

Explanatory Statement

AASB 2005-2 Amendments to Australian Accounting Standard

June 2005



Australian Government

**Australian Accounting
Standards Board**

EXPLANATORY STATEMENT

Reasons for Issuing AASB 2005-2

AASB 2005-2 is an amending standard, which makes amendments to AASB 1023 *General Insurance Contracts*. AASB 1023 was issued in July 2004.

In January 2005 some AASB constituents raised concerns with the AASB about the liability adequacy test, namely:

- the test constitutes a significant change to existing practice, considering that Phase I of the Insurance Project¹ is intended to introduce minimal change;
- requiring the same or similar probability of adequacy in performing the liability adequacy test, to that used in determining the outstanding claims liability, could create deficiencies in the unearned premium liability that are not expected to eventuate in practice; and
- requiring the liability adequacy test to be performed at an Australian Prudential Regulatory Authority (“APRA”) class of business level, or at an equivalent level for entities not regulated by APRA, goes beyond the requirements of, and expectations for, Phase I and creates unnecessary complexity for entities consolidating entities regulated by APRA with entities not regulated by APRA.

In response to these concerns, the AASB issued an Invitation to Comment *Liability Adequacy Test in AASB 1023 General Insurance Contracts* in March 2005.

¹ The International Accounting Standards Board (“IASB”) is engaged in an Insurance Project to develop an accounting standard for insurance contracts. The AASB is working closely with the IASB to develop this standard. Phase I of this project was completed in time for the 2005 adoption of international accounting standards by Australian and European entities. Phase I was intended to make limited improvements to accounting for insurance contracts. Phase I of the project is incorporated in IFRS 4 *Insurance Contracts*. In Australia, Phase I is incorporated in AASB 4 *Insurance Contracts*, updated AASB 1023 (July 2004) and updated AASB 1038 *Life Insurance Contracts* (July 2004). Phase II of the project is dealing with recognition and measurement issues and is not expected to be completed until at least 2007.

Main Features of this Standard

This Standard was made by the AASB on 3 June 2005 under section 334 of the *Corporations Act 2001*.

Application Date

This Standard is applicable to annual reporting periods beginning on or after 1 January 2005 with early adoption not permitted.

Main Changes from AASB 1023 (July 2004)

The main changes from AASB 1023 (issued July 2004) are identified below [showing the relevant paragraph numbers in the Standard in square brackets].

1. The liability adequacy test is to be performed at the level of a portfolio of contracts that are subject to broadly similar risks and are managed together as a single portfolio. In contrast, under AASB 1023, issued in July 2004, the liability adequacy test is performed at the reporting entity level by class of business. 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. [Paragraph 9.1]
2. Insurers are not required to adopt the same or similar probability of adequacy in performing the liability adequacy test, to that used in determining the outstanding claims liability. However, the users of financial reports need to be presented with information explaining any differences in probabilities of adequacy adopted, and insurers are required to disclose the reasons for any differences in accordance with paragraph 17.8(e). In contrast, under AASB 1023, issued in July 2004, insurers were required to adopt the same or similar probabilities of adequacy. [Paragraph 9.1.2]
3. Insurers are required to provide additional disclosures in relation to the liability adequacy test. In addition to existing disclosures, insurers are required to disclose:
 - a) where a deficiency has been identified, the amounts underlying the calculation performed, that is:
 - (i) unearned premium liability;
 - (ii) related reinsurance asset;

- (iii) deferred acquisition costs;
 - (iv) intangible assets;
 - (iv) present value of expected future cash flows for future claims, showing expected reinsurance recoveries separately; and
 - (v) deficiency;
- (b) in relation to the present value of expected future cash flows for future claims:
- (i) the central estimate of the present value of expected future cash flows;
 - (ii) the component of present value of expected future cash flows related to the risk margin;
 - (iii) the percentage risk margin adopted in determining the present value of expected future cash flows (determined from (i) and (ii) above);
 - (iv) the probability of adequacy intended to be achieved through adoption of the risk margin; and
 - (v) the process used to determine the risk margin, including the way in which diversification of risks has been allowed for;
- (e) where the probability of adequacy adopted in determining the outstanding claims liability is not the same or similar to the probability of adequacy adopted in performing the liability adequacy test, the reasons for the difference; and
- (f) where a surplus has been identified, the insurer should disclose that the liability adequacy test identified a surplus.
[Paragraph 17.8]

Consultation prior to Issuing this Standard

Public consultation was part of the process undertaken by the AASB prior to its decision to issue this Standard, amending the existing version of AASB 1023 (issued July 2004).

An Invitation to Comment *Liability Adequacy Test in AASB 1023 General Insurance Contracts* was issued for public comment in March 2004, with a comment period ending on 4 April 2005.

Six submissions relating to the Invitation to Comment were received and the AASB considered these submissions in finalising the amendments to AASB 1023.

A Regulatory Impact Statement has not been prepared in connection with the revision of this Standard as the amendments it makes do not have a direct, or substantial indirect, effect on business or restrict competition, are of a minor or machinery nature and do not substantially alter existing arrangements.