected claims liabilities, should there be any, and if so what, allowance for the consequent risk? Should accounts be prepared using the principles for discounting future liabilities in the new Prudential Standards GPS 210?

The AASB has not issued any guidance on discounting insurance liabilities other than that contained in AASB 1023.

The issue of which discount rate should be used in present value calculations is a complex one that the AASB has agreed should be tackled at a broad level (other assets and liabilities are required to measured at discounted amounts – for example, some employee benefits liabilities under AASB 1028 "Employee Benefits" and the IASB's IAS 19 "Employee Benefits"). Some people hold the view that discounting should only involve allowing for the time value of money and, accordingly, that discounting should be done at the risk free rate. Other people hold the view that risk should be reflected in discount rates, but generally cannot agree on whether that would mean a higher or lower rate of discount than the risk free rate in the case of a liability. The results of the IASB's insurance project are likely to be known and used by the AASB before there is an international consensus on the issue of discount rates.

The notion underlying the market-determined risk-adjusted discount rate is that the liability for outstanding claims should be the amount an insurer would need to have today to meet existing claims and related costs. Since many of those costs need not be met until some time hence, discounting by an amount that is expected to be earned in the meantime can be considered to be appropriate. It is important to note that the notion of expected future payments, that are being discounted, includes the impacts of inflation [AASB 1023, paragraph 5.1.2]. The rates at which outstanding claims liabilities are discounted are usually net rates, being the gap between the effects of inflation and discounting.

The issue of mismatching of assets and liabilities relates more to prudential regulation. Under the financial reporting framework, the benefits or costs of mismatching assets and liabilities will be reflected in an insurer's results.

Other

Q26. Since the introduction of AASB 1023 (which has operated since the financial year ended 30/6/92) have the requirements for:

(a) discounting claims liabilities and reinsurance recoveries; and

(b) measurement of integral investments at net market value at balance date, and the recognition of unrealised gains or losses in the profit and loss account,

improved the quality of financial reporting for general insurers? If so, how? If not, why not?

Any assessment of whether AASB 1023 has improved financial reporting among general insurers is a value judgement. The AASB considers that the promulgation of particular requirements with regard to the measurement of both insurance assets and insurance liabilities has had a positive impact. Financial reporting by general insurers has become more comparable (both between insurers and between insurers and other entities) since the introduction of AASB 1023, and comparability can be regarded as a virtue in itself.

The AASB considers that the requirement to measure integral investments at net market value has increased the transparency of general insurers' results. In the absence of a standard some, but not all, general insurers measured investments in a manner that smoothed their results and did not reflect economic reality.

NB: This list is not exhaustive. Submissions are welcomed on any specific policy issue relating to the accounting for general insurance business and whether there should be any, and if so what, regulation of general insurers in entering into financial reinsurance transactions. The list has been prepared by Counsel Assisting the Royal Commission, and any views expressed or which may be thought to be implicit in the issues raised, or the preambles thereto, are not to be taken as the views of the Commissioner.