

# TREASURY ANALYSIS – INTERNATIONAL ACCOUNTING STANDARDS

## AASB 1023 “General Insurance Contracts” replaces AASB 1023 “Financial Reporting of General Insurance Activities”

### Major impact of changes

- Increases scope of Standard i.e. may apply to certain contracts that were not previously subject to AASB 1023, because of the wide definition of an ‘insurance contract’.
- Increases outstanding claims liability, compared to previously, because of:
  - *Risk margin* – requirement to include a risk margin to reflect the inherent uncertainty in the central estimate, where previously no risk margin was required.
  - *Discount rate* – must be discounted for the time value of money using risk free rates, where previously the discount rate was based on the expected rates of return on assets.
- Applies an expanded liability adequacy test to the unearned premium liability.
- Requires assets backing general insurance liabilities to be measured at fair value, wherever possible, where previously they were generally recognised at net market value.
- Increases disclosure requirements, compared to previously.
- Comparative information for 2004/05 need not comply with the revised AASB 1023 (refer AASB 1). This defers the AASB 1023 date of transition by 12 months to 1 July 2005, rather than 1 July 2004.

### Key features of Standard

#### Background

- This Standard has been revised to incorporate the limited improvements to accounting for insurance contracts required by IFRS 4 *Insurance Contracts*. IFRS 4 is being implemented in Australia using three accounting standards:
  - AASB 4 *Insurance Contracts* – applies to fixed-fee service contracts only;
  - AASB 1023 *General Insurance Contracts* which applies to general insurance contracts; and
  - AASB 1038 *Life Insurance Contracts* which applies to life insurance contracts.
- AASB 1023 substantially replicates the requirements of the previous AASB 1023, except for the areas discussed under ‘scope’, ‘definitions’ and ‘main differences’ below.

#### Scope

- AASB 1023 applies to, among other things (para 2.1):
  - ‘General insurance contracts’ that a ‘general insurer’ issues i.e. applies at a transaction not an entity level.
  - Certain assets backing general insurance liabilities.
- The Standard does not apply to, among other things (para 2.2):
  - Fixed-fee service contracts e.g. maintenance contracts (see AASB 4).
  - Direct insurance contracts that the entity holds as a policy holder.
  - Financial guarantees that an entity incurs or retains when it transfers financial or non-financial assets or liabilities to another party (see AASB 139).

#### Definitions (para 19)

- *General insurance contract* is an ‘insurance contract’ that is not a life insurance contract.
- *Insurance contract* means a contract under which one party (the insurer) accepts ‘significant insurance risk’ from another party (the policy holder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.
- *Insurer* means the party that has an obligation under an insurance contract to compensate a policyholder if an insured event occurs. The Standard describes any entity that issues an insurance contract as an ‘insurer’, whether or not the issuer is regarded as an insurer for legal, regulatory or supervisory purposes (para 2.1.3).

- *Insurance risk* means risk, other than financial risk, transferred from the holder of a contract to the issuer. Insurance risk is ‘significant’ if, and only if, an insured event could cause an insurer to pay significant additional benefits in any scenario (Appendix, para 22)
- *Examples of general insurance contracts* include insurance against theft, damage and product liability etc, performance bonds, surety bonds, fidelity bonds, credit insurance or financial guarantees (except where covered by AASB 139 – refer ‘scope’ above).

## **Main differences compared to previous Australian requirements**

### *Scope*

- AASB 1023 applies to ‘general insurance contracts’ (i.e. transaction level) and certain assets backing general insurance liabilities. The previous AASB 1023 applied to ‘general insurance activities’ (i.e. entity level) but did not define what was meant by ‘general insurance’. By widely defining ‘general insurance contracts’ the revised AASB 1023 may include certain contracts that were not previously subject to AASB 1023 e.g. certain financial guarantees and letters of credit.

### *Measurement of outstanding claims liability*

- The revised AASB 1023, will increase the outstanding claims liability, compared to previously, because of:
  - *Risk margin* – requirement to include a risk margin to reflect the inherent uncertainty in the central estimate (para 5.1), where previously there was no risk margin included. However, no specific risk margin is prescribed.
  - *Discount rate* – must be discounted for the time value of money using risk free rates that are based on current observable, objective rates that relate to the nature, structure and term of the future obligations e.g. government bond rates (para 6.1-6.1.3), where previously the discount rate was based on the expected rates of return on assets.

### *Liability Adequacy Test – unearned premium liability*

- The revised Standard requires the adequacy of the unearned premium liability to be assessed by considering current estimates of the present value of the expected future cash flows relating to future claims arising from the rights and obligations under current general insurance contracts (para 9.1). If this amount, plus the risk margin, exceeds the unearned premium liability, then the unearned premium liability is deficient and the entire deficiency must be recognised in the income statement. Previously, AASB 1023 only required a write-down of deferred acquisition costs but not the additional recognition of a provision for the deficiency.

### *Assets Backing General Insurance Liabilities*

- *Fair value vs net market value* - The revised AASB 1023 requires ‘assets backing general insurance liabilities’ to be measured at fair value, under relevant Accounting Standards, wherever possible (para 15), where previously they were generally recognised at net market value.
- *Investment assets vs operating assets* - The term ‘assets backing general insurance liabilities’ is not defined and insurers will need to determine this. Previously, the net market value approach was limited to ‘investment assets’.
- *Fair value model vs revaluation model* - There may be some ‘assets backing general insurance liabilities’, such as owner-occupied property, previously measured at net market value through profit or loss (i.e. fair value model) that will need to be accounted for under AASB 116 through the asset revaluation reserve (i.e. revaluation model) (para 15.4).

### *Disclosures*

- The revised AASB 1023 includes extensive disclosures compared to previously, including:
  - valuation of the outstanding claims liability at a central estimate and the component related to the risk margin (para 17.2(a));
  - the process used to determine the assumptions that have the greatest effect on measurement (para 17.6.1(c));

- the effect of changes in assumptions, showing separately the effect of each change that has a material effect (para 17.6.1(d)); and
- detailed disclosures regarding the amount, timing and uncertainty of future cash flows from insurance contracts (para 17.7).

#### **Impact on the public sector**

- This Standard is expected to impact a limited range of NSW public sector agencies, but this will need to be confirmed by individual agencies.
- Agencies that 'self insure' (i.e. retain the risk that could have been covered by insurance) must apply AASB 137 *Provisions* and not AASB 1023 i.e. as there is no insurance contract because there is no agreement with another party. Therefore, the AASB 1023 risk margin and discount rate are not applicable to self insurers. However, AASB 137 notes that some of the other principles in AASB 1023 (in particular para 5.2) are relevant to determining the best estimate of the self insurance provision.
- Captive insurers are entities restricted to insuring the interests of a group of which they are a member (AASB 137, Australian Guidance, G5<sup>1</sup>). At an individual entity level, a captive insurer may issue 'insurance contracts' that must be accounted for under AASB 1023. However, in the group's consolidated financial statements (i.e. at the whole of government level), the arrangement constitutes 'self-insurance' and is subject to AASB 137.

#### **Policy and Implementation issues (see attached)**

- *Date of transition / comparative information* – Treasury has deferred the date of transition to AASB 1023 to 1 July 2005 (refer NSWTC 06/14).
- *Scope* - Agencies will need to determine whether they have any contracts that meet the definition of an 'insurance contract'. In particular, agencies that have any outstanding claims provisions may need to determine whether they are subject to AASB 137 or AASB 1023.
- *Other implementation issues* - Agencies that are required to apply AASB 1023 will need to:
  - Adjust the opening claims liability at the date of transition to include a risk margin and a risk free discount rate.
  - Apply a liability adequacy test to the unearned premium liability.
  - Determine what assets back the general insurance liability, and:
    - Designate financial assets backing general insurance liabilities that are within the scope of AASB 139 as 'at fair value through profit or loss'.
    - Ensure investment property (AASB 140) and property, plant and equipment (AASB 116) that back general insurance liabilities are accounted for using the fair value and revaluation model, respectively.

#### **Outstanding IASB / AASB issues**

- Possible future changes to this Standard may impact sometime *after* 2005/06:
  - *Phase II of the IASB Insurance project* – Among other things, the IASB is considering measuring assets and liabilities arising from insurance contracts at fair value.
  - *Financial guarantees and credit insurance* – The AASB has issued AASB 2005-9 amending AASB 4, AASB 1023, AASB 132 and AASB 139. Under these amendments financial guarantee contracts and credit insurance that meet the definition of an 'insurance contract' are to be recognised initially at fair value under AASB 139 and subsequently measured at the higher of the amount determined under AASB 137 *Provisions*, and the amount initially recognised less accumulated amortisation. However, if the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either AASB 139 or AASB 1023. AASB 2005-9 is applicable to annual reporting periods ending on or after 1 Jan 2006.

This summary has been written in general terms and is intended for general reference only. Agencies should review the contents of the AASB Standard to determine its application in particular circumstances.

<sup>1</sup> However, this Guidance has subsequently been omitted by the AASB.

**SUMMARY OF POLICY, IMPLEMENTATION & SYSTEM ISSUES  
AASB 1023 “GENERAL INSURANCE CONTRACTS”  
TREASURY & AGENCIES**

	Issue	Treasury Policy		System/ Implementation Issue	Mandate Options for GFS Harmonisation	Budget / Total State Sector Issue
		Mandate Option	Additional Guidance			
1	First time adoption – Date of transition - Comparative information need not comply with AASB 1023.	✓		✓		✓
2	Scope – agencies to determine whether they have any contracts that meet the definition of an ‘insurance contract’			✓		✓
3	Adjust outstanding claims liability to include a risk margin			✓		✓
4	Adjust outstanding claims liability for discount rate using risk free rate.			✓		✓
5	Identify and review assets backing general insurance liabilities to ensure that they are measured at fair value, under relevant Accounting Standards, where possible e.g. designate financial assets under AASB 139 backing general insurance liabilities as ‘fair value through profit and loss’.			✓		✓
6	Apply a liability adequacy test to unearned premium liability			✓		✓
7	Additional disclosure requirements			✓		✓